Approved by Decree of the President
of the Republic of Azerbaijan
dated December 6, 2016

Strategic Roadmap for Development of Financial Services in the Republic of Azerbaijan

CONTENTS

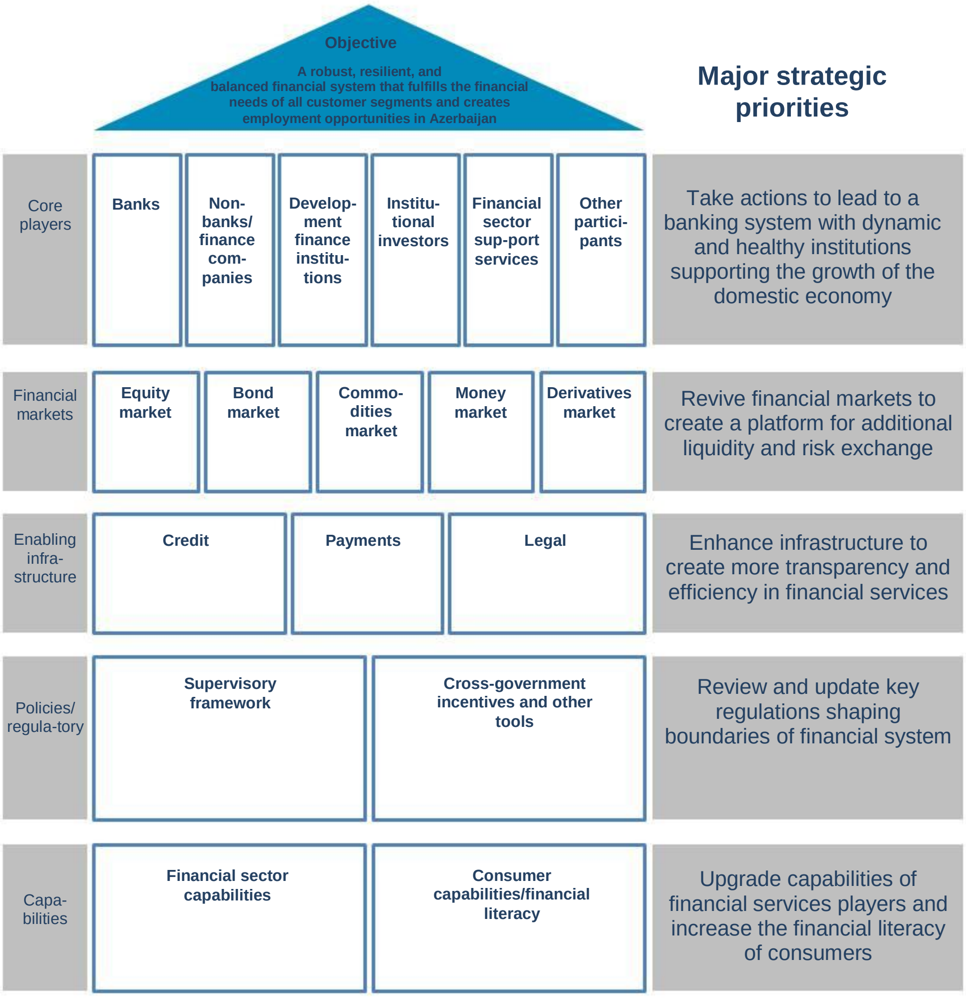
1. Executive summary

With a view to performing the duties specified by the Decree of the President of the Republic of Azerbaijan “On approval of “Main directions of the strategic roadmap for national economy and main sectors of economy” and issues arising out of this”No.1897 dated March 16, 2016, Strategic Roadmap for development of financial services in the Republic of Azerbaijan” (hereinafter referred to as Strategic Roadmap) has been prepared.

This Strategic Roadmap has been prepared by considering flexible adaptation to processes that are observable in the global economy and financial markets as well as new challenges and opportunities for supporting the post-oil economic development model. This document has been prepared based on the principles of flexibility, competitiveness, innovation and support for economic development.

The Strategic Roadmap covering short, medium and long terms is comprised of the strategic vision and action plan for 2020, long term vision for by 2025 and aspirational vision for post 2025. There have been prepared 5 strategic targets and 16 priorities for 2020 in order to achieve the objectives specified in the Strategic Roadmap.

Exhibit 1: Strategic targets for implementation of Strategic Roadmap



Strategic target 1. Establish a financial system comprised of dynamic and sound institutions.

Since 2015, the risk vulnerability of financial system has increased and financial indicators worsened affected by external economic shocks and devaluation of the national currency. Under the circumstances of growing risks, the lack of a sustainable and long-term target-focused business model and strategy as well as simple risk management have made it difficult for financial system to adapt to the new economic situation and market conditions and restricted financial mediation. Strategic targets, which reflect actions aimed at the restructuring and capitalization of the banks, improvement of the assets, and development of the insurance market and strengthening of financial inclusiveness towards the solution of new challenges, have been determined.

Strategic target 2. Develop the financial markets

There is a limited activity of investors and issuers in the financial markets. The factors such as investors' and issuers' lack of information on capital markets and financial instruments, information asymmetry and traditional single ownership way of thinking restrict the development of securities market and cause inefficient distribution of the financial resources in economy. With a view to eliminating their restrictive factors, strategic targets have been developed in order to develop capital and money markets and create efficient environment for market participants.

Strategic target 3. Strengthen the infrastructure

The judicial system and enforcement mechanisms for the protection of the creditors' rights and performance of obligations, as well as the infrastructure for the exchange of credit information fail to support efficient adaptation of the financial system to new challenges. For the purpose of improving the infrastructure, strategic objectives aimed at developing the system for the exchange of credit information, creating effective mechanisms for the protection of creditors' rights, standardizing the judgments of courts and improving the enforcement discipline.

Strategic target 4. Improve regulation and control mechanisms

Increase in the risk vulnerability of financial institutions and emergence of new risk zones have necessitated the improvement of risk management practices in the financial sector. Strategic targets for establishing new regulation and control architecture that promote sound risk management process and digital transformation in the financial institutions have been determined.

Strategic target 5. Improve financial literacy

The establishment of a sound, reliable, sustainable and effective financial system may be supported by increasing the quality of the knowledge and skills of financial system employees as well as improving the financial literacy of the consumers of financial services.

Strategic objectives aimed at deepening the specialization of financial system specialists and at improving their financial literacy.

Table 1. The required investments and expected results of the actions to be taken within the scope of the Strategic Roadmap

No	Description of priority	Real GDP impact (2020), AZN mln	Employment, (FTE, 2020)	Investment, AZN mln
1.1.	Ensure the capitalization and liquidity of the banking system	130	-	-
1.3.	Develop the insurance market	125	1600	-
2.1.	Create a favorable environment for issuers and financial intermediaries	125	-	10
3.1.	Improve credit information exchange system	-	-	5
4.1.	Ensure sound risk management in the banks	235	-	-
4.3.	Improve the regulatory mechanism for facilitating the digital transformation of the banks	135	-	100

Note 1. This table shows only the priorities allowing for a growth in real GDP by over AZN 10 million or creation of over 100 jobs in 2020. Other priorities may have a supporting role in achieving the outcomes that have been envisaged.

Note 2. These figures are provided for the purpose of creating an understanding of the impact of these priorities. It is necessary to conduct comprehensive analyses and specify the exact figures for each priority during the implementation of the actions.

An investment in amount of AZN 115 million is required in order to achieve the strategic objectives, and eventually added value in amount of AZN 750 million is expected to be created in the economy in 2020. On the whole, the efficient realization of the specified complex actions will lay the foundation for establishing a sustainable, sound and balanced financial system, which would provide all the customer groups with a wide variety of financial services.

2. Highlights on global trends

Factors such as the transformation of the world economy and accelerated development of information technologies are a precondition for creating new trends in the global financial system. These new trends have been observed in prudential regulation and strengthening of control, digitalization of financial services, expansion of alternative banking, change in the behaving models of the population, rise in the demands for new knowledge and skills as well as in changing operating models of financial institutions.

Change in prudential regulation and control approach

The recent processes in the world economy have once more proved the importance of dynamic economic growth in the financial sector and changed the prudential regulation and control vision. Regulation and control should support the stability in the sector and risk reduction in the system on the one hand, and its dynamic and efficient development on the other hand. To this end, since 2008 the global initiatives for the improvement of regulation and control mechanisms have been stepped up, the range of controlling tools has been expanded as well as the importance of macro - prudential regulation has increased.

The central component of the initiatives taken in strengthening the risk – absorbing potential of the bank sector is Basel III regulatory framework. Basel III has toughened the capital requirements and specified new instruments for liquidity risk management. At the same time, with a view to managing the system risks and mitigating their impact, the requirements for the creation of a counter – cyclic capital buffer and differential regulation requirements for system – important banks have been specified.

For the purpose of minimizing the use of government funds in the process of improving financial institutions, a framework for the improvement and restructuring of financial institutions has been established and application of more efficient tools has been started.

A wider application of the principles of consolidated and risk – based approach in the organizing of control overthe financial sector is observable. In this case, the business models and strategies of financial institutions are more deeply assessed and preventive control actions are implemented. Established a legal framework for the personal responsibility of bank managers and shareholders for bank insolvency is underway.

Improve the digitalization and information volume of financial services

The expansion of technological opportunities has improved the quality of the customer relationship of financial institutions, created additional incentives for the modernization of traditional business models and given a boost to the formation of new markets. The expansion of internet and mobile communication usage has increased the capability for low – cost and high – speed offering of traditional financial services through alternative channels and by new market players. Social networks with large user audience offer platforms to the consumers of financial services to enable direct financing without applying directly to the banks.

Due to the automation and customer orientation of processes and enhancement of the requirements for risk mitigation, it can be observed that credit bureaus, which gradually collect broader information on customers, are established and, in addition to government and financial institutions, non-traditional companies, which deal with communication, utilities, wholesale and retail trade, are integrated with those bureaus.

Expansion of alternative banking channels

Further toughening of the regulatory mechanisms for banks reduces their competitiveness as compared to other players of financial markets and increases the attraction of alternative banking. Financial institutions with lighter regulatory burden create new opportunities and threats by taking an active part in the fields that are specific to traditional banking.

Change in the behaving models of the population

There emerge new young customer segments that have different expectations and communication methods with regard to financial institutions, in real time (online) mode and linked to social networks, and fail to demonstrate traditional customer loyalty. The requirements and behavior of middle aged customers and retired persons are also changing. In addition, increase in middle and high income classes in emerging economies also creates potential business opportunities for financial institutions.

Increase in the demands for new knowledge and skills

Toughening the requirements of regulatory bodies for risk management has increased the requirements for professional qualities of the risk analysts and other specialists operating in this field. The existing situation makes it necessary to involve new specialists and to improve the professional level of the existing specialists. At the same time, there are growing initiative stewards the improvement of financial literacy for rational behavior and responsible indebtedness of financial services consumers.

Change in the operating model of financial institutions

Increase in the burden of regulation has raised the pressures on the traditional operating structure of financial institutions and restricted the capability for maintaining the wide-range and universal banking model that serves for various customer groups. Consequently, there is a necessity for the specialization of financial institutions according to customer and product segments.

High development potential for insurance market in the emerging countries

It is expected that the insurance market on the global scale will grow and both life and non-life insurance will contribute to this. The fact that insurance penetration level in the emerging countries (ratio of insurance premiums to GDP) is low while GDP growth rate is high will allow higher growth rate of insurance markets in these countries. It is expected to have two – digit growth rate of especially life insurance in the developing markets.

3. ANALYSIS OF CURRENT SITUATION

3.1. Current situation of financial services sector

As a result of the successful reforms implemented in the non-oil sector under the circumstances of growing oil revenues in 2004 – 2014, Azerbaijan has joined the ranks of the countries with accelerated growth rate on the global scale. The observed economic growth has made a positive contribution to the financial system in addition to other sectors of economy.

Continued reforms towards the establishment of an effective financial system and institutional development were conducted within the past period; works to build the financial system were performed. A regulatory legal framework for the regulation of the financial markets was prepared and the works that were aimed at bringing it into line with international practices were performed. The application of modern operating systems in various segments of the financial markets was started.

According to information of the Central Bank of the Republic of Azerbaijan (CBAR), the average annual growth rate of bank lending within the period was approx. 30 percent. Increases in the profitability of the sector, toughening of the requirements on regulatory capital as well as increase in internal and external capital investments were the precondition for a significant rise in capital buffer. According to information of CBAR, regulatory capital at the end of 2014 was AZN 4,3 billion and constituted 7.3 percent of GDP.

The fact that oil prices cheapened starting from the second half of 2014 also affected Azerbaijani economy. As a result of decline in oil revenues, the foreign currency inflow into the country reduced and the fact that inertial demand for foreign currency exceeded the currency supply increased the pressure on the exchange rate of AZN. Devaluation was carried out for two times in 2015 in order to balance the situation in the currency market, and to ensure the strategic sustainability of the balance of payments and country's international solvency. While dollarization in deposit and credit portfolio occurred following the first devaluation, the removal of financial resources from bank system was observed following the second devaluation. Under the conditions of weakening economic growth, the activity, which had been observed in the banking sector for a long time, declined.

The weakened solvency of the borrowers was a precondition for the increase of credit risks. The banks started restructuring the credits for the purpose of managing the existing risks including mitigating the indebtedness of the borrowers. Though the actions, which were taken, resulted in certain positive outcomes, the continuation of the macroeconomic uncertainties increased the costs for credit risk reserves, which the banks incurred. Consequently, part of the capital cushion created in the period of the economic growth was lost, the adequacy ratio of the regulatory capital approached the specified minimum norms, and according to information of CBAR, it declined by 4.2 percent to 14,7 percent in 2015 as compared with the previous year.

According to information of Financial Markets Supervision Chamber (FMSC), the average annual growth rate in 2010 – 2015 in the insurance market, which is another segment of the financial system, constituted 20 percent. In 2015, the volume of insurance premiums in Azerbaijan increased to AZN 444 million. However, the specific weight of insurance premiums in GDP is 0.8 percent in total. High dependence on the bank sector is considered to be the major risk of the insurance companies.

Expanding the scope of the compulsory insurance legislation was the main factor that created demand in the insurance sector. Starting from 2011, the actions taken by the government played an important role in accelerated development of life and non- life insurance. The main focus in relation to non – life insurance was on re-defining and applying the compulsory civil liability motor insurance and compulsory real estate insurance. The expansion of compulsory personal accident insurance instruments supported the development of the life insurance segment.

The initial elements of a credit information exchange system were shaped for the purpose of encouraging the effective and comprehensive assessment of credit risks as well as strengthening the financial discipline of economic units.

Important works were performed during that period with the aim of developing the financial markets infrastructure, and, in the meantime, the State Program for “Development of securities market in the Republic of Azerbaijan in 2011 – 2020” was adopted. Within the framework of the State Program, works aimed at reviving the financial markets were started. In the first stage of the State Program covering 2011 – 2014, necessary conditions were created for the modernization of securities market infrastructure, improvement of the regulatory legal framework for this purpose, strengthening of the material and technical base as well as for the development of human capital in the securities market. However, the underdevelopment of corporate governance standards of the open joint stock companies operating in the country and low transparency limited the attraction of capital through securities market. The volume of the operations in the stock and debt securities markets at the end of 2015 constituted AZN 657 million and AZN 3550million respectively (Exhibit 8). A considerable part of the operations in the securities market was implemented in corporate securities.

Works towards the establishment of the mechanisms for effective protection of financial service consumer rights and education of the population have been performed, and modern intellectual tools have been used for the purpose of improving financial literacy.

Despite reduction in the poverty level in the country and diversification of investments in non-oil sector, the financial inclusiveness level is still low.

In general, according to information of the Financial Markets Supervision Chamber, 43 banks, 27 insurance companies, 48 non – bank credit organizations, 109 credit unions and 5 investment companies operated in the country at the end of 2015. Credit organizations hold a dominant position in the financial system. The share of the banks and non- bank credit organizations in the total assets of the financial system constituted 88 percent and 9.7 percent respectively in 2015 while the share of the insurance companies in the total assets was 2.3 percent.

3.2. SWOT analysis of financial services sector

Strengths	Weaknesses
• Availability of a single regulator for the regulation of and control over financial markets; • Establishment of financial market and institutions; • Creation of key financial infrastructure elements; • Existence of basic elements of risk management; • Modern platform in securities markets.	• Fragile position of the bank system's capital; • High credit risks of the banks; • Lack of legal mechanisms for regulation and sales of non-performing assets; • Lack of hedging instruments for market risk management in the banks; • Lack of effective instruments for improvement and restructuring of the banks; • Lack of operational mechanisms for creditor rights protection, weaknesses in the organizational – legal mechanisms of pledging relations; • Poor accessibility of financial services; • Underdevelopment of the non-bank financial segment; • Low financial literacy.
Opportunities	**Threats**
• Reforms in financial sectors are among the government priorities; • Deposits are fully insured; • High volume of strategic currency reserves; • Developed telecommunication infrastructure and large service network are available.	• Volatility in oil prices continue; • Business activeness is not restored; • Asset quality is worsened; • There structuring program of the banks is not completed; • The risks, which the banks are exposed to, cause volatility in the entire financial markets; • Economic activeness of trade partners is weakened.

4. STRATEGIC VISION

4.1. Strategic Vision for 2020

The strategic vision for the development of Azerbaijan's financial sector by 2020 is to establish a financial system with a development potential that is sustainable against internal and external shocks, deeply focused on risk management processes and covered by strong infrastructure elements

Interpretation of the Strategic Vision

The completion of the initial works for building a financial system and the reforms conducted to develop the system and the personnel potential that has been created have laid the foundation for the transition of the financial system to a new development stage.

During the period until 2020, the financial institutions, especially the banks, will be revitalized, the liquidity and capitalization problems of the financial institutions will be solved, and actions will be taken for restructuring non-performing assets. Necessary conditions will be created for the involvement of issuers and investors in the securities market, the infrastructure will be expanded, and incentivizing actions will be identified. For efficient operation of the financial institutions, new infrastructure elements such as credit bureaus will be established and the legal framework will be improved. The financial system will be directed towards the process of more advanced risk management, transparency in financial services and accountability will be increased, and control mechanisms that support customer – oriented services and digitalization will be established. At the same time, the education level in the sector of financial services as well as the mechanism for the consumer's financial literacy and protection of rights will be improved.

4.2. Long – term vision for 2025

Long – term vision for financial services for 2025 is to have a robust, resilient and balanced financial system that is enabled by a well-established regulatory legal framework and that provides a wide range of financial services for all customer segments.

Interpretation of the Long- Term Vision

The resolution of liquidity and capitalization challenges in 2016- 2020 and improvement of regulative and legislative infrastructure will allow setting new targets for the development of the financial system by 2025. Within this period, it is envisaged to build a financial system with healthy banks, well-functioning financial markets, sound risk management practices in compliance with Basel III requirements, more efficient and digitalized processes and a higher-quality workforce.

By 2025, the financial services sector will be comprised of strongly-positioned and diversified financial institutions and exhibit steady growth and improved profitability. At the same time, accelerated consolidation process in the banking sector would be observed, along with less contrast in performance across the banks. As a result, banks will be growing and diversifying their product portfolio and new non-bank financial institutions will start to emerge. Various financial products offered by these institutions will increase accessibility to alternatives in consumer loans and drive up the competition within the sector. Similarly, a variety of new commercial loans will emerge for corporate clients.

By 2025, equity and bonds markets in Azerbaijan will have already reached an efficiently-operating state. A considerable number of large companies operating in the country would be listed in this equity market; and both domestic and international companies will actively carry out trading operations with a significant amount of shares issued by these companies. The implementation of operations will be facilitated as a result of increased transparency and improved technical infrastructure. The transparency will enable investors to better estimate risks and expected returns over their investments and make well-grounded decisions. This will result in a diverse profile of domestic and international investors trading in equity and bond markets.

At the same time, new developments will be used in information technologies for the purpose of ensuring improvement of the credit bureau infrastructure and close integration of the financial institutions into the credit information system. This will enable more agile and cost-effective response to requests of credit organizations.

The bank sector will be brought in full compliance with the requirements of Basel III standards by 2025. Sound credit risk assessment mechanisms, scoring models, corporate governance structures and risk processes in line with international standards will ensure enhanced risk management capabilities in financial institutions. Compliance with Basel III standards and existence of the credit risk bureau that will feed the sector with quality inputs will enable financial institutions to better foresee potential future delinquent and non-performing loans (NPL) and improve their credit underwriting and monitoring systems accordingly. As a result, Azerbaijan will have lowered its NPL ratio and significantly increased its healthy credit volumes.

Improving efficiency and digitalization in the financial institutions will be further continued until 2025. Following the regulatory amendments and advancements in technology, the banks in this era will have thoroughly digitized their processes and operations. Certain functions would be centralized under a dedicated unit to ensure high quality outputs, optimizing time and effort spent and above 90% of all banking transactions will be carried out through alternative delivery channels. Along with creating added value, branches will build a new and more deepened customer relationship.

In order to secure these envisioned targets in 2025 and beyond, specialists with high-level knowledge and skills will be prepared through higher education institutions, private training institutions, regulatory authorities and market players. The performance of these specialists will be evaluated and appropriate changes will be made to the curriculums of relevant educational and training institutions. With increased numbers of participants into these programs, knowledge and capabilities in the financial services sector will significantly increase. At the same time, through a variety of certifications programs, the standardization of traditional and typical operations within the sector will be incentivized. By taking into consideration the latest digitization trends in the sector, these educational and training institutions will ensure improving the technological knowledge of the participants.

4.3. Aspirational vision FOR post 2025

Aspirational vision forpost 2025 is to establish a financial sector that attracts foreign investors and is competitive on a regional scale.

Interpretation of the aspirational vision

To achieve the objectives specified in the aspirational vision for post 2025, a banking system with high operating efficiency, profitable performance and, mostly, digitalized operational processes and banking products that target more innovative customers including investment products will be offered. This way Azerbaijan will be internationally recognized as a successful case example for the development of financial services sector and will attract foreign investors.

Building up on the strategic priorities launched until 2025 to ensure a sectoral maturity in banking operations, products and risk management, Azerbaijan will complete the digitalization of its banking sector in post2025 period. In this highly competitive environment, most of the customers will be making their transactions through online and mobile channels. Sales and service processes will be fully digitized and available over these channels. During this period, it is envisaged to transform digital banking services into a comprehensive experience, integrating it with a variety of other platforms such as social media and online shopping. This integration will also be supported by increased penetration of digital payments systems and mobile applications. In addition, digitization will also optimize intra-bank operations through a vast database. By investing in the database, banks will have more complete data about customers and this data will allow building a targeted marketing policy as well as more accurate assessment of credit risk and default probability in the long term.

The financial product portfolio will be expanded for individuals and corporate clients. The retail banking will transform from the current state of traditional time deposits to more complex investment products and professional portfolio management. At the same time, the volume of mortgage loans will exhibit a steady growth as in the European countries to constitute a significant share in the loan portfolio of the banks. For corporate clients, especially for micro businesses and SMEs, sophistication of products will largely grow and more complicated loans will be available. The loan granting process will be simplified through digitalizing the loan application stage, credit risk assessment and underwriting. This way, banks will be able to meet demanding needs of their corporate clients.

Through increased transparency on the financial markets and overall sectorial maturity reached, there more international investors will be attracted to the financial services sector in the long term. Among various financial institutions, international banks would constitute the majority share in these foreign investments. In addition to the investments from foreign banks, the financial sector and the country’s economy will also benefit from the global know-how, especially on data processing, ideal risk management practices and product portfolio.

Considering its suitable geographical situation, the possibility of the strategy that will make Azerbaijan the financial hub of the region in post 2025 can be assessed. In this direction, the prospects of developing the technical infrastructure and regulation framework will be considered in order to increase the volume of the currency transactions with neighboring countries (if applicable, this experience may also be applied to underwriting and sales of regional bond issues).

The service level of the banks will be fully aligned with international standards by 2025. This way, Azerbaijan targets to develop its financial services sector further into a regionally competitive level, setting example for the neighboring financial markets.

5. Target indicators

As a result of implementing the priorities in the financial services sector, it is forecasted that:

- GDP will increase by AZN 750 million in real terms in 2020;
- 1600 jobs will be created in the financial services sector.

The following target indicators have been defined for 2020 according to the actions envisaged for the development of financial services:

- Increase in bank sector profitability by 7 percent as compared to 2015;
- Ensure five additional companies from major sectors are listed in the stock exchange by 2020**;**
- Increase the financial penetration rate (the ratio of loans to non-oil GDP) to 60%
- Decrease non-performing loans rate to 8%;
- Bring insurance penetration (ratio of insurance premiums to non-oil GDP) up to 1,4 percent.

6. Strategic objectives

- Increase the financial system sustainability against internal and external shocks;
- Increase the quality of risk management processes and improve the regulatory framework;
- Strengthen the financial system infrastructure;
- Enhance the financial system development potential.

7. Strategic targets

7.1. Strategic target 1. Establish a financial system comprised of dynamic and robust institutions

Azerbaijan's banking system is comprised of retail and corporate banks offering a variety of traditional banking products. Corporate banks mainly serve for government organizations and large private companies, while retail banks provide services to broad population segment. There is a limited number of the institutions specialized in financing micro, small and medium enterprises.

According to information of the Central Bank of the Republic of Azerbaijan, the bank system demonstrated a high growth rate with the volume and profitability of the bank system assets in 2005 – 2014 being approx. 30 percent. However, the foreign economic shocks and devaluation of the national currency increased the risk vulnerability of the sector from 2015 and caused the worsening of the financial indicators. Individual banks had unequal sustainability against the foreign shocks. The banks which applied healthy risk management principles and had high capital buffer, demonstrated higher sustainability. The failure of the financial sustainability in a number of banks was due to the processes occurring in the country's and world's economy only. The fact that some banks have lacked a business model and strategy focusing on sustainable and long – term targets in the recent 10 – 15 years as well as the weaknesses that result from unsustainable growth models and simple risk management are among the major catalysts of the problems in the banking system. Due to such institutional gaps, the banks have suffered difficulties in adapting to the new economic trends and market conditions, flexibly transforming business models and identifying new income sources.

7.1.1. Priority 1.1. Ensure the capitalization and liquidity of the banking system

Rationale

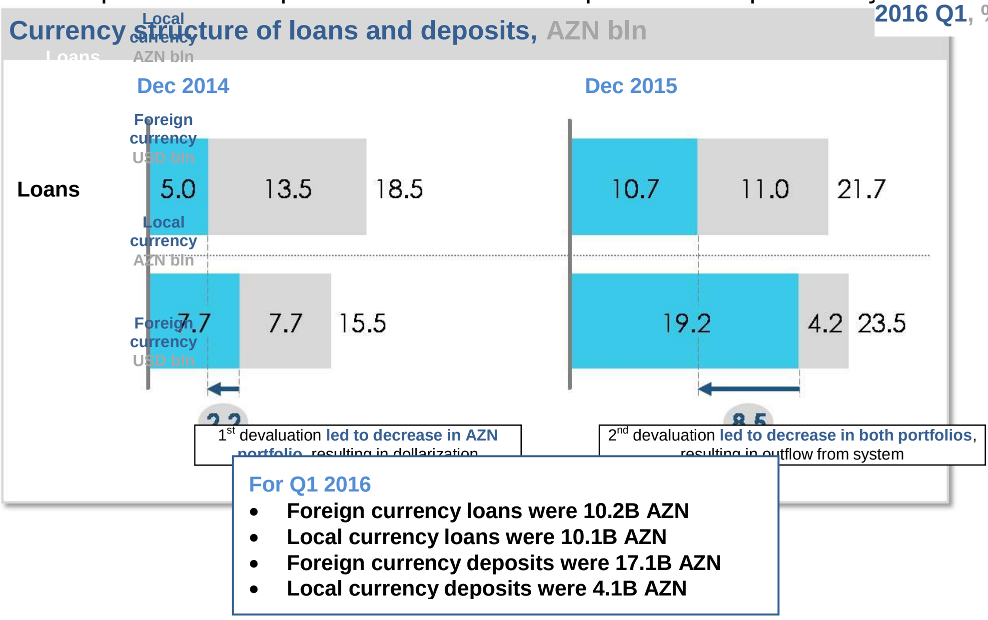
According to information of the Central Bank of the Republic of Azerbaijan, the profitability of the bank sector was in the negative zone in 2015, while the capital adequacy coefficient decreased by 20 percent and the contrast between healthy and risk – vulnerable banks increased further. There emerged new problems that caused potential threats for long – term functionality of the banking system (dollarization of economy, pressure on the capital position of the financial institutions, decline in economic growth rate and worsening of the credit portfolio quality).

While the dollarization of deposit and credit portfolio following the first devaluation indicated that trust in national currency had decreased, the removal of financial resources from the banking system after the second devaluation reflects a concern about the sector's healthiness (exhibit 2). In this case, the adoption of the Law of the Republic of Azerbaijan "On full insurance of the deposits" dated January 19, 2016 served for raising the trust of the population in the banking sector. Thus, according to the new law, all protected deposits within the annual interest rate limit, which was specified by Deposit Insurance Fund's Board of Trustees, were insured for a period of 3 years irrespective of their amount. At the same time, the annual interest incomes paid for the deposits of physical persons were exempted from taxes for a period of 3 years as from February 1, 2016 in order to increase the attraction of deposits. Furthermore, the Financial Markets Supervisory Chamber was established in accordance with Decree of the President of the Republic of Azerbaijan No. 760 dated February 3, 2016 with a view to ensuring the sustainability of the financial sector and improving the supervision mechanisms in this area.

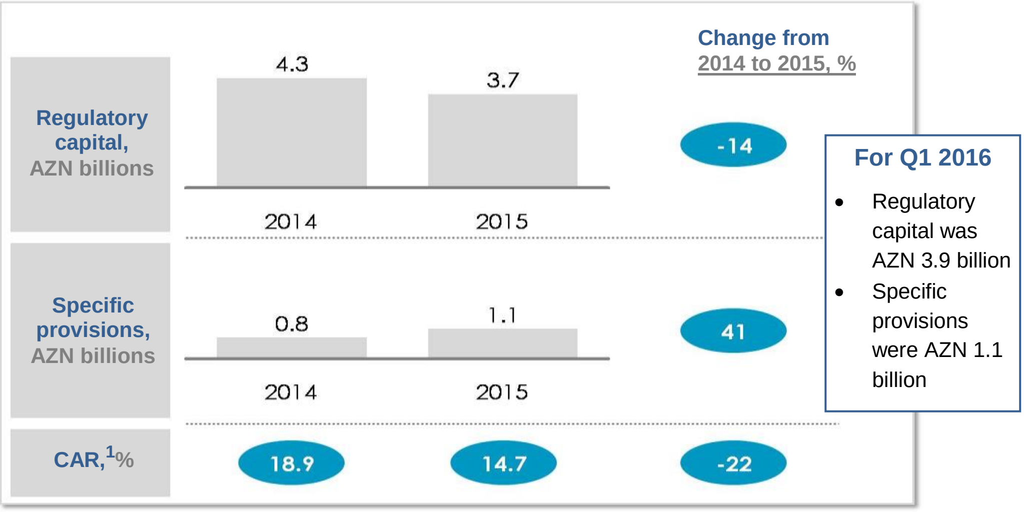
1 As of Feb 2016

Change, %

Dollarization in loans increased from 27 percent to 50 percent anc Change btw on in deposits from 50 percent to 80 percent in 2015 as compared to the previous y 2014 Q4- 2016 Q1, % t 3).



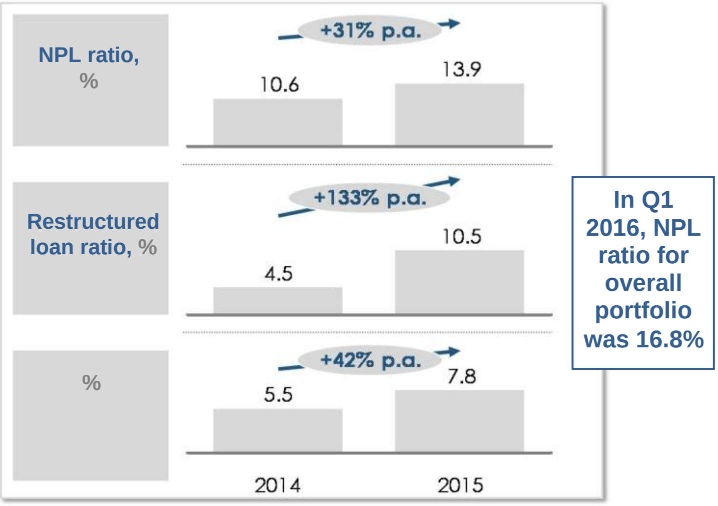
The negative processes occurring throughout the year increased pressures on the banks' capital position. Though some financial cushion was established by increasing the minimum capital requirement by five times to AZN 50 million in the period of dynamic growth rate, this was not enough to neutralize the occurred internal and external shocks. While net profit for the sector was AZN 381 million in 2014, the banks suffered a loss of AZN 351 million in 2015. The banking sector's CAR went down to 14.7 percent from 18.9 percent (exhibit 4).



1 Capital adequacy ratio, Loan weighted average CAR for the sector is used
SOURCE: Central Bank of Azerbaijan (CBA), Financial Market Supervisory Chamber (FMSC)

Weakening growth rate in the assets of the banking system was fueled by demand of potential borrowers for credit and reduction in credit supply of the banks.

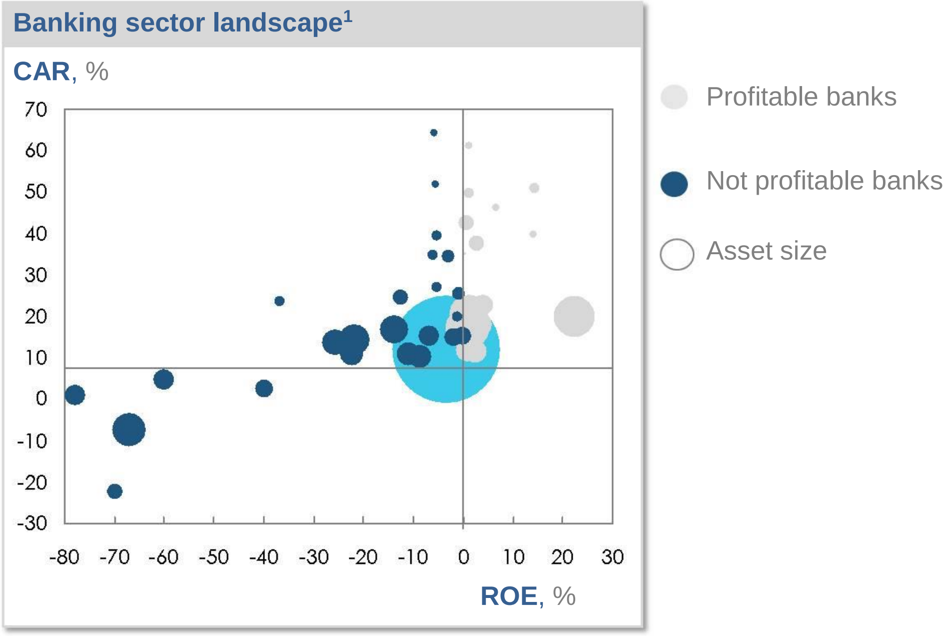
The depreciation of the national currency affected the solvency of the borrowers for credits in foreign currency and caused the worsening of the banks' credit portfolio. The specific share of non – performing and restructured loans in the total portfolio in 2015 increased by 30 percent and 130 percent respectively as compared to previous year and the share of special reserves in the total portfolio increased by 40 percent. (exhibit 5).



1 Generic and specific provisions
2 Excluding International Bank of Azerbaijan (IBA)
SOURCE: Central Bank of Azerbaijan (CBA)

Since 2015 the overall profitability of banks in Azerbaijan and their financial sustainability indicators have decreased, and the gap between unhealthy and healthy banks has increased (exhibit 6).

December 2015



1 Some banks are not accurately shown on the graph
SOURCE: Central Bank of Azerbaijan (CBA)

Actions to be taken

Action 1.1.1: Conduct a comprehensive analysis of the banking sector

Financial Markets Supervisory Chamber (FMSC) will perform a thorough analysis of all banks. FMSC will gather information to understand the liquidity position, capital and currency position, diagnostics of asset quality of each bank as well as the liquidity position and lending capabilities of the overall banking sector. Based on these studies FMSC will determine each bank's cluster (systematically important, sustainable and solvent, or fragile and insolvent) (activities have already started in this area and further through studies will be conducted in the future).

Action 1.1.2: Develop an action plan for the capitalization of problematic banks

FMSC will establish an action plan for each bank. When defining the plan, the potential capital requirements, opportunities such as improvement of non – performing assets and consolidation of banks etc. will be analyzed. The action plan will define roles for the bank and its shareholders, state bodies and other related parties (execution of this action has started).

Action 1.1.3: Implement the plan and conduct monitoring

FMSC will establish a monitoring system for the purpose of controlling the implementation of the action plan for each bank and timely completion of the envisaged works.

Action 1.1.4: Create institutional and legal mechanisms for restructuring problematic banks

FMSA along with the relevant bodies will develop proposals regarding complex institutional and legal mechanisms for restructuring the problematic banks with minimum losses or removal from the system. To this end, the draft of the amendments to be made to the Law of the Republic of Azerbaijan "On Banks" dated January 16, 2004 will be prepared and submitted accordingly.

Action 1.1.5: Restructure the banks whose capital sustainability cannot be restored

FMSC along with other relevant state bodies will carry out the restructuring of the banks wholes capital sustainability cannot be restored (by means of selling the bank, full or partial transfer of the assets and liabilities, establishment of bridge bank etc.).

Action 1.1.6: Improve the mechanisms for deposit insurance

Works will be carried on to improve the deposit insurance system taking account of the international best practices. Various financing mechanisms for the capitalization of the Deposit Insurance Fund will be taken into consideration as well as works aimed at the application of differential calendar fees will be performed.

Action 1.1.7: Expand the instruments for providing liquidity

FMSC, Central Bank, Ministry of Finance and other relevant state bodies will implement actions in creating new instruments to ensure capital and long – term liquidity support to the banks.

Expected results and indicators

It is of particular importance to take actions to achieve the specified targets that are related to capitalization and liquidity.

The implementation of this priority will be a precondition for increasing the net incomes of the banking sector, thereby it is estimated to bring AZN 130 million total GDP impact in real terms comprised of AZN 115 million direct and AZN 15 million indirect impacts by 2020. No measurable direct impact on employment is forecasted.

Key Performance Indicator is 7 percent increase in the sector's profitability as compared to 2015.

The required investment

A certain amount of financial resources will need to be mobilized to address the capitalization and liquidity challenges of the banking system. However, the amount of these resources will very much depend on the methodology adopted to address the challenge, which is a task defined as part of the priority. Thus, no financing or investment figure is estimated at this stage, and this will need to be studied in detail as part of the actions of the Strategic Roadmap.

Expected risks

The major risks in achieving the objectives that are envisaged within the priority may include incompletion of the actions for restructuring the problematic banks, low interest or capabilities of shareholders in investing additional capital in the banks, delays in establishing institutional and legal mechanisms for the restructuring of the banks and increase in the number of the banks as a result of continuation of the negative trends under macro – economic conditions.

7.1.2. Priority 1.2: Prepare a restructuring plan for non-performing assets

Rationale

The volume of non-performing asset portfolios in the banks grew following the devaluation of the national currency. The dynamics of the restructured loans indicates that the trend towards the worsening of the banks' credit portfolio will continue and that the volume of non-performing loans will increase.

The failure to use the instruments for transferring credit risks results in risks remaining in the banks balances. Those banks failing to properly provide the working procedure for non-performing assets suffer great losses. In international experience, the transfer of non – performing assets to specialized institutions ensures restoring the market price of the asset without its full devaluation. There is a need for restructuring non – performing loans in order to solve the existing problem.

Actions to be taken

Action 1.2.1: Create legal mechanisms for management of non-performing assets

FMSC along with the relevant bodies will implement actions for creating the legislative framework to establish a market for the management of non – performing assets. Following the establishment of the legislative framework, a regulative framework for asset management institutions will be determined. FMSA, Ministry of Finance and other relevant state bodies will assess the opportunities for applying new mechanisms, especially tax discounts, in order to incentivize the sales of non – performing assets and take relevant actions.

Action 1.2.2: Define criteria for non – performing loans to be included in the restructuring plan

FMSC will define criteria for non – performing loans to be included in the restructuring plan. FMSC will also perform a profit and loss analysis of the non – performing asset portfolio as well as different restructuring methods in order to specify the economic benefit of the restructuring. Approaches such as individual restructuring for each bank, accumulation of NPAs in the centralized restructuring institution and so on will be taken into consideration.

Action 1.2.3: Define a restructuring strategy

FMSC will ensure that an accelerated process is carried out to maximize the benefit from the restructuring program and that working strategies for the portfolio are investigated, defined and selected.

Action 1.2.4: Implement the restructuring program and conduct monitoring

FMSC will ensure the development of a roadmap based on the strategies, establishment of a monitoring system and launch of the restructuring program.

Expected results and indicators

Establishing a restructuring plan for non-performing assets, led by the FMSC, in coordination with relevant stakeholders is a key enabler for shaping a dynamic and healthy financial services sector. This s priority does not have quantifiable direct impact to real GDP and employment in 2020; its expected indirect impact is included in Priority 1.1.

The required investment

The restructuring plan will address challenges defined in priority 1.1. Therefore, its investment needs to be considered in tandem.

Expected risks

The major risks in achieving the objectives within the priority may include further increase in the level of non – performing assets of the banks, partial recognition of non – performing assets in the financial statements, lack of interest by the banks to sell non – performing assets at a discounted price, lack of interest by private investors in management of non – performing loans, insufficient incentive mechanisms for management of non – performing assets, failure to specify the financial sources for implementation of the restructuring plan.

7.1.3. Priority 1.3: Develop the insurance market

<u>Rationale</u>

The development of the insurance market contributes to the sustainable development of the country's economy by helping to protect from uncertainties and risks and by providing an investment channel for the accumulation of domestic saving. Though Azerbaijan's insurance market demonstrated a stable growth under the circumstances of general economic development in the recent years, it has a minimum impact on the financial sector and economy. According to information of FMSC, the ratio of insurance premiums to GDP, which indicates financial penetration of the insurance sector, was 0,8 percent in total at the end of 2015.

One of the reasons why the ratio of insurance premiums to GDP is low is that the insurance companies are not fully informed of certain sectors and the risks associated with those sectors. And this results in lack of interest by the insurance companies to prepare various product offers for these groups. For example, agricultural insurance as the most complicated and difficult segment requires special knowledge associated with the risks.

At the same time, most insurance companies are not so much interested in developing products to meet the insurance need of certain economic groups or sectors with high risks or with low investments. For instance, insurance companies endeavor to avoid general risks in relationship with small and medium businesses and individual households with low incomes. In particular, the low financial accessibility of insurance products to individual households, small and medium businesses with low incomes may be another reason why insurance penetration in these groups is low. In this respect, micro insurance and joint insurance can be given as a sample.

There is a need for creating new insurance products with a view to expanding the insurance market, supplying insurance products to the segment of the population who receive no insurance coverage, improving the access to financial services and supporting the diversification of the economy.

Agricultural insurance. One of the efficient tools for improving the access to financial resources is to reduce agriculture – specific risks through insurance instruments. On the one hand, agricultural insurance reduces the farmers' risks related to productivity and profitability, which are caused by weather conditions and price volatility, and, on the other hand, improves the lending potential for the sector by increasing the opportunities for serving credit liabilities.

Insurance against agricultural risks as one of the most complicated fields requires special sectorial knowledge. Therefore, insurance companies assess this segment as a high risk area of activity and refrain from taking risks. The low level of statistical and analytical data in this field makes it difficult to lend to the sector.

It is of special importance to select and apply an agricultural insurance model which is compliant with the Azerbaijani insurance market characteristics, agricultural conditions and government policy. Since the agricultural insurance mechanism is quite a large institution, factors such as the strategic policy of the government towards agriculture, the importance of agricultural infrastructure etc. should be kept in focus when establishing and creating it.

Micro insurance. The development of micro finance market allows low income households to be insured on a basis of lower insurance premium. There is no provision for a micro-insurance mechanism in the legislation and this type of insurance is not developed.

A comprehensive legal framework is an important factor for the development of micro-insurance market. In this case, while efficient supervision is carried out, the establishment of micro-insurance offer and delivery of this service to the households efficiently should be encouraged.

Co-insurance. Whilst insurance companies operating in Azerbaijan carry out "traditional" i.e. commercial insurance activities, they fail to offer a non-commercial co-insurance product. Traditional insurance is a system of insurance relationship based on risk transfer while cooperation insurance is a system of relationship based on risk sharing. There is a need for establishing non-commercial cooperation insurance in Azerbaijan.

Compulsory insurance. Initiatives for the realization of compulsory medical insurance are underway in Azerbaijan, which is widely applied in the healthcare system of a number of countries. Several regulatory acts have been enacted with a view to applying compulsory medical insurance and establishing its management system, and the State Agency of Compulsory Medical Insurance under the Cabinet of Ministers of the Republic of Azerbaijan has been established. In the meantime, relevant instructions have been given with regard to implementing a pilot project for the application of compulsory medical insurance in the territories of Mingachevir city and Yevlakh region according to Decree of the President of the Republic of Azerbaijan No. 1127 dated November 29, 2016.

The law of the Republic of Azerbaijan "On medical insurance", which establishes the organizational, legal and economic basics of compulsory medical insurance as a multi-directional process and which regulates the relations between entities, has been in force since October 28, 1999. From 1999 onwards, the compulsory medical insurance models applied in developed country have been improved and new approaches and concepts have been proposed. Currently, successful mechanisms in mandatory medical insurance systems, which have been proven in international practices, such as funding based on market economy principles, accumulation and management of insurance premiums in the Funds are being applied. In this respect, the compulsory medical insurance model of Azerbaijan could be adapted to the model of the countries with best practices and the law of the Republic of Azerbaijan "On medical insurance" could be improved.

<u>Action to be taken</u>

Action 1.3.1: Establish relevant working groups

FMSC will establish working groups with the involvement of the relevant bodies.

Action 1.3.2: Conduct an analysis of the current situation

Working groups will identify the works and operating model for each insurance field that will be implemented towards establishing the legal, regulatory and institutional framework for each insurance field, with the diagnostics of the current situation conducted and international best practices investigated.

Action 1.3.3: Establish a data system

Data collection in insurance system, data systems and exchange process will be considered in the context of the relevant initiatives in this field of the financial services sector. For instance, the establishment of data system to fix the prices for agricultural insurance products will be taken into account.

Action 1.3.4: Develop an action plan and start its execution

Action plans for each insurance field will be prepared and their execution will be initiated. The working group will regularly evaluate the development level of the sector in line with the identified initiatives. In addition, it will continuously assess the opportunities to focus on additional areas in the insurance sector and appropriate changes in the insurance policy as well.

Expected results and outcome indicators

The creation of new insurance services will help deepen the financial intermediation and increase inclusiveness. Insurance against risks in the agricultural sector will expand the access to financial resources and support growth in the sector. According to information of Financial Markets Supervisory Chamber, insurance penetration was AZN 444 million in 2015. The following vision indicators have been identified for this priority:

- Bring insurance penetration (insurance premiums ratio to non – oil GDP) to 1,4 percent.

It is expected that the impact of the priority on real GDP in 2020 will be AZN 125 million in total with AZN 85 million directly and AZN 40 million indirectly. Positive contribution to GDP is accounted for by an increase in the insurance sector's incomes and, eventually, a rise in the penetration level. As a result of implementing this priority, 1600 new jobs are expected to be created.

Required investments

At this stage, no additional substantial investing is required to develop the insurance sector. Thus, it is envisaged to more efficiently use the existing resources initially. The requirement for additional investment for the development of insurance market will be identified based on the action plans to be prepared.

Expected risks

The major risks in achieving the objectives within the priorities may include poor coordination of the activities of the stakeholders with respect to the development and application of new insurance products, failure to identify the sources of financial resources, difficulties that arise in creating demand for new insurance types, low interest by insurance companies in serving for new customer segments due to high risk.

7.1.4. Priority 1.4. Strengthen financial inclusiveness

Rationale

One of the important works in transition to post- oil economy and development of non-oil economy is to establish an efficient financial inclusion system. The achievement of financial inclusion in the country may provide additional support to economic activity, development of entrepreneurship, improvement of employment, and increase in consumption opportunities in households and elimination of income inequality. Furthermore, the improvement of access of the micro, small and medium enterprises (MSME) to financial services may help increase productivity in individual companies and in the country as a whole, expand employment opportunities and more efficiently distribute the resources.

According to the results of a survey conducted by World Bank among small and medium enterprises in 2014, high interest rates and complicated procedures are the primary factors restricting access to loans, which is one of the main elements of financial inclusion. In addition, the burdensome collateral requirement for bank credits, which are the main funding source of MSME, limits the access to financial resources.

Micro financial services, which serve for financial inclusion, are provided by banks, non-bank credit organization and credit unions. These services cover segments such as trade, service, industry and agriculture aimed at micro, small enterprises and households in urban and rural areas.

There are opportunities for expanding the non – cash operations that serve to increase financial inclusion. According to information of the Central Bank of the Republic of Azerbaijan, while operations amounting to AZN 1250 million were conducted with approx. 5,7 million bank cards in December of 2015, however, 72 percent out of this (5,3 million operations amounting to AZN 906 million)consisted of cash withdrawals from ATMs within the country.

The partnership model between mobile operators and banks in a number of countries were successful, and banks started providing quality and innovative financial services to a broader customer segment by using a mobile communication platform. The high competition in the mobile communication market in Azerbaijan, especially in Baku city, supports the development of this market which may ensure the provision of financial services in a more advanced digital manner (detailed actions on digital transformation of the banks are given in priority 4.3 in this Strategic Roadmap).

Despite an increase in the financial penetration of the insurance sector in the recent years, according to the outcomes of the Asian Development Bank's financial inclusion survey, 58 percent of the customers are not informed of the insurance services and nearly half (49 percent) of these customers have low trust in the insurance companies. This exposes a number of customers, small and medium business entities to high risks by limiting insurance activities. The simplification of the processes and application of low cost micro-insurance products may increase the opportunities of consumers, small and medium business units to manage their risks (detailed actions on development of insurance market are given in priority 1.3 of this Strategic Roadmap).

Leasing has become one of the methods of investing in economy in most countries of the world. As compared to Azerbaijani banking and insurance sector, the leasing market is underdeveloped. The purchase of new machinery and equipment as well as renewal of obsolete machinery and equipment by means of leasing may support the development of entrepreneurship (detailed actions on the development of leasing market are given in the Strategic Roadmap for the production of consumer goods on the level of small and medium enterprises in the Republic of Azerbaijan).

In general, despite a number of existing positive trends, there are broad opportunities for deepening the financial inclusion in Azerbaijan.

Actions to be taken

Action 1.4.1: Develop the channels for the delivery of financial services

The expansion of the delivery channels for financial services will be encouraged and agent banking prospects will be investigated. The legislative framework for electronic payments will be strengthened. Actions will be taken towards the integration of micro finance institutions into payment systems.

Action 1.4.2: Create suitable regulatory and dynamic supervisory frameworks for the financial institutions that serve for financial inclusion

Risk-based regulatory and supervisory frameworks for the activities of those institutions, which provide micro finance services, will be applied. This will ensure that healthy lending and responsible borrowing principles are applied in all the institutions that provide financial service.

Expected results and indicators

The target is to deepen the financial inclusion in the country through realization of the mentioned actions, particularly to improve the supply of financial services in the regions and rural areas, to provide comprehensive and quality financial services to the customers and to support regional economic development and employment.

Required investment

Required investment will be identified as a result of the feasibility study to be performed.

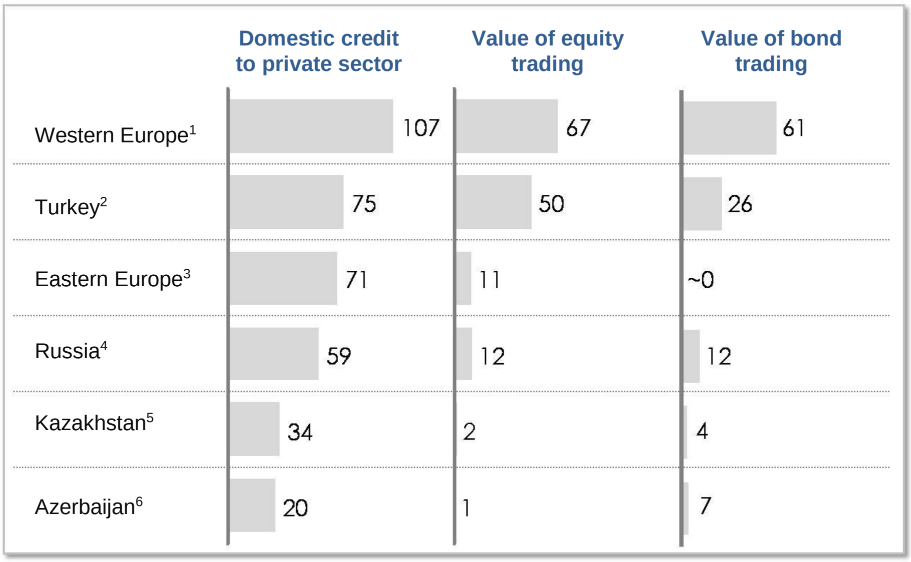
Expected risks

The major risks in achieving the envisaged objectives within this priority may include low demand among the population for new financial services, failure to bring the financial literacy to the targeted level and inadequacy of the institutional potential of financial intermediaries.

7.2. Strategic TARGET 2: DEVELOP Financial Markets

The access of physical and legal entities to the financial markets in Azerbaijan is low in comparison to other countries (Exhibit 7).Though operations are conducted in the securities market, the trade volume is small (exhibit 8).

% of GDP



1 London Stock Exchange and Deutsche Börse (UK and Germany)
2 Borsa İstanbul
3 Athens Stock Exchange and Warsaw Stock Exchange (Greece and Poland)
4 Moscow Stock Exchange
5 Kazakhstan Stock Exchange
6 Baku Stock Exchange

SOURCE: Central Bank of Azerbaijan (CBA), Financial Market Supervisory Chamber (FMSC), Stock Exchanges

While certain progress was made due to the actions carried out within the State Program for “Development of the securities market in the Republic of Azerbaijan in 2011 – 2020”, it is necessary to continue improvement works in this area. Thus, lack of information of potential investors about the capital market and financial instruments, the fact that corporate management do not show interest in transparent accountability to register securities and single-ownership have a negative impact on development of the securities market.

1 Over the counter, alternative market transactions are taken into consideration
SOURCE: Financial Market Supervisory Authority (FMSC), Baku Stock Exchange (BSE)
Primary market stock exchange Secondary market stock exchange OTC[1]

7.2.1. Priority 2.1: Create a favorable environment for issuers and intermediaries

Rationale

Equity market

Increasing the interest of Azerbaijani companies in listing may accelerate the development of the financial markets. Thus, relevant government authorities may increase the number of companies in listing by improving regulation and legislation in three directions (promotional actions, listing process, and ownership way of thinking).

Bond market

The current legislation and regulation do not create additional incentives for the listing of companies and do not differentiate between those companies that are listed and those that are not listed. Temporary incentives, both financial and non-financial, can be taken into consideration to encourage companies to list.

The duration of the registration process has been reduced from three - four weeks to one - two weeks as a result of renewing the listing requirements within the framework of “Modernization of capital markets” project. However, this duration may be further shortened by improving the registration procedures.

It is of special importance to change the traditional way of thinking with regard to the retention of full ownership tile in terms of encouraging the companies to be listed in the stock exchange. The current legislation supports full ownership title and restricts the protection of minority shareholder rights by giving preference to the existing shareholders. The actions to strengthen corporate governance, accountancy and financial supervision, and equal protection of foreign and minority shareholders will be taken into consideration. In addition, the preferential rights of the existing shareholders may be abolished (offerings of shares to the existing shareholders prior to the sales of shares in the open market during share re-issuance).

There is a need for defining a reference profitability level in order to identify the value of the securities issued by companies. The profitability curve of government bonds is used as reference profitability in international financial markets. There should be a regular issue and resale market for longer duration spectrum of government bonds in order to establish profitability curve (for example, 3- month, 6- month, 1-year, 2-year, 5-year, 10- year and 30-year).

There is a need for the issuing of securities which are secured with cash flows from assets in order that companies, especially the banking sector, may efficiently manage their assets and get access to liquid funds. However, it is required to improve the legislation in order to carry out the issue of this type of securities.

<u>Actions to be taken</u>

Action 2.1.1: Analyze the factors that restrict access to listing

FMSC will analyze the legal and regulatory framework and identify relevant actions for incentivizing and improving listing requirements as well as changing the single ownership mindset of businesses.

Action 2.1.2: Determine incentives

FMSA will learn international practices on incentivizing companies for listing. It will define suitable incentive schemes to listed companies that can be provided by public institutions.

Action 2.1.3: Determine new listing procedures

FMSC will hold workshops with relevant public and private parties to determine current obstacles and simplification needs in listing process. Taking into account all relevant barriers in the current process, FMSC will design new listing processes, and align it with all related parties.

Action 2.1.4: Change ownership mindset

FMSC will conduct studies in order to identify existing problems related to ownership mindset. It will conduct benchmarking studies to find alternative solutions.

Action 2.1.5: Develop and execute a roadmap

After analyzing incentives, listing processes and ownership mindset, FMSC will prepare a roadmap for the changes with defined actions, responsible entities, and timeline of activities and launch the process.

Action 2.1.6: Establish a profitability curve

Ministry of Finance, FMSC and Central Bank will develop and implement a relevant action plan in order to establish profitability curve for securities.

Action 2.1.7: Promote the process of securitization

FMSC envisages establishing a regulatory legal framework for securitization.

Expected results and indicators

Increasing number of company listings through regulatory and legislative improvements will revive financial markets. It is estimated to bring AZN 125 million total GDP impact comprised of AZN 110 million direct and AZN 15 million indirect increases by 2020. Positive contribution to GDP is accounted for by a reduction in financing costs and increase in the transactional profitability of issuers due to a rise in transactions and profits (EBITDA). No major additional employment is expected.

Adding 5 more large companies from significant sectors to the stock market's listing could be considered as a key performance indicator.

Required investment

Investment in amount of AZN 10 million is required to improve technology and information infrastructure of the stock exchange.

Expected risks

The major risks in achieving the objectives that are envisaged within this priority may include low level of transparency in the activities and financial standing of companies, insufficiency of the incentives to attract companies to the listing, unsuitability of the economic environment for companies' listing, long time required for the actions related to changing the ownership mindset.

7.2.2. Priority 2.2: Improve investors' access to financial markets

Rationale

In addition to creating a suitable environment for issuers and intermediaries, it is of special importance to undertake initiatives to identify the incentives within the framework of cooperation with representatives of the private sector, improve the infrastructure, enhance transparency and ensure liquidity with a view to increasing the investors' market access.

Though the commission fees are low in the securities market (1 – 4 basis points depending on the type of the financial instrument), there are few incentives for the participation of investors, especially institutional investors, in the securities market.

Market infrastructure is one of the important factors ensuring the participation of the investors in the securities market. Currently, the attraction of the domestic market is reduced due to the fact that the foreign investors are required to deposit their funds in the National Depositary Center in order to perform operations in the securities market. Establishing the relations between National Depositary Center and custodian banks may enable the involvement of foreign investors in the domestic financial markets. In the meantime, relationship building with global custodian banks may allow using foreign securities as collateral in the domestic financial markets which may increase market liquidity by expanding the range of the securities in the domestic markets.

Transparency is an important factor which is a precondition for the participation of investors in the market. According to its level of listing, though international accounting standards are applied in the main market segment, the requirements in other segments are softer.

The low level of market liquidity reduces the investors' interest in securities market. Thus, transactions conducted in the regulated resale market account for only 2 percent of the total transactions (Exhibit 8). Share value fixing is limited which makes it difficult to define the real value of investments.

Actions to be taken

Action 2.2.1. Analyze the access to financial markets

FMSC will study best international practices and conduct discussions with market players. Based on this, it will identify improvements in each of the following areas: incentive schemes, infrastructure, transparency and liquidity.

Action 2.2.2: Differentiate incentives for individual and institutional investors

FMSA will consider incentives for institutional and individual investors and also differentiation of incentives depending on the duration of the investments.

Action 2.2.3: Improve foreign investors access to domestic market

National Depositary Center will establish relations with the global custodian banks and perform relevant works for the purpose of facilitating clearing and settlements.

Action 2.2.4: Identify initiatives for the enhancement of transparency

FMSC will review international practices, identify the mechanisms for efficient delivery of information to public, enhance the supervision potential and toughen regulation in insider trade (domestic trade).

Action 2.2.5: Implement the defined actions

FMSC will identify the responsibilities with regard to the defined actions and their period of execution, improve the supervision potential and conduct coordination and supervision of the respective implementation process.

Expected results and indicators

Further improving financial markets accessibility (including incentives, infrastructure, transparency and liquidity) is a key enabler for reviving financial markets. This priority does not have quantifiable direct impact to GDP and employment in 2020. Its indirect impact is calculated under priority 2.1.

The required investment

This priority does not have a defined major investment need. The implementation of incentives and establishment of platforms could require a certain level of resources to be mobilized. The amount will be estimated approximately for these specific initiatives as part of the action steps.

Expected risks

The major risks in achieving the objectives proposed within this priority may include a low level of transparency in the activities of security-issuing companies and in their financial standing, insufficiency of the incentives for institutional and individual investors, failure to ensure liquidity in the initial and resale market, low level of investor interest in the securities.

7.2.3. Priority 2.3. Enhance activity in the interbank money market

Rationale

There two segments of the interbank money market: an organized market which is based on a single trade platform and a non- organized market where transactions are conducted over telephone. It is important to develop an organized interbank money market in terms of ensuring transparency and liquidity in the financial markets.

Though growth trends in the organized interbank money market are observable, the volume of the operations performed there is small and it accounts for a limited portion of the interbank money market. Several actions have been taken by the CBAR towards the establishment and development of the organized interbank money market. Thus, a secured money market segment has been created at the initiative of the CBAR. However, the activeness of the market is limited by some factors such as lack of trust among the banks, limited range of security and lack of market intermediaries.

Failure to complete the restructuring and improvement processes in the banking system increases lack of trust among the banks. The implementation of the actions envisaged within the first and fourth strategic targets is of special importance in terms of eliminating the issue of lack of trust.

In addition, the limited volume and range of the securities that could be used as collateral has an adverse impact on the development of the market. The actions to develop deep and liquid securities market are provided in the priorities 2.1 and 2.2.

Another important element for ensuring liquidity in the interbank market is a market maker institution, which is a market intermediary. The banks selected as market makers undertake liabilities such as performing transactions in the interbank market in consideration for exceptional entry to the initial market auctions and privileges, fixing purchase –sale prices in the initial market auctions, ensuring the liquidity of the resale market and disclosing information on its activities etc.

Actions to be taken

Action 2.3.1: Promote the interbank money market

FMSC and CBAR will coordinate their activities for the development of the interbank money market. Actions to encourage the implementation of interbank operations on a single trading platform will be defined.

Action 2.3.2. Increase the range of collateral

CBAR will consider opportunities to expand the spectrum of the securities acceptable as collateral in open market transactions.

Action 2.3.3. Establish a market maker institution

CBAR together with FMS C will assess the opportunities for introducing a market maker institution. If the establishment of the market maker institution is considered reasonable, CBAR together FMSC will determine selection criteria (total assets, systemic importance, accessibility to modern technologies, financial sustainability etc.), requirements and privileges.

Expected results and indicators

The volume of the transactions in the interbank money market will increase, which will have a positive impact on financial market liquidity, liquidity management of financial institutions and its efficiency. An advanced interbank money market will also allow achieving the targets of the monetary policy through open market transactions. This priority is not expected to have direct impact on real GDP and employment in 2020.

Required investment

No additional investment is expected to be required for the implementation of this priority.

Expected risks

Major risks in achieving the objectives proposed within this priority may include lack of interest by the leading banks in forming a collateral mechanism and the failure to fully form the market maker institution due to high risks.

7.3. Strategic TARGET 3: Enhance infrastructure

The initial works for building the financial infrastructure in Azerbaijan have been completed. The regulatory legal framework for regulating payment systems[1], credit register and financial relations, which are elements of the financial infrastructure, has been established. However, credit data exchange system and the existing regulatory legal framework should be further improved.

7.3.1. Strategic Priority 3.1: IMPROVE credit DATA exchange system

Rationale

Central Credit Registry (CCR) has been operating in the country since 2005 with a view to prompt, comprehensive and efficient assessment of credit risks by financial institutions, promotion of the protection of creditors' and borrowers' rights and interests as well as the strengthening of the financial discipline of economic entities. The linkage of CCR to "ASAN" Service since 2013 has given a boost to increasing the efficiency and access of economic entities to the services provided.

However, information exchange in CCR is limited to banks operating in the country, non-bank credit organizations and potential borrowers. Though detailed information regarding borrowers and guarantors is collected in the CCR (type and amount of credit, payment history, type of collateral and its value), the central registry does not produce a financial risk score. Scoring services are offered by private credit bureaus in international experience. In addition, credit bureaus may offer additional services such as behavioral data reports (based on trade, utilities, and telecom payment data), fraud prevention, credit decision-making tools, customer prospecting and marketing research, behavioral risk scores for corporate customers (including non-borrowing activities).

In addition to scoring, a credit rating assigned to companies is one of more advanced tools that are used for the management of credit risks. Issuers of securities, individual and institutional investors when establishing the investment strategy as well as relevant regulatory and supervisory bodies may benefit from credit ratings. Thus, the assessment of a credit risk based on an individual credit rating enables the exact specification of capital and prudential requirements. And this lays the foundation for improving the financial sustainability and competitiveness of individual financial institutions and bank sector as well as more efficient use of resources. Due to the shortage of national rating agencies, these services are offered only by international rating agencies. Consequently, few large companies have access to the mentioned services.

On the whole, there is a need for improving the credit data exchange system.

Actions to be taken

Action 3.1.1: Promote the establishment of private credit bureaus

A law on credit bureaus and regulative documents will be enacted and other actions in support of establishing private credit bureaus (this action has started) will be defined.

Action 3.1.2: Organize the exchange of information between CCR and private credit bureaus

FMSC will determine a mechanism and technical requirements for the exchange of information between private credit bureaus and CCR.

---

[1] Detailed information on payment systems is provided in the Strategic Roadmap for development of telecommunication and information technologies in the Republic of Azerbaijan".

Action 3.1.3: Assess the opportunities for establishing national credit agencies

FMSC will assess the opportunities for establishing national credit agencies by considering international best practices. An action plan according to the relevant decision will be prepared and its implementation will be initiated.

Expected results and indicators

As a result of implementing this priority, a more detailed database on borrowers will be created. This priority does not have quantifiable direct impact to real GDP and employment.

The required investment

Upgrading the functionality and IT systems of the credit bureaus is estimated to require investment in amount of AZN 5 million.

Expected risks

Major risks in achieving the objectives proposed within this priority are low interest or potential of the banks in establishing the private credit bureau, the failure of credit bureau services to meet the expectations, failure to ensure data security adequately.

7.3.2. Priority 3.2: Revise legal framework, accelerate court decisions and execution processes

Rationale

The availability of a well-functioning court system and an execution mechanism for the protection of creditor rights and fulfillment of liabilities is one of the most significant instruments to reduce the volume of non-performing assets. Limited legislative clarity, delays in passing court orders and their execution indicate that there is a necessity for further improvement of the judicial practices.

There are limited clarities in the legislation on banking operations. The fact that execution methods of court orders are not detailed leaves room for different interpretations, which make it difficult to enforce relevant orders. Courts face difficulties in determining the methods for repayment of debts (for instance, salary, deduction of funds from assets etc.). Especially, this is observable in complex court cases. In addition, the fact that legislation on the liquidation process and collateralization is unclear extends the duration of fulfillment of liabilities. In the liquidation process, the legislation does not clearly specify deadlines, valuation responsibilities and procedures, priority classification, sales of assets and other items, which causes enforcement delays and discrepancies.

Court processes can easily be extended through various objection practices. In case the borrower is not satisfied with the valuation of the assets on sale, then the auction for selling the property may be postponed for many times. Furthermore, the execution of court orders in financial cases is delayed due to the large number of court cases and fixing of unclear deadlines. Under these circumstances, the enforcement officers prioritize certain cases, which cause the postponement of other cases for an indefinite period of time.

On the whole, the expenditures of financial institutions are raised by the fact that creditor rights' protection mechanisms are not satisfactory and there is relatively low discipline in the enforcement of court orders, while also increasing the risks. Financial intermediation is limited by longer procedures for recovery against collateral and relatively high costs incurred for this process. And this makes it necessary to take complex actions in continuation of the reforms conducted so far and improvement of the judicial – legal infrastructure as well as revision of the legislative acts.

Actions to be taken

Action 3.2.1: Identify the directions for analysis and improvement of court order enforcement

FMSC, in coordination with Ministry of Justice and financial institutions, will assign a working group to thoroughly analyze the current enforcement process of financial service cases in Azerbaijan. By identifying the circumstances that complicate and prolong the process, the analysis will cover court decisions and execution, collateralization and levy on collateral, liquidation, valuation and auction processes for collateral assets, and appeals. In this case, the opportunities for establishing legal base for out-of-court levy against the collateral, determination of the service fee for collateral sales auctions based on areal expenditure principle and alternative methods of collateral sales will be assessed and the relevant actions will be taken.

Action 3.2.2: Identify a set of comprehensive solutions

The working group will prioritize the mentioned areas in terms of their impact to the quality and duration of enforcement process. Next it will compare Azerbaijan processes to global practices and determine a set of comprehensive solutions and amendments to the legislation will be developed.

Action 3.2.3: Develop an action plan and start its application

The working group will develop an action plan. Relevant authorities will start applying the approved action plan.

Action 3.2.4: Monitor the action plan

The monitoring and assessment of the results of the actions that have been implemented will be conducted with a view to improving the system. If necessary, additional actions will be specified.

Expected results and indicators

Assigning a working group to revise the financial services legal framework with the objectives of standardizing court orders and accelerating execution process is an enabler to enhance transparency and efficiency in financial sector. This priority has wide impacts not only in financial sector but also in improving the legal framework. It does not have quantifiable direct impact to GDP and employment.

The required investment

Since this priority defines mostly regulatory and legislative changes, there is no major investment need foreseen at this stage. Reforming operations for certain processes could require resources, yet those will be defined later in the actions and will be relatively limited.

Expected risks

Major risks in achieving the objectives that are envisaged within this priority may include such factors as different approaches of individual associated bodies to this issue, failure to timely develop and submit the changes to regulatory and legal acts, the fact that the required knowledge of judges is not always sufficient regarding the issues that arise out of financial services.

7.4. Strategic target 4: Improve regulation and supervision mechanisms

FMSC may achieve sound risk management in the banks by identifying the capital requirements for the main types of risks based on the advanced regulation principlesthat are accepted in international practices as well as by specifying risk-based supervision mechanisms. At the same time, financial penetration may be increased by promoting the enhancement of transparency in the financial sector and expansion of access to finance due to technological tools.

7.4.1. Priority 4.1. Ensure sound risk management in the banks.

The fact that the regulatory requirements on risk management in the banks are periodically toughened has allowed developing a risk management tradition in the sector. However, under the existing economic conditions, an increase in risk vulnerability of the banks and emergence of new risk zones make it necessary to improve the risk management practices. It is important to adapt stage-by-stage the existing prudential requirements with the regulatory principles specified by the Basel Committee and to improve corporate management traditions in order to improve risk management in the banks.

Credit risks account for most of the risks in the risk profile of the banks. From 2011 through 2015, NPL ratio is at a historic high (see exhibit 9). That is while overall NPL ratio stood at 13.9 percent in 2015, the relevant indicator was 2.8 percent for Turkey. In the first quarter of 2016, NPL ratio in the total portfolio in Azerbaijan reached 16, 8 percent.

1 High NPL ratio is mainly driven by IBA
2 Excluding portfolio transferred to Agrocredit
SOURCE: Central Bank of Azerbaijan (CBA), Financial Market Supervisory Chamber (FMSC),

Non-Performing Loan (NPL) ratio, %

NPL ratio Turkey, %

Overall

Local currency portfolio

Foreign currency portfolio

In Q1 2016, NPL ratio for

Overall portfolio is 16.8%

Local currency portfolio is 11.3%

Foreign currency portfolio is 22.4%

Mar 2015

In addition, an increase in the restructured portfolio in recent periods makes it necessary to apply a new approach to credit risk management in Azerbaijan. Thus, the total amount of the restructured loan in 2015 increased by 6 percentage point as compared to the previous year while there was a higher increase in the foreign currency portfolio (exhibit 10).

1 Indicators provided by IBA were not taken into consideration in the analysis.
SOURCE: Central Bank of Azerbaijan (CBA)

On the whole, the poor coordination across sales, risk management and underwriting procedures is one of the factors that cause an increase in credit risks. Best practices provide for separation of powers with a balance between sales, underwriting and validation.

In the area of risk mitigation, best practices provide that customer actions and strategies be defined case by case for corporate and large commercial customers, and that there be a standard set of actions and strategies for each segment in SMEs. Currently in Azerbaijan, customer actions for all segments are identified on a case-by-case basis with no standardization for the SME and micro segments.

Credit risk monitoring procedures should be improved. Thus, the banks typically conduct risk classification mechanically or periodically. An automated system is not commonly used for risk identification. Risk identification is conducted based on automated “early warning systems” in best practices.

The risk vulnerability of the banks has increased due to limited hedging tools for the management of market risks, especially exchange rate risks. Consequently, more accelerated dollarization of the liabilities as compared to assets caused the sector to suffer large losses during devaluations which occurred in 2015. Eventually, it is important to require additional capital buffer against market risks.

Actions to be taken

Action 4.1.1: Analyze risk management in the bank sector

FMSC will analyze the current situation in order to improve risk management practices in the banks and compare it to Basel II/III standards. Based on this analysis, FMSC will identify and prioritize the improvement areas and specify the relevant practices to be referenced. At the same time, actions to improve corporate governance will be taken.

Action 4.1.2: Develop a roadmap

The FMSC will identify a clear schedule and exact deadlines for full application of the column 2 of the Basel II standard for the bank sector in the next stage and develop necessary regulations and methodologies in this area. In the meantime, a prudential regulation mechanism for market and operational risks will be established, and a procedure for the capital coverage of market risks will be defined. Presentations will be conducted for bank representatives.

Action 4.1.3: Define a mechanism for regulating the banks of systemic importance.

Changes in the prudential requirements with respect to applying differential regulation mechanisms for the banks of systemic importance within the framework of transition to Basel standards will be taken into consideration.

Expected results and indicators

Applying sound risk management practices in banks is estimated to create AZN 235 million total GDP impact in real terms comprised of AZN 205 million direct and AZN 30 million indirect increases by 2020. No major additional employment is expected.

The following Key Performance Indicators have been determined for this priority:

- Increase financial penetration rate (ration of outstanding loans to non-oil GDP) to 60%
- Decrease non-performing loans rate to 8% from its current level of 14%

The required investment

There is no significant investment required to realize this priority.

Expected risks

The major risks in achieving the objectives provided for within this priority may include the failure of the banks to be ready for applying new prudential requirements, low potential for ensuring the investments that are required for adaptation to the new requirements, adverse effect of the new prudential framework on banks' profitability and capital position in the short term.

7.4.2. Priority 4.2: Apply a consolidated risk-based supervision model in the financial services sector

While the existing framework for supervision over the financial markets allows conducting a personalized analysis of the supervision entities, it causes some restrictions for conducting consolidation-based analyses. The lack of consolidated prudential supervision and accountability system may cause difficulties during the assessment of total risk profile including the subsidiaries of the banks.

The limited application of consolidation-based supervision is the reason why the external factors likely to affect the financial institutions are not included in the risk profile assessment and why systemic risks arise. In international practices, the financial institutions, which are the subsidiaries for management of such risks, are required to submit consolidated periodic prudential reports in addition to individual prudential reports, and effective supervision is carried out.

According to the existing approach, the risk profile of banks and systemic importance are partially taken into account when determining the supervision regime. Consequently, there is limited risk identification in the preventive regime. According to best practices, a risk – based supervision approach for solving this issue is applied and, within this framework, a functionality-based supervision approach is replaced by a bank-based approach. This model ensures that more comprehensive risk assessment of the bank's risk profile is conducted and regularly updated. And the risk profile and systemic importance of the banks, which act as the main factor in determining the supervision regime, ensure more efficient performance for resources.

The risk-based supervision model will also ensure more effective supervision over the banks of systemic importance.

According to best practices, the risk – based supervision approach is applied to other players of the financial system in addition to banks. The exercise of supervision in the insurance sector in line with the risk – based approach may also be important in terms of establishing a sound financial system.

And the expansion of the supervision arsenal through a risk-based model will, in its turn, ensure more accurate risk assessment, forecasting and management in the financial markets.

Actions to be taken

Action 4.2.1: Investigate the consolidated prudential supervision mechanism

FMSC will carry out the investigation of international practices with a view to identifying the coverage of the consolidated prudential supervision mechanism and the depth of the required reports.

Action 4.2.2: Organize a consolidation – based prudential supervision

If it is proved as a result of investigations that these actions are relevant for Azerbaijan, a roadmap for establishing a consolidated prudential supervision mechanism will be prepared and its realization will be launched.

Action 4.2.3: Investigate the consolidated risk-based supervision approach

The methods of applying a consolidated risk-based supervision model for banking and insurance sectors will be investigated, international best practices will be studied and a suitable model will be identified.

Action 4.2.4: Ensure the transition to consolidated risk- based supervision

Internal procedures for exercising a risk – based supervision will be prepared, the forms of reporting and business process will be determined. Relevant training will be organized for supervisors and financial institution representatives for the purpose of transition to the new model.

Expected results and indicators

This priority does not have quantifiable direct impact to GDP and employment.

Required investments

No major investment is required for implementation of this priority.

Expected risks

The major risks in achieving the objectives that are envisaged within this priority may include the following factors: internal supervision and internal audits in the banks are not organized in line with the required standards, quality criteria are not properly assessed during risk assessments the methods for application of the consolidated risk-based supervision are not properly identified.

7.4.3. Priority 4.3. Improve the regulatory mechanism for accelerating the digital transformation of the banks

Over the past several decades, global customer expectations for banking have shifted significantly. The new expectations are focused on increasingly personalized products and simpler services and, as a result, the operating models of banks have transformed in terms of efficiency. To ensure a sustainable development of the banking system in the country and provide high-quality services to customers, it is of particular importance to support digitization and efficiency improvement.

In international practices, the transition from a standard product approach to a personalized product approach was observed. While the old system promoted basic products including loans, deposits, simple transactions and payments, the new system must cater to endless customer requests for customizations of payment terms, interest rates, cash transactions, and so forth. As a result, the expectations of bank customers for convenient, speedy and personalized services have transformed. The consumer wishes to use their mobile phones for transactions and receive immediate responses to inquiries could be given as an example of such changes.

Customer- oriented changes promote the transformation of banks towards digitalization. In order to achieve full digitalization of banks, standard transactions and simple products are transferred to alternative service channels. IT architecture and infrastructure are transformed for the efficient operation of alternative service channels.

Some actions have been taken in this area in the banking system of Azerbaijan. Most of the banks are at the stage of standardization and centralization while some banks are at the early stage of digitalization process. Full transition to digitalization may ensure reduction in operating risks in the sector.

Actions to be taken

Action 4.3.1: Assess the current situation of digitalization in the banks

In order to analyze the existing processes and regulations, FMSC will establish a working group. The working will assess the digitalization readiness of the banks by conducting meetings, interviews and surveys, and it will also study the global digitization-related practices.

Action 4.3.2: Determine necessary changes in the regulatory mechanism

Then, the working group will define necessary changes in the regulatory mechanism by focusing on such matters as paper transactions and controls, limitations on cashless transactions, and excessive reporting.

The actions will be prioritized based on efficiency and digitalization of bank transactions.

Action 4.3.3: Implement the defined actions

FMSC will support the acceleration of banking digitization processes by implementing changes in regulations and supervising the application of new regulations.

Expected results and indicators

Expected results and indicators (high-level forecast)

Due to reviewing and revising the regulatory mechanisms, digitization will enable efficiency improvement in the sector. This will bring up to AZN 135 million total GDP impact in real terms comprised of AZN 120 million direct and AZN 15 million indirect increases by 2020. No additional employment is forecasted, since the main assumption is to create efficiencies.

The following key performance indicators have been defined for the priority:

- Ensure that all retail banks participate in digitalization transformation efforts

- Improve consolidated banking net income of the retail banks additionally by up to 20% in 2020 as a result of digital transformation.

GDP impact is assumed to come from improving net income margins through higher sales, better service quality, and creating new efficiencies.

The required investment

A total of AZN 100 million major capital investment is required for overall banking sector by 2020.

Expected risks

The major risks in achieving the objectives that are envisaged within this priority may include the following factors: banks fail to prioritize the digitalization process as necessary and are not interested in ensuring the necessary investments; internal personnel potential is not adequate for carrying out the digitalization and operating risks emerge.

7.4.4. Priority 4.4: Increase transparent reporting in the financial services sector

The financial services sector has room to improve on its reporting activities. The coverage of information available regarding the banking sector as well as the quality of that information are not at a satisfactory level. More transparency on disclosure of information should benefit all market players by enabling more accurate and data-driven decisions.

Action to be taken

Action 4.4.1: Analyze the current situation in reporting and disclosure of information

By conducting a study of international best practices, FMSC will identify the exiting gaps in reporting and disclosure of information. Along with reporting templates, it will focus on areas like public report and statements, global reporting metrics, and overall sector indicators.

Action 4.4.2: Develop new reporting templates

Based on benchmarking, FMSC will identify relevant areas for improvement. It will create standardized reporting templates and relevant instructions.

Action 4.4.3: Establish a mechanism for disclosure of information

FMSC will set up a working group in order to define procedures for data collection and publishing including the content, disclosure date, frequency and platform of information to be published. FMSC will create an execution plan and initiate its implementation.

Expected results and indicators

Pursuing standardization in data collection and sharing processes is an important enabler to increase transparency in the financial sector. This priority does not have quantifiable direct impact to GDP and employment. Most of the actions' impact is on increasing data availability and quality.

The required investment

This priority will not require a major investment.

Expected risks

The major risks in achieving the objectives proposed within this priority may include the following factors: the financial institutions are not interested in disclosing the sensitive information or the disclosed information is not properly interpreted by the market players and consequently there emerge undesired risks for financial sustainability of the companies, and the internal information systems of the financial institutions fail to fully generate the information required to be disclosed.

7.4.5. Priority 4.5. Strengthen the mechanism for regulating insurance activities and supervision over it

Rationale

The existing regulatory and supervisory mechanisms for the insurance sector create restrictions for proper risks assessment and implementation of preventive supervision actions. Regulatory requirements for available independent risk management of insurance market players, conformity and actuary supervision functions have not been defined. Consequently, there emerge difficulties in establishing efficient management and internal supervision system in the insurance sector.

The mechanism for supervising the activities of insurance market players are mainly aimed at the verification of conformity with the requirements of the legislation rather than the assessment of the activities in the sector based on proactive and risk – based principles. Capital requirements for insurance market players are not adapted to the risk profile of the market players. And this causes high risk vulnerability of the market players against external shocks. Regulation is defined based on “Solvency II” standards in international practices where the creation of reserves and calculation of capital are carried out by focusing on risk-based approaches. According to best practices, transition to “Solvency II” standards takes place within a certain period of time.

There are opportunities for the development of the prudential reporting system in the insurance sector. The quarterly reports submitted by companies limit timely identification of risks and implementation of preventive measures. The development of the scope and depth of reports is also necessary.

FMSC may achieve the sustainability of individual market players and the sector in general by transforming the supervisory and regulatory mechanism in the insurance system from a traditional model to a risk –based model.

Actions to be taken

Action 4.5.1: Conduct an analysis of the regulatory and supervisory mechanism in the insurance sector

FMSA will conduct an analysis of the legal, regulatory and methodological mechanism for insurance supervision and regulation taking account of international best practices and will identify the areas for improvement.

Action 4.5.2: Develop an action plan for the application of new mechanisms

Based on the outcomes of the analysis, an action plan for the renewal of the regulatory and supervisory mechanism will be defined. The action plan will include the improvement of management and internal supervision system at insurance market players, application of risk – based capital requirements, supervision ranking model for insurance risk assessment and improvement of prudential reporting system.

Action 4.5.3. Implement the action plan

In order to implement the action plan, a working group will be established and actions will be initiated.

Expected results and indicators

No quantifiable GDP and employment impacts are expected in this priority.

Required investment

No additional investments are required since the existing resources will be used for regulating insurance activities and establishing a supervisory framework.

Expected risks

The major risks in achieving the objectives that are envisaged within this priority may include such factors as: unpreparedness of some insurance companies to apply new prudential requirements, low potential for ensuring the required investment in order to adapt to the new requirements and an adverse effect of regulatory requirements on the profitability of insurance companies and capital position.

7.5. Strategic target 5: Upgrade the knowledge and capabilities of financial market players

Increasing the potential of financial market players is an overarching issue for Azerbaijan. The necessary knowledge and capabilities of financial sector specialists as well as consumers of the financial services are limited. The upgrade of knowledge and capabilities could spur the dynamic development of the financial system and ensuring long – term sustainability.

7.5.1. Priority 5.1 Upgrade the knowledge and capabilities of specialists employed by the financial sector

Rationale

There are higher education institutions and various scientific centers in Azerbaijan specialized in finance. These education institutions shape the basic knowledge of specialists working in the financial sector. In addition, the regulatory authorities and market players promote continuous upgrading of the knowledge and capabilities of the specialists. Thus, according to the existing legislation, the appraisal of administrative staff and senior employees of the financial institutions by FMSC is required. The relevant authorities and private training centers organize trainings, “round tables”, presentations and discussions regarding regulatory acts for financial sector employees.

However, it is necessary to further upgrade the knowledge and capabilities of the human resources in the financial sector and to adapt the financial education to the existing situation and to sector-specific requirements.

Actions to be taken

Action 5.1.1: Coordinate the actions for improvement of the potential

By coordinating their activities, FMSC and CBAR will organize training and certification programs in the relevant areas in order to upgrade the knowledge and capabilities of financial sector specialists.

Action 5.1.2: Improve the higher education program

FMSA, CBAR and Ministry of Education along with higher education institutions will assess if the higher education and vocational education programs conform to the needs of the financial sector and conduct necessary works towards the improvement of education programs.

Expected results and indicators

Further improving the knowledge and capabilities of employees in the sector is an important enabler to other strategic priorities. Although this priority does not have quantifiable direct impact to GDP and employment, it serves as a support to all efforts in developing the financial services sector in Azerbaijan.

The required investment

The priority is not expected to require a major investment.

Expected risks

The major risks in achieving the objectives that provided for within this priority may include such factors as non-conformity of quality of the implemented training programs to expectations, failure of the market players to properly prioritize trainings and low interest in necessary investing.

7.5.2. Priority 5.2: Increase the financial literacy of consumers and strengthen the protection of their rights

Rationale

A number of works have been carried out in Azerbaijan with respect to ensuring the protection of financial service consumer rights and increasing their financial literacy. Institutional reforms have been conducted in this area, and progress has been made towards the establishment of efficient protection mechanisms and education of the population. However, the development of the financial services sector, deepening of financial intermediation and expansion of mutual relations between the financial sector and consumers have necessitated the protection of the interests of financial service consumers and upgrading of financial literacy.

There are the following primary objectives of consumer protection:

- Provide clear and accurate information about financial products and increase comparability;
- Improve the efficiency of the banking system by coordinating the activities of relevant authorities and ensure resilient economic growth;
- Stimulate the use of financial services by the population through bolstering financial awareness, literacy, and capabilities of consumers
- Apply fair market practices and enhance competition
- Prevent financial harm to consumers through proactive supervision.

A number of actions have been taken towards consumer rights protection in Azerbaijan in the above mentioned areas. Responsible lending requirements have been imposed including the requirement to provide consumers with information on application process and loan terms and conditions. In addition, banks are required to disclose effective annual interest rate (EAIR) that includes all the expenses which borrowers incur with respect to loans. At the same time, a customer's right to appeal has been defined and complaint handling standards have been applied. Based on the requirements, banks are obliged to disclose financial reports to the public on a regular basis.

CBAR, international financial institutions and private sector have taken actions in increasing the financial literacy of the population and entrepreneurs. There is a need for coordinating the activities of relevant authorities with a view to mobilizing financial literacy resources and increasing the efficiency of the works performed.

Actions to be taken

Action 5.2.1: Identify the areas for increasing financial literacy

By considering the results of surveys to be conducted among the market players and proposals of the stakeholders, FMSA and CBAR will define the works to be performed towards increasing financial literacy and identify priority areas. During the prioritization, the significance of problems from the view point of consumers and cost factors will be taken into account.

Action 5.2.2: Determine the actions

Relevant authorities will analyze international best benchmarks with respect to increasing financial literacy and determine the actions to apply those practices in Azerbaijan. Such factors as costs, potential impact and ease of implementation will be taken into consideration during the analysis.

Action 5.2.3: Implement pilot projects

Relevant authorities will select certain initiatives and implement a pilot run. To evaluate the results and emerging challenges, continuous feedback will be gathered during the implementation of the pilot project and, based on that, the actions will be reviewed once again.

Action 5.2.4: Implement and monitor the actions

Relevant authorizes will implement all initiatives and perform continuous monitoring of the process. To assess the impact, periodic surveys and target group interviews will be organized.

Expected results and indicators

Improving the financial literacy of consumers and strengthening the protection of their rights will be an enabler for more efficient and developed financial services market. This priority does not have quantifiable GDP and employment impacts.

The required investment

Initiatives and programs to improve financial literacy will require certain level of budget. Yet overall, these strategic initiatives are not estimated to require major resources in investment form.

Expected risks

The major risks in achieving the objectives that are envisaged within this priority may include such factors as failure to continuously implement financial literacy actions in a coordinated way and inconsistency of outcomes with expectations.

8. FINANCING MECHANISMS

The achievement of the specified strategic targets requires AZN 115 million investments. The implementation of actions in the Strategic Roadmap will be funded by using the following sources:

- Government budget;
- Funds of Central Bank;
- Off-budget funds;
- National Fund for Entrepreneurship Support and funds from other governmental credit and investment organizations
- Local budgets;
- Funds of local institutions, enterprises and organizations irrespective of their type of ownership;
- Foreign direct investment;
- Securities market;
- Credits from the country's banking system;
- Loans, grants and technical assistance provided by international organizations and foreign countries;
- Other sources not prohibited by law.

In order to ensure the effective spending of funds for priority targets, the budgets will be prepared within the framework of performance-based budgeting process. A larger portion of the required funds will be provided at the expense of the restructuration of the existing budgets, joint financing initiatives of private sector and various investors.

9. IMPLEMENTATION, MONITORING AND EVALUATION

Implementation of Strategic Roadmap

Coordination and governance: Accelerated decision making, clear accountability and additional execution capacity will ensure appropriate coordination and governance.

- A mechanism for accelerated decision making at the highest political level will be set up for the Strategic Roadmap. This mechanism will enable appropriate leadership from key stakeholders for other decision makers for the implementation of the program. Decisions about implementation priorities and concrete targets will be made using this mechanism

- The main executive organization will appoint responsible persons for each relevant priority and action in order to implement them in a timely and proper manner. With the involvement of other organizations specified in the action plan, working groups will also be formed for each priority under the leadership of responsible organizations. Reporting meetings of the work groups will be conducted under the leadership of the main executive organization on a quarterly basis. Quarterly work progress and activities to be performed during the next quarter will be discussed in the meetings. The work groups will carry out their activities based on annual work programs. Daily work schedules and task allocation will be determined by the responsible person. Typically, current work group meetings will be held in the offices of the main executive organization as requested by the responsible person. The main executive organization will ensure that appropriate conditions are created for unimpeded activity of the work group and, when necessary, it will involve external experts to make best use of their technical support.

- An appropriate coordination group (delivery unit) will be established to monitor the implementation of the Strategic Roadmap and provide central execution support in areas such as in problem solving or coordination across institutions. The unit's major work will serve to create organization across the institutions, processes, and technology required for implementation. This coordination unit will oversee teamwork across work groups in line with the action plan, summarizing of quarterly reports and preparation of annual reports. Furthermore, it will be responsible for ensuring that the involved institutions arrange for the required financial and human resources, and empowered to inject additional resources when needed.

Strategic alignment and financing: To allow for an efficient implementation process that avoids wasted resources and conflicting objectives, the Strategic Roadmap will be fully integrated into other sectorial plans and existing budgets.

- All related strategic documents proposed by relevant governmental institutions will be harmonized with the Strategic Roadmap and the mandates of existing state agencies will be realigned to the objectives wherever necessary. This alignment work will include developing transparent, measurable implementation targets, which will be communicated publicly and used to track progress.

- Detailed implementation plans will be developed for all strategic priorities as governance for their execution, based on provided actions, to provide transparency regarding the resources required and expected impact. While the assigned leading group will bear overall responsibility for fulfilling the implementation plan, it will involve all key institutions and private sector organizations in its application.

Stakeholder mobilization platform: Both domestic and international partners from both public and private sectors will be mobilized to join in the execution of the Strategic Roadmap.

- Appropriate actions will be taken to identify and involve key strategic partners. The involvement of multiple organizations and stakeholders is required for the successful implementation of each strategic priority. To ensure alignment of objectives and proper coordination, advisory councils and working committees will be formed to work with the private sector and state owned enterprises as well as with critical international partners, such as international financial institutions.

- Civil society will be mobilized and engaged to generate broad support for the Strategic Roadmap. Furthermore, active communication, transparency and inclusiveness will help to mobilize the public and private sectors, society as a whole, and other relevant stakeholders.

Monitoring and evaluation of the Strategic Roadmap

The Strategic Roadmap will be monitored and evaluated to ensure successful implementation through required tools, processes and other resources. During monitoring and evaluation, focus will be placed on the implementation of core actions, expected results and indicators versus priorities, and also compliance with the completion schedule will be checked. The monitoring and evaluation will be carried out in accordance with procedures based on international methodologies.

The annual activity programs of the work groups will be agreed with the coordination unit and approved by the main executive organization. Representatives of the coordination unit will participate in the quarterly meetings of the work groups.

The main executive organization will submit quarterly work progress reports to the coordination unit at least 10 days prior to the work group's quarterly meeting. By taking into account extensive analysis and evaluation of quarterly reports including discussions held in the quarterly meeting of the working group, the coordination unit will submit quarterly monitoring results and its recommendations for the next period to the main executive organization within 10 days following the meeting date. The coordination unit and the main executive organization will take actions to ensure that the monitoring results and recommendations are taken into consideration by the working group in its daily activities.

10. Action plan

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
Strategic target 1. Establish a financial system comprised of dynamic and sound institutions.					
1.1. Ensure the capitalization and liquidity of the banking system					
1.1.1.	Conduct a comprehensive analysis of the banking sector	Financial Markets Supervision Chamber		• 7 percent increase in the sector's profitability as compared to 2015; • This priority is estimated to bring AZN 130 million total GDP impact in real terms comprised of AZN 115 million direct and AZN 15 million indirect impacts by 2020.	2017-2020
1.1.2.	Develop an action plan for the capitalization of problematic banks	Financial Markets Supervision Chamber	Ministry of Finance, Central Bank, Deposit Insurance Fund		2017
1.1.3.	Implement the plan and conduct monitoring	Financial Markets Supervision Chamber	Ministry of Finance, Central Bank, Deposit Insurance Fund		2017
1.1.4.	Create institutional and legal mechanisms for restructuring problematic banks	Financial Markets Supervision Chamber	Ministry of Justice , Ministry of Taxes		2017
1.1.5.	Restructure the banks whose capital sustainability is not restored	Financial Markets Supervision Chamber	Ministry of Finance, Central Bank, Deposit Insurance Fund		2017-2018
1.1.6.	Improve the mechanisms for deposit insurance	Financial Markets Supervisions Chamber	Ministry of Finance, Central Bank, Deposit Insurance Fund		2017-2019

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
1.1.7.	Expand the instruments for providing liquidity	Central Bank	Financial Markets Supervision Chamber, Ministry of Finance		2017-2019
1.2. Prepare a restructuring plan for non-performing assets					
1.2.1.	Create legal mechanisms for management of non -performing assets	Financial Markets Supervision Chamber	Ministry of Finance, Ministry of Justice , Ministry of Taxes, Central Bank	• This priority will be a key enabler for other priorities, but it does not have GDP and employment impacts; • Indirect GDP impact of this priority is described in the expected results of Priority 1.1.	2017-2018
1.2.2.	Define criteria for non – performing loans to be included in the restructuring plan	Financial Markets Supervision Chamber	Ministry of Finance, Central Bank		2017-2018
1.2.3.	Define a restructuring strategy	Financial Markets Supervision Chamber			2017-2018
1.2.4.	Implement the restructuring program and conduct monitoring	Financial Markets Supervision Chamber			2018-2020
1.3. Develop the insurance market					
1.3.1.	Establish relevant working groups	Financial Markets Supervision Chamber	Ministry of Agriculture , Ministry of Finance, Ministry of Economy	• Bring insurance penetration (insurance premiums ratio to non – oil GDP) up to 1,4	2017

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
1.3.2.	Conduct an analysis of the current situation	Financial Markets Supervision Chamber	Ministry of Agriculture , Ministry of Finance, Ministry of Economy	percent; ● Impact of the priority on real GDP in 2020 will be AZN 125 million in total with AZN 85 million direct and AZN 40 million indirect impacts ; ● 1600 new jobs are expected to be created.	2017
1.3.3.	Establish a data system	Financial Markets Supervision Chamber	Ministry of Agriculture , Ministry of Finance, Ministry of Economy		2017-2019
1.3.4.	Develop an action plan and start its execution	Financial Markets Supervision Chamber	Ministry of Agriculture , Ministry of Finance, Ministry of Economy		2017-2020
1.4. Strengthen financial inclusiveness					
1.4.1.	Develop the channels for delivery of the financial services	Financial Markets Supervision Chamber		● Improve the availability of financial services.	2018-2019
1.4.2.	Create suitable regulatory and dynamic supervisory frameworks for the financial institutions that serve for financial inclusion	Financial Markets Supervision Chamber			2019-2020
Strategic target 2: Develop financial markets					
2.1. Priority 2.1: Create a favorable environment for issuers and intermediaries					
2.1.1.	Analyze the factors that restrict access to listing	Financial Markets Supervision Chamber		● Additional 5 companies from key sectors will	2017

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
2.1.2.	Determine incentives	Financial Markets Supervision Chamber	Ministry of Taxes , Ministry of Justice	be included in the listing of the stock exchange;	2017-2018
2.1.3.	Determine new listing procedures	Financial Markets Supervision Chamber		• AZN 125 million total GDP impact in real terms comprised of AZN 110 million direct and AZN 15 million indirect increases by 2020.	2017-2018
2.1.4.	Change ownership mindset	Financial Markets Supervision Chamber			2017-2019
2.1.5.	Develop and execute a roadmap	Financial Markets Supervision Chamber			2018-2020
2.1.6.	Establish a profitability curve	Ministry of Finance, Central Bank	Financial Markets Supervision Chamber		2017-2018
2.1.7.	Promote the process of securitization	Financial Markets Supervision Chamber	Ministry of Justice		2017-2020
2.2. Improve investors' access to financial markets					
2.2.1.	Analyze the access to financial markets	Financial Markets Supervision Chamber		• This priority will be a key enabler for other	2017

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
2.2.2.	Differentiating incentives for individual and institutional investors	Financial Markets Supervision Chamber	Ministry of Taxes	priorities, but it does not have direct GDP and employment impacts; • The indirect GDP impact of this priority is described in the expected results of Priority 2.1.	2017-2018
2.2.3.	Improve foreign investors' access to domestic market	Financial Markets Supervision Chamber	Central Bank, Ministry of Communication and High Technologies		2017-2018
2.2.4.	Identify initiatives for enhancement of transparency	Financial Markets Supervision Chamber			2017-2018
2.2.5.	Implement the defined actions	Financial Markets Supervision Chamber			2018-2020
2.3. Enhance activity in the interbank money market					
2.3.1.	Promote the interbank money market	Central Bank	Financial Markets Supervision Chamber	• This priority will be a key enabler for other priorities, but it does not have direct quantifiable GDP and employment impacts; • The volume of the transactions in the interbank money market will increase.	2017
2.3.2.	Increase the range of collateral	Central Bank			2017-2018
2.3.3.	Establish a market maker institution	Central Bank	Financial Markets Supervision Chamber		2017-2018

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
Strategic target 3: Enhance infrastructure					
3.1. Improve credit data exchange system					
3.1.1.	Promote the establishment of private credit bureaus	Financial Markets Supervision Chamber		• A more detailed database on borrowers will be created; • This priority will be a key enabler for other priorities, but it does not have direct GDP and employment impacts	2017
3.1.2.	Organize the exchange of information between CCR and private credit bureaus	Financial Markets Supervision Chamber			2017-2018
3.1.3.	Assess the opportunities for establishing national credit agencies	Financial Markets Supervision Chamber			2018-2019
3.2. Revise legal framework, accelerate court decisions and execution processes					
3.2.1.	Identify the directions for analysis and improvement of court order enforcement	Financial Markets Supervision Chamber	Ministry of Justice , financial sector representatives	• This priority will be a key enabler for other priorities, but it does not have direct GDP and employment impacts.	2017
3.2.2.	Identify a set of comprehensive solutions	Financial Markets Supervision Chamber	Ministry of Justice , financial sector representatives		2017
3.2.3.	Develop action plan and start its application	Financial Markets Supervision Chamber	Ministry of Justice , financial sector representatives		2017-2018

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
3.2.4.	Monitor the action plan	Financial Markets Supervision Chamber			2018-2020
Strategic target 4: Improve regulation and supervision mechanisms					
4.1. Ensure sound risk management in the banks					
4.1.1.	Analyze risk management in the bank sector	Financial Markets Supervision Chamber		• Decrease non-performing loans ratio to 8%; • Increase penetration rate to 60%; • AZN 235 million total GDP impact comprised of AZN 205 million direct and AZN 30 million indirect increases by 2020.	2017
4.1.2.	Develop a roadmap	Financial Markets Supervision Chamber			2017-2020
4.1.3.	Define a mechanism for regulating the banks of systemic importance.	Financial Markets Supervision Chamber			2017-2019
4.2. Apply a consolidated risk-based supervision model in the financial services sector					
4.2.1.	Investigate the consolidated prudential supervision mechanism	Financial Markets Supervision Chamber		• This priority will be a key enabler for other priorities, but	2017

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
4.2.2.	Organize a consolidation – based prudential supervision	Financial Markets Supervision Chamber		it does not have direct GDP and employment impacts.	2017-2019
4.2.3.	Investigate the consolidated risk-based supervision approach	Financial Markets Supervision Chamber			2017
4.2.4.	Ensure the transition to consolidated risk-based supervision	Financial Markets Supervision Chamber			2017-2020
4.3. Improve the regulatory mechanism for accelerating the digital transformation of the banks					
4.3.1.	Assess the current situation of digitalization in the banks	Financial Markets Supervision Chamber		• Ensure that all retail banks participate in digitalization	2017
4.3.2.	Determine necessary changes in the regulatory mechanism	Financial Markets Supervision Chamber			2018
4.3.3.	Implement the defined actions	Financial Markets Supervision Chamber			2018-2020
4.4. Increase transparent reporting in the financial services sector					
4.4.1.	Analyze the current situation in reporting and disclosure of information	Financial Markets Supervision Chamber		• This priority will be a key enabler for other	2017

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
4.4.2.	Develop new reporting templates	Financial Markets Supervision Chamber		priorities, but it does not have direct GDP and employment impacts.	2017-2018
4.4.3.	Establish a mechanism for disclosure of information	Financial Markets Supervision Chamber			2018-2019
4.5. Strengthen the mechanism for regulating insurance activities and supervision over it					
4.5.1.	Conduct an analysis of the regulatory and supervisory mechanism in the insurance sector	Financial Markets Supervision Chamber		• This priority will be a key enabler for other priorities, but it does not have direct GDP and employment impacts	2017
4.5.2.	Develop an action plan for the application of new mechanisms	Financial Markets Supervision Chamber			2017
4.5.3.	Implement the action plan	Financial Markets Supervision Chamber			2017-2020
Strategic target 5: Upgrade the knowledge and capabilities of financial market players					
5.1. Upgrade the knowledge and capabilities of specialists employed by the financial sector					

No.	Action	Main executive entity	Other entities	Indicators	Period of execution
5.1.1.	Coordinate the actions for improvement of the potential	Financial Markets Supervision Chamber	Central Bank	• This priority will be a key enabler for other priorities, but it does not have direct quantifiable GDP and employment impacts.	2017-2020
5.1.2.	Improve the higher education program	Central Bank	Financial Markets Supervision Chamber, Ministry of Education		2018-2020
5.2. Increase the financial literacy of consumers and strengthen the protection of their rights					
5.2.1.	Identify the areas for increasing financial literacy	Central Bank	Financial Markets Supervision Chamber	• This priority will be a key enabler for other priorities, but it does not have direct GDP and employment impacts.	
5.2.2.	Determine the actions	Central Bank	Financial Markets Supervision Chamber		2019-2020
5.2.3.	Implement pilot projects	Central Bank	Financial Markets Supervision Chamber		2017-2018
5.2.4.	Implement and monitor the actions	Central Bank	Financial Markets Supervision Chamber		2018-2019