

*Better Research, Better Policy, Better Reform*



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# **Banking System in Azerbaijan: On the light of New Transformation**

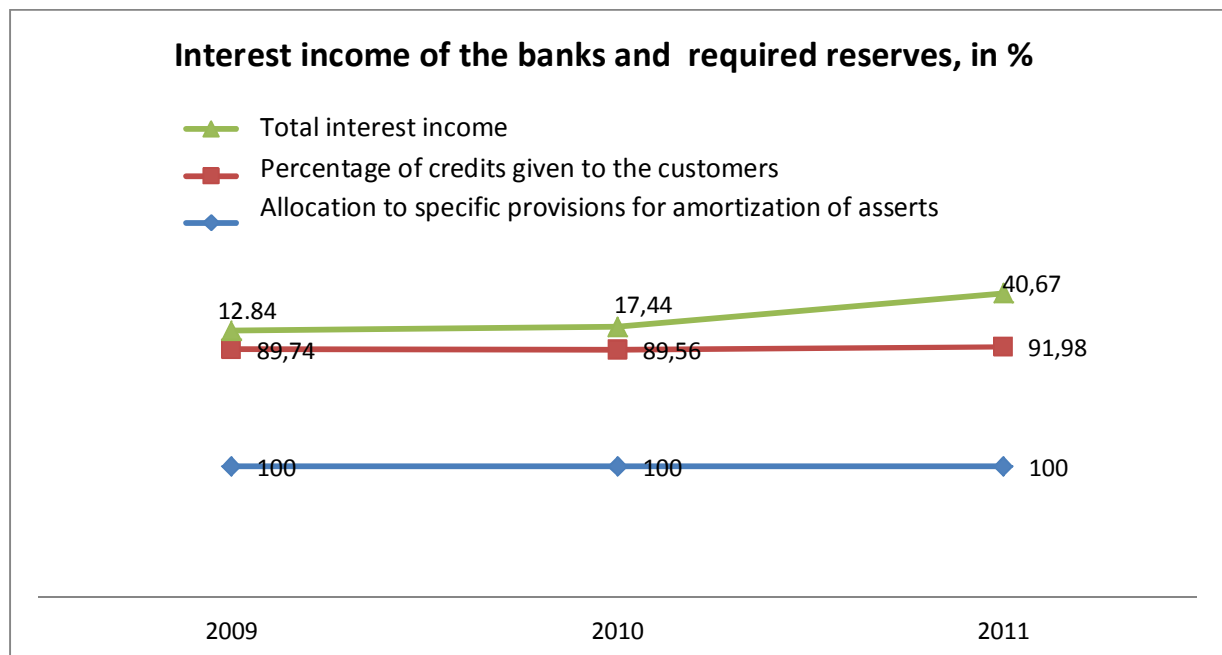
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## Banking System in Azerbaijan: On the light of New Transformation

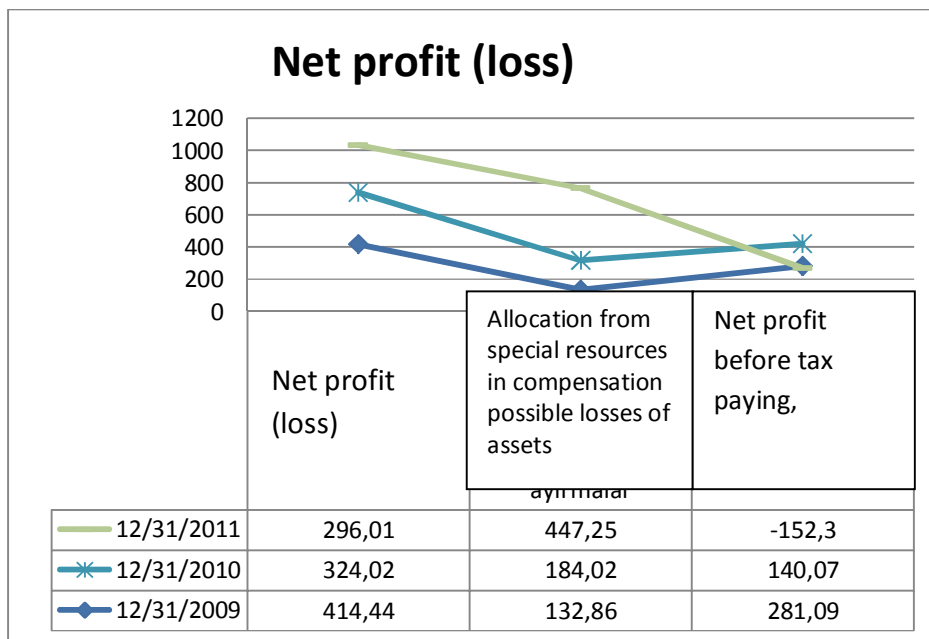
The paper touches upon three main problems in Azerbaijan banking system, their solving and the estimated direction of its future prospect. The first problem is a trend between incomes coming from the interests of banking credits and compulsory resource allocation and solutions related with this issues; the second problem is an improvement of banking capital, to bring it more sustainable and take into consideration the credit risks; the third issue are to activate banks in the regions and pragmatic approach to the solutions of the problems.



According to the Central Bank of the Republic of Azerbaijan(CBAR), “*Financial Results of Banking Activity*” quarterly review 01.07.2012.

The positive trend in increasing income of interests of the credits in total share of interest income should be noted. It happens because of specific share of credit portfolio was growing up year in year out. However, it is difficult to say the same about the quality of credit portfolio. Thus, in case when the interest income grew from 89.74% to 91.98% in accordance to the law, the special share of total resources in total interest income increased from 12.84% to 40.67%. In other words, 44 % of interest income, which was received by the primary function of banks at the turn of

2011, has been spent on special resource allocations. At the same time, the indicator of net profit regresses from 414.44 million manat (in 2009) to 296.01 million manat (in 2011), in contrary to this results the specific share of resources increased from 132.86 million manat to 447.25 million manat. Preventing this type of cases is important in the future. Otherwise, interest of the credit, which is the main source of banks' profit, will lose its effectiveness.

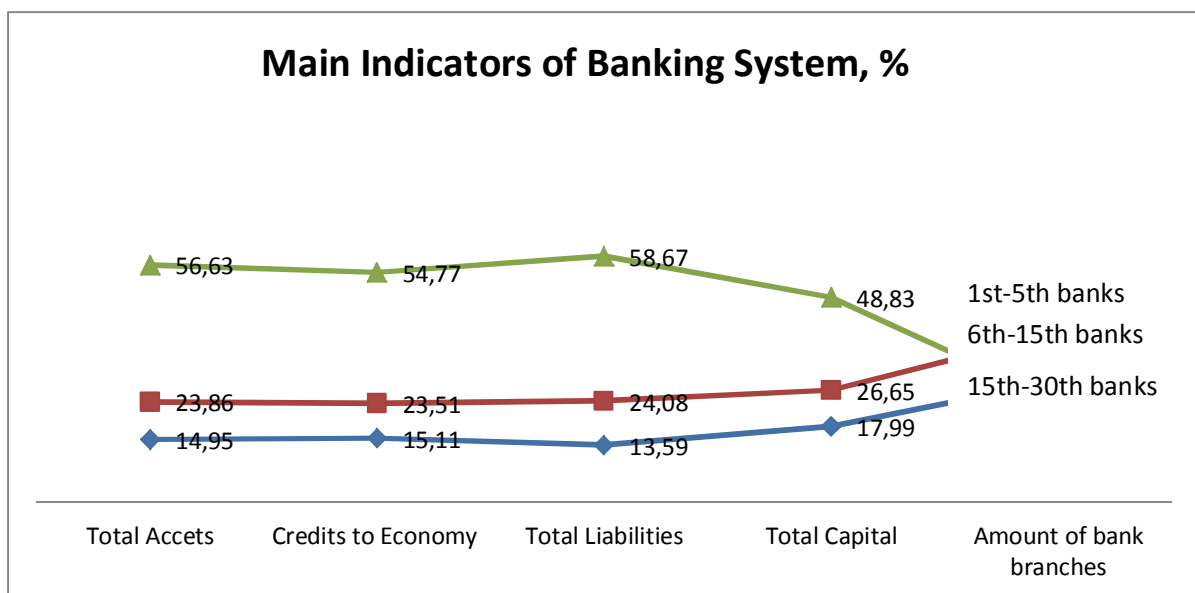


According to the Central Bank of the Republic of Azerbaijan(CBAR), “*Financial Results of Banking Activity*” quarterly review 01.07.2012.

The reliance of credit portfolio, which is a significant part of share of assets, will be doubt alongside with the special growth rate of credits. On the other hand, in comparison with interest rates, average level of interest rates on credits differs several times. On the background of decreasing profitability this brings the declining of rates of credits. Overall low international ranking level of most of the banks challenges their opportunities to attract resources with relevant interest rates. The chaining processes reflect on weakening of most banks with fragile finance under the burden of debt. In order to keep profitability and continue their activity, banks prefer to have high interest rate that put them under the high risk.

Created by high interest rate, this risk is observed with difficulties in turning back of credit burden in real sector. As a result, the rate of problematic credits increases and it also influences

on increasing of specific applicable weight of resources. As a solution it is suggested to estimate risk management more optimally and also to estimate the usage of credit in accordance to risk management, at the same time the capital base should be strengthened in order to establish an appropriate resources. Although there is no serious problems with the liquidity of banks; however, if current trends continue, the quality of assets will decrease rapidly and this may lead to hard preventive difficulties.



According to the Central Bank of the Republic of Azerbaijan, “Bank Income and Expenditure Framework” review, 01.07.2012.

[http://cbar.az/assets/2282/Banklar\\_n\\_g\\_lir\\_v\\_x\\_rcl\\_rinin\\_strukturu.pdf](http://cbar.az/assets/2282/Banklar_n_g_lir_v_x_rcl_rinin_strukturu.pdf)

If we focus on the overall performance of banks in the country, we will notice that these indicators form on results of the first 15, more precisely on the results of the first 5 banks. If we focus on the proportion of total bank assets, the proportion of credit in the economy, the proportion of liabilities and total equity per share, it will be obvious that the first 15 banks lead on each indicator by 80%. Taking into consideration only 2/3 of banks in accordance with their quantity, we will see that these indicators encompass at least 95%. In this case, the question is on which level can other 14 banks fulfill remaining 5 %? Of course, the banks which linger on their main function fall behind on from competitiveness. In particular, the weakness of structure can

negatively influence on active part of balance and decrease a special weight of credit. It is enough to observe the following structure in order to characterize above mentioned points.

### Grouping according to the amount of cumulative capital of banks

	Up to 3.5 mln.AZN		From 3.5 mln.AZN to 5mln.AZN-		From 5mln.AZN to 10 mln.AZN		From 10mln. AZN – up		Total amount of banks
	Amount	The share of total bank capital. In %	Amount	The share of total bank capital. In %	Amount	The share of total bank capital,%	Amount	The share of total bank capital, %	
12/31/2009	1	0.2	0	0	3	1.1	42	98.7	46
12/31/2010	0	0	1	0.5	2	0.9	42	98.9	45
12/31/2011	0	0	1	0.9	1	0.4	42	99.4	44
3/31/2012	0	0	1	0.10	1	0.3	42	99.5	44
6/30/2012	1	0	1	0.11	2	0.8	40	99.4	44

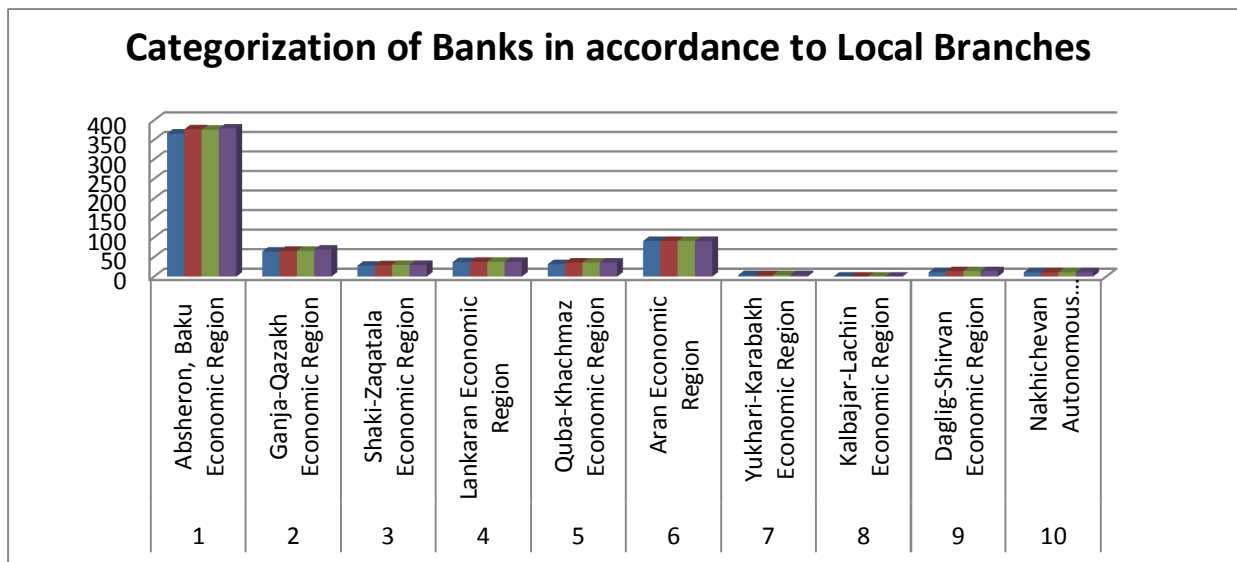
According to the Central Bank of the Republic of Azerbaijan

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Taking into account that credits encompass 65% of bank asserts, then the decrease of the probability can cause liquidity risks of the banks. What should be done in order to overcome these shortages? The solution for this question can be merging these types of banks or selling them to other banks, or continuing their activities without attempt to increase their capitals. This can be observed in the administrative policy of Central Bank. It is planning that the operating banks will have to increase their capitals to 50 million manat by January 2014. This is not real for many banks. Of course, merging various banks will strengthen capital basis, and it will help developing this sector. At the same time, it will be desirable factors if the banks develop institutionally, and if they merge on the basis of competitiveness, they will be able to follow the market rules. At this stage, it is more appropriate if this type of banks merge with other 10 medium level banks; otherwise, consolidated share capitals will be kept away from other mid-

level banks. This can reduce competitiveness of the mid-level banks. In comparison, banks should be developed on the regular basis. Leading on the region by their liability our banks should increase their sustainability in comparison with bank with foreign capital. Although the banks with foreign capital do not cause serious problems for current banking system, the situation can be changed in the future. Strengthening capacity of our banks today will increase their competitiveness with above mention types of banks

"The National Fund for Entrepreneurship Support" directs a portion of the budget to investment projects. However, only a limited number of small and mid-sized businesses. The following schedule is a good example of local banks inactivity.





According to the Central Bank of the Republic of Azerbaijan, quarterly review *01.07.2012*.

[http://cbar.az/assets/2283/Bank\\_yerli\\_filiallar\\_n\\_n\\_razi\\_bzr\\_t\\_snifat\\_.pdf](http://cbar.az/assets/2283/Bank_yerli_filiallar_n_n_razi_bzr_t_snifat_.pdf)

An important issue is the strategic plan on development of non-oil sector. The concentration of both manufacturing industry and financial sector in Absheron economic region led to concentration of population in Baku. The development of non-oil sector connects directly with the economic development of the regions. In this case, the government subsidies shouldn't direct to regions, yet vice versa the budget should be composed by the revenues from business activities operating in the regions. However, in order to achieve, investment of banks in regional real sector is very important. Currently, the opportunities of credits given to agrarian and private sector are limited. Basically, credits to these sectors are given with high interest rate by credit organizations. As a result, there is a growing gap between the incomes of population and the rate of interest rates.

In summary, paying significant attention to form of either social or demographic or economic values of resources is one of the important issues in future perspective.