WHAT IS HAPPENING IN THE BANKING SECTOR IN AZERBAIJAN?

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February, 13, 2014
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After closing the year of 2013 with a credit boom, the banking sector was unable to withstand the cold months of the current year: commercial banks almost halted all personal lines of credit. Despite the optimistic view of the Central Bank of Azerbaijan Republic regarding the general situation, the commercial banks have remained skeptical. After imposing loan restrictions, some of the banks even made a decision to close their operating branches. Certainly, it is not difficult to assess the situation: 73.5 per cent of all outstanding banking assets (20.4 billion AZN) with a total amount of 15.0 billion AZN are loans and this consequently has a restrictive impact on banking. An inability or unwillingness to lend makes it virtually impossible to run the main bank activities. As a result, this has a detrimental impact on the primary income of banks. The Banks involved in retail banking will suffer more if the status not going to be changed within a short period.

Prior to the last restrictions, it was clear that the situation regarding the loan interest rate was not decent in Azerbaijan. In CIS, Azerbaijan, Ukraine, and Belarus are the countries that offer the highest interest rates. Regardless of an increasing level of liquidity position of the banks of Azerbaijan and low interest rates on deposits, there was not observed any decrease in loan interest rates. Loan interest rates offered by commercial banks varied in the range of 16-34 percent, but the average interest rate on deposits fell to 8% from 16% in the last year. While it is not contested that interest rates are the main element of the restrictive measures of the CB, it has tried to review the general situation by taking a number of steps.

Naturally, the question arises: What is happening in the banking sector? Why did all banks make the decision to restrict consumer loans on the same day and mayhap at the same time?
Firstly, the aim of imposed restrictions is assumed to achieve targeted inflation rates in 2014. According to the Central Bank, restrictions on lending were not instructed; current rules do not actually give the Central Bank this right. However, it is unquestionable that any recommendations by the Central Bank are no less effective than real orders to commercial banks. In order to achieve price stability, the Central Bank will implement adequate anti-inflation tools as per the “Statement of the Central Bank of the Republic of Azerbaijan on main directions of the monetary and financial stability policy for 2014”.

Demand and expenses factors will be on target while implementing the anti-inflation policy. There will also be more emphasis on the reinforcement of empirical-based monetary regulations and the coordination between monetary and macroeconomic policy.

At the end of 2013, the CB considered regulative tools to be used due to the previous retail credit boom. The increase of energy prices at the end of last December economically is expected to affect the price of local goods in February and March this year.

In this regard, on the one hand increase in regulated prices, on the other hand rise in consumer loans are the main issues CB faces in achieving its goals. The single digit inflation is the priority for CB in terms of maintaining Bank’s Executive Boards position. However, increase in consumer loans calls into question this priority.

Furthermore, increase in circulation of currency is yet another limitation for sustaining inflation rate. As though money supply (M2 monetary aggregate) in the end of 2012 was more than 13.8 billion AZN, these numbers increased by 16% in 2013 and reached 16.4 billion AZN. The cash volume outside the banks was about 10.6 billion AZN in 2013. There
was 13% growth over the past year taking into account that M0 monetary aggregate had been 9.3 billion AZN in 2012. If we consider that M2 monetary aggregate is the main indicator for prediction of inflation, then it is not too hard to depict the real situation. At the same time, the ratio of cash in circulation to total monetary reserves was 93.6% according to 2013s’ reports. Thus, the official figures show that boom of previous years hinders the maintaining of inflation rate. Therefore, CB tries to limit the inflation rate and maintain money circulation by controlling money supply of banks.

Secondly, since there were 22% increase in assets of banking system and 25% in savings, CB is concerned about disproportion of existing balance by consumer loans. The loans in regions increased by 31%, whereby loans in private sector increased by 25% over the period. The share of long-term loans in the loan portfolio increased by 79 %. There was a high demand for consumer loans and these increased by nearly 37%. In practical terms, CB targeted direct control of consumer loans. CB noted in its policy that “The quality properties of the increase in banking sector will be assessed and diversification will be adjusted to general growth of economy”. In this context, the special attention will be given to risk analyses of individual credit options and to growth rate of consumer loans. Preventive regulation of consumer credit risk will be an important priority. In general, the role of banks' lending activity to ensure optimum economic cycle role will be appreciated. The attempts to preserve and improve the quality of formed portfolio will be strengthened. "Debt to income" ratio of loans and of the degree of the maximum of this ratio will be determined by the Central Bank. In fact, the CB's official announcement of monetary policy is trying to achieve the objectives of; the credit supply limit, reduce the number of retail customers. 38.6% of 14.9 billion AZN worth of loans is given by banks to consumer loans. Currently 400 AZN out of 1000 AZN is consumer loans. In this regard, the Central Bank advises not to give the consumer loans without
reference. For comparison, in developed countries, consumer credit and does not constitute more than 20% of the total loan. In this respect, the performance figures are large enough in the country given that 1.7 million citizen of Azerbaijan take loans from banks. Taking into account the fact that the distribution of consumer loans to banks by the principle pyramids, continuation of consumer lending retail banks by this way could be the foundation for a new level of the crisis.

Third, the Central Bank advised commercial banks to limit consumer loans, meanwhile to extend capacity of their business credits. According to the “Lending Rules in Banks” document, which is accepted in 2008 and made amendments in 2010, the CB prohibits to commercial banks to give credit to the customers without profitability. How contradictory this rule is for current legislation is another side of the problem, but the case is that, referring to this rule, the CB might direct banks to business loans. Observed increases in the volume of problematic loans also gives an opportunity to the CB to use this instrument. Again, if we consider the approved monetary and credit policy for 2014, it becomes obvious that this was among main goals of the the CB. The paper notes that, “adaptation of Basel-3 standards to local conditions will be ensured, formation of "counter-cyclical banking supervision" framework will be continued.

Within the framework of policies aimed at increasing financial depth, of the objectives of the adaptation of the bank's business model to the new strategic development, incentives for the reduction of interest rates will be enforced”. Attaining on increase of business loans, the CB tries to escape from "consumer crisis", also hopes for regulation of interest rates. On the other hand, according to the results of 2013, commercial banks, was able to give 1.52 billion manat whole credit amount to industrial and manufacturing sector, which is only 9.8 percent of the total loan portfolio and 733.3 million manat to the agriculture sector, which is 4.8 percent of the total loan portfolio. In fact, figures also show that last years, commercial banks were not
interested in financing the business. In this case, offer of business loans with lower interest rate compared to consumer loans, will bring an opportunity for the CB to create an impression of decrease on interest rates of bank loans. Of course, up to now, the CB linked high rate of loan to "market factor". As there were high profit rate in other sectors, so for banks it was not possible to decrease interest rates, in full.

Researches of the Center for Economic and Social Development show that in most cases, majority of real sector segments have close to 50 percent interest rate. In all cases, the high rate of profitability in the real sector, has led to banks’ high interest rates, in order to get higher profits. Obviously, rate of return in the real sector is clearly one of the key factors that dictate banks' interest rate policy. Unfortunately, in the current situation, this is expressed by the formation of the higher bank rates. But it must be accepted that the interest rate policy of banks operating in Azerbaijan are managed centrally: It also doesn’t create possible condition for the decrease of interest rates. Higher interest rates also were associated with some banks’ desire of making profit in the short term. In fact, mentioned bank tries to use administrative methods, and keep the market factor away. However, with that, the CB can also make break from criticism of the Parliament, and may achieve to decrease on portfolio interest rates. Thus, even though the CB trying to make seasonal structural changes in the banking sector, its target is to increase business loans over consumer loans.

Fourth, Central Bank is going to regulate process, bewaring of huge increase in amount of overdue loans. In according to the official report of the bank, overdue loans consist of 792.8 million AZN, on the other word 5.1% of portfolio in 2013.

Actually, the situation is not heartwarming: the amount of problematic loans is growing permanently and it will cause new default risk in banking sector. Obviously, the main reason
of increasing overdue loans was related to existing boom in consumption crediting market in recent 2 years. There was no doubt that, experiencing the banks with “overdue loan” issue was expected under distributing their plastic cards in the public places. Substituting short-term consumption credit with middle-term will give chance to Central Bank – to distracting all attention from “overdue loan” issue.

Fifth, crediting limitations also can be linked cooperative interests. This will be cause the substitution of existing players with new ones in retail banking. As result of those, “spoil players” will be dismissed from playground.

Sixth, using administrative ways Central Bank is trying to solve “failing bank” problem till the end of the year. By the end of 2013, the requests about rising minimum capital from 10 million AZN to 50 million AZN will be valid during the next year. In the last two years, The Central Bank, could not tackle the problems in joining of banks and changing status of banks, in 2014 it is going to get effective result “Game with strict rules” will give chance to Central Bank, transferring mentioned banks to ”obedient banks”.

Thus, the new era start in banking sector. In fact, the Central Bank should not only manage supply, in spite of this, it must regulate commission fees which have crucial impact on rising of loan rate and organize defining “price ceiling”.

Unfortunately, commission fee are the common used method by banks to attract more customers with “low interest rate” loans. Some commercial banks offer even 10-12 percent commission fee. The “interest trap” of bank sis just simple: banks announce the interest rate, on the other hand do not give any information about commission fee in advance. In addition
to all, Central Bank should expedite liberalizing in banking sector. There are artificial obstacles in entering to the banking sector. All of them do not give any chance to creating competition in banking sector and dropping interest rates. Actually, any international bank cannot operate in Azerbaijan Banking Sector on free base. So, this does not create sustainable competition atmosphere. Also, the opportunities of commercial banks on entering to centralized credit resources have been too widened.

4.75 interest rate of Central Bank is less than the interest rates of commercial 4 times. From economic point of view it is abnormal.

The amount of centralized credits of Central Bank equals to 7 percent of all collected loans by banks. It means that, banks attract 93% of resources from outside. From this approach, credit resources are becoming more expensive and interest rates are increasing due to more external financial resources.

Taking into consideration that the one of the main reason of real high interest rates in banks is the low international credit ranking of local banks, so importance of this issue is crucial. Low international credit ranking scores do not give chance to banks for directly applying to financial resources. Generally banks are displaying interest to get credit resources with mediators. This also directly affects to increase of rates. That is why, there will be additional administrative costs and fees, at the end of this rise total loan expenses. Therefore, with “cheap resources” Central Bank may achieve less credit expenses and interest rates. The gradual process of decreasing of interest rates of insured deposits has to been continued. High
deposit interest rates cause growth in loan interest rates. The main object is minimizing
deposit rates and restore interrelations between two rates.

For the present, not only customers, but also commercial banks think about one question:
When will crediting be renewed?

_The official exchange rate is 0.7880 manat to $1 on February, 13, 2014_