



Center for Analysis of  
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and Communication

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# AZERBAIJAN ECONOMIC REFORMS REVIEW





# THE STRATEGIC ROADMAP FOR DEVELOPMENT OF FINANCIAL SERVICES IN THE REPUBLIC OF AZERBAIJAN



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.

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.

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. The Strategic Roadmap for development of financial services contains the following strategic targets:

- **Establish a financial system comprised of dynamic and sound institutions.**

In order to overcome challenges associated with growing risks since 2015, this strategic target reflects 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.

- **Develop the financial markets**

Elimination of factors such as investors’ and issuers’ lack of information on capital markets and financial instruments, information asymmetry and traditional single ownership way of thinking, which restrict the development of securities market

- **Strengthen the infrastructure**

Improve the infrastructure, strategic objectives aimed at developing the system for the exchange of credit information, create effective mechanisms for the protection of creditors’ rights, standardize the judgments of courts and improve the enforcement discipline.

- **Improve regulation and control mechanisms**

Establish new regulation and control architecture that promote sound risk management process and digital transformation in the financial institutions have been determined.

- **Improve financial literacy**

In order to establish of a sound, reliable, sustainable and effective financial system, deepen the specialization of financial system specialists and at improve their financial literacy. 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.

### **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.

### **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.

### **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.

## **ANALYSIS OF CURRENT SITUATION**

### **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. Whereas the 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.

Important works were performed during that period with the aim of developing the financial markets infrastructure, and, in the meantime,

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. 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.

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.

## **SWOT analysis of financial services sector**

### **Strengths**

- 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.

### **Weaknesses**

- 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**

- 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.

### **Threats**

- Volatility in oil prices continue;
- Business activeness is not restored;



- Asset quality is worsened;
- The restructuring 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.

## **STRATEGIC VISION**

### **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.

### **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

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. 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.

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. 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.

### **Aspirational vision for post 2025**

Aspirational vision for post 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.

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.



- 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.

### **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.

## **STRATEGIC TARGETS**

The Strategic Roadmap for development of Financial Services in the Republic of Azerbaijan identified 5 strategic targets and appropriate priorities for each strategic targets. These targets are classified as follows:

### **Strategic target 1:**

- **Establish a financial system comprised of dynamic and sound institutions**
  - capitalization of the banks and ensuring its liquidity;
  - Prepare restructuring plan for non-performing assets.
  - development of the insurance market
  - strengthening of financial inclusiveness

### **Strategic target 2:**

- **Develop the financial markets**
  - Create favorable environment for emitters and financial intermediaries;
  - Increase access of investors to financial markets.
  - Increase active participation in inter-bank exchange market

### **Strategic target 3:**

- **Strengthen the infrastructure**
  - Improve infrastructure for the exchange of credit information;
  - Review legal framework, accelerate the process of adopting and enforcing court decisions

### **Strategic target 4:**

- **Improve regulation and control mechanisms**
  - Ensure sound risk management in banks;
  - Introduce consolidated risk-based control model in financial services sector
  - Improve regulation mechanism for acceleration of digital transformation in the financial institutions;
  - Increase transparency in financial services sector;
  - Regulate insurance activity and strengthen control mechanism over this activity

### **Strategic target 5:**

- **Improve financial literacy of financial market participants**
  - Improve knowledge and skills of financial sector specialists;
  - Increase financial literacy of consumers and strengthen the protection of their interests.

## 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.

## MONITORING AND EVALUATION

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.





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