



Support to the State Social Protection Fund on the introduction of funded element within the insurance-pension system, establishment of non-state pension funds and development of legal framework for regulating their activity
Twinning Project AZ/13/ENP/SO/24



ANNEX 1

Study report on demographical, economic, financial and capital market situation and social insurance system of Azerbaijan



September 2014

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Introduction

Report is drawn up within the framework of the Twinning Project AZ/13/ENP/SO/24 “Support to the State Social Protection Fund on the introduction of funded element within the insurance-pension system, establishment of non-state pension funds and development of legal framework for regulation their activity” by Latvian experts.

Report is designed specifically for achieving objectives of the project - to enhance capacity of the State Social Protection Fund to establish the regulatory, legal and administrative framework for the introduction of a funded element in the state insurance-pension system and the establishment of non-state pension funds.

Report contains description and evaluation of current demographical, economic situation, state social insurance system, financial and capital markets developments, supervision of financial and capital markets and assessment of gaps for successful funded pension system introduction in Azerbaijan.

1. Economic situation

The assessment of Azerbaijan's current economic situation is based on the analysis prepared by World Bank, International Monetary Fund, Asian Development Bank and Standard & Poor's rating services (see Appendices A-H) and expert analysis.

Azerbaijan's general economic situation remains favorable with relatively strong GDP growth, low inflation and falling unemployment rates. Exchange rate has been stable during the last few years while current account surplus has narrowed but still remains in significant surplus. Country's current fiscal position remains strong, with fiscal balance in surplus and single digit government debt level to GDP. According to Global Competitiveness Report 2013-2014 published by the World Economic Forum, Azerbaijan is ranked in 39 position out of 148 countries, well ahead its regional peers.

Country's de facto exchange rate regime is classified as stabilized arrangement and is the key anchor for monetary policy. Exchange rate system retains high degree of capital mobility with relatively little restrictions on payments and transfers for international transactions. The currency has appreciated by less than 2 percent since November 2010. Compared to other financial instruments, deposit rates remain relatively high, being, on average, 10 percent, but are gradually decreasing.

Country's economic growth is highly dependent on oil production and evolution of oil prices. Public expenditures, including investments are largely driven by oil-related revenues and transfers from the oil fund, that are estimated to account 2/3 of the budget revenues (according to FITCH). According to IMF, in an environment of high oil prices but with a relatively short oil production horizon, the overarching challenge for Azerbaijan remains bringing fiscal policy to a sustainable position while accelerating structural reforms to foster broad-based private sector-led growth. Besides other measures, IMF staff recommends fostering private sector-led growth in the non-oil sector by ensuring financial stability, promoting the deepening of financial markets, strengthening governance, and removing barriers to competition and trade.

IMF has identified 4 key risks to Azerbaijan's fiscal position:

1. Exposure to adverse oil sector developments
2. Implicit liabilities associated with pension obligations
3. Activities of the State Oil Company (SOCAR)
4. Activities of the systemic and largely state-owned bank (IBA)

According to IMF, the funding gap of liabilities inherited from the Soviet regime is projected to increase to 2% of GDP by 2024. The NPV of these liabilities through 2050 was estimated by an IMF technical assistance mission in the order of 54% of 2012 GDP.

According to World Bank estimates, share of people with formal contracts is estimated at 33%. Informal employment remains a problem with significant negative implications for the long term fiscal sustainability.

FITCH in its March 2014 country's assessment exercise has identified the main factors that individually or collectively could lead to rating action are as follows:

Positive	Negative
<ul style="list-style-type: none">• A longer track record of sound management of the public finances in a context of static oil revenues;	<ul style="list-style-type: none">• Rapid spending growth that would erode the country's fiscal strength in the medium term.

<p>further growth in sovereign assets.</p> <ul style="list-style-type: none"> • Diversification and development of the non-oil economy, improvements in the business environment and other structural indicators. 	<ul style="list-style-type: none"> • A prolonged period of low oil prices. • A domestic or regional geopolitical shock, such an escalation in hostilities over the disputed region of Nagorno Karabakh.
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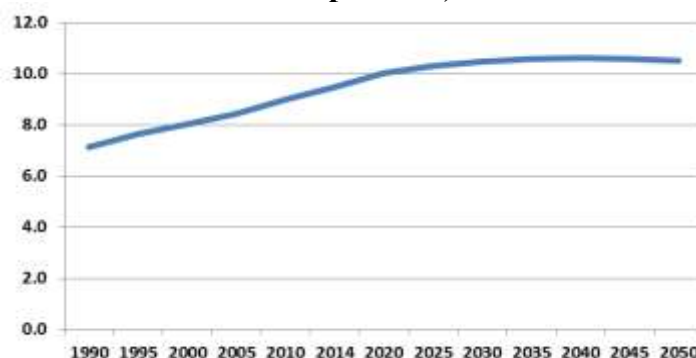
The Standard and Poor's (S&P) ratings services has affirmed its BBB-/A-3 long and short term sovereign credit ratings for Azerbaijan with a stable outlook. Stable outlook reflects the agency's view that Azerbaijan's general government net asset and external creditor positions are currently solid, despite some gradual weakening from the previous several years when country experienced rapid oil-related revenue growth. Agency expects modest slowdown in economic growth to about four percent in 2014-2017, due to stagnating oil production, gradual weakening of oil prices to about 103\$/barrel in 2015/2016, and decelerating growth rates in the non-oil sector. After a period of government surpluses, S&P anticipates a gradual deterioration in Azerbaijan's fiscal profile, with the general government fiscal balance posting modest deficits averaging about 1.5% of GDP in 2014-2017.

2. Demographic situation in Azerbaijan

An actual demographical situation in state, past and future tendencies of population dynamics directly influence a social and economic development in state, included of pension systems is highly important and makes timely to discover risks and opportunities for the future.

The actual demographic situation in Azerbaijan is favourable. The Azerbaijani population exceeded 9,5 million people on January 2014. In comparison with 1990 (7.1 million people) the number of population has grown by 2.4 million people. According to the UN projections for Azerbaijan¹ (the 2012 revision; medium scenario) the number of population will reach 10.6 million people in 2040 and will slowly start to shrink (chart 1).

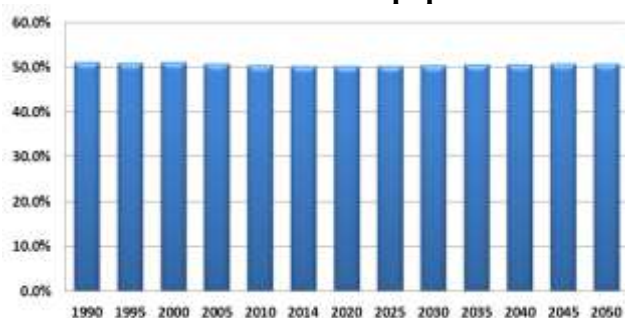
Chart 1: Population, million



Source: data until 2014 – internet site of the State Statistical Committee of the Republic of Azerbaijan; data 2015 to 2050: World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

About 53.2% of people in Azerbaijan live in urban areas, 46.8% - in rural areas. The current gender distribution of the population is almost equal. The women's share in the total number of population was 50.3%, the men's share - 49.7% (in the beginning of 2014). The UN projections show that population sex ratio almost stays stable in the longer term (chart 2).

Chart 2: Women's share in population



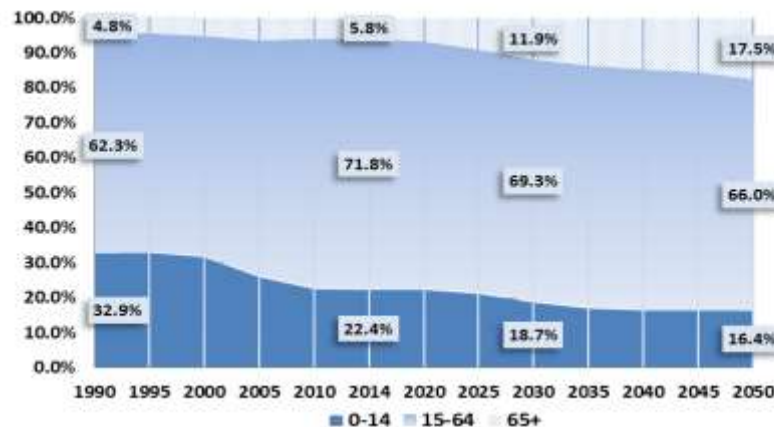
Source: data until 2014 – internet site of the State Statistical Committee of the Republic of Azerbaijan; data 2015 to 2050: World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

An age composition of the population is highly significant to the country's demography. The current population of Azerbaijan is quite young. Over the time period from 1990 to 2012 the share of working age population (15-64) increased

¹ World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

rapidly and reached the peak – 72% of the total population. From 2012 the share started to decrease and under UN projections a fall in working population to 69.3% in 2030 and to 66% in 2050 is expected. The share of older people (65+) changed marginally from 4.8% in 1990 to 5.8% in 2014 though in the long term the share of them will rise significantly and will reach 17.5% of the total number of population in 2050. According to the actual figures the share of children (0-14) of the total population has decreased from 32.9% in 1990 to 22.4% in the beginning of 2014 and under the UN projections the share will continue falling to 16.4% in 2050 (chart 3).

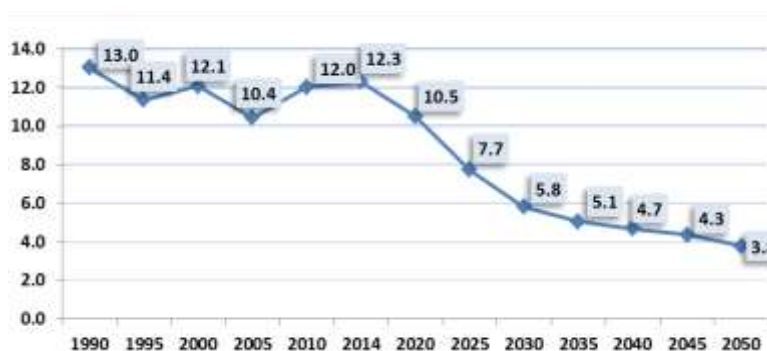
Chart 3: Age structure



Source: data until 2014 – internet site of the State Statistical Committee of the Republic of Azerbaijan; data 2015 to 2050: World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

Significant changes in dependency ratio are a result of changes in age structures. After a fluctuation period sharp changes are expected in old age dependency ratio. There were 12.3 persons in working age (15-64) per one person age 65+ in 2014, but only 3.8 working age persons per one old person are projected in 2050 (chart 4).

Chart 4: Number of persons age 15-64 per one person age 65+, persons



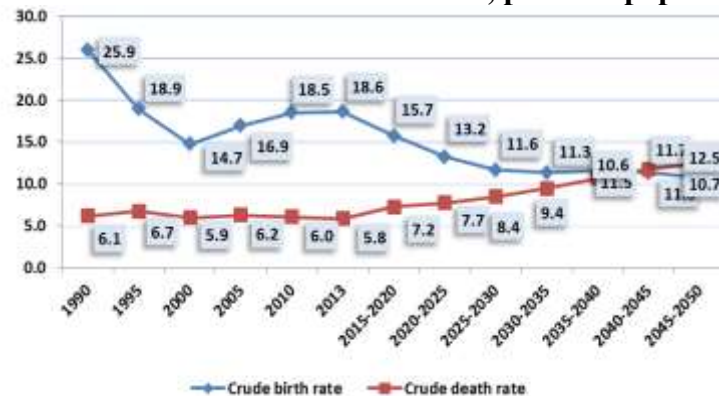
Source: data until 2014 – calculations used data from internet site of the State Statistical Committee of the Republic of Azerbaijan; data 2015 to 2050: calculations used from the World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

Azerbaijan has historically a high birth rate – number of birth per thousand people was 35.9 in 1960. Since 1960 the crude birth rate started to decline and fell to 25.9 in 1990 and this trend continued until about 2003 and then began to rise again. In 2013, the crude birth rate was 18.6 per thousand.

The death rate has remained almost without changes. A small increase was from 1992 to 1994 when the mortality rate was 7.1-7.3 per thousand, mostly due to the Karabakh war, but then began to fall again. In 2013, the number of deaths per thousand people was 5.8.

According to the UN projections the crude birth rate will decline sharply from 18.6 in 2013 to 11.6 per thousand in 2025-2030 and to 10.7 in 2045-2050, whereas death rate will increase and reach 12.5 per thousand in 2045-2050. Changes to the birth and death rates reflect in population development. A negative natural crude rate will be expected from 2040-2045 (chart 5).

Chart 5: Crude birth rate and crude death rate, per thsd population



Source: data until 2013 – internet site of the State Statistical Committee of the Republic of Azerbaijan; data 2015 to 2050: World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

Accordingly, a total fertility rate declined from 5.5 in 1965 to 2.8 in 1990 and to 1.8 in 2002. For the following nine years the total fertility rate increased, but from 2011 it began to decrease. In 2013 the total fertility rate was 2.2. Under the UN projections a decrease in next years of projection until 2030-2035 is expected. Afterwards a total fertility rate remains almost stable (chart 6).

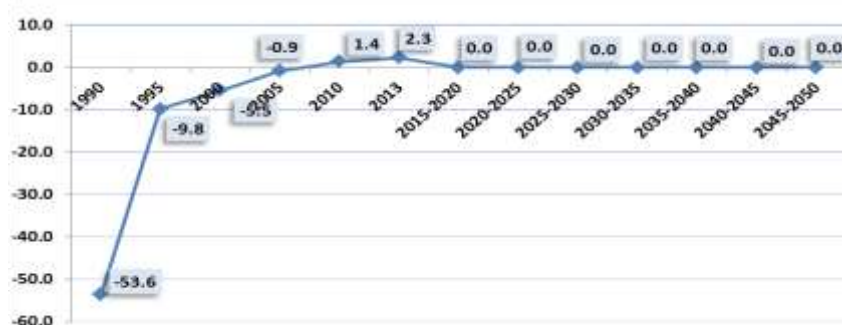
Chart 6: Total fertility rate



Source: data until 2013 – internet site of the State Statistical Committee of the Republic of Azerbaijan; data 2015 to 2050: World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

The most significant changes in international migration in Azerbaijan are related to the collapse of the Soviet Union, in the early years of independence – 1990th. A number of emigration and immigration increased substantially. According to the UN projections zero net migration is used for future calculations of number of population (chart 7).

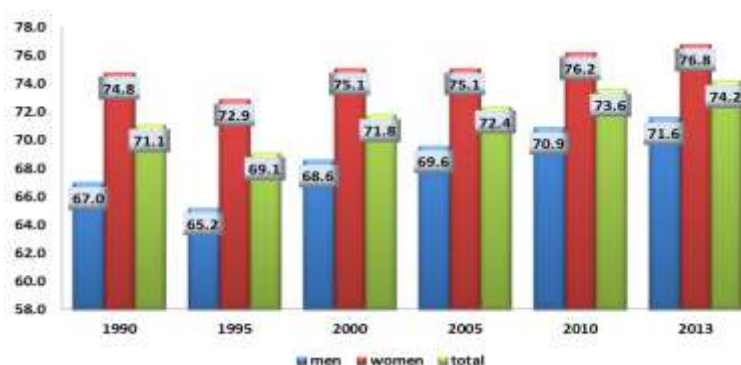
Chart 7: Net international migration, thousand persons



Source: data until 2013 – internet site of the State Statistical Committee of the Republic of Azerbaijan; data 2015 to 2050: World Population Prospects: The 2012 Revision, medium scenario, <http://esa.un.org/unpd/wpp/index.htm>

Life expectancy has been constantly growing and in 2013 reached 74.2 years on average: 71.6 for men and 76.8 for women (chart 8). According to the UN projections for Azerbaijan (the 2012 revision; medium scenario) life expectancy at birth on average will reach 74.5 years in 2045-2050. A higher figure was projected by the UN 2010 revision, where life expectancy will reach 76.7 years in 2050².

Chart 8: Life expectancy from birth, in years



Source: data until 2013 – internet site of the State Statistical Committee of the Republic of Azerbaijan

² Social Protection and Social Inclusion in Azerbaijan (2011), European Commission; Directorate-General for Employment, Social Affairs and Inclusion (completed in 2011 - U.N. Population Projections for Azerbaijan (Medium Variant Scenario) 2010.

3. Social insurance system

3.1. Reforms, projects and legislation. Reducing poverty among elderly people and providing compensation of incomes lost as a result of old-age, disability and other cases, social insurance - pension system has been implemented. In 2001 the government adopted a reform concept regarding to the pension system's financial sustainability, strengthening links between social insurance contributions and pensions/benefits, improving transparency and access to information for taxpayers and beneficiaries, and reducing incentives for avoiding of contributions payments. The social insurance - pension system functions on the basis of three laws – “On Social Insurance”, “On personal accounting in state social insurance system” and “On Labour Pensions”.

In 2003-2004 agreements were concluded with UNDP on the joint “Capacity Building for the State Social Protection Fund” project, and then with the World Bank for the “Pension and Social Assistance” project. These projects worked to significantly increase the Social State Protection Fund's (SSPF) managerial capacity by introducing e-governance instruments, in order to automate payments and data processing, to improve transparency and access to information (for beneficiaries and the general public) and to improve the flow of information between the SSPF's head office and local branches³.

3.2. Administration. Administratively, the functions of the social protection system in Azerbaijan are divided between two entities: the Ministry of Labour and Social Protection of Population and the SSPF. The SSPF of Azerbaijan Republic (SSPF) was established in 1992 on the basis of the Pension Fund of Azerbaijan Republic and the Social Insurance Fund of Azerbaijan Republic. Though the SSPF is not a ministry, it has a ministry-like structure and has ministerial functions. The SSPF has the following (administrative) structure: a central office, an office for the Nakhchivan Autonomous Republic, 3 departments and 75 city (district) branches. About 2,616 civil servants are employed with the fund. The head of the SSPF is appointed by the president of Azerbaijan. The main duties of SSPF are: (1) to work out proposals on the state policy in the area of social insurance and labour pension and implementation of this policy; (2) to collect of mandatory state social insurance contributions; (3) to ensure financing of expenses from SSPF budget (including labour pensions); (4) to ensure personal accounting system. The budget of SSPF is determined separately from the budget of other ministries and it is approved by parliament and signed into the law by the president. The Ministry of Labour and Social Protection is responsible for disability pensions, targeted social assistance, social allowances, occupational injuries and funeral benefits among others.

3.3. Personal accounting system. Personal accounting system has been established in mandatory state social insurance area. The individual account with the permanent social insurance number is opened by the SSPF in the accounting period for every insured person. For each account SSPF has issued electronically plastic card which can be used for information of contributions paid into individual account and gives opportunity to control fiscal discipline of employer regarding to state social contributions payments. Each insured person receives annual report reflecting

³ Implementation Completion and Report (IDA-39230) on a Credit in the amount of SDR 6.8 million (US\$10 million equivalent) to the Azerbaijan Republic for a Pension and Social Assistance Project, November 15, 2011

relevant data on personal account. Contributions accounted on individual accounts are not separated from state budget cash flow and money is used to provide pension benefit payments to existing pensioners.

Individual accounts and accessibility of personal data of social insurance contributions in these accounts: (1) increases population awareness on state social insurance system and personal responsibility; (2) would help diminish shadow economy impact in country. The number of contributors has increased from 1.1 million in 2007 to 2.3 million in 2013 or 47.6% from economically active population in Azerbaijan is covered by pension insurance. However, undeclared taxable persons exist as well: (1) most of them produce agriculture goods mainly for family consumption and there is not much income to declare which may be taxed; (2) employers choose to save their expenditure and not to declare their employees and do not pay labour force taxes. The Government losses of fiscal revenues but peoples stay without or with small cover of social insurance system.

3.4. Social insurance financing. Financing of the state social insurance – pension system is based on following main elements: (1) all officially registered employers, employees, farmers, self-employed persons are subject under state social insurance system; (2) social insurance contributions object is all types of labour payment and incomes (with some exceptions); (3) general social insurance contributions are 25% of gross labour payment (employers pays 22%, employees – 3%); (4) social insurance contributions object and contribution rate is reduced for some categories (like as farmers, self-employed persons - not exceeding 12% of the minimum wage); (5) SSPF provides following expenditures: labour pensions, health care, temporary disability (illness), maternity leave, unemployment benefits and others.

Reforms has been supporting instrument for stability of social insurance - pension system. Social insurance contributions collection increased 2.3 times in 2013 compared with 2007. Although SSPF budget is set on a separate budget status (non-budget funds), current state social insurance contributions (25% from gross salary) cannot cover all expenditures necessary for social protection needs. There is a high imbalance between necessity payments for labour pensions (95.2% from total SSPF budget expenditures in 2014) and registered social contributions for pensions (12.5% of gross incomes). Incomes of SSPF is approved in the amount of 2 928.5 mill AZN, expenditures - 2 928.5 million AZN for 2014. Expenditures for labour pensions - 2 788,6 million AZN or 95% of total budget expenditures. Total expenditures increased by 11.2% and labour pensions expenditures – by 11.5% in 2014 compared with 2013. Half (or 50%) of total contributions (12.5% from gross salary) are accounted for social insurance pensions on individual accounts from 2006. Mandatory state social insurance contributions provide only 61% of all necessary expenditures in 2014 (59% -2013). There are high dependency from the state budget dotation for financing of social insurance system – 39% in 2014 and 41% in 2013. More than 50 % are redirected for non-insured pension – basic part of labour pension – expenditures. SSPF budget is not operating on self-financing system without the state budget dotation.

3.5. Pension system. Azerbaijan's pension system has gone through significant changes since 2006. The new pension system is based on social insurance principles and consist on three parts – basic, insurance and saving part:

(1) The basic part of old age labour pension - a minimum level of pensioners income – available to all individuals who qualify by having completed minimum years of

service and age requirements. The amount of basic part has gradually increased from 35 AZN in 2006 up to 100 AZN in 2014⁴. According to the law “On Labour Pensions” there are several categories⁵ whom the supplement (the amount of supplement ranges from 200 AZN to 10% of basic part of old age labour pension) to the basic part of labour pension is provided, as well as the supplement to labour pension for service record is guaranteed to a number of labour pensioners⁶. This supplement is calculated considering person`s average monthly salary particular cases reaching a replacement rate of 80% of previous income.

(2) The insurance part of labour pension – like as Notional Defined Contribution (NDC) scheme - notional account is taken all individual contributions since 2006 and adds 170 AZN per year of service prior to 2006 and divides the total by the life expectancy at retirement (constant - 144 months or 12 years). The indicator in respect of time period, during which old-age labour pension disbursement is planned, starting from the pension granting year, is fixed number regardless of the retirement age (the same indicator at the age of 55 or at the age of 63). Growing life expectancy and thereby higher numbers of months really needed for pension payments could promote financial problems of the system. Since the social insurance pension system has been established, the amount of insurance part is gradually increased from 24.4 AZN in 2009 up to 68.5 AZN in 2013. It is still lower than the basic part of labour pension.

(3) The saving part of labour pension - to encourage additional individual savings through private pension funds and should provide annuity payments at retirement. This part of the pension system has not been implemented.

Gradual increase (by 6 months every year from January 1, 2010) in the retirement age was carried out in Azerbaijan both for men and women in order to reach 63 years for men in January 1, 2012 and 60 years for women in in January 1, 2016. In 2014 old-age labour pension right is provided to men at age of 63 years and women at the age of 59, with minimum social insurance record 12 years. Besides, there are several categories eligible to the lower retirement age.

3.6. Future challenges. To continue the reforms, the Government would have to address emerging concerns about the long-term fiscal sustainability of the pension system. On November 29, 2012, President Ilham Aliyev issued a decree requesting the Cabinet of Ministers to prepare a Pension System Development Strategy for Azerbaijan. As a result of the joint effort of the State Social Protection Fund, the Ministry of Finance, and other government agencies, a Draft Concept of the Strategy was prepared.

⁴ State Statistical Committee of the Republic of Azerbaijan, available: <http://www.stat.gov.az/source/healthcare/indexen.php>

⁵ family members of national Heroes of Azerbaijan, family members of martyrs, for persons with I and II group disability, unemployed labour pensioners with scientific degree and etc.

⁶ Former deputies, civil servants, military servants, judges, employees of different authorities and etc.

4. Financial Markets and capital Markets

The assessment of Azerbaijan's financial markets is based on the analysis prepared by World Bank, Asian Development Bank (see Appendixes C, D, F) and expert analysis.

Securities markets are still small in Azerbaijan, but increasingly contribute to capital mobilization. The basic market infrastructure has been in place for more than a decade, although it was initially designed to support the privatization of state-owned enterprises. The State Committee for Securities (SCS) under the president of Azerbaijan is the regulatory body. Trading takes place at the Baku Stock Exchange (BSE) and over the counter (OTC). There are 13 broker-dealers, 2 registrars, and 3 depositories. The National Depository Center, which mainly serves the BSE, partly integrated its systems with the BSE in 2009 (see appendix F). There are 3 life insurance companies.

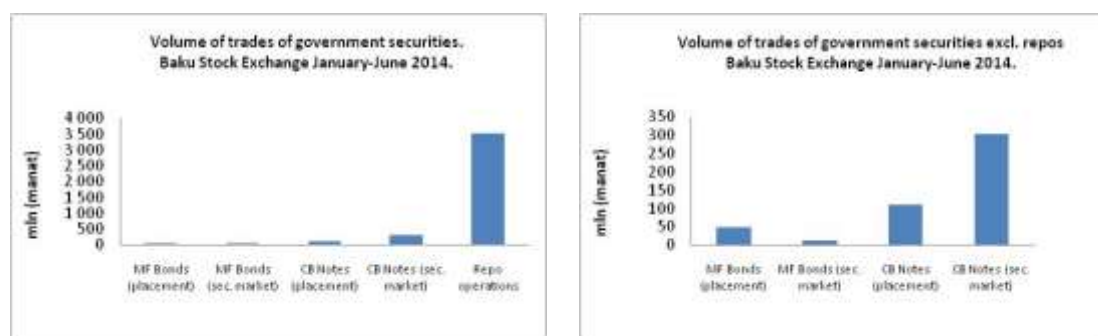
The BSE organizes trades in company shares (equity), corporate bonds, treasury bills and bonds, and Central Bank of Azerbaijan notes; no derivatives are traded. It also engages in clearing, information services, and consulting, and has a tailor-made online trading system with remote access.

According to Financial sector assessment performed by Asian Development Bank, the pool of enterprises that could issue securities in Azerbaijan is not small. Out of a total of more than 80,000 enterprises, about 1,200 are joint stock companies with more than 20 shareholders. About 250 of them have more than 100 shareholders. Many larger companies are still state owned and have alternative sources of funding. The government has also not yet started to list state-owned enterprises and there are few incentives for private companies to list; only one company is now listed on the BSE.

Capital markets are dominated by government or quasi-government securities and corporate bonds, with stock market capitalization ratios remaining very low. Investment fund market is not developed.

Private savings market is dominated by bank deposits that yield significantly more than other fixed income instruments. Stock market has only one listed security while most of the share trading is happening in the unlisted non-regulated market.

Chart 9

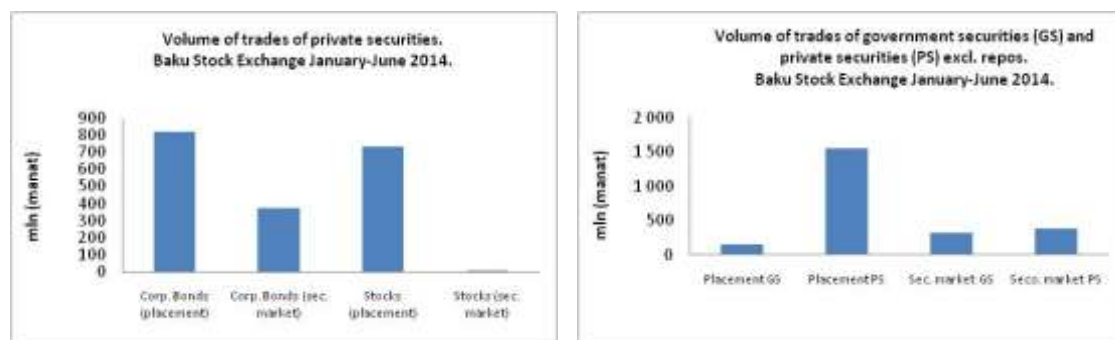


Source: Baku Stock Exchange.

Volumes of trade of government securities is dominated by repo transactions (chart 9). Placement of central bank notes has exceeded Ministry of Finance bond placement during H1 of 2014 while the secondary market trading has been significantly more active in central bank notes. In terms of amount outstanding on March 2014, T-bills were totaling 159.4 million AZN (739 terms to maturity) while Central Bank notes

totalled 90 million AZN (9 days to maturity).

Chart 10



Source: Baku Stock Exchange.

In private market securities, corporate bond placement was similar to that of stock placement while corporate bond liquidity in the secondary market was significantly higher (chart 10). Overall, placement of private securities (PS) is significantly higher than government securities (GS) while in terms of secondary market liquidity it is approximately the same. Due to favorable budget situation, issue of government securities has been relatively limited; however, situation could change during next few years as budget balances start to deteriorate.

Azerbaijan's mortgage fund is country's largest issuer - 8 securities issues with the volume of issues totaling 340 million AZN. Maturity varies from 7 to 10 years, with yield to maturity (YTM) for most of the issues standing at 3%. Such relatively low interest rate is achieved by Central Bank ensuring full liquidity of the issues at the fixed yield to maturity levels. As a result, mortgage issues are used for short term liquidity needs of financial institutions. Term structure risk is, essentially, taken by the Central Bank. Remaining maturity ranges from May 2016 to December 2023. Main investors are local banks.

Government securities and the securities of the mortgage fund are rated BBB- while most of the domestic corporate issues are not rated by international rating agencies.

In February 2012, the State Oil Company of Azerbaijan realized its first corporate bond offering, the main purpose of which was for financing of capital investment. SOCAR has two bonds, one maturing in 2017, and a second in 2023. Yields are approximately 3.4% for the 2017 paper, and 5.5% for the bond maturing in 2023.

In March 2014, Azerbaijan issued its benchmark 1.25 million dollar Eurobond issue with the yield of 5% and maturity of 10 years. U.S. investors purchased 47% of sovereign Eurobonds of Azerbaijan, from Great Britain - 25%, Germany - 18%, and the remaining 10% were purchased by buyers from other countries, including Singapore and Israel.⁷ The issue was oversubscribed, with demand for four billion.

International Bank of Azerbaijan (IBA), SOCAR, Access Bank, Baghlan Group, Azerbaijan State Railways and VG Microfinance Invest have had international bond issues since 2007. Maturity dates range from 2014 to 2023 for SOCAR. Issue volumes ranged from 10 million dollar for Access Bank to 500 million dollar for IBA.

IOSCO (Corporate bond markets: A global perspective, February 2014) ranked

⁷ <http://en.trend.az/business/finance/2252327.html>

Azerbaijan's bond market activity in the 42nd place out of 64 countries with activity in 2013 estimated at 1.33% of GDP.

Alternative investment markets, like private equity and venture capital, is not developed in Azerbaijan. There could be significant potential in the development of infrastructure and real estate financing, given the rapid growth in the segment and potential for financing.

New legislation on securities will bring about significant changes in the financial system and operations of the market institutions.

5. Personal Savings Market Development

This chapter aims to analyze the possibilities of the accumulation and mobilization of savings and their role in the economic development of the Republic of Azerbaijan. Currently, the national economic growth of Azerbaijan is mostly based on the resource components; crude oil, natural gas and oil products. For the development of the non-oil sector the mobilization of domestic savings into investments would prove very useful. Savings of people should be the most important investment resource for the development of the non-oil sector, as the foreign capital is mostly involved in production of natural resources like oil and gas. The mobilization of domestic savings is crucial for raising the economic growth and promoting development, as it is the private savings that affect the domestic investments significantly. The most of the savings are made when they are fully channeled into the productive investments. As a result, this will lead to the solution of problems of employment and economic growth.

As it is known, in the long run the level of investments in national economy closely correlates with the level of national savings. Population's savings are an integral part of the economic system and contribute to the future economic development. These savings can be the most important investment resource for the development of the real sector, because foreign capital is mostly invested in production of natural resources like oil and gas. It is of vital importance for the state to mobilize the savings of the people into the economy. The state will be less dependent on foreign investments and the domestic investments accumulated due to the savings will provide better stability of the country. This could contribute to the economic growth and development.

For maintaining a stable growth rate of the economy of Azerbaijan it will be necessary to increase the investments by means of domestic resources. Savings attracted from population in Azerbaijan is developing very slowly due to quite weak banking system and on 2013 the ratio of savings attracted from population and the GDP in Azerbaijan is close to 11% (regarding to State Statistical Committee data), which is not considered to be an optimal level, taking into account, that all savings of population are short term. There is no pension savings and long-term life insurance savings still in the economy.

Table 1 – Savings attracted from population (mln.AZN)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Savings attracted from population	79.3	117.0	153.4	251.9	403.1	495	820	1468.4	1905.3	2334.9	3029.8	4,119.8	5,113.4	6,395.8
of which:														
national currency	11.8	12.0	13.5	18.9	30.1	56	250	676	1036.7	966	1,410.00	2,281.7	2,963.9	3,888.3
foreign currency	67.5	105.0	139.9	233.0	373.0	439	569	792	868.6	1 369.3	1 619.8	1,838.1	2,149.5	2,507.5
Increasing of savings, in per cent	153.0	147.5	131.0	164.2	160.0	122.6	165.7	179.1	129.7	122.5	129.8	135.9	124.1	125.1
Gross domestic product-total	4718.1	5315.6	6062.5	7146.5	8530.2	12522.5	18746.2	28360.5	40137.2	35601.5	42465.0	52082.0	54743.7	57708.2
Savings to GDP, per cent	2%	2%	3%	4%	5%	4%	4%	5%	5%	7%	7%	8%	9%	11%

Source: State Statistical Committee

Bank deposits are the main attractive savings instrument for population and deposit rates are attractive also – 1 year deposit rate 9% p.a. Up to 30 000 AZN deposit is guaranteed by state guaranty mechanism with deposit rate no higher than 9% p.a. It means that through state guaranty system for deposits, deposit rates are regulated by the state and not by banking competition.

International Bank of Azerbaijan in the beginning of 2014 has introduced new long term deposit product “Pension”, so called, Pension Deposit to provide long term saving opportunities to customers. As a pilot project this product has been introduced only for employees of the International Bank of Azerbaijan (aprox. 1500 employees), not to bank customers. Pension deposit has minimal term of 15 years with guaranteed

rate of 8,4% p.a. with condition, if interest rate is changed, then customer can withdraw savings before term. There are 3 options for payout phase of Pension deposit – 1) lump sum; 2) regular benefits; 3) interest payments for life. Minimal sum for starting savings is 5 AZN. There is some insurance mechanism of pension deposit savings. There are no tax advantages for such long-term savings product.

Other financial instruments are not used for savings and investments of private persons due to high deposit rates and lack of competition with equity markets.

Economic growth in Azerbaijan has been reflected to a considerable extent in the household budgets of every citizen. Thus, in a three-month-period in 2014 the incomes of the population have risen by 4.5%, whereas inflation only rose 2%. In the first quarter, moreover, the average wage went up almost 7% and reached a level of 430 AZN. This has led to a growth in citizens' savings, with the amount in the population's bank accounts rising more than 20%. In these circumstances the need has arisen for new types of investments and boosting incomes. One of the attractive offers may be a life insurance policy with a savings' plan.⁸ Introduction of mandatory funded state pension schemes or private pension savings would be an option to consolidate personal savings in state economy.

Although the changes in the legislation aimed at developing the life insurance market and at life-insurance related tax concessions were introduced a few years ago, it was not until last year that this type of insurance began to become especially popular. But 2013 became a turning point for life insurance, first and foremost for life insurance policies with savings' plans. In 2013, the insurance premium for this type of insurance amounted to 37.7 million. AZN and had gone up 3.1 times compared to 2012. To get personal income tax and social contribution advantages for savings in life insurance policy, there is request of minimum term of life-policy, respectively 3 years period.

This tendency continued in the first quarter of 2014. Premiums for life insurance policies with savings' plans amounted to 17.6m AZN or approximately 15% of all insurance premiums and had increased by 57.8 per cent compared with January-March 2013. It should be noted that in the first quarter of 2014 it was life insurance policies with savings' plans that manifested the highest growth rate. So, in the period under review, the total amount of insurance premiums collected by insurance brokers increased by 15.3%.

The development of an institution of nonbanking financial intermediaries in Azerbaijan could also be a positive factor for the accumulation and the mobilization of savings of population. These institutions are indispensable suppliers of loan capital. Specialized nonbanking institutions unlike banks accumulate financial savings for sufficiently long periods and therefore can make long-term investments. The main forms of activities of these institutions are accumulation of savings of people, granting credits by means of issuing bonds, mobilization of capital and granting mortgage and consumer loans. Expansion of the nonbanking segment of the financial market by way of introducing new financial instruments will stir up investment activities of people. As we know, strong financial system promotes the transformation of savings into investments.

Due to lack of trust to financial sector and high need for accumulating long-term

⁸ <http://regionplus.az/en/articles/view/2264>

savings in economy, there would be social and financial stimulus needed with state guaranties to promote pension and long-term life insurance savings development in Azerbaijan.

6. Supervision of the financial and capital markets

The State Program on Poverty Reduction and Sustainable Development of the Republic of Azerbaijan for 2008–2015 (Poverty Reduction Program) identifies the banking, insurance, and securities markets as priority areas for financial market development. Financial sector reforms in recent years have closely followed the objectives outlined in the Poverty Reduction Program, despite the distraction of the global crisis and its impact.

There is no single competent authority responsible for joint supervision of the financial markets participants. Instead there is sectorial division of the supervisory duties. Currently there are three separate competent authorities performing supervision activities:

- Banking supervision is performed by Central Bank of the Republic of Azerbaijan (CBA)
- Securities markets participants are supervised by State Committee for Securities (SCS)
- Insurance supervision is done by State Insurance Supervision Service (SISS)

6.1. Supervision on commercial banks

Banking sector is dominating in financial markets providing most volume of the financial services. Financial services provided by banks are mostly focusing on serving corporate and individual clients on their daily activities. Private banking, brokerage and asset management services are not developed. As a result also custody service being one of the cornerstones for successful asset management is considered to be highly underdeveloped.

CBA is responsible for licensing and supervising of the commercial banks. There are following 43 commercial banks under CBA supervision:

«Accessbank» JSC», «AFB BANK» JSC», «Amrahbank» Joint-Stock Bank JSC», «AtaBank» JSC», «Atrabank» JSC», «International Bank of Azerbaijan» JSC», «Azerbaijan Credit Bank» JSC», «Azerbaijan Industrial Bank» JSC», «Azerigazbank» JSC», «Azer-Turk Bank» JSC», «EuroAsia Bank» JSC», «Bank of Baku» JSC», «Bank of Azerbaijan» JSC», «Bank BTB» JSC», «Bank Respublika» JSC», «Bank Silk Way» JSC», «Bank Standard» Commercial Bank QSC», «Bank VTB (Azerbaijan)» JSC», «Dekabank» Commercial Bank JSC», «Demirbank» JSC», «Expressbank» JSC», «EuroBank» JSC», «Ganja Bank» SKB», «Gunaybank», «Xalq Bank» JSC», «Kapital Bank» JSC», «Kredobank» JSC», «Caucasus Development Bank» JSC», «Milli Iran Bank» Baku branch», «Muganbank» JSC», «Nakhchivanbank» JSC», «NBCBank» JSC», «Nikoil» Investment Commercial Bank JSC», «Parabank» JSC», «Pasha Bank» JSC», «Rabitabank» JSC», «RoyalBank» JSC», «Bank Technique» JSC», «Turanbank» JSC», «Unibank» Commercial Bank JSC», «Yapi Kredit Bank Azerbaijan» QSC», «Yunayted Kredit Bank» JSC», «Zaminbank» JSC».

Most of Azerbaijan's banks are small. The exception is the remaining state-owned bank, International Bank of Azerbaijan, which still accounts approximately 30% of banking sector assets.

According to CBA data⁹ the total assets of banks in Azerbaijan amounted to 14.78

⁹ (<http://en.trend.az/azerbaijan/2055202.html>)

billion AZN as of July 1, 2012 increasing by 12.48% compared to the beginning of the year. According to the CBA, the country's top five banks have total assets at 8.37 billion AZN, or 56.63% of total banking assets and 58.67% (7.4 billion AZN) of the total market liabilities. The share of banks occupying 6-15 positions accounts for 3.53 billion AZN assets (23.86%), 3.02 billion AZN obligations (24.08%), and 0.56 billion AZN of total capital (26.65%). The share of banks that ranks above the 31th, account for only 4.57% of total assets (675.51 million AZN), 3.66% of liabilities (459.38 million AZN), 6.54% of total capital (136.3 million AZN). Crediting of the country's economy by 5 top banks accounts for 5.672 billion AZN (54.77% of total credit investments) compared to 2.642 billion AZN (25.51%) by 6-15th banks in the country, 1.565 billion AZN (15.11%) by 16-30th banks, while the share of banks that are located from 31 to 43rd place accounts for 476.56 million AZN (4.6%).

Several financial indicators of the banking system excluding the largely state owned International Bank of Azerbaijan (IBA) improved in 2013. The capital ratio increased to 21.6% boosted by a fivefold increase in banks' minimum regulatory capital requirement. Though liquidity declined, bank profitability also improved on the back of the recent consumer-lending boom. Disclosed nonperforming loans (NPLs) as a percentage of total loans decreased slightly to 4.5%, despite the rapid increase in consumer loans, reflecting the write-off of fully provisioned loans (Table 2). NPL figures, though, only include the overdue portion of principal and interest, suggesting that NPLs are higher. Recent changes in the regulatory framework of the banking system include measures to tighten consumer loans and strengthen the provisioning rules and requirements for the accurate classification of NPLs. The CBA also extended the deadline on the new capital requirements until January 1, 2015, giving some banks (comprising about 8% of total banking system assets) more time to fulfill this requirement. The largest bank, IBA, is in compliance with the capital adequacy ratio. But as the financial position of IBA remains fragile, the shareholders' assembly decided to increase the bank's statutory capital over the next four years, even in the absence of clear plans for the restructuring of the bank. This increase will bring an additional burden of about \$300 million (about 0.5% of GDP) on the government, which may double if the other (private) shareholders do not participate in the increase.

Table 2

Azerbaijan: Banking Sector Excluding IBA—Financial Soundness
(In percent)

	2011	2012	2013
1. Regulatory Capital to Risk-Weighted Assets	21.0	19.9	21.6
2. Liquid Assets to Total Assets	17.4	15.0	13.2
3. Nonperforming Loans to Total Loans ^{1/}	5.4	5.6	4.5
4. Bank Return on Assets	1.3	0.7	2.0
5. Bank Return on Equity	7.7	4.9	11.4

Source: Central Bank of Azerbaijan.

1/ Disclosed NPLs are somewhat underestimated, as only the overdue portion of principal and interest is disclosed as NPL.

Developing the banking system requires measures by the CBA to increase competition in the banking sector. The ongoing capitalization process provides an opportunity for the CBA to encourage some consolidation in the system. This could

entail reducing bureaucratic and judicial formality for mergers and acquisitions of healthier banks, introducing debt/equity swaps, and offering incentives to banks in the form of lower deposit insurance premia or tax advantages. Banks that do not meet the minimum capital requirement by the newly established deadline should be liquidated or converted into non-bank financial institutions. Restructuring the largely state-owned bank IBA so as to reduce its dominance of the sector is also a priority for achieving a more level playing field in the banking system. CBA prognosticates that actions taken by the CBA would increase competition in interest margins (e.g., creating a private credit bureau) and help banks reduce their costs (e.g., protecting creditors' rights) and would also place the system in a better position to support private sector-led growth, particularly for SMEs, which face high costs of borrowing.

Enhancing the regulatory framework while promoting financial deepening is critical for the development of the non-oil economy. CBA prognosticates that recent measures taken by the CBA to strengthen banking regulations will help ensure correct capital needs; but increasing the resilience of the banking system also requires reducing the exposure of banks to connected lending and to un-hedged borrowers. Strengthening the banking system to facilitate a sustainable and broad-based growth led by the private sector will require actions aimed at encouraging market-led consolidation of banks without extending the new deadline to meet the capital requirement; creating a private bureau to promote competition in interest margins; protecting creditors' rights to help banks reduce their costs; and ensuring a level playing field in the banking system by further reducing the IBA's (International Bank of Azerbaijan) dominance in the system. Restructuring the IBA is also needed to help strengthen the monetary transmission mechanism and contain the associated fiscal risks.

Financial sector risks - the weak position and supervision of the systemic public bank (IBA) could compromise the stability and soundness of the system.

A further deterioration of this bank could create systemic problems in the banking system. Though the government is likely to step in with important fiscal costs.

6.2. Soundness and stability of banking system.

Banking sector stability does not seem at risk in the short to medium term.¹⁰ The sector coped relatively well with the "stress test" of the global financial crisis. What is more, non-hydrocarbon growth, essential for the banking sector, has been strong over the past 2 years and is expected to remain so. However, Azerbaijan's economy and, by extension, the operational environment for banks, remain sensitive to external shocks; such as a sharp decline in hydrocarbon export prices. Furthermore, most banks are not well diversified geographically and by sector, increasing their vulnerability. There is also anecdotal evidence that some banks have lost control over branches, some of which are apparently managed like franchises, posing considerable risks for these institutions and potentially for the sector.

Azerbaijan's banks have generally managed to keep administrative costs under control by rationalizing their operations. As a result, many of them benefit from a relatively low cost base, which is comparable with that of larger banks in other

¹⁰ IMF Country Report No. 14/159. Republic of Azerbaijan. IMF 2014 article iv consultation—staff report; press release. June 2014.

countries in the Commonwealth of Independent States. Efficiency indicators diverge widely among banks, although there are highly efficient institutions in the system. However, these too benefit from the large, system-wide difference between lending and deposit rates.

There is already consensus among industry specialists that while banking legislation and regulation have significantly improved in recent years, weaknesses remain, and particularly in the area of corporate governance of banks, single-borrower concentration, related-party lending, loan classification, consolidated supervision, and cross-border banking supervision. Weak capacity and the strong political connections of many banks might make it difficult for the Central Bank of Azerbaijan to implement and further strengthen the legal and regulatory framework for banking in line with international good practice. The central bank, which is formally independent from the government, still plays an important role in implementing government-sponsored development programs. This suggests that the central bank might prioritize development objectives over sector soundness in cases of conflict. Furthermore, regulatory actions appear to be not as transparent as desirable to safeguard regulatory independence.

On the issue of disclosure, all banks are required to submit their financial statements in line with International Financial Reporting Standards. Banks are also required to have their financial statements audited by a qualified external audit company. In recent years, most leading banks have undergone audits from the big-four international audit firms, while smaller banks have preferred to work with other (top-ten) international audit firms.

6.3. Supervision on securities market

For the securities market, the Poverty Reduction Program establishes objectives, such as strengthening the legal framework, protecting investor rights, improving settlement of transactions, establishing a national depository centre, encouraging self-regulatory bodies, strengthening market surveillance, and using securities to mobilize resources for mortgage loans. While some of these steps have already been taken, it is the much more detailed State Program for Development of the Securities Market for 2011–2020, approved by presidential decree in May 2011, which is now guiding reforms. This program includes a comprehensive, specific, and time-bound reform agenda. The program covers (i) the improvement of capital market infrastructure and trading architecture, (ii) stimulating supply to enhance the range of capital market instruments and services, (iii) encouraging demand through corporate education and public awareness outreach, and (iv) strengthening the legal and regulatory framework, as well as improving the capacity of the regulatory body.

Financial instruments' market is not considered to be highly developed. Mainly bond market is developed while equities market is highly undeveloped and illiquid. Main financial instruments issued and traded are government and quasi-government bonds forming most of the volume for financial instruments market. Corporate bonds market is inactive.

Asset management services are not developed. Although there is the legislation in place for more than few years establishing legal framework for investment

management companies to be licensed to provide investment funds services at the moment there are no investment funds offered. Two asset management companies are licensed but they are providing consultation services only. Since there is no investment funds introduced also custody function which is part of the investment management service is not developed.

SCS is responsible for licensing and supervision of dealers, asset managers, depositories, stock exchange activities, clearing activity, registry service, production and sale of all types of securities, running a printing house and running a lottery.

The law "On Securities" provides a definition of deposit activity, general duties of the custodian (deposit-taker) and terms to be included in custodian (deposit) agreement.

There are following market participants under supervision of SCS - Organizations which registered with SCS and holding a licence from SCS for security market activities:

Asset Management – *"Invest Az Asset Management", "AzFinance Asset Management"*

Broker – *"ADB Broker", "Chelsea Capital", "BoB Broker", "Brokdil-AZ", "Standard Capital", "Texnika Capital Management", "Unicapital", "Yapi Kredi Invest", "International Transaction System", "Qarant Invest", "Pasha Capital", "PSG-Broker", "Invest-AZ", "Xalq Capital", "AzFinance Invest".*

Dealer - *"ADB Broker", "Chelsea Capital", "BoB Broker", "Brokdil-AZ", "Standard Capital", "Texnika Capital Management", "Unicapital", "Yapi Kredi Invest", "International Transaction System", "Pasha Capital", "PSG-Broker", "Invest-AZ", "Xalq Capital", "AzFinance Invest".*

Depository – *"National Depocitory Centre", "Baku Stock Exchange", "Corporate Trust Agency".*

Stock Exchange Activity – *"Baku Stock Exchange".*

Clearing Activity – *"Baku Stock Exchange", "National Depocitory Centre".*

Registry Activity – *"National Depository Centre", "Corporate Trust Agency".*

Printing Houses – *"Indigo", "Master Print", "Tuna".*

Also foreign printing houses operating in Azerbaijan: *"Garsu Pasaulis", "UKMERGES SPAUSTUVE", "Banknote Fabric of the Central Bank of Kazakhstan", "Zorya Poligraphy".*

6.4. Supervision on Insurance companies

In insurance, the Poverty Reduction Program 2008–2015 envisages an improvement in the legal framework, encouraging the development of reinsurance, establishing insurance associations, improved control over insurance activities, and a single register on foreign reinsurers and insurance brokers. Actual reforms have moved along these lines with the enactment of a new insurance law and the establishment of associations. In addition, minimum capital requirements for insurance companies have been increased and various types of mandatory insurance established to create a mass market for insurance products.

Insurance sector is mostly run by non-life insurance business (there are 25 non-life

companies and 3 life companies licensed by SISS) but the life insurance business seems to be developing quite rapidly due to the tax incentives introduced to 3years life-contracts although the overall activities are still considered low.

SISS is responsible for licencing and supervision of the insurance companies. There are 28 insurance companies under supervision of SISS – 25 of them being none-life companies: *"A-Qroup Sigorta Shirketi" Joint Stock Company ; "Alfa" Insurance Joint Stock Company ; "Atasigorta" Joint Stock Company; "Ateshgah Sigorta Shirketi" Joint Stock Company ; "AXA MBASK Sigorta Shirketi" Joint Stock Company ; "Azerbaijan Senaye Sigorta" Joint Stock Company; "Azerqarant Sigorta" Joint Stock Company ; "Azersigorta" State Insurance Commercial Company ; "AzSigorta" Joint Stock Company; "Baki Sigorta" Joint Stock Company ; "Bashak Inam Sigorta Shirketi" Joint Stock Company ; "Beynalxalq Sigorta Shirketi" Joint Stock Company; "Buta Sigorta" Joint Stock Company; "Chartis Azerbaijan Sigorta Shirketi" Joint Stock Company; "Emrah Sigorta" Joint Stock Company; "Era-Trans Sigorta Shirketi" Joint Stock Company ; "Gunay Sigorta" Joint Stock Company; "İpek Yolu Sigorta" Joint Stock Company; "MEQA Sigorta" Joint Stock Company; "PASHA Sigorta" Joint Stock Company; "Qarant Sigorta" Joint Stock Company; "Ravan Sigorta" Joint Stock Company; "Royal Sigorta" Joint Stock Company; "Standart Insurance" Joint Stock Company; "Xalq Sigorta" Joint Stock Company and 3 life companies: *Pasa Heyat Sigorta, Qala Heyat JSC, Atesgah Heyat.**

By information from State Insurance Supervision Service:

- In 2013 the insurance market recorded of growth rate of 18,44% in local currency, where main driver was voluntary insurance, which went up by 26%. The life insurance market grew by 1.9%, while the non-life insurance sector saw a 13.6% increase in gross written premiums. At the same time, the mandatory insurance increased by only 5%. The market trends indicate high rates of public interest in the life insurance products. The most dynamic insurance lines have become mixed life insurance, with an increase of 2.16%, and life insurance, with an increase of 90%. The main impetus for higher interest in life insurance products is the growing awareness of the benefits from this type of insurance for the protection of the family property. Moreover, there are tax benefits to those people who have concluded a mixed life insurance contract.
- At the end of 2013, the Ministry of Finance of Azerbaijan has made certain changes in the requirements for the minimum capital level for life insurance companies and reinsurance companies. These changes have not affected the other insurance companies. The existing life insurance companies should increase their capital from AZN 5 million to AZN 10 million over the next three years. For the reinsurance companies the capital requirement also increased 2-fold - from 10 to 20 million AZN. The reason for such decisions was the rapid growth of the life insurance and domestic reinsurance, which in the conditions of the still-unformed market generates significant risks that need to be addressed, including through higher capitalization of the companies.

The government's reforms in the insurance sector are taking place. However, external support is needed to further strengthen regulation, build capacity for supervision, and conceptualize reforms to invigorate competition and improve the quality of services.

7. Conclusions and issues for consideration to develop sustainable state social security system together with financial market development.

7.1. Conclusions on Economic situation

At first glance Azerbaijan appears to be the strongest country in the region in terms of macroeconomic stability, but its heavy dependence on the oil and gas sector is a risk factor.

Country's economic growth is highly dependent on oil production and evolution of oil prices. Public expenditures, including investments are largely driven by oil-related revenues and transfers from the oil fund, that are estimated to account 2/3 of the budget revenues. At the same time shadow economy is valued close to 50 - 70% from total economy and that means, that income from oil production generally are used to cover uncollected tax revenues in the state budget. Taking into account that state budget provides transfers up to 40% to cover labor pension's expenditures, situation in public finances is not sustainable in long run and further development of non-oil sector and solving of tax evasion issues are very crucial for economy.

Country's current economic situation would be favorable enough to address the issues of long term fiscal sustainability and stability of the pension system. Changes in pension system and accumulation of significant long term pension resources and the development of financial markets have the potential to bring about substantial positive development to the economy, in general, and country's industry, in particular.

7.2. Conclusions on Demographic situation

Azerbaijan has a relatively young population compared to other countries in the region and in the countries of the European Union, with share of working age people – almost 72% and share of people 65+ - less as 6% (in 2013). Such a demographical situation will not stay for a long. Projected increase of the share of people in the age 65+ wherewith sharp growth in old age dependency ratio would leave an impact on financing of pension expenditure in the future. The timely established 2nd tier of the pension system would reduce the state liabilities for future pensioners and stimulate financial sustainability of pension system.

7.3. Conclusions on state social insurance system

The pension system in Azerbaijan contained numerous barriers to financial stability in a long term. Despite introduced reforms, the pension system is not financially sustainable for the long term: (1) high financial burden of non-insurance payments and supplements to the labour pension; (2) unclear separation between social insurance and others state programs; (3) social insurance rate is not linked to social insurance expenditures; (4) replacement rate of the insured labour pension part is critically small (12.5% of gross payroll for pension capital).

Although SSPF budget is set on a separate budget status, current state social insurance contributions (25% from gross salary) cannot cover all expenditures necessary for social protection needs and does not operate on self-financing system without the state budget dotation, as well as high dependency from state basic budget exists.

Individual accounts and accessibility of personal data of social contributions in these accounts increases population awareness on state social insurance system and personal responsibility as well. This situation stipulates personal participation in state social insurance system and helps to cover social insurance needs from the state

budget funds – old age pensions and other social benefits covered by state. Personalized data availability on pension accruals in state insurance system would help diminish shadow economy impact in country by understanding of social systems operation basic principles. However, there is a high share of people outside of the social insurance system (main uncovered occupations could be self-employed persons in services sector and farmers in agriculture sector).

The gradually on-going increase in life expectancy (even after retirement age) extends the payment period of labour pension and growing share of population aged 65 and more would create additional pressure for the pension system in the future.

Although the basic part of labour pension plays an important role in securing and improving the livelihoods of older people and thus works as safety net, it breaks the link between contributions and benefits. Therefore, it should to be designed to provide protection, but not to be so generous that it distorts incentive to join to the social insurance system. The average pension, including both the basic and insurance parts, in 2013 amounted to just over 39.6% of average wage for the old age pension. Adequacy of pension requires generation of private savings, diverting current contributions to funded scheme.

Despite the fact that the current pension system in the country is built on insurance principles, there is a large group of people who pensions based on non-insurance principles like as public officials, police, employees of some ministries, the military and other categories which are entitled for earlier retirement and higher pensions will constitute a large share of the population. So generous rules modify defined contribution pension (which is the main principle of the pension system) to the defined benefit pension, as well as it demands definite financial resources from social insurance budget leaving an impact on pension system sustainability.

Revising structure of the SSPF budget regarding to high dependency from the state budget (oil production revenues) and coverage of individual contributions. Long-term strategy for SSPF budget balancing - balance between social insurance contributions and expenditures for existing and future social insurance pensions and benefits - should be developed. Social insurance system on self-financing basis would build financially stable state social insurance system in the long run, which would be less dependent from oil industry. A further improvement of contributions collection is an important part of pension system's stability.

Evaluation of adequacy of state social insurance contribution rate for pension insurance (12.5% from gross salary) to cover pension payments (provide adequate replacement rate) regarding to the age structure of population, existing employment rate, shadow economy and other economical criteria.

Although life expectancy increases every year, the *factor/element* of the insurance part of labour pension – number of months of expected pension payment period (T) – is not related to life expectancy after retirement and it changes.

In order to provide adequate state social protection and pension insurance level in the future for all population groups taking into account that main labour force (approx. to 90%) is working in agriculture and services sectors, there is an obvious need to create special pension savings and social protection vehicles for self-employed persons and farmers, for example, farmers pension scheme with mandatory and voluntary savings component. At the same time some special communication campaign for self-employed persons and farmers would be necessary.

Pension adequacy requires generation of private savings, diverting current contributions rate to funded scheme.

7.4. Conclusions on financial and capital markets development

Despite the fact that capital market is relatively underdeveloped, it should provide sufficient scope and depth for the management of country's pension resources, especially at the initial stages. Government bonds, mortgage bonds, corporate bonds and deposits provide sufficiently attractive investment opportunities. Investment in international markets can also be considered. The development of pension management market would ensure accumulation of country's long term capital resources that can be effectively used for the financing of country's economy. Stock market, corporate bonds, infrastructure projects, industrial investments, real estate investments, private equity and venture capital are only some of the examples.

However, several issues should be noted:

- Liquidity risk management given low liquidity of local financial market instruments
- Credit risk management given lack of rated local issues
- FX risk management due to country's exchange rate arrangement and lack of opportunity to effectively hedge FX risks
- Lack of listed equity instruments on the stock exchange
- Corporate governance practices and financial information disclosure

Despite the abovementioned issues, development of the pension management would be a positive trigger for the development of wider capital markets and their institutional framework. To reduce the risks initially, investment policy could be structured conservatively initially and relaxed thereafter as securities markets mature and overall capital market infrastructure develops to the required degree.

Special consideration should be given to the degree pension assets will be available for investments abroad, given exchange rate arrangement, effect on FX flows and currency and domestic market development.

Besides asset management, fund accounting, fund management, depository services, financial market supervision and custodian services should be well-established. Centralization of some of these services could be considered to enhance supervision and governance, and reduce cost. To develop asset management and related services, special training and certification could be considered.

As asset management business depends on the scale, initial business scale is important to ensure successful operation of asset management companies. External financial sources could be considered for this purpose.

Liquidity management would depend on the general arrangements of the pension system and factors like overall pension contributions and their frequency, extent of regular subscriptions and redemptions, settlement options, option for pension plan participants to change pension provider or investment strategy, competition, asset management practices etc. Marketing activities can also have direct impact on liquidity management practices.

The financial sector enabling environment is reasonably good in some respects, but corruption (irregular payments and bribes) is a major problem.¹¹

7.5. Conclusions on Private Saving's market development

For maintaining a stable growth rate of the economy of Azerbaijan it will be necessary to increase the investments by means of domestic resources. Savings attracted from population in Azerbaijan is developing very slowly due to quite weak banking system and on 2013 the ratio of savings attracted from population and the GDP in Azerbaijan is close to 11% which is not considered to be an optimal level, taking into account, that all savings of population are short term. There is no pension savings and long-term life insurance savings still in the economy.

At the same time banking standard products like current account and debit cards are not widely used due to high ratio of shadows economy (~50-70%).

In these circumstances the need has arisen for new types of investments and boosting incomes. One of the attractive offers may be a life insurance policy with a savings' plan, as well as introduction of mandatory funded state pension schemes or private pension savings would be an option to consolidate personal savings in state economy.

The development of an institution of nonbanking financial intermediaries in Azerbaijan could also be a positive factor for the accumulation and the mobilization of savings of population.

Due to lack of trust to financial sector and high need for accumulating long-term savings in economy, there would be social and financial stimulus needed (like tax advantages) with state guaranties to promote funded pensions and long-term life insurance savings development in Azerbaijan.

Sophistication of financial services is very low; Azerbaijan's overall score of 0.35 (5 = Best) is much worse than the dismal average for Eurasia of 0.64.¹²

Public awareness of financial instruments and financial literacy are crucial issues for further personal savings market development. Individual accounts and accessibility of personal data of state social contributions in these accounts increases population awareness of state social system, state pension savings and personal responsibility for old age pension as well. This situation stimulates personal participation in state social insurance system, diminishes tax evasion and helps to cover social insurance needs from the state budget funds. Promoting long term savings in the state accounts would be good starting point for funded elements introduction in state and private pension systems.

7.6. Conclusions on financial and capital markets supervision

The stability of the financial sector in Azerbaijan has deteriorated to a level which is slightly better than average for Eurasia and slightly worse than in the Eurozone. Azerbaijan's financial sector is very small in relation to the size of the economy – even after giving consideration to the large role played by the petroleum sector - and

¹¹ Financial Sector Benchmarking System, by USAID, Overview for Azerbaijan November 2013

¹² Financial Sector Benchmarking System, by USAID, Overview for Azerbaijan November 2013
http://www.pfsprogram.org/sites/default/files/Azerbaijan_FSBS_11-15-2013.pdf

has grown only moderately over the past few years.¹³

Currently there are three separate supervision authorities performing financial market participants' supervision.

Among the obstacles to a swift and immediate implementation of those fully funded schemes is the current state of the financial market and the fragmented financial and capital market supervisory institutions. Currently financial market supervision is carried out by 3 separate institutions – Central Bank of Azerbaijan for banking sector supervision, State Insurance Supervision Agency (under Ministry of Finance) for insurance market supervision, State Committee for Securities (under President of Azerbaijan) for securities market supervision. Such financial and capital market supervision infrastructure with different subordination could lead on some risks, when non-state pension funds would be created and strong cooperation between existing supervisory authorities on regular basis would be crucial.

Introduction of funded mandatory and funded voluntary tier of the pension system would introduce new players into the financial markets that are required authorization and supervision from the competent authorities.

For the successful activities of the pension business there are three important components that should be considered:

- Administration
- Asset management
- Custodianship

While single body could perform administration and asset management function, custody function should be ring fenced and outsourced to the banking sector.

As the result strong interconnection between competent authorities supervising pension management companies and custodian banks is envisaged.

Sound, modern and independent supervision is important component of the successful functioning of pension management function and protection of the interests of the members.

There are two options how the authorization and supervision of the pension management could be structured:

First option to be considered would be consolidation of the supervision and creation of the single competent authority to be entitled for authorization and supervision of all financial market participants. There would be highlighted positive sides of this approach one of most important being single supervisory approach for all components and stages for the pension management function. The main disadvantage to be mentioned is crucial restructuring of whole supervision system of the financial market that will need the careful impact analysis before being considered. Also according to official of the Azerbaijan creation of single supervision authority has been discussed recently and refused therefore this option although there are many issues the financial markets would benefit from would not be considered as the main possibility and

¹³ Financial Sector Benchmarking System, by USAID, Overview for Azerbaijan November 2013
http://www.pfsprogram.org/sites/default/files/Azerbaijan_FSBs_11-15-2013.pdf

another option needs to be considered firstly.

Another option would be to follow the current approach of sectorial division of the supervision. Analysing current structure and functions of three existing supervisory bodies and bearing in mind importance and potential volume of the pension management function the most appropriate way to consider seems to be creation of the separate supervision authority being responsible for authorization and supervision of the pension management companies (hereafter - pension funds). This supervision agency will need to have strong cooperation with CBA supervising banks because custody function should be mandatory outsourced to the commercial banks.

The main potential responsibilities of the pension supervision authority would be authorization and supervision of the pension funds. The pension funds authorized activities under supervision the supervisory authority would be providing mandatory pensions to the working population as well as voluntary pensions including both: occupational pensions that are voluntary sponsored by employers in favour of their employees and personal pensions that are voluntary accrued by individuals themselves to ensure adequate replacement on retirement.

The activities of the pension funds would include all three stages of the life cycle: pre-enrolment, accumulation and decumulation. Since asset management activities and annuities market are highly underdeveloped mandatory outsourcing of above-mentioned functions does not seem feasible although this is a very popular approach to ensure simplicity and possible cost efficiency of the system. If asset managers and annuity providers will show significant growth of the activities and competencies it would be always possible to outsource these activities on voluntary basis.

Possible legal structure of the pension funds and potential design of the pension products would be considered at the later stage of the project.

Considering that the only competency in asset management currently lays with State Oil Fund it should be analysed how these competencies would be used in benefits of potential members. Involving State Oil Fund in pension management function perhaps as provider of the asset management at the early stage of the system development would be one of possibilities to consider.

Given these circumstances the development of fully funded pension schemes should be based on a comprehensive plan to develop a broad range of financial market regulations that cover the whole delivery process of fully funded pensions. Such a comprehensive plan calls for the involvement of all the agencies and stakeholders interested in fully funded pension provision in due time after consultation with the project beneficiary.

APPENDIX A

IMF country report No. 14/159 Republic of Azerbaijan. IMF 2014 article iv consultation—staff report; press release. June 2014.

Table 3a. Azerbaijan: Consolidated Central Government Operations, 2009–15
(in millions of manat)

	2009	2010	2011	PreL 2012	2013	Proj. 2014	2015
Total revenue and grants	14,368	19,386	23,292	21,832	22,807	24,153	24,385
Total revenue	14,368	19,383	23,285	21,832	22,807	24,153	24,385
Tax revenue	5,591	5,834	7,016	7,004	7,739	8,252	9,097
Income taxes	1,911	2,020	2,850	3,065	3,038	3,008	3,067
Social security contributions	582	697	744	158	380	407	436
Value added tax (VAT)	2,013	2,082	2,223	2,367	2,688	3,041	3,487
Excise taxes	485	515	480	531	607	665	746
Taxes on international trade	421	292	440	590	686	750	933
Other taxes	179	227	280	293	340	381	428
Nontax revenue 1/	8,777	13,549	16,269	14,828	15,067	15,901	15,287
Of which: Oil Fund revenues 2/	8,274	13,087	15,521	14,183	14,132	14,874	14,153
Total grants (current)	0	3	7	0	0	0	0
Total expenditure	12,028	13,450	17,368	19,782	22,332	24,130	26,387
Current expenditure	7,649	8,157	9,160	11,108	12,360	13,680	15,272
Interest	36	39	210	98	172	177	124
Investment expenditure and net lending	4,379	5,293	8,209	8,674	9,971	10,450	11,115
Domestically-financed	4,093	4,768	7,442	7,697	8,895	8,427	9,988
Foreign-financed	286	525	767	977	1,076	2,023	1,126
Statistical discrepancy	-142	-277	-1,043	-581	-247	-159	121
Consolidated government balance, cash basis	2,482	6,213	6,967	2,630	722	183	-2,123
Non-oil primary balance 3/	-6,942	-8,070	-10,245	-13,504	-15,171	-16,355	-17,905
Financing	-2,482	-6,213	-6,967	-2,630	-722	-183	2,123
Domestic (net)	-2,705	-6,686	-7,654	-3,502	-1,286	-2,092	1,115
O/w Banking system	-25	-133	-1,631	93	-240	-370	700
Oil Fund (includes treasury balances)	-3,018	-6,700	-6,088	-3,608	-1,091	-1,767	-585
External (net)	223	473	687	872	564	1,909	1,008
Loans	288	526	768	977	1,076	2,023	1,126
Amortization due	65	53	81	105	512	114	118
Memorandum items:							
Oil revenue	9,461	14,323	17,422	16,231	16,065	16,714	15,907
Non-oil revenue 4/	4,907	5,063	5,870	5,600	6,741	7,439	8,478
Non-oil tax revenue 5/	3,942	4,033	4,508	4,924	5,339	5,911	6,707
Non-oil GDP (in billion of manats)	19,536	22,243	25,393	29,766	34,051	38,144	42,850

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

1/ Includes contingent revenues accrued on the "deposit account" of budgetary organizations.

2/ Includes profit oil, acreage fees, and income earned on Oil Fund assets.

3/ Defined as non-oil revenue minus total expenditure (excl. interest payments) and statistical discrepancies.

4/ Excludes AJOC profit tax, profit oil, and SOCAR profit tax.

but includes VAT and excise taxes on oil and gas, tax withholding on the AJOC's subcontractors.

5/ Tax revenue excluding AJOC and SOCAR profit tax, and social contributions.

APPENDIX B

World Bank Group - Azerbaijan Partnership Program Snapshot prepared in April 2014 (www.worldbank.org/content/.../Worldbank/.../Azerbaijan-Snapshot.pdf)

Recent Economic and Social Developments

Summary information

- GDP growth picked up in 2013, aided by a renewed increase in oil production and the continued strong performance of the non-oil economy.
- With technological upgrades and extraction process optimization, oil production finally rebounded after two consecutive years of decline.
- An increase in imported machinery by the oil sector reduced the trade surplus to 18 percent of GDP in 2013 compared with 20.7 percent in 2012.
- The current account surplus narrowed to 15 percent of GDP in the third quarter of 2013 from 19 percent in the third quarter of 2012,
- Oil- and gas-related foreign direct investment (FDI) inflows narrowed the deficit on the capital account by 5 percent in the third quarter of 2013 compared with the same period in 2012.
- Increases in administered fuel and food prices raised the average inflation rate to 2.4 percent in 2013, marginally higher than 2012.
- Increases in administered fuel and food prices raised the average inflation rate to 2.4 percent in 2013, marginally higher than 2012.
- With a stable nominal exchange rate and inflation lower than among its key trading partners, the real exchange rate depreciated by 0.9 percent in 2013 (figure 5).
- Economic growth in 2014 will be supported by the stabilization in oil production and continued growth in the non-oil sector, albeit at a slightly lower pace.
- Overall, private sector development trends were positive in 2013.
- The number of private sector enterprises increased in 2013.
- As for the business environment, Azerbaijan was ranked 70th out of 189 countries in the 2014 Doing Business report.
- The country is one of the worst performers in dealing with construction permits, getting electricity, and trading across borders.
- Unfair competition and monopolization of the economy continue to remain issues in Azerbaijan.
- Azerbaijan improved its ranking from 46 to 39 according to the Global Competitiveness Report (GCR) 2013–2014 published by the World Economic Forum.
- The main improvements were in the areas of macroeconomic environment, efficiency in the functioning of the market for goods and labor, and innovation.
- However, corruption still remains a major concern, followed by tax rates, an inadequately educated workforce, and access to finance.
- Azerbaijan performed poorly in the “financial market development” pillar, where the country ranking was 88 out of 148 countries. According to the report, in this pillar, the “availability of financial services” (108th), “affordability of financial services” (73th), “soundness of banks” (112th), and “regulation of securities exchanges” (98th) have yet to be adequately developed in Azerbaijan.
- With lower oil revenues and sustained expenditures, the fiscal balance decreased

- to 1.8 percent of GDP in 2013 from 4.2 percent a year ago.
- Consolidated budget expenditures in 2013 did not change much from last year because the increase in capital expenditures was offset by the decline in recurrent spending.
 - Social spending, which includes education, health, and social protection, was maintained in 2013 at last year's level of 7 percent of GDP.
 - The decline in average oil prices in 2013 lowered the overall revenue collections compared with the previous year.
 - Driven by increased transfers to the state budget and higher extra-budgetary spending, the Oil Fund saved only 10 percent of its revenues in 2013 compared to 23 percent in 2012.
 - Growth during the 2000s contributed to a decline in consumption poverty by more than half between 2001 and 2008.
 - Social transfers also contributed to the observed reduction in poverty, but spending is low by ECA standards. A World Bank study from 2010 estimated that without social transfers, the poverty rates would have been higher in Azerbaijan
 - Azerbaijan continues to spend less than most countries in ECA on social protection, especially on labor market policies (0.1 percent of GDP) and social assistance (1 percent of GDP). Preliminary evidence suggests that the poverty reduction potential of TSA is under-utilized and that a majority of poor households remained uncovered in 2012 (see section below on Social Insurance).
 - Inequality is high, especially in urban areas.
 - Despite the impressive poverty reduction, indicators of access to services show significant disparities between rich and poor.
 - In line with output expansion, new jobs were created in the non-tradable sectors, which led to a decline in the unemployment rate to 4.9 percent in 2013 from 5.2 percent in 2012.
 - In Azerbaijan, the oil sector accounts for less than 1 percent of total employment.
 - Informal employment, however, continues to be a problem. The share of people working with formal labor contracts is about 33 percent and this has not changed much over the past few years. This problem is more acute in regions outside Baku. In Baku, formal employment accounts for 60 percent of the total, while in the regions, this figure ranges between 10 and 30 percent.
 - There is room for improvement in the administration of social assistance, and in expanding its coverage.
 - The Government of Azerbaijan is progressing with further reforms of TSA.
 - Azerbaijan's pension system has gone through significant changes since 2005.
 - The changes introduced by two new laws—on labor pensions and on state pensions—involved streamlining the benefits and improving the linkage between benefits and contributions.
 - All business processes are integrated through a comprehensive, fully automated management information system (MIS) that is recognized as a best practice in the region. Records of all 1.3 million pensioners are computerized, and the social insurance contributions of 1.97 million people are recorded in the Central Automated Registry.
 - The Government is now well placed to harness the system for business planning and management purposes. To continue the reforms, the Government would have to address emerging concerns about the long-term fiscal sustainability of the pension system.

- On November 29, 2012, President Ilham Aliyev issued a decree requesting the Cabinet of Ministers to prepare a Pension System Development Strategy for Azerbaijan. As a result of the joint effort of the State Social Protection Fund, the Ministry of Finance, and other government agencies, a Draft Concept of the Strategy was prepared and submitted to the Administration of the President for approval.

APPENDIX C

World Bank Group - Azerbaijan Partnership Program Snapshot prepared in April 2014 (www.worldbank.org/content/.../Worldbank/.../Azerbaijan-Snapshot.pdf)

Financial and Private Sector Developments

Summary information

- The financial sector in Azerbaijan is dominated by banks, and the non-banking sector still continues to offer limited opportunities.
- Banks hold about 95 percent of total financial sector assets.
- Insurance services also remain small but are experiencing high growth, with gross written premiums at less than 1 percent of GDP.
- Venture capital and private equity are at a nascent stage.
- Capital markets are dominated by government securities and corporate bonds, with stock market and debt market capitalization ratios below 1 percent of non-oil GDP.
- The banking sector experienced high growth rates in 2013. However Azerbaijan's financial penetration indicator remains one of the lowest in the Europe and Central Asia (ECA) region.
- While the performance of the banking sector improved in 2013, wide variations exist among banks in terms of credit quality and capital, particularly for a systemically important part of the banking sector.
- Return on equity (ROE) went up from 7 to 11.75 percent during 2013.
- The capital adequacy ratio (CAR) was 18.1 percent, which is above the minimum requirement of the CBA of 12 percent, however, the liquidity ratios declined slightly during 2013.
- While disclosed nonperforming loan (NPL) figures were still relatively low at 5.1 percent at end-2013, they may be understated, as only the overdue portion of principal and interest is reported as an NPL.
- One of the key vulnerabilities in the banking sector is the prolonged market dominance and chronic underperformance of the biggest and only state-owned bank, the International Bank of Azerbaijan (IBA), which holds more than one-third of total banking sector assets. The concentration and quality of its assets remain a serious concern.
- Azerbaijan's financial sector remains exposed to continuing and growing internal risks associated with the deterioration of credit quality, low provisions for NPLs, and the high loan-to-deposit ratio.
- The sector-wide loan-to-deposit ratio (LDR) increased and reached 167.4 percent in 2013, due to banks' prolonged reliance on internal and external borrowing and central bank liquidity support.
- Provisions continue to remain inadequate and need to be increased to help clean banks' balance sheets and encourage new lending in the medium term. Currently, provisions provide only 56 % coverage for NPLs.
- Given the inherent structural weaknesses in the legal framework supporting creditors, foreclosure is extremely difficult and protracted for banks, thus limiting the scope for asset recovery.
- The CBA continued its policy of ensuring financial sector stability and sustainability in 2013 and undertook some policy actions to that end.

APPENDIX D

World Bank Group - Azerbaijan Partnership Program Snapshot prepared in April 2014 (www.worldbank.org/content/.../Worldbank/.../Azerbaijan-Snapshot.pdf)

Capital Markets Modernization Project

Summary information

- The capital market in Azerbaijan is underdeveloped, with equity and debt market capitalization of only 0.5 percent and 1.9 percent of non-oil GDP, respectively, at end-2010. Development of capital markets in the medium term is crucial to support the economic diversification of the non-oil sector.
- The main activity of the Baku Stock Exchange (BSE) is to serve as the auction mechanism for the issuance of Government Securities. However, due to a number of factors, secondary trading of this treasury debt does not exist.
- Only two companies have listed their shares on the BSE to date, and the most active trading surrounds shares of about 500 companies privatized in the mid-1990s representing the “unlisted securities market,” which is not regulated by the State Committee for Securities (SCS).
- As a consequence of the underdevelopment of capital markets, the banking sector dominates the financial sector with more than 95 percent of total assets. Banks have had little interest in investing in low-yielding existing market instruments due to the weak investor base.
- **World Bank Project Development Objective** is to increase the use of equity and corporate debt as financing and/or investment instruments through the adoption of an effective capital markets regulatory framework and infrastructure.
- **The Project** is providing financing for
 - (i) streamlining and automating the market infrastructure;
 - (ii) updating and strengthening the legal and regulatory framework;
 - (iii) stimulating supply; and
 - (iv) building capacity at the SCS and developing public awareness activities.
 - **Results achieved:**
 - State Program on the Development of the Securities Market in 2011–2020 was endorsed by the president on May 16, 2011.
 - SCS has submitted a draft of the new Law on Securities and conforming amendments to the Civil Law to the Cabinet of Ministers. This draft law is recognized as an important milestone in the State Program on the Development of the Securities Market of the Republic of Azerbaijan in 2011–2020. SCS has successfully completed all steps in the tender process for selecting the main consultancy firm and the contract has been awarded. This single main consultancy assignment of US\$8.4 million is aimed at providing comprehensive support to reforming and modernizing the Azeri capital market. Contract implementation started in September 2012 and is progressing satisfactorily. In addition, a Capital Markets Training Center has been established, its Charter was approved, and its head appointed by SCS.
 - **Key Development Partners** include

- (a) Swiss State Secretariat for Economic Affairs (SECO), which cofinances components 2 and 3 of the Capital Markets Modernization Project in the amount of about US\$1.6 million;
- (b) European Union (EU), which is providing support for improving the capital markets legal framework under the project of Technical Assistance to the Commonwealth of Independent States Program (TACIS);
- (c) International Financial Corporation (IFC), which supported the drafting of the new Laws on Investment Funds and Covered Bonds, and amendments to the Civil Code; and
- (d) International Monetary Fund (IMF), which has been supporting the development of a government securities market under a regional initiative funded by SECO.

APPENDIX E

Standard and Poors Azerbaijan Rating Upgrade (August 4, 2014)

Summary information

- The Standard and Poor's ratings services has affirmed its BBB-/A-3 long and short term sovereign credit ratings for Azerbaijan with a stable outlook on August 4.
- Stable outlook reflects the agency's view that Azerbaijan's general government net asset and external creditor positions currently solid, despite some gradual weakening from the previous several years when country experienced rapid oil-related revenue growth.
- Agency expects overall fiscal profile to remain strong over the next couple of years
- Agency expects modest slowdown in economic growth to about four percent in 2014-2017 from 5.8% in 2013, due to stagnating oil production, gradual weakening of oil prices to about 103\$/barrel in 2015/2016, and decelerating growth rates in the non-oil sector.
- Lower public sector capital spending will further slow economic growth. Nevertheless, S&P anticipate that GDP growth will be supported by a substantial inflow of investment into the development of new oil and gas fields in conjunction with; last year's increase in public sector salaries and other social related expenditures.
- After a period of government surpluses, S&P anticipates a gradual deterioration in Azerbaijan's fiscal profile, with the general government fiscal balance posting modest deficits averaging about 1.5% of GDP in 2014-2017.
- S&P also expects some consolidation on the capital spending side.
- Capital expenditures comprise almost 40 percent of total expenditures in 2013 which, according to the agency, provides a large degree of fiscal flexibility. Over the next three years, the revenue base will likely remain highly concentrated and exposed to the volatile oil sector, which, according to agency's estimates, provides 60% of revenues directly from oil sales and another 10 percent from related revenues.
- S&P estimates non-oil tax base to remain relatively limited.
- Risks of potential financial distress from a sharp and sustained decline in oil prices can be mitigated by large liquid government assets accumulated in SOFAZ.
- In early 2014, Azerbaijan issues its debut \$1.25 billion Eurobond, which will cover deficit financing needs in 2014 and 2015 and might allow government to further accumulate reserves.

APPENDIX F

Azerbaijan: Financial Sector Assessment by Asian Development Bank (December 2012) <http://www.adb.org/sites/default/files/pub/2012/azerbaijan-financial-sector-assessment.pdf>.

Summary information

- Total financial sector assets represent just 31% of gross domestic product (GDP), falling well short of the financial sector's potential to contribute to economic growth through savings mobilization and investment financing.
- Nonbank financial services may provide a particularly strong area for development, with banks still accounting for 93% of financial sector assets.
- Financial sector development did suffer setbacks during the 2008–2009 global financial crisis. However, Azerbaijan's banks avoided serious damage, due to their limited exposure to credit from abroad, state support through banks for infrastructure projects, and direct state-support for large borrowers with payment difficulties.
- The sector has now entered the post-crisis period, with bank credit growing and the securities markets reviving. Growth is particularly strong in microfinance and insurance, albeit from a low base.
- Although small, Azerbaijan's securities markets do contribute to capital mobilization. About 250 companies have more than 100 shareholders. Some of them issue securities on a regular basis, even if listing remains underdeveloped and the secondary markets are narrow and illiquid.
- In 2011, companies issued shares equivalent to 2% of GDP through 142 issues; banks accounted for 14% of the volume. In addition, capital raised through a total of 101 corporate bond issues amounted to 1.2% of GDP.
- State-owned Azerbaijan Mortgage Fund was the largest issuer, followed by a number of private financial institutions. The basic institutional framework for the securities markets has been in place for more than a decade.
- The authorities are now strengthening it under the State Program for the Development of Securities Markets for 2011–2020 with World Bank support, alongside measures to strengthen the legal and regulatory framework.
- Securities markets are still small in Azerbaijan, but increasingly contribute to capital mobilization. The basic market infrastructure has been in place for more than a decade, although it was initially designed to support the privatization of state-owned enterprises. The State Committee for Securities (SCS) under the president of Azerbaijan is the regulatory body. Trading takes place at the Baku Stock Exchange (BSE) and over the counter (OTC). There are 13 broker-dealers, 2 registrars, and 3 depositories. The National Depository Center, which mainly serves the BSE, partly integrated its systems with the BSE in 2009.
- The BSE organizes trades in company shares (equity), corporate bonds, treasury bills and bonds, and Central Bank of Azerbaijan notes; no derivatives are traded. It also engages in clearing, information services, and consulting, and has a tailor-made online trading system with remote access and 30 workstations for brokers at its floor.⁵⁴
- The pool of enterprises that could issue securities in Azerbaijan is not small. Out of a total of more than 80,000 enterprises, about 1,200 are joint stock companies

with more than 20 shareholders. About 250 of them have more than 100 shareholders. Many larger companies are still state owned and have alternative sources of funding. The government has also not yet started to list state-owned enterprises and there are few incentives for private companies to list; only one company is now listed on the BSE.

- Shares totaling \$1.2 billion equivalent (2.0% of GDP) were issued through 142 issues in 2011, with banks accounting for 14%, insurance and leasing companies accounting for 1%, and non-financial companies for the balance. According to SCS, all share issues in 2011 were issued to attract external capital. BSE dominates the primary market for equity with a share of 99% in issuance volume. Nearly 100% of issues were paperless (i.e., electronic).
- The BSE claims that shares of about 700 enterprises are traded on its secondary market, but most of them only occasionally. With total turnover of \$60 million equivalent and 4,580 transactions in 2011—18 on average per trading day—the secondary market is still very small. The BSE now accounts for 75% of all transactions, in contrast to OTC dominations before the crisis.
- Bond markets. The number of corporate bond issues increased from 20 in 2007 to 101 in 2011, for total capital raised of more than \$740 million equivalent (1.2% of GDP) in 2011, up from \$90 million equivalent (0.3% of GDP) in 2007. While this is a substantial amount, 65% of the capital raised was for a single OTC bond issue in US dollars. The remaining issues were predominantly in local currency and through the BSE.
- 57. Bonds are issued with maturities of up to 10 years. The most active bond issuer is the state-owned Azerbaijan Mortgage Fund (AMF), which accounted for 93% of primary bond issues in 2009. AMF bonds in circulation have a maturity of 7 or 10 years and a yield of 3% (for covered bonds). When the market for corporate bonds revived in 2010 and 2011, AMF's primary market share fell to 82% and 39%, respectively.
- 58. Banks accounted for 17% of corporate bond issuance in 2011. This included Unibank, which issued several bonds in 2011 and early 2012. 56
- 59. Secondary corporate bond market turnover amounted to almost \$0.7 billion equivalent in 2011, or about 10 times higher than equity market turnover.
- However, the total number of transactions was much smaller, at 120. The secondary market for corporate bonds is therefore very illiquid. Most transactions take place at the BSE rather than on an OTC basis, which is unusual from an international perspective.
- Leasing companies accounted for another 6% of issuance in 2011. The remaining 38% of corporate bonds were issued by nonfinancial enterprises. It is important to note that there were no bond defaults in Azerbaijan during the global financial crisis.
- 60. The issuance of treasury bills increased over the crisis period to peak at 2.1% of GDP in 2009, before declining to the precrisis level of 0.5% of GDP by 2011. The longest available maturity period is 3 years, but most bills have shorter maturities. Bills in circulation only amounted to 0.3% of GDP at the end of 2011. Short-term Central Bank of Azerbaijan notes in circulation added another 0.2% of GDP. Most treasury bills and central bank notes are held until maturity, so secondary market trading volumes are very small. However, treasury bills and central bank notes are actively used as collateral for money market transactions (repo deals).

APPENDIX G

IMF Country Report No. 14/159. Republic of Azerbaijan. IMF 2014 article iv consultation—staff report; press release. June 2014.

Summary Information

- In an environment of high oil prices but with a relatively short oil production horizon, the overarching challenge for Azerbaijan remains bringing fiscal policy to a sustainable position while accelerating structural reforms to foster broad-based private sector-led growth. Staff recommends:
 - Pursuing a growth-friendly fiscal consolidation strategy by cutting investment projects with small growth returns and advancing decisive reforms to improve the business environment and thereby create opportunities for private investment;
 - Maintaining monetary policy in a neutral stance while improving the transmission mechanism and taking steps to enable greater exchange rate flexibility in the medium term; and
 - Fostering private sector-led growth in the non-oil sector by ensuring financial stability, promoting the deepening of financial markets, strengthening governance, and removing barriers to competition and trade.
- Recent developments and near-term economic prospects are favorable
- The growth of non-oil GDP reached almost 10 percent in 2013 supported by high public spending and a rapid increase in consumer loans. Non-oil GDP growth will remain strong albeit somewhat slower in 2014–15, mostly reflecting the recently announced fiscal consolidation process. Oil output is likely to be flat for a number of years following the stabilization in 2013 that ended two consecutive years of decline.
- Inflation increased slightly to 2.4 percent in 2013, on the back of adjustments to the regulated price for petroleum products toward the end of the year.⁴ Though the output gap turned positive in 2013, inflation is projected to remain in low single-digit levels during 2014–15, mainly on the back of the fiscal consolidation.
- The de facto exchange rate regime is classified as a stabilized arrangement and is the key anchor for monetary policy. The manat exchange rate has appreciated by less than 2 percent relative to the U.S. dollar since November 2010. The impact of depreciation pressures in a number of neighboring countries has been limited, with few signs of lower manat demand or capital flight. Moreover, the CBA has continued to intervene to prevent appreciation of the manat since the beginning of this year, increasing reserves by about \$0.5 billion in the first quarter of 2014.
- Fiscal policy. Preliminary information suggests that the 2013 non-oil primary deficit in percent of non-oil GDP remained at 2012 levels at about 45 percent, but still well above the 35 percent sustainability level implied by the permanent income rule under a conservative scenario of oil and gas production.⁵ The deficit would have been even larger had it not been for spending restraint towards the end of 2013 and some under-execution of spending at the state budget level and, particularly, on investments financed by the oil fund outside the budget. The spending restraint helped reduce the break-even fiscal oil price slightly to \$77 dollars per barrel. Parliament approved a consolidated budget for 2014 that lowers the government-spending-to- GDP ratio and implies a decline in the non-oil fiscal deficit by about 2 percent of non-oil GDP. The overall fiscal surplus declined to 1

percent of GDP, on flat revenues, but this allowed the oil fund to continue to grow (its size now stands at 48 percent of GDP).

- Monetary policy. The Central Bank of Azerbaijan (CBA) kept the refinancing rate steady between February 2013 and end-April 2014, when it lowered the rate by 50 basis points to 4.25 percent and decreased the lower and upper limits of the interest rate corridor by 50–100 basis points (setting the floor at 0.5 percent and the ceiling at 6 percent). In August 2013, the CBA prompted a reduction in lending rates by cutting the interest rate ceiling of the Azerbaijan Deposit Insurance Fund (ADIF) from 12 percent to 10 percent. Following this reduction, private sector credit accelerated while remaining highly concentrated in personal loans. The CBA though has followed through with plans to stop lending to the real economy.
- Several financial indicators of the banking system excluding the largely state owned International Bank of Azerbaijan (IBA) improved in 2013. The capital ratio increased to 21.6 percent boosted by a fivefold increase in banks' minimum regulatory capital requirement. Though liquidity declined, bank profitability also improved on the back of the recent consumer lending boom. Disclosed nonperforming loans (NPLs) as a percentage of total loans decreased slightly to 4.5 percent, despite the rapid increase in consumer loans, reflecting the write-off of fully provisioned loans. NPL figures, though, only include the overdue portion of principal and interest, suggesting that NPLs are higher.
- Recent changes in the regulatory framework of the banking system include measures to tighten consumer loans and strengthen the provisioning rules and requirements for the accurate classification of NPLs.⁶ The CBA also extended the deadline on the new capital requirements until January 1, 2015, giving some banks (comprising about 8 percent of total banking system assets) more time to fulfill this requirement. The largest bank, IBA, is in compliance with the capital adequacy ratio.⁷ But as the financial position of IBA remains fragile, the shareholders' assembly decided to increase the bank's statutory capital over the next four years, even in the absence of clear plans for the restructuring of the bank. This increase will bring an additional burden of about \$300 million (about 0.5 percent of GDP) on the government, which may double if the other (private) shareholders do not participate in the increase.
- The baseline scenario reflects the authorities' plans to sustain the recent change in the course of economic policies and tackle fiscal vulnerabilities over the medium term. The government's plans to rein in spending, particularly in the public investment program, would enable a decline in the non-oil primary deficit to non-oil GDP ratio to the sustainable level of 35 percent by 2019. Over the medium term, non-oil GDP growth could be in the 5 percent range, if it is underpinned by fiscal consolidation and supported by non-oil foreign direct investment (FDI).
- Azerbaijan's external position is strong. External buffers, namely the CBA reserves and the oil fund, now amount to about 33 months of import cover and provide strong support to the peg. The current account surplus is high and sovereign foreign assets are expected to reach \$55 billion, or 64 percent of overall GDP, by 2015. These assets are projected to decline to about 40 percent of GDP by 2019 as the oil fund engages in the financing of some energy-related projects of strategic importance. Although the planned fiscal consolidation would tend to increase the current account surplus over the medium term, the dominating influence is expected to be a decline in oil exports, as oil prices soften and production begins to tail off. Staff projections assume moderate returns from the

energy-related projects given the inherent uncertainty, but further investment in the oil sector could keep revenues higher than in the baseline scenario.

- Against this backdrop, which implies a lower underlying current account, there is no conclusive evidence of exchange rate misalignment (Box 1). The fact that Azerbaijan has been able to broadly maintain its share in global non-hydrocarbon exports also suggests that competitiveness is balanced. The authorities agreed with this assessment and stressed that improving competitiveness is a top policy priority. They saw public spending on infrastructure as critical to easing physical constraints on the business climate and improving the productivity of private investment.
- Risks to the baseline scenario are tilted to the downside but financial buffers are comfortable. The application of the “Silo” model of Cherif and Hasanov (2012), a finite horizon precautionary saving investment model under uncertainty, suggests that the current government consumption and investment in Azerbaijan are well above the optimal levels.¹ The Silo model suggests that in the face of highly volatile revenues, the optimal investment rate is 15 percent of total revenues while saving in safe assets is 37.3 percent initially. The gap between projected and optimal investment is very large in 2014.
- There are four key sources of fiscal risks to the consolidated budget in Azerbaijan:
 1. *Exposure to adverse oil sector developments*
 2. *Implicit liabilities associated with pension obligations*
 3. *Activities of the State Oil Company (SOCAR)*
 4. *Activities of the systemic and largely state-owned bank (IBA)*
- Despite successive reform efforts, the funding gap of liabilities inherited from the Soviet regime is projected to increase to 2 percent of GDP by 2024. The NPV of these liabilities through 2050 was estimated by an IMF technical assistance mission in the order of 54 percent of 2012 GDP.
- Plans are also advanced to approve a reform of the pension system this year — consistent with recent IMF Technical Assistance (TA)—that would ensure a sustainable pension system that provides a sufficient degree of income replacement.
- The currency of Azerbaijan is the manat, which became sole legal tender on January 1, 1994. The *de jure* exchange rate regime is “other managed arrangement” since March 2011, but the *de facto* regime remains as “stabilized arrangement”, based on the authorities’ policy to allow greater exchange rate flexibility since late 2010.
- Azerbaijan accepted the obligations of Article VIII, Sections 2, 3, and 4 effective November 30, 2004, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions maintained for security reasons that have been notified to the Fund.

APPENDIX H

Fitch Affirms Azerbaijan at BBB-; Outlook Stable. March 28, 2014 (source: CBONDS).

Fitch Ratings has affirmed Azerbaijan's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'BBB-'. The Outlooks are Stable. The issue ratings on Azerbaijan's senior unsecured foreign and local currency bonds have also been affirmed at 'BBB-'. The Country Ceiling has been affirmed at 'BBB-' and the Short-term foreign currency IDR at 'F3'

Key Rating Drivers

- The affirmation reflects Fitch's expectation that oil production will remain broadly stable for the next five years. Oil production grew 0.3% in 2013, halting a steep decline from the 2010 peak. New wells and a possible extension of the production sharing agreement between the BP-led consortium and the government will mitigate natural output decline rates. The natural gas export outlook is also more certain, after stakeholders in the Shah Deniz 2 natural gas project chose an export route to Europe in December.
- The government plans to progressively reduce transfers to the budget from SOFAZ, the State Oil Fund, and generate more non-oil revenue. Oil revenues will still account for around two-thirds of the budget, underscoring high dependence on commodity prices. The 2014 budget calls for spending growth to halve on the previous year to just 5% in nominal terms, so that spending as a share of GDP, which reached 39% of GDP in 2013, will stop growing.
- Azerbaijan issued a debut USD1.25bn 10-year sovereign Eurobond in March, establishing a presence in the bond market. Despite the fiscal consolidation under way, the state budget will run a deficit. The consolidated budget, including SOFAZ, will be close to balance.
- Azerbaijan's sovereign balance sheet is one of the strongest among rated sovereigns and underpins the rating. SOFAZ accumulated USD1.7bn in 2013 to reach USD35.9bn (49% of GDP) by end-2013. International reserves of the Central Bank of Azerbaijan (CBAR) are a further USD14.4bn. Fitch expects further modest growth in sovereign assets, providing a buffer against oil price or production shocks.
- Fitch estimates the current account surplus at nearly 18% of GDP in 2013, driven by a wide trade surplus. The current account surplus will narrow but remain in excess of 10% of GDP in 2015.
- Fitch expects growth to moderate to 3%-4% in 2014-2015, as the government seeks to rein in capital spending. Real GDP grew 5.8% in 2013 with non-oil growth exceeding 10%. Inflation will rise from recent lows after the government raised fuel prices in December. The real effective exchange rate has appreciated owing to Russian ruble and Turkish lira weakness. The Azeri manat remains pegged to the US dollar, backed by large CBAR reserves.
- CBAR has acted to curb rapid lending growth by increasing the risk weighting on consumer loans and Fitch expects this to slow lending growth. The authorities have given banks until January 2015 to meet a higher minimum capital requirement. The banking system is a relative weakness, given the asset quality problems at the

dominant, state-owned International Bank of Azerbaijan (IBA). The government has pledged to inject more capital into IBA.

- Governance is weaker and political risk higher in Azerbaijan than in the median 'BBB' sovereign, according to World Bank governance indicators.

Rating Sensitivities

The Stable Outlook reflects Fitch's view that upside and downside risks to the rating are balanced. The main factors that individually or collectively could lead to rating action are as follows:

Positive:

- A longer track record of sound management of the public finances in a context of static oil revenues; further growth in sovereign assets.
- Diversification and development of the non-oil economy, improvements in the business environment and other structural indicators.

Negative:

- Rapid spending growth that would erode the country's fiscal strength in the medium term.
- A prolonged period of low oil prices.
- A domestic or regional geopolitical shock, such an escalation in hostilities over the disputed region of Nagorno Karabakh.

Key Assumptions

- Fitch assumes that the price of oil, Azerbaijan's main export and source of budget revenue, will average USD105/barrel (Brent) in 2014, and USD100/barrel in 2015.
- Growth and fiscal projections are sensitive to oil production assumptions. Fitch assumes that oil production stabilizes from 2014-2018, although fluctuations are inevitable.
- Fitch assumes that Azerbaijan avoids domestic or regional political shocks, such as no escalation in hostilities with Armenia over Nagorno Karabakh, and domestic political stability is preserved.
- Fitch assumes that the government broadly adheres to the 2014 budget