

THE WORLD BANK

COMMONWEALTH OF INDEPENDENT STATES
PAYMENTS AND SECURITIES SETTLEMENT INITIATIVE



**PAYMENTS AND SECURITIES CLEARANCE
AND SETTLEMENT SYSTEMS IN
AZERBAIJAN**

FEBRUARY 2006

FOREWORD

Following the successful experience of the Western Hemisphere Payments and Securities Clearance and Settlement Initiative (WHI) in the Latin American and Caribbean region, in September 2004, the World Bank launched the Commonwealth of Independent States Payments and Securities Settlement Initiative (CISPI). The CISPI aims to assess and strengthen payments and securities systems in the Commonwealth of Independent States with a view to improving their safety, efficiency and integrity. The long term goal of the initiative is to build institutional capacity within the region in order to sustain the continued development of payment and securities settlement systems.

A key component of the CISPI is the International Advisory Council (IAC), which is comprised of representatives of international and national institutions with experience in the field of payments and securities systems. In addition to representatives from the World Bank, this council includes members from the Secretariat of the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements (BIS), Banque de France, European Central Bank (ECB), International Monetary Fund (IMF), Swiss National Bank (SNB), and the U.S. Securities and Exchange Commission (SEC). Other central banks, securities commissions and international organizations are expected to join the IAC over the course of the program.

To assure quality and effectiveness, the CISPI includes two important elements. First, all studies are conducted with the active participation of country officials and the project builds on the existing work being undertaken in the respective countries. Second, the initiative draws on international and national expertise on the subject, through the IAC, to provide guidance, advice and alternatives to current practices.

The initiative is undertaking a number of activities. These include: the preparation of public reports containing a systematic in-depth description of each country's payments, clearance and settlement systems; the delivery of recommendations reports to country authorities on a confidential basis; the organization of IAC meetings to review country studies and provide input for future work; the organization of workshops focusing on issues of particular interest; the creation of a web-page (www.cis-pi.org) to present the outputs of the Initiative and other information of interest in the payments systems area; and the promotion of working groups to ensure a continuation of the project activity.

The Kazakhstan Interbank Settlement Center (KISC) of the National Bank of Kazakhstan is currently acting as Technical Secretariat of the CISPI and is playing a major role in making the process sustainable. To this end, the initiative has helped strengthen KISC's in-house expertise. Additionally, practitioners in payments and securities clearance and settlement in some countries in the region have participated in the studies under the initiative through KISC coordination, and this has contributed to the broadening of knowledge and the transfer of know-how within the region. The endeavors of the working groups in coordination with the KISC will maintain the infrastructure created under the initiative and provide a permanent forum for the countries in the region to discuss, coordinate, and add a collective impetus to the work in the area of payments and securities clearance and settlement systems.

This report, *Payments and Securities Clearance and Settlement Systems in Azerbaijan*, is one of the public reports in the CISPI series and was prepared with the active support of the National Bank of Azerbaijan.

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This document is the result of the work developed by an international team, in coordination with a local team. The team visited Azerbaijan in February 2006. The international team was comprised by Mr. Jose Antonio Garcia (World Bank, mission leader), Mr. Sait Abdulkarimov and Mr. Alexander Shishlov (KISC, as Secretariat for the CISPI). The local team comprised officials from the National Bank of Azerbaijan (NBA) and was lead by Mrs. Kamala Gurbanova (Head of Payment Systems Department). This mission built on the work of a previous mission coordinated by Mr. Shishlov in mid-2005.

ABBREVIATIONS AND ACRONYMS

AML	Anti-money Laundering
ATM	Automated teller machine
AZIPS	Azerbaijan Interbank Payments System
BCSS	Bulk Clearing Settlement System
BEST	Bourse Electronic System of Trade
BICEX	Baku Interbank Currency Exchange
BIS	Bank for International Settlements
BSE	Baku Stock Exchange
CISPI	Commonwealth of Independent States Payments and Securities Settlement Initiative
CIS	Commonwealth of Independent States
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
CTF	Combat to Terrorism Financing
DVP	Delivery versus Payment
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EFTPOS	Electronic Funds Transfer at the Point of Sale
FIFO	First-In-First-Out
GDP	Gross Domestic Product
IAS	International Accounting Standards
IAC	International Advisory Council
IMF	International Monetary Fund

IPO	Initial Principal Offering
ISIN	International Securities Industry Numbering
KISC	Kazakhstan Interbank Settlement Centre of the National Bank of Kazakhstan
LTA	Local Treasury Authority
ML	Money Laundering
MOF	Ministry of Finance
MOJ	Ministry of Justice
NBA	National Bank of Azerbaijan
NDC	National Depository Center
OTC	Over-the-counter
POS	Point of Sale
RTGS	Real time gross settlement
SCS	Azerbaijan State Committee for Securities
SML	Securities markets law
SOCAR	State Oil Company of Azerbaijan Republic
SRO	Self-regulatory organization
SSPF	Social Security Protection Fund
STP	Straight-through processing
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TF	Terrorism Financing
UNDP	United Nations Development Program
WB	World Bank
WHI	Western Hemisphere Payments and Securities Clearance and Settlement Initiative

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1 ECONOMIC AND FINANCIAL MARKET OVERVIEW

1.1 OVERVIEW OF RECENT REFORMS

A comprehensive and successful stabilization program launched in the second half of the 1990s has resulted in strong economic recovery of Azerbaijan. Cumulative growth during the last 5 years has exceeded 40 percent. Both in 2002 and 2003, the gross domestic product (GDP) expanded by over 10 percent in real terms, reflecting a generally sound policy environment, high oil prices and significant growth of investments in the oil and gas sectors. Non-oil sectors have improved their performance as well.

As a result of the prospects of the oil sector, reforms in the country's administration system, and low state arrears, the international rating agency Fitch IBCA recently raised Azerbaijan's sovereign long-term rating and local currency long term rating to "BB stable".

Currently, foreign direct investment is equivalent to 60 percent of the GDP, which puts Azerbaijan in one of the leading positions among CIS, Baltic and eastern European countries. The country is now ready to penetrate international capital markets and start negotiations with potential investors for the issuance of Eurobonds. The issuance of these instruments is expected to strengthen the development of the non-oil sector, and help improve the business environment and development of regions and rural areas.

A brief description of some of the most relevant reforms made in recent years is provided below.

1.1.1 Reforms to the Judicial System and Legal Environment

During the past ten years Azerbaijan has taken many actions to meet European standards and consolidate the institutions and processes of a democratic state. Azerbaijan restructured its Ministry of Justice (MOJ) and reformed its Prosecution System. With respect to the judiciary, it has taken the important steps of introducing constitutional provisions to support judicial independence, redesigned the governance structure and organization of the courts, introduced improvements in the personnel management of judges, established the judicial council, and created a judicial code of ethics. To strengthen its legal framework, it has upgraded legal databases and introduced legal code reforms, including new criminal procedure codes, and new civil and civil procedure codes. To improve access to services, Azerbaijan has broadened access to the judicial system by creating legal assistance centers in some regions, and has updated legal protections for citizens by promulgating new laws on the operation of the legal profession, and developing human rights training and other programs.

International data show that scores rating the performance of the judiciary as a constraint for doing business have improved progressively between 1999 and 2005, as well as scores based on user perceptions of the timeliness of court decisions and ratings of the fairness and honesty of the courts.

Several donors are working with the MOJ and the courts in the areas of law drafting, procedural reforms and training of judges. These include: the Council of Europe and European Union for law drafting and appropriate selection and hiring of 100 additional judges and development of supervision systems; USAID and GTZ for training; and ABA CEELI for legal education and information, judicial training on ethics and commercial law ADR and studies.

1.1.2 Reforms to the Pension System

Distorted economic relations, weak currency and low purchasing power of money, inefficient legislation and finally the collapse of the Soviet Union worsened the conditions of the pensioners in Azerbaijan. The pension amounts decreased comparing to 1970s and 1980s.

In early 1990s the pension system could not afford the social protection of senior-aged pensioners. The problems with the pension payments also persisted. On 17 July, 2001 the Government of Azerbaijan adopted the "Pension Reform Concept" to introduce a new pension system based on individual social insurance accounts.

In March 2006, the parliament adopted a law to increase the minimum monthly pension benefit to equal at least the poverty level, currently 120 AZN (USD 132), by 2008.¹ Before this law was passed, about 720,000 of the 1.3 million pensioners received the minimum benefit of 30 AZN (about USD 33). In 2006, the minimum monthly benefit will increase to 45 AZN, and it will rise again to between 60 and 65 AZN in 2007. This measure will be funded from the state budget, which has tripled over the past 3 years mainly as a result of increasing oil revenues. For 2006, 29.42 percent of the public pension fund's revenue is expected from the state budget. Pensions will be indexed to inflation annually beginning in 2008.

Following up on 2001 and 2003 presidential decrees to improve the public pension system, these benefit increases are part a series of reforms to shift Azerbaijan to a new two-tiered pension system based on individual accounts. Since the beginning of this year, the government has been registering workers and employers for the new mandatory system that is to be introduced on January 1, 2007.

On September 23, 2004, the Government of Azerbaijan Republic and The World Bank signed a loan agreement aimed at completion of activities started within the UNDP/Social Security Protection Fund (SSPF) project, and replication of the outcomes of this Project across the country.

These include renovation of the local branches of SSPF, supply of modern computer hardware and software, and enhancement of overall managerial capacity of SSPF, among others. A loan in the amount of USD 5 million is to be implemented within the Project "Pension and Social Assistance Project during 2005-2008". This Project aims to significantly improve effectiveness and transparency in the providing public pensions and social assistance to eligible-beneficiaries.

In accordance with the Pension Reforms Concept, the Government of Azerbaijan is planning to establish a multi pillar pension system that includes three components - basic, partly funded, and fully funded (FF). Since the latter is a totally new system for Azerbaijan, the SSPF is negotiating a technical assistance grant with other international donor organizations.

1.1.3 Major Privatizations

At the end of 1995, the privatization of state property in Azerbaijan started with the adoption of the "State Program of Privatization of State Property in the Azerbaijan Republic, 1995-1998". The program took a mass privatization approach, which was intended to transfer

¹ All throughout this Report, the symbol "AZN" is used to represent the currency of Azerbaijan, the new manat, while "USD" is used to represent the United States dollar. The symbol "AZM" is also used to represent the manat, which was the country's legal tender until 2005.

state ownership to private individuals while limiting the inflationary impact of privatization, focusing mainly on small-scale enterprises. Some 15 percent of the small-scale enterprises were sold to the workers' collectively on preferential terms and 85 percent were disposed through cash auctions. The first privatization program expired in 1998, and the Second State Program of Privatization of the State-Owned Property came into effect on June 1, 2000. The privatization program in Azerbaijan is supported by the World Bank's Second Structural Adjustment Credit and the Farm Privatization Project.

Voucher privatization, which marked the beginning of privatization of medium and large enterprises, was launched in 1997. According to section 4.3 of the "Second State Program of Privatization of the State-Owned Property", the selling of state-owned property through specialized voucher and cash auctions comprises the sale of shares or package of shares of the joint stock companies established during privatization to buyers on the basis of orders. For small-scale domestic investors, the vouchers were a useful tool to purchase corner shops and smaller production units. Initially, government plans also suggested that vouchers would give foreign investors a claim on Azerbaijani state-owned shipping, electricity, telecommunications, and most importantly, oil and gas companies (e.g., SOCAR - the State Oil Company of Azerbaijan Republic - the country's largest and the most valuable company). Later, however, foreign investors were required to buy an "option" for each privatization booklet that they held in order to participate in the privatization process. The opportunities for foreign investors in the privatization process and the scale of their participation were never clearly defined. The mass (voucher) privatization program was expected to be completed by August 2000, but the expiry date was extended until 2002. The program has run into problems because of the limited number of state-owned companies for sale.

On April 30, 2001, by presidential decree, the Ministry of State Property was transformed into the Ministry of Economic Development. The new institution has been responsible for formulating and implementing state policy related to the socio-economic development and international cooperation, including privatization and management of state property. The Department of Privatization of State Property was established within the Ministry of Economic Development for continuing and ensuring the privatization process.

In accordance with the Law on Privatization of State Property, the decision to privatize state-owned property is to be taken by the relevant executive power agency, either through presidential decree, or by decision of the Ministry of Economic Development. Moreover, the decision has to include justification and methods of privatization. Within the process of making a decision on privatization, the strategic importance of the entity in terms of national security and economic interests of the country has to be taken into consideration.

Since 1998, the privatization process in Azerbaijan has slowed down, and sales of medium and large-scale firms have dwindled. Based upon reports of the World Bank, the International Monetary Fund (IMF) and the European Bank for Reconstruction and Development (EBRD), among others, structural reforms, good governance, modernization of infrastructure, as well as adequate access to financing, are required to boost private sector development. By 1999, land had been largely privatized (almost 90 percent); owners had been given the right to land shares and to receive land titles. Moreover, the State Committee of Land and Mapping was established to supervise the development of the land market. By January 2000, 21,544 small enterprises had been privatized, and 966 joint stock companies had been established. By March 2001, the figures were 23,539 and 1,230, respectively. By mid-2002, the privatization of large enterprises was underway, with approximately 1,500 medium and large enterprises having been privatized.

Although the Government has allowed large-scale foreign direct investment in the oil sector, SOCAR has not been privatized. The main venture has been the Azerbaijan International Operating Company, a consortium of 10 major international companies (British Petroleum,

TPAO, ITOCHU, Statoil, Lukoil, Delta Hess, Pennzoil, Exxon and Unocal) and SOCAR, established in December 1994. In March 2002, the reform policy of the energy sector was adopted. Measures included the restructuring of major energy companies, such as Azernerji and Azerigaz. In addition, in November 2001, a 25-year concession for the Baku electricity distribution network was awarded to the Turkish company Barmek. In July 2002, the Department of Privatization announced that shares of the joint stock companies Baku Electrostamp and Baku Rubber Products were purchased. Regarding the banking sector, only a few initiatives as regards privatization have been completed. The International Bank of Azerbaijan, one of the largest banks, has been expected to be privatized since 1998, but the Government has sold only a minority stake to the EBRD.

1.2 MACROECONOMIC BACKGROUND

1.2.1 Real Sector

In 2004, favorable domestic and foreign economic environments had a significant impact on the country's economy, helping to retain the high economic growth rate Azerbaijan has achieved in recent years. Real gross domestic product (GDP) growth rate was 10.2 percent in this year. An expansive fiscal policy combined with record-high oil prices were among the key factors ensuring the high economic growth in 2004. Nevertheless, the growth rate of the non-oil sector was even higher than that of the total GDP at 13.4 percent.

The 2004 GDP totaled 41,872.5 AZM billion (USD 8.5 billion). GDP per capita increased by 9.2 percent versus 2003. GDP increased by 10.8 percent in commodity production sectors and by 8.9 percent in service sectors.

A significant increase in practically all components of aggregate demand played an important role in retaining the high rate of economic growth. A 20.7 percent increase in nominal income of households caused nominal expenses to go up by 24.4 percent. This drastic upturn in household expenditures, in turn, caused the consumption demand component of the aggregate demand to increase substantially in contrast to previous years. On the other hand, the nominal increase in the consumption demand had a positive impact on both consumer prices and expansion of commodity supply.

An increase in public expenditures also represented a key factor behind the growth of the aggregate demand in 2004. In this year, public budget expenditures grew by 21.6 percent. The increase in public expenditures sought to speed up the economic growth in social sectors and improve the social welfare.

Investment expenses funded from a variety of sources increased by 36.1 percent in 2004. Just like in the previous years, investments were mainly drawn to finance construction works associated with large-scale projects hence entailing a demand for investment-oriented commodities, which is covered mostly with imports. Yet, total investments, where foreign investments account for 73.7 percent of the total, continue to provide a significant contribution to the economic growth. Thus, investments related to implementation of both oil and non-oil sector large-scale projects boosted certain construction services, which turned into a key factor behind the dramatic increase in the construction sector in 2004.

Continued State's support to private business development in 2004 helped in improving the business environment and the effective utilization of the resource potential of the non-oil sector. In 2004, the private sector accounted for 73.5 percent of the total GDP.

The share of the private sector in terms of investments drawn continued to increase in 2004. Investments made in the non-public sector in the reported year increased by 39.9 percent while investments to the public sector went up by 6.6 percent.

The upward trend in the industrial and construction sectors observed for a number of years now still continued. With the construction sector being the most fast-paced in terms of growth since recently, its share in the GDP went up from 8.7 to 13 percent in the last two years.

Almost all sectors contributed to growth in the industrial production. Growth in the agricultural sector totaled to 4.6 percent in 2004. The growth affected almost all sectors of the agricultural industry save for fruit, vegetable and melons and gourds. Agricultural production upturn constituted 3.6 percent in crop production and 6 percent in livestock.

The transport sector, which represents a substantial component of the overall GDP growth, continued to increase its turnover whereby cargo transportation went up by 6.9 percent and passenger transportation by 3.6 percent. Cargo transportation growth included railway transportation growth of 3.1 percent, motor transport of 10.4 percent, while passenger transportation included a 3.1 percent upturn in motor transport sector, 7.8 percent in subway transportation and 26.1 percent in air carriage sector.

The significant growth in the consumer demand in 2004 caused a drastic growth of the consumer market. The real volume of retail commodity turnover went up by 13 percent and chargeable services by 16.4 percent in the reported year versus the corresponding figures of 2003.

1.2.2 Monetary Sector

In 2004, the National Bank of Azerbaijan (NBA) pursued a monetary policy designed to support the rapid economic growth, retain the baseline inflation rate as a major factor of macroeconomic stability, ensure competitiveness of the non-oil sector, accelerate re-monetization of the economy, and meet the real cash needs.

Up to February 2006 the reserve requirement was 10 percent for short-term deposits and 0 for long-term deposits. Beginning on that date, deposits with maturity over 1 year have also been included in the basis for the reserve requirement and are weighted also at 10 percent.

In 2004, the NBA decided to allow the banks operating in the country to use their *manat*-denominated required reserve for daily clearing transactions within the AZIPS interbank payment system. In that same year the NBA started issuing short-term notes, continued to issue Lombard and overnight loans, and conducted a number of swap transactions. The NBA decided to issue short-term notes in order to reduce the excessive cash in circulation as a result of previous actions to sterilize the excess liquidity of the banking sector. Short-term notes were first issued on September 14, 2004. A total of 11 auctions of short-term notes were held during 2004.

Prices for consumer goods and services rose by 6.7 percent during 2004. Consumer price increases were 10 percent for food products, drinks and tobacco, 1.5 percent for non-food products and 0.3 percent for services.

Table 1: Main Monetary Indicators in 2004-2006*

	2002	2003	2004	2005*
Inflation	2.8	2.5	2.5	n.a.
Exchange rate manat vs. USD (annual average)*	4,861	4,911	4,975	0.917
Foreign exchange reserves (USD mn)	681.7	760	800	n.a.
Broad money (M-3) (manat bn)	3,926	4,829	5,988	1.84
<i>growth rate</i>	14.3	23	24	66
Broad manat money (M-2) (manat bn)	2,026	2,512	3,215	0.797
<i>growth rate</i>	15.4	24	28	35
Refinancing rate, percent	10	7	7	9
Total deposits in the bank system (manat bn)	2,257	2,810	3,595	1,294
<i>growth rate</i>	14.8	25	28	95
Individuals' savings (manat bn)	767.3	1,212	1,940	0.495
<i>growth rate</i>	31.1	58	60	35
Credits to economy (manat bn)	2,601	3,277	4,260	1,441
<i>growth rate</i>	7	26	30	83

Source: NBA.

*In 2005 the new manat was introduced. All currency figures for year 2005 are stated in new manats.

Salary levels increased by 22 percent in nominal terms. The average monthly salary was 118 AZN (approximately USD 128). The highest salary levels were in the mining, financial, and construction industries.

1.2.3 Public Finances

The structural and socio-economic adjustments underway in the country provided a positive impact on further improving the sustainability of the public finance system and increasing the public budget revenues and expenditures.

Public budget revenues and expenditures showed a significant increase in 2004. Budget revenues increased by 1,278.2 AZM billion or 20.8 percent, and were equivalent to 17.7 percent of GDP. Budget expenditures grew by 21.6 percent and represented 17.9 percent of GDP. Although the public budget deficit was originally projected at 315 AZM billion, the actual figure for 2004 was only 99.2 AZM billion, equivalent to 0.2 percent of GDP.

1.3 FINANCIAL SECTOR

The banking system in Azerbaijan includes the NBA and credit organizations. Commercial banks are credit organizations with the exclusive right to perform all banking operations

* The following conventions for notation are used in all Tables and Figures throughout this Report: "n.a." indicates data that are not available; "..." stands for data that are not applicable; "neg" indicates where data are very small relative to other relevant data in the table concerned.

allowed in the relevant Laws. Non-banking credit organizations have licenses for conducting limited banking operations.

The establishment of the legal and institutional framework for the banking system in Azerbaijan began in 1991 after the country's independence. The adoption of the Law on the National Bank of the Azerbaijan Republic and the Law on Banks and Banking Activity set forth the legal and normative basis of the banking system.

Reform of the banking system in the 1990s included the gradual introduction of prudential supervision and the modernization of the legal framework to coincide with international standards. Special attention was also devoted to improving banks' capital, liquidity, profitability, security of transactions, use of progressive technology, and management information systems. These reforms led to consolidation of the banking system, enlargement of banks, and improved capitalization. As a result, aggregate bank capital increased 22 times, total investment three times, and the amount of attracted savings increased eight times. Special weight of bank assets in GDP increased and reached 19 percent in 2005.

In recent years, strategic targets set by authorities include improvements to the banking laws to comply with international best practices and standards, enhancing the safety and soundness of the banking system, expanding access to banking services, increasing transparency within the banking system and improving the market discipline, and improving the effectiveness of the banking supervision function. In this regard, "third generation" banking Laws were passed in accordance with the NBA's Strategic Plan for 2001-2004.

Box 1: Reforms in Accounting and Reporting

"Bringing Accounting and Reporting to conformity with the International Accounting Standards"

Starting in 1997, a series of measures were launched that aimed to bring accounting standards in line with the International Accounting Standards (IAS) in the banking system. These included:

- Preparation of a Plan of Accounts for the banking system which should be in full compliance with international standards;
- Depuration of accounting rules for the banking system and ensuring transition to the IAS.

The Single Plan of Accounts for banking institutions was prepared by the NBA together with experts from the consulting firm Price Waterhouse Coopers and was implemented in September 2001.

To ensure transition of the banking system to IAS and accounting instructions were prepared and implemented in 2000-2001. The module entitled "Ensuring full transition of accounting in the banking sector of Azerbaijan to the IAS" was implemented. It is worth noting that the Module started to be operational in July 2002 and became fully implemented on March 2003.

Source: NBA.

The reforms to the banking sector have led to the consolidation of the country's banking system. Bank capital has increased several times during the last decade. In 2005, bank equity increased by 47 percent while paid-in capital of banks increased by 41.2 percent. On the other hand, bank deposits have soared, leading to a significant increase of bank assets both in nominal terms and as percentage of GDP. Thus, as during 2005 bank assets

increased by 35.4 percent and the total credit portfolio by 56 percent, as a percentage of the GDP bank assets increased from 17.7 to 19 percent, and loans from 9.4 to 11.5 percent.

The Law on Banks of the Republic of Azerbaijan became effective in 2004. This Law, developed in compliance with international standards, including the European Union's banking directives and the Basel Core Principles of Banking Supervision, has enabled the reform of the banking system to further ensure effective protection of depositor and creditor interests. For the first time in the banking laws focus has been placed on requirements related to the moral qualities of shareholders and administrators. Only "fit and proper individuals" and individuals with proven "civil integrity" qualify to be major shareholders and administrators. Besides, any applicant for a banking license now has to endure a two-level authorization procedure and be economically and institutionally ready from risk management standpoint.

Currently, there are 44 banks in Azerbaijan with approximately 390 branches. An estimated 203 of these branches are located in Baku. Development of the banking infrastructure, along with liberalization of the banking services market, has enabled banks to expand the range of quality and diversified banking services.

As the state authority responsible for implementation of the government policy in terms of regulating the banking sector, the NBA has launched several initiatives aimed at strengthening the system. These comprise both an improved banking supervision function and several legal and regulatory initiatives, including the implementation of international accounting standards. By passing the new Law on Banks, the banking supervision system in Azerbaijan has formed a complete legal framework and basis which will enable it to conform to the best international practices and standards. At the same time, balanced on-site and off-site supervisory tools and techniques are now used. As a result of a tougher banking regulatory system, several licenses of both banking and non-banking credit institutions have been revoked in recent years. Banking system capitalization activities were also supported by the compulsory exit of two banks from the system, which failed to comply with prudential requirements, without causing damage to the interests of their respective creditors and depositors.

Special attention is being given recently to the promotion of mortgage lending and to creating a framework for deposit insurance. The draft Mortgage Law developed by the NBA was enacted in April 2005. On the other hand, the preparatory measures upon deposit insurance are being continued and as a result the appropriate law draft has been prepared and submitted to the Parliament.

A resolution of November 23, 2003 issued by the National Bank's Management Board eliminated the domestic market participation limit with respect to foreign banks as of January 1, 2004. These actions made an extremely important contribution to enhancing the access opportunities of business entities and individuals in respect of banking services.

Resolution No.09 of May 3, 2004 issued by the NBA's Management Board set the minimum total capital requirement with respect to operating banks at USD 3.5 million equivalent as of January 1, 2005 and USD 5 million equivalent as of January 1, 2006. As a result of meeting the minimum total capital requirement, banks increased the regulatory capital in 2004 by 520 AZM billion to a total of 1,198 AZM billion. Along with what mentioned above, according to the appropriate decree of the Board of NBA dated 23 December, 2005, a gradual increase of the minimum capital for the banks is being considered in the following sequence: by July 1, 2006 it should be 6.4 AZN million; January

1, 2006 it should be 8.2 AZN million; and by July 1, 2007 the amount should be increased to 10 AZN million.

A set of comprehensive measures have been implemented including the introduction of corporate governance standards at banks that meet international standards; completion of transition towards International Financial Reporting Standards; and increasing requirements with regard to the contents and volume of periodical publications. The National Bank has requested and acquired foreign technical assistance to support implementation of corporate governance standards at commercial banks. The German development bank KfW has already started implementing corporate governance standards at four pilot banks under the technical assistance project.

Consolidated reporting formats for banking system development progress to be used by both experts and the general public were prepared and posted on the NBA website for the first time in 2004. This measure had an important impact on improving the oversight of banks' financial positions and transparency in the banking system.

The public confidence in the banking system has improved, as measured by the increased share of long-term deposits (over 1 year) in total deposits totaling 20 percent in 2005. In this same year, long-term loans grew by 82 percent. Nonetheless, the major source of growth on the asset side of the balance sheet is still short-term consumer loans.

The private sector's share of the total loan portfolio was 80.1 percent. However, the share of state-owned banks within the total loan portfolio increased from 50.1 to 53.4 percent.

A decrease in past due loans has also contributed to the overall improvement in asset quality. While past due loans totaled 11 percent as of December 31, 2004, they dropped to 4.7 percent as of year-end 2005. Loans on non-accrual status went down from 8.3 to 5.8 percent.

1.4 CAPITAL MARKETS

The formation of an organized securities market started in 1996 with the creation of State debt instruments. In that year, the Ministry of Finance announced the first issuance of treasury bills (T-bills) for a total amount of 5 AZM billion (about USD 1 million) and with a yield-to-maturity of 31.18 percent.

Created in 1999, the Azerbaijan State Committee on Securities (SCS) has been establishing the key elements for the development of the securities market. Under the legislation, market intermediaries are subject to prudential requirements. Regulations aim to ensure that investors are given fair access to market facilities and market information.

Investor protection is emphasized in the normative acts. To enable investors to better assess potential risks and rewards of their investments, the regulations emphasize and require full disclosure of information materials to investors. Only duly licensed and otherwise authorized agents are permitted to provide securities investment services, including advice. The SCS also pays special attention to corporate governance principles and supervises strict observance of these principles.

In October 2000, the Baku Stock Exchange (BSE) was established by a group of shareholders drawn mainly from the banking sector and with Turkish and British capital. Today the BSE renders a range of services to market participants—depository, clearing

and settlement, information services, consulting, and training. Any interested person who has been duly authorized by the SCS to perform capital markets activities may purchase a seat in the trading floor of the BSE.

In September 2004 the NBA began issuing short-term notes to support its monetary policy operations. On the other hand, in that same year the Ministry of Finance considerably reduced the issuance of T-bills. The latter change occurred in spite of the fact that the value of T-bills in the market exceeded 500 AZM billion (USD 100 million), which, together with increased liquidity and the development of market infrastructure, had allowed the government to achieve substantial cost reductions in the service of the internal debt. No further issuances of T-bills are being foreseen.

Also, 2004 was the starting point for the large-scale issuance of corporate instruments. Thus, banking institutions started issuing debt securities which soon have become quite popular. The market value for corporate debt instruments currently exceeds 60 AZM billion.

Recently there also has been an increase in initial principal offerings (IPOs) by private sector firms. As a result, the securities market structure increased the share of the private corporate sector. The private corporate sector now accounts for nearly 40 percent of the total value of securities in the marketplace while the government sector represents the remaining 60 percent.

The core elements for the good functioning of the securities market appear to be in place now, and the securities market is expected to become one of the engines to facilitate foreign capital inflows to the country. This will be particularly important as Azerbaijan moves forward with the implementation of several regional mega projects such as the Baku-Tbilisi-Ceyhan pipeline, the Baku-Tbilisi-Erzurum pipeline, the North-South route, the rehabilitation of the Great Silk Road, and the construction of South Caucasus pipeline.

1.5 MAJOR TRENDS IN PAYMENT SYSTEMS

The payments system in Azerbaijan is characterized by the use of credit transfers for large value payments and mainly credit transfers and cash for retail transactions. To date, debit payment instruments such as cheques and direct debits are not widely used either at the intrabank or interbank level. The *new manat* is the unique legal tender in the country. According to the law, all payments within Azerbaijan made by residents must be made in *new manats*.

There are two major payment systems in Azerbaijan: the Azerbaijan Interbank Payment System (AZIPS) for large value and high priority payments, and the Bulk Clearing Settlement System (BCSS) for low value payments. Both are operated by the NBA and are available only for transactions denominated in the local currency, the new manat (AZN).

The AZIPS is a real-time gross settlement (RTGS) system that conducts electronic funds transfers between participant accounts at the NBA. There are 43 participants in this payments system. The AZIPS provides settlement in AZN on a real time basis if sufficient funds are available to cover a payment. If sufficient cover is not available, the transaction is sent automatically to a waiting queue, where it is kept pending until funds become available as a result of incoming payments. The NBA provides overnight and free-of-charge intraday credit facilities for participants with insufficient liquidity. This process is not automated, however, and participants must call the Money Market Operations Department to arrange the loan. Participants are permitted to use their reserve requirement during the day, which at present

stands at 10 percent of a group of bank liabilities in both local and foreign currency. In 2005 the AZIPS system processed a total of 316,061 payments for a value of USD 14.7 billion.

Batch processing is the main feature of the BCSS. Payments are processed during two sessions from 9:15 a.m. till 1:35 p.m., and from 1:35 till 3:05 p.m. with same-day settlement. Batches are settled on a gross basis if sufficient funds are available in the BCSS sub-account. For this purpose, participants must first fund their BCSS accounts by transferring funds from AZIPS. If sufficient cover is not available, the transaction is sent by the system to a waiting queue, where it is kept pending until funds become available as a result of incoming payments. At the end of the day, payments waiting in the queue are cancelled, and remaining balances in BCSS sub accounts are transferred back to the main AZIPS accounts. In 2005, the BCSS system processed 754,490 payments for a value of USD 1,319 million.

Regarding other cashless payment instruments, the payment card base is low but growing at a fast pace, particularly in recent years. The majority of cards (85 percent) in circulation are debit cards, and in general cards are used for cash withdrawals from ATMs and much less so as payment instruments at point of sale (POS) terminals. The are two main payment card operators in the country: AzeriCard, owned by the International Bank of Azerbaijan and which is by far the major player in the marketplace, and MilliKart, a recent venture sponsored by the NBA.

Currently, 40 commercial banks are connected to SWIFT. Remittances, a particular type of cross-border retail payment, are very relevant to Azerbaijan both in terms of the number of residents that receive remittances from relatives living abroad, mainly in Russia, and as a percentage of the GDP.

Smaller population centers in Azerbaijan are generally not served by banks. Hence, access to financial services is not widespread beyond the major cities. Some basic payment services in Azerbaijan in such areas are provided mainly by the national postal service, Azeri Post, which has over 1,200 branches in areas outside the capital city of Baku. The government has initiated a major project to modernize the infrastructure of Azeri Post to provide it with the necessary means to become a relevant player in the retail payments arena.

The NBA prepared the State Program for Development of the National Payments System in Azerbaijan for 2005-2007 and submitted it to the Cabinet of Ministers. It was approved by Presidential Decree on December 9, 2004. The principal objectives of the State Program are (i) to ensure broader usage of electronic payment systems by all business entities and the wider population, and each and every household; (ii) to create a single electronic payment area for them covering the entire country, regardless of actual administrative boundaries; (iii) to improve access of legal entities and individuals to financial services and, vice versa, and to improve access of the banking system and financial markets to business entities and households; (iv) to replace cash in circulation with non-cash turnover and by accumulating such resources within the banking system to create an enabling environment to invest these resources in the economic development in the country.

There is also a project for the technological integration of public utilities payments (for electricity, gas, water, telephone, etc.) as well as tax and customs payments into the national infrastructure of payment systems. This project considers creation of a single database of all utility bills with wide access of householders to the information and possibility to initiate payments from any commercial bank branch, AzeriPost, ATMs and the Internet. Settlement will occur at the BCSS.

Development of the oversight function is also a short term priority for the NBA. The NBA and a team of international experts recently completed a study of the payment system and are working on implementation of new oversight features at the NBA.

1.6 MAJOR TRENDS IN SECURITIES CLEARANCE AND SETTLEMENT SYSTEMS

The securities market is in its early stages. The most relevant instruments are the T-bills issued by the Ministry of Finance and NBA notes, although most T-bills issuances have been paid-off by the Ministry of Finance and no new issuances are foreseen for the immediate future. The Azerbaijan State Committee for Securities (SCS) is the regulator of the securities market.

By law, securities in Azerbaijan can be issued in both dematerialized and physical form and must be registered in one of two existing registrars if the number of shareholders exceeds 20. At present, 99 percent of all securities are dematerialized in one of the three institutions that have a license to perform securities depository services in Azerbaijan: National Depository Center (NDC), the BSE, and another private sector organization.

The NDC is the major securities depository. It is a non-for-profit joint stock company totally owned by its regulator, the SCS. Deposit accounts at the NDC identify the final beneficiary. There are approximately 97,000 accounts belonging to individuals, while 281 others belong to legal entities.

In general, trading and settlement processes are extremely cumbersome; as a result, nearly 2/3 of total securities transactions are not made through the BSE but by means of bilateral addressed transactions through brokers and partly through public notaries. Trades are settled according to the BIS Delivery Versus Payment (DVP) model 1.² Settlement risks are managed by means of pre-funding of both cash and securities before trades take place at the BSE.

² "Delivery versus Payment in Securities Settlement Systems", Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries of the Bank for International Settlements, September 1992.

2 INSTITUTIONAL ASPECTS

2.1 GENERAL LEGAL FRAMEWORK

The legal framework for the Azerbaijan Payment System is based on the following key documents: Civil Code, The Law on the National Bank of the Republic of Azerbaijan, and The Law on Banks in the Republic of Azerbaijan. Additionally, there are statutory acts (regulations) of the NBA such as the "Settlement rules for banks operating in the Azerbaijan Republic", and the "Cashless settlements and money transfers rules in Azerbaijan Republic". The NBA also has various contracts with commercial banks regarding the services it provides to the latter.

The Laws on the National Bank of the Azerbaijan Republic as well as the Law on Banks in the Republic of Azerbaijan were reformed recently. After having gone through extensive public discussion, the reforms were enacted by the National Parliament in 2004.

The Law on the National Bank of the Republic of Azerbaijan was based on Presidential Decree of December 26, 2002 and took effect after its approval by the National Parliament. The Law clearly identifies the NBA's legal status, objectives and functions, position and role within the government and provides mechanisms to improve the NBA's accountability and operating transparency. The stability and development of payment systems is regarded as one of the main tasks of the NBA along with ensuring price stability and the stability and development of the banking system.

The legal framework for payment systems in Azerbaijan is flexible because the NBA has the right to issue regulations that are enforceable in Law. The internal regulations of the NBA are approved either by its Board, or by the Chairman of the Board. However the normative regulations of the NBA are approved by the NBA Board and registered by the Ministry of Justice. The NBA has been working for some time, together with the IMF, to ensure that the payment system legal framework can support a modern electronic system. New draft laws have been developed and are currently in the process of being declared Law. The promulgation of these draft Laws will provide further legal support to the payment system of Azerbaijan.

2.1.1 Payments

According to the legislation, all interbank transactions in national currency have to be settled either through AZIPS or BCSS. Settlements in manat by means of correspondent accounts opened in banks are prohibited.

The rules and procedures developed for AZIPS are updated by the NBA. The main ones are the "Settlements rules for banks operating in the Azerbaijan Republic", the "Cashless settlements and money transfers rules in Azerbaijan Republic", various procedures manuals, and contracts between the NBA and commercial banks. These documents explain the system design, time-table and risk management procedures as well as the legal basis and roles of the different parties. The above-mentioned documentation is readily available.

Box 2: Other relevant Laws and Normative Acts in Azerbaijan

1. Methodical instruction on drawing up of statistical reports № 747 and 748 on cash desk turnover.
2. Procedures for the organization and management of the cash function in the banking system.
3. Procedures of liquidation of banknotes of the National Bank of the Azerbaijan Republic removed from turnover.
4. Provisional instructions of the National Bank upon regulation of operations regarding application and utilization of electronic payment instruments (plastic cards) in Azerbaijan Republic.
5. Procedures of issuance of memorial coins in the Azerbaijan Republic.
6. Procedures of organization of settlements between current and transit accounts of the General Treasury.
7. Procedures upon conducting of cash transactions and collection of valuables in credit organizations of Azerbaijan Republic.
8. Procedures of arrangement of settlements between banks operating in the Azerbaijan Republic.
9. Regulations on import to and export from Azerbaijan Republic of foreign currency by physical persons.
10. Regulations on control of currency operations of residents and non-residents in Azerbaijan Republic.
11. Procedures of opening and maintenance of correspondent accounts for foreign banks in national currency by credit organizations of the Azerbaijan Republic.
12. Procedures of establishment and regulation of limits of open currency position of the authorized banks of the Azerbaijan Republic.
13. Procedures of opening, management and closing of bank accounts.

Source: NBA.

2.1.2 Securities

The Civil Code of the Republic of Azerbaijan is the main Law regulating the securities market. Activities are also regulated by the acts and standards of the SCS, which also monitors trades by analyzing the reports prepared by the BSE and by securities markets participants at the end of each operational day.

Securities holdings in the licensed securities depositories are protected from claims of third parties as stated in the Civil Code, Section 1078-33-5. The Civil Code also indicates that the legal ownership of the securities is to be found in the securities depository. In order to reduce custody risk in the current system of double registration of securities ownership (i.e. with the securities depository and with a Registrar), the securities depositories appear as the nominal holders of the securities with the relevant Registrar. In practice, the NDC itself is the Registrar of all securities with the exception of a few issuances of small size.

2.1.3 Derivatives

Derivatives are very rarely traded in Azerbaijan. As far as clearance and settlement are concerned, derivatives exchanges would in principle be governed by the same legal framework applicable to securities exchanges.

2.1.4 Specific Legal Issues Related to Clearance and Settlement

2.1.4.1 Netting

Netting is covered in Civil Code Article 441, Section XXVII, paragraph 3.

2.1.4.2 Settlement Finality and Zero-Hour Rule

Current regulations define the timing of settlement and the irrevocability of payment orders accepted for settlement by the relevant system. These regulations state that a payment is final and irrevocable once it has been transacted across the accounts of the parties in the books of the NBA.

There is no reference to the so-called zero-hour rule.³ The Banking Law describes the procedures to be followed in case a bank goes bankrupt. Article 60 specifically states that neither the Law on Insolvency and Bankruptcy of the Republic of Azerbaijan, nor any other Law amending or replacing the Law on Insolvency and Bankruptcy in whole or partially shall apply to banks. Article 73 of the Banking Law with the title “Settlement Finality in Payment Systems” states that notwithstanding the provisions of Article 72.1 (which describes bankruptcy procedures), irrevocable money and securities transfer orders entered by a bank into a payments or securities settlement system shall be legally enforceable and binding on third parties, even in the event of a court decision opening bankruptcy proceedings against the bank, but only if the transfer orders become irrevocable before the bankruptcy decision takes effect. If a bank enters irrevocable money or securities transfer orders into a payment system or securities settlement system after a court decision opening bankruptcy proceedings against that bank takes effect, the transfer orders shall not be legally enforceable nor binding on third parties, unless the receiver can prove that the system operator was aware of the bankruptcy decision before the transfer orders became irrevocable. No regulation, rule or practice which annuls or delays contracts and transactions concluded before the court decision to pronounce the bank bankrupt takes effect shall lead to unwinding of a clearing by settlement systems.

2.1.4.3 Electronic Documents and Signatures

The current legislation in particular the “Law of the Azerbaijan Republic about Electronic signature and electronic documents” explicitly defines rules and procedures of electronic processing.

2.1.4.4 Collateral Arrangements in Settlement Systems

Collateral provided for settlement systems generally consists of short-term government securities which are instrumented via repurchase agreements (repos). The rights of the

³ As defined by the CPSS, the zero-hour rule is “a provision in the insolvency law of some countries whereby the transactions of a closed institution that have taken place after midnight of the date the institution is ordered closed may be retroactively rendered ineffective”.

holders of these securities are protected in the Laws and regulations of Azerbaijan. They are also protected in cases of insolvency.

2.2 THE ROLE OF FINANCIAL INSTITUTIONS: PAYMENTS

2.2.1 The Banking Sector

The banking system officially comprises the NBA and credit organizations. Credit organizations represent corporate bodies, which are entitled to conduct banking operations with the aim of profit and on the basis of a license of the NBA. Banks are credit organizations, having the exclusive right to fulfill all banking operations. Non-banking credit organizations have licenses for conducting limited banking operations.

A branch is defined as a separate subdivision of a credit organization, which is not a corporate body and is opened with the consent of the NBA in a separate location from that of the credit organization. The branch conducts all or part of banking operations, specified by the license, on the credit organization's behalf.

Currently, there are 44 banks in Azerbaijan with approximately 390 branches. An estimated 203 of these branches are located in Baku. One new bank was licensed to operate recently.

Table 2: Banking System in Azerbaijan

Number of credit organizations, having a license for conducting bank operations:	133
- out of which: non-banking credit organizations	89
Number of credit organizations allowed to carry the following operations:	
- attracting savings from the population	39
- foreign currency transactions	43
- operations with precious metals	2
- guarantees, orders	41
- conducting operations with plastic cards	34
Number of banks	44
- out of which: banks with share of foreign capital	18
* out of which: banks with foreign capital from 50 percent to 100 percent	7
* banks with share of foreign capital less than 50 percent	11
* number of branches of non-resident banks	2
Number of branches of operating credit organizations	390
Structures of credit organizations, operating on abroad:	
- branches – total	1
- representatives – total	2
- affiliated bank	1
Number of branches of operating non-bank credit organizations	26

Source: NBA.

The Law of Banks introduced some changes to the institutional and legal form of banks. Thus, a bank can be formed as an open joint-stock company by at least three legal entities or individuals. This provision is considered to be of great significance for the institutionalization of the banking system in Azerbaijan as joint-stock companies, whose stock are available for public trading and hence are subject to public scrutiny, are expected to perform better in aspects such as implementing corporate governance standards, ensuring transparent operations, and improving internal controls, among others.

2.2.2 Other Institutions that Provide Payment Services

2.2.2.1 Azeri Post

Azeri Post is a state-owned enterprise managed by the Ministry of Communication and Information Technologies. It has over 1,200 branches throughout the country. Most branches provide postal and payment services; approximately 100 branches are “one-person” agencies that provide limited services only.

Azeri Post currently offers a number of product lines beyond traditional postal services such as mail and parcel delivery. These include:

- *Domestic and International money transfers:* payments and remittances have been growing significantly in both volume and value over the past 18 months since the “Money Gram” product was introduced. For remittances, Azeri Post applies a combination of communication equipment using fiber optic lines, terrestrial lines, vehicles and person to person to deliver its current postal products and financial services within its market areas, with varying speeds, safety and times of delivery.
- Azeri Post provides the traditional billing and collection of payments from users for the monthly charges and billings of the telephone company Aztelcom, electricity, gas, water and other utilities. These services are not provided in rural areas, where there is no interconnectivity, a necessary condition to support the bill payment systems.
- *Pensions and Social payments and other Payments for Governmental Authorities.* Azeri Post also provides delivery of monthly pensions, social security allowances and other allowances to recipients designated by the Pension Fund. It also provides services to other entities, such as collection of fines imposed by road police and/or tax payments.

2.2.2.2 AzeriCard

The AzeriCard system is the country’s largest processing center, serving 29 banks in Azerbaijan and abroad. It is owned and operated by AzeriCard Ltd, a subsidiary of International Bank of Azerbaijan and is fully certified by Visa, MasterCard and American Express. The company provides services related to embossing and encoding of plastic cards, as well as clearing and authorization center for payment card operations. Settlement for international transactions is achieved through correspondent accounts, via the relevant card organization. Settlement for domestic transactions is done through the NBA.

AzeriCard has a network of approximately 867 automated teller machines (ATMs), and 1,140 EFTPOS devices. During the last three years, AzeriCard has introduced several projects on utilities payment collections using the ATM network and Internet banking. There is also a project on mobile phone banking that is ready for implementation.

Finally, since 2004 AzeriCard has issued more than 400,000 cards for pensioners.

2.2.2.3 MilliKart

MilliKart is the second processing center in the country and was established by the NBA at the end of 2004. Live operations started in March 2005. Currently it has a small network of 50 ATMs and a membership of 9 banks.

2.3 THE ROLE OF FINANCIAL INSTITUTIONS: SECURITIES

2.3.1 Securities Market Participants

The Law recognizes seven different professional roles within the securities markets. These are as follows:

- *Issuers:* Issuers can be private and public sector corporations, governments, or private companies that meet registration requirements of the SCS to sell an offering of securities.
- *Brokers–Dealers:* By Law only brokers-dealers can participate in trades at the BSE. There are currently 12 companies of this kind licensed by the SCS. Commercial banks cannot act as dealers. Dealers cannot act as the nominal holders and hold securities in a securities depository on behalf of their clients. Therefore, the NDC's system of accounts has only one level where the final beneficiary is identified. Currently there are more than 97,000 securities accounts belonging to individuals and over 281 belonging to legal entities.
- *Depositories:* There are three licensed securities depositories in Azerbaijan. The biggest one is the National Depository Center (NDC), which is a non-for-profit entity solely owned by its regulator, the SCS. The NDC is also one of the two official securities Registrars in Azerbaijan. With one exception, the NDC holds all securities issued by the private sector. Any interested investor may open an account, and although trades at the stock exchange must be conducted through brokers, the NDC does not perform any securities transfers unless it receives written confirmation by both the final buyer and seller that the trade must be performed. The BSE acts as central depository for T-Bills and the NBA Notes. The depository is not a separate subsidiary but an integral part of the BSE. Therefore, the decision-making for CSD activities is based on the same overall ownership structure of the BSE. The BSE has a total of 18 shareholders, and the number of shares is equally distributed among them. Main shareholders are the biggest local banks, brokerage companies and the Istanbul Stock Exchange. As for the criteria for participation in the system, in principle any individual or firm may request that an account be opened in its behalf. In practice, however, the market for T-Bills and the NBA notes is almost exclusively a wholesale market for financial institutions. The third licensed depository is a private institution which at present only holds one issuance from a subsidiary of the International Bank of Azerbaijan. In this regard, it is worth mentioning that corporations with less than 20 shareholders are allowed to perform a register-keeping function regarding their own holders of securities. Securities depositories are considered self-regulatory organizations (SROs) in Azerbaijan. Depository activities are supervised and licensed by the SCS.
- *Registrars:* The SCS is the primary registrar of securities. The NDC holds a registrar of all joint stock companies which was created during the privatization process.

Participants in auctions are companies or individuals that possess a license to operate as brokers and/or dealers and also are members of the stock exchange. They must announce their orders and conclude deals in accordance with the rules of stock exchange.

Only authorized traders may submit orders at auction and conduct deals on the stock exchange, either on their own behalf or on behalf of their companies. Authorized traders must be members of the stock exchange and possess a license issued by the SCS.

2.3.2 Exchanges

2.3.2.1 Baku Stock Exchange (BSE)

The main stock exchange in Azerbaijan is the *Baki Fond Birjasi* (Baku Stock Exchange, BSE). The BSE is a close joint stock company established in 2000 and provides physical and technological infrastructure to facilitate operations in the securities market. Since 2004 the BSE has become a commercial company.

The BSE's main shareholders are leading Azeri banks, brokerage companies and the Istanbul Stock Exchange. The BSE carries out its activities on the basis of a license issued by the SCS.

The role of the BSE is to:

- Provide and regulate an orderly market for government, municipal, corporate and other securities to be traded (shares and debt instruments)
- Provide a market where securities can be classified into categories of listing
- Make rules regulating the way its members use the market place
- Provide dealing systems
- Provide price and trade information
- Provide clearing and settlement mechanisms
- Supervise, monitor and discipline its members in the use of the market place
- Report to regulatory bodies

The BSE, as organizer of trades and also engaged in depository activities, cannot undertake any other type of activities in the securities markets such as a trading, broking or investment management.

The BSE lists securities on its markets according to its own requirements over an above those requirements of the SCS. This allows its members to trade in securities that the stock exchange has determined to be from a company with a suitable business structure and a history of proper ownership by their sellers. The exchange is also responsible for de-listing of the securities if they are no longer in accord with the requirements.

2.3.2.2 Baku Interbank Currency Exchange (BICEX)

The formal trading and settlement system is operated by the Baku Interbank Currency Exchange (BICEX). BICEX was established in 1993 and is managed by the Board and the general meeting of its shareholders which are the NBA and three commercial banks, each holding an identical percentage of total shares. Participation in BICEX is possible only for banks that are licensed to enter into foreign currency transactions. At present there are 40 participants in this system.

BICEX's role consists of the following:

- To hold regular auctions for the trading of foreign currency
- To determine exchange rates in the open market
- To provide a mechanism for payments between governments (between countries)
- To provide services to organize currency transactions
- To provide information on currency transactions
- To organize transactions in the national and foreign currencies
- To arrange interbank credit auctions (inter-bank loan and deposit markets)
- To organize and arrange for transactions in derivatives (Not yet undertaken)
- To provide for the application of new financial tools

BICEX is the principal market place in Azerbaijan for foreign currency transactions as well as the market place where banks can borrow and lend money between them. The currencies that are traded at BICEX are the US dollar, the Euro and the Russian Ruble, although the US dollar represents 98 percent of total market volume. Trading takes place via the Bourse Electronic System of Trade (BEST). Spot trades (T+0) can be settled on the same day as well as T+1 and T+2. Participant can make trades without having to pre-fund their settlement accounts in either manats or foreign currency up to a certain limit. In case the amount of the trade exceeds the limit, the difference must then be pre-funded.

There is also a formal money market trading system operated by BICEX. A total of 26 banks participate in this system, in which mainly uncollateralized loans are traded.

2.3.3 Securities Clearance and Settlement Institutions

Clearing and settlement of securities takes place in two relevant institutions: the BSE and the NDC. None of the depositories are direct participants in the payment systems the NBA operates.

The third licensed depository is a private institution which at present only holds one issuance from a subsidiary of the International Bank of Azerbaijan.

Corporations with less than 20 shareholders are allowed to perform their own securities depository function.

2.4 MARKET STRUCTURE AND REGULATION

Two agencies are responsible for the regulation and supervision of financial entities. The NBA supervises banks as well as several other types of financial intermediaries. It is also responsible for supervising all transactions in the foreign exchange, credit and money markets. Due to its responsibility for the money market, the NBA, as well as the Ministry of Finance, has jurisdiction over government securities (T-bills, and Notes).

The SCS supervises the securities market participants and is responsible for regulation of corporate bonds, shares and T-bills on the market as well as transactions involving all other debt securities.

2.5 THE ROLE OF THE CENTRAL BANK

As early as August 7, 1992, alongside with the Law of the Azerbaijan Republic On banks and banking activity in the Azerbaijan Republic, was adopted the Law on the National Bank of Azerbaijan. December 1, 1992 Resolution on Approval of the Charter of the National Bank of the Azerbaijan Republic was passed by the National Parliament. The aforesaid legislative acts determined the NBA as the supreme state bank, which has exclusive rights of banknotes issuance and fulfills the function of reserve bank for the banking system. At the same time, the National Bank was granted regulatory and controlling authorities over the banking system. The first Constitution of independent Azerbaijan Republic, which was adopted in a referendum, held on November 12, 1995 endorsed once again that the right of issue of banknotes and withdrawal from circulation belongs only to the National Bank.⁴

The current Law on the National Bank of Azerbaijan, enacted in 2004, identifies the rights and responsibilities of the NBA, both as a government authority and as the government's bank and financial agent. It provides for its participation in discussions of the national economic policy, including fiscal, price and tariff, domestic and foreign debt amount and management issues. This provision serves the purpose of coordinating activities of government agencies responsible for implementing the national economic policy and ensuring more effective use of the available resources.

The NBA is responsible for monetary policy and has regulatory and controlling functions over the banking and financial system.

The NBA has its head office in Baku. There are an additional 11 regional offices spread throughout the country. These regional offices are generally small and tasked mainly with the responsibility of the distribution of bank notes. The regional office in the autonomous Republic of Nakhichevan is the largest one.

2.5.1 Monetary Policy and Other Functions

According to the Constitution and its own Law, the basic functions of the NBA are to:

- Determine and implement monetary and exchange rate policy;
- Organize cash circulation, in accordance with 2nd paragraph of article 19 of the Constitution and this Law, issue, put into, and withdraw banknotes from circulation;
- Determine and announce the official exchange rate of the manat;
- Implement foreign currency regulation and control;
- Maintain and manage the gold and foreign currency reserves in its charge;
- Manage the drawing up of the reporting balance of payments and participate in the drawing-up of the projected balance of payments of the country;
- License, regulate and supervise banking activities of banks in accordance with the "On banks" law of the Azerbaijan Republic, and other normative legal acts adopted pursuant thereto;
- Determine, coordinate and regulate payment systems;
- Implement other functions stipulated by the legislation.

The basic objectives of the NBA arising out of its basic functions are to:

⁴ Article 19, Paragraph II.

- Maintain price stability;
- Ensure the development and strengthening of the banking and payment systems.

The NBA Law stipulates means and methods for the execution of the government's monetary and credit policy. This envisages market transactions, interventions in the foreign exchange market, and controls on the transactions that may be performed by commercial banks, among many other measures. In practice, the NBA sets the central interest rate of Azerbaijan through decision of internal committees.⁵

2.5.2 Involvement in the Payments System

The participation of the NBA in the payment system is required by Law. The NBA places high priority on developing a healthy financial system and fostering a well-functioning payment system, It also has powers to regulate financial intermediation, financial services, as well as the payment system.

The NBA owns and operates two systems for the transfer of interbank funds: AZIPS and BCSS. These systems are described in detail in Chapter 4.

The NBA holds current accounts for all the participants of AZIPS and BCSS. These include the Treasury of the Ministry of Finance, commercial banks, and non-bank credit organization. Moreover, the NBA holds settlement accounts for the BSE and the BICEX.-

2.5.2.1 Payment System Oversight

The NBA devotes much of its attention to the development of oversight function. The NBA has a clear legal empowerment for the oversight of payment systems. Article 4.2 of the Law of the Republic of Azerbaijan on the National Bank of the Republic of Azerbaijan includes as one of the goals of the NBA activity "...to ensure the development and strengthening of the banking and payment systems". Article 5, which describes the functions of the NBA, gives powers to this institution to "determine, coordinate and regulate activities of payment systems". Articles 44-45 describe the NBA powers regarding payment systems in more detail.

An oversight concept note has been drafted and was approved by the NBA Board. According to the draft concept note, the most important objective of the oversight function is to provide efficiency and reliability of payment systems. Other objectives include: i) achieving greater transparency; ii) compliance with the international standards, in particular the CPSS Core Principles for Systemically Important Payment Systems (hereinafter the "CPSS Core Principles"); iii) continuity; and, iv) cooperation with other authorities.

The CPSS Core Principles are set as minimum requirements for all systems; the standards will be implemented partially to payment systems that are not considered systematically important. Therefore, it is implied by the concept note that the scope of this function will cover both systemically and non-systemically important payment systems. No explicit mention to securities settlement systems is contained in the concept note.

According to the concept note, the NBA intends to perform its oversight function by three means besides its regulatory powers: i) monitoring; ii) appraisal/ assessment; and, iii) enforcement of necessary actions/amendments.

⁵ The key interest rate in the country is known as the "refinancing rate".

Methodological guidance in regard to evaluation of systematically important payment systems was prepared and approved by the NBA Board. The purpose of methodological guidance lies in the definition of the systematically important payment systems' estimation procedures, as well as determination of criteria for estimating a system's conformity to the CPSS Core Principles. A "Core principles for systematically important payment systems" paper has been prepared and submitted to the NBA Board for approval.

The principles introduced in this paper were implied for the operators of all systematically important payment systems. The paper defines the appropriate duties of the NBA in adopting the Core Principles.

2.5.3 Supervision of Financial Entities

The major elements of a coherent banking supervision system are already in place in Azerbaijan. The NBA serves as the primary supervisory body and comprehensive legislation and a set of regulations have been established.

The NBA conducts off-site monitoring and on-site supervision. To develop the methodological framework and ensure compliance with Basel Core Principles for Effective Banking Supervision, the NBA engaged in the following actions:

- Improving the risk management process, including capital adequacy and standards, through introduction of prudential reporting system.
- Developing the methodological guidelines for organization and implementation of the bank supervision process.
- Introducing on-site inspections of banks' performance based on CAMEL rating system and assessment process in consistency with related international standards.

2.5.4 Anti-Money Laundering Measures

In connection with the entering into force of the new banking Law, the NBA has conducted a major organizational restructuring. Within the framework of this process, a new anti-money laundering unit has been formed in the bank supervision department to combat money laundering (ML) and terrorism financing (TF) in the banking sector. The unit has appropriately been staffed and resourced. In case of necessity during the discharging of their duties there is a possibility for them to apply for a qualified technical assistance. The main functions of the unit are as follows:

- To receive and analyze information about suspicious transactions from the credit organizations;
- To receive and analyze information on cash foreign exchange brought into the jurisdiction of the Republic of Azerbaijan by physical persons amounting to more than USD 50,000, as well as forwarding them to the law-enforcement agencies in case of suspicion;
- To receive and analyze information on physical persons making a transfer amounting to more than USD 10,000 outside of the jurisdiction of the Republic of Azerbaijan;
- To maintain a practical cooperation with foreign financial intelligence units and/or relevant foreign governmental structures;
- To update its electronic database on the persons suspected of ML/FT;
- To develop the new requirements towards banks (elaboration of new regulations);
- To study advanced AML/CFT experience and preparing proposals for the management of the NBA.

The NBA continues its activity in anti-money laundering sphere and implements legislative/institutional reforms for the establishment of effective AML/CFT framework.

As a result of these efforts, on May 12, 2006, the amendments to the Criminal Code entered into force, and new article was added on the criminalization of money laundering offence with "all-crimes approach", including a full compatibility of the definition of money laundering with international standards and a mandatory confiscation requirement for all criminally obtained proceeds.

In a close cooperation with USAID, a new banking supervision methodology has been worked out and adopted, which requires the inspectors to inspect and analyze anti-money laundering and terrorism financing policies of the banks, to pay attention to potential ML transactions, among others.

In 2005, a total of 543 suspicious transactions reports have been submitted to the NBA by commercial banks. Of these totals, 95 reports have been further scrutinized with the banks within the on-site inspections. In the course of such on-site inspections, only 8 violations of administrative rules have been detected, which resulted in imposing administrative sanctions against 2 banks.

In the meantime, 17 reports were sent to the law-enforcement agencies for further investigations.

2.6 THE ROLE OF THE SECURITIES REGULATOR

Until 1998 securities markets were regulated by the Securities Market Law. After that, the relevant provisions were included in the Joint Stock Companies section of the Civil Code. These provisions were reformed in March 2004.

The securities regulator in Azerbaijan, the Azerbaijan State Committee for Securities (SCS) was created by a Presidential Decree. Its roles are defined in the Decree of December 1998. Among its powers, it can regulate securities market activities through the issuance of regulations, circulars, and standards. The SCS Chairman reports directly to the President of Azerbaijan.

In particular, the SCS is responsible for: (i) granting licenses to market intermediaries and for prudential regulation and supervision of these activities, (ii) the regulation of brokerage companies and (iii) the examination of self-regulatory organizations (SROs) such as the BSE and NDC. The SCS is also the sole shareholder of the NDC.

The specific areas that fall under the responsibility of the SCS within the country's securities market are:

- Securities issuance and circulation;
- Rules and standards;
- All matters concerned with lotteries;
- Information systems;
- Accounting standards of issuers and participants in the markets;
- Protecting the legal interests of investors and shareholders;
- Establishing regulations in relation to advertising.

The supervision executed by the SCS includes inspections, surveillance, prevention, and correction actions to all professional participants of the market. In addition, the SCS continuously examines and certifies the personnel of above-mentioned participants.

The SCS is also empowered to impose penalties.

2.7 THE ROLE OF OTHER PRIVATE AND PUBLIC SECTOR ENTITIES

2.7.1 The Ministry of Finance

The Ministry of Finance is the central executive authority carrying out state financial policy and organizing the management of state financing. Government payments are organized through the Central Treasury of the Ministry of Finance. The Treasury has a single account within the NBA, although all collections and disbursements are organized through the commercial banks' network. The Treasury has direct access to the AZIPS, and also, starting in mid-2006, to the BCSS.

2.7.2 Bankers' Association

The Bankers' association in Azerbaijan represents commercial banks of the country. The main objectives of the Bankers' Association are:

- to promote and establish relationships with local authorities including the NBA and the government.
- to promote participation in financial market development projects and studies oriented toward development and smooth functioning of the banking system.

The Azerbaijan Bankers' Association has been very active in the area of payment system development. This Association has 43 members, including all commercial banks, the BSE and another non-bank association. The Association created a payment systems group within which most technical discussions regarding payment system improvement and development take place. The main focus of the payment system group at present is the implementation at the operational level of the State Program for Development of the National Payments System in the Republic of Azerbaijan.

3 PAYMENT MEDIA USED BY NON-FINANCIAL ENTITIES

3.1 CASH

Effective January 1, 1994 the national currency, the *manat*, was declared the only means of payment of the country. The NBA is the only issuer of legal tender in the country.

Cash remains the dominant payment method in Azerbaijan. Bank notes represent approximately 70 percent of M1. In most areas outside of the capital city of Baku, cash remains the only means of payment.

The NBA designs and prints bank notes, distributes them, replace damage ones, and identifies and removes from circulation counterfeit notes. The NBA has 11 regional offices in the country intervening in the collection and distribution of bank notes.

Table 3: Bank Notes and Coins
(in AZM million)

	2003	2004
Total currency issued	2,168,520	2,631,036
Total banknotes issued	2,168,515	2,631,031
<i>of which:</i>		
50'000 manats	1,217,918	1,706,080
10'000 manats	826,507	799,800
1'000 manats	106,379	109,259
500 manats	10,528	8,767
250 manats	2,643	2,584
100 manats	2,951	2,954
50 manats	1,247	1,245
10 manats	260	260
5 manats	63	63
1 manat	19	19
Coins issued	5	5
Notes and coins held by banks	499,813	488,942
Notes and coins circulating outside banks	1,668,700	2,040,900

Source: NBA.

Since January 1, 2006 Azerbaijan re-denominated its national currency. The new *manat* is worth 5,000 old *manats*. The new bank notes were issued in the following denominations: 1, 5, 10, 20, 50 and 100 new *manats*. At the same time the new coins were issued in the following denominations: 1, 3, 5, 10, 20 and 50 *qapiks*.

Old and new banknotes will circulate simultaneously throughout 2006 and old banknotes will be withdrawn from circulation from January 1, 2007.

3.2 PAYMENT MEANS AND INSTRUMENTS OTHER THAN CASH

3.2.1 Cheques

Cheques are not used in Azerbaijan.

3.2.2 Direct Debits

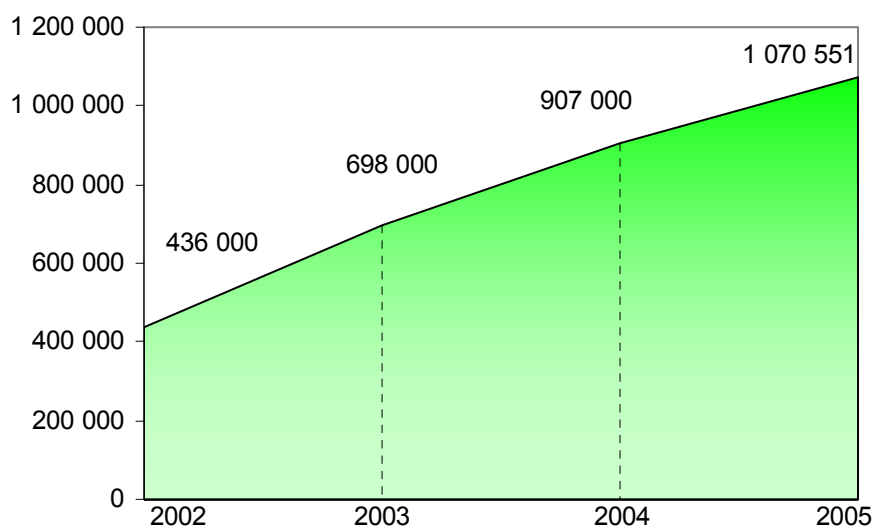
The direct debit instrument is not used in the country at present.

3.2.3 Credit transfers

Credit transfers are used to make interbank credit payments. A client can initiate transaction by submitting a paper request to a commercial bank or Azeri Post. Recently, large banks in Azerbaijan offer their clients electronic means of submitting payments via client-bank applications. The transfers are processed electronically via the BCSS or AZIPS systems.

In recent years the number of credit transfers is growing steadily, in 2005 the growth rate was 18 percent.

Chart 1: Volume of transactions in the Interbank Payment Systems



3.2.4 Payment Cards

Credit and debit card facilities are available throughout the country. The main brands in Azerbaijan are VISA, MasterCard, AMEX, AzeriCard and MilliKart.

The number of cards increased substantially in 2004 in comparison to the previous year and reached 790,000. The majority of the issued cards are debit cards, but a few have credit limits.

The number of transactions reached 4.5 million with a total value of transactions AZM 1,216.1 billion (for both ATM and EFTPOS).

Approximately 85 percent of total cards in circulation are debit cards, and in general cards are used for cash withdrawals from ATMs and much less so as payment instruments at POS terminals. There are two card operators in the country: AzeriCard and MilliKart.

AzeriCard is the card processing arm of the International Bank of Azerbaijan and, at present, has a 99 percent market share. A total of 34 banks are operating with AzeriCard, integrating a network of some 850 ATMs and nearly 2000 EFTPOS.

ATMs are owned by each bank and are interoperable through AzeriCard. For the settlement of interbank obligations stemming from ATM transactions, participants receive information about their bilateral clearing positions from AzeriCard at the end of operational day, and obligations must be settled bilaterally through AZIPS or BCSS within two days.

The remaining share of the market belongs to the MilliKart processing center, created by the NBA at the end of 2004. Currently, the NBA is the sole owner of MilliKart. A protocol of intention on taking ownership on MilliKart was signed between NBA and 6 banks at the end of 2005. Currently, the number of banks participating in this initiative has increased to 18 and by the end of 2006 MilliKart will change the owner.

At present, 9 banks have joined MilliKart. The network consists of 50 ATMs and a total of 5,000 cards have been issued so far and only international cards for the moment are accepted in the AzeriCard network. A small number of these cards have been issued under a local brand. Recently, MilliKart was certified by Visa and MasterCard as cards personalization bureau and third-party processor. Therefore, member banks are expected to begin issuing Visa and MasterCard branded cards shortly.

In the case of the MilliKart network, interbank settlement is performed through the correspondent accounts at the NBA. For the settlement of interbank obligations stemming from ATM transactions, participants receive information about their bilateral clearing positions from MilliKart at the end of the operational day, and obligations must be settled bilaterally through AZIPS or BCSS within three days.

There are official plans to have all merchants with monthly sales of approximately USD 1,000 or more having EFTPOS devices installed. In fact, there is a Presidential decree on this issue, which foresees a two-year transition period has been signed at the end of 2005.

3.2.5 Postal Instruments

Azeri Post provides the service of money transfers through more than 1,200 branches in the territory of Azerbaijan. The capacity of Azeri Post to provide financial services is nevertheless deemed rudimentary for the most part. In many locations there is no interconnectivity, so even the basic services cannot be provided in rural areas.

In urban areas Azeri Post also provides billing and collection services for utility firms, as well as collection of fines imposed by police and tax payments.

Finally, Azeri Post also provides delivery of monthly pensions, and other social security allowances to recipients designated by the Pension Fund.

3.3 NON-CASH GOVERNMENT PAYMENTS

The total annual volume of payments made by the central government amounts to approximately USD 2.5 billion. Government payments and collections are not centralized in Azerbaijan.

In order to provide government payments, the Treasury of the Ministry of Finance has 85 district branches — so called “Local Treasury Authorities” (LTA). Each LTA chooses a commercial bank as its agent for payment and collection purposes amongst five banks selected by the Treasury on a competitive basis in respect to offered services. State-owned enterprises are prohibited to hold a bank accounts and have accounts opened in LTAs.

In principle, all disbursements have to be processed strictly according to the approved Treasury plan, although the final decision on whether to make a payment or not is taken at the level of the LTAs. Before authorizing a payment, invoices provided by enterprises are checked towards the conformity with the overall Treasury disbursement plan. As soon as the check is successful, the payment instruction is forwarded to the Bank-agent for execution.

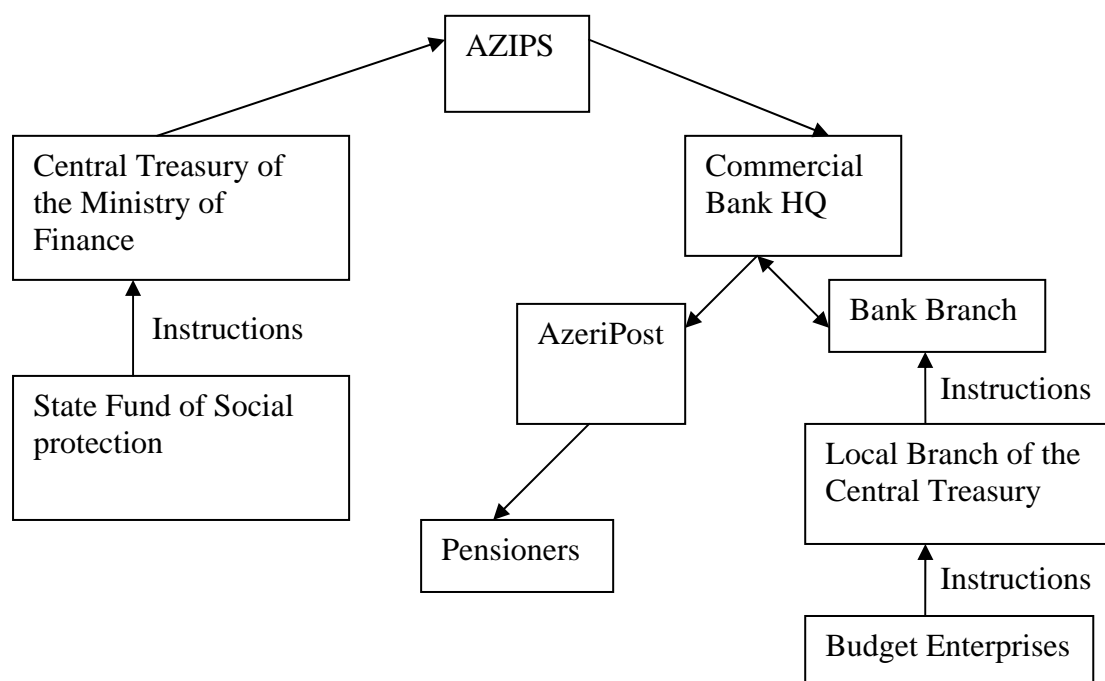
Bank-agents process the LTAs payments until 3:00 p.m. daily, including tax payments collected from people and legal entities, salaries to state employees and administrative payments of LTAs. After the deadline, if the total daily LTA balance is positive then the Bank-agent transfers the amount through its headquarters to the account of the Treasury at the NBA. In case disbursements prevail over daily collections, then the Bank-Agent sends the reimbursement request through its headquarters to the Treasury, which immediately or on T+1 initiates the necessary reimbursement.

At the end of each day a Bank-Agent prepares and submits the confirmations of all processed government transactions to its corresponding LTA. The final settlement between commercial bank and Treasury takes place in AZIPS. The Treasury is a direct participant of AZIPS since 2003 and holds its consolidated account at the NBA.

Salaries are paid mostly in cash or by the transfers to the payment card accounts through Bank-agents. In order to receive money, state enterprises apply for a cheque to the LTA where the former holds an account and further presents the cheque to the Bank-agent to withdraw the cash.

For payments to individuals to be withdrawn with payment cards, state-owned enterprises deal directly with Bank-agents. Every month they must provide the bank-agent with a document stamped by the LTA which contains a list of the persons and the amounts to be settled to in card accounts.

Pension payments are delivered through the Azeri Post network. Azeri Post is not a direct payment system participant and uses commercial banks for payment services. Information about pensions to be paid is provided by the State Fund of Social Protection. As soon as this information available, the Treasury transfers money to the Azeri Post accounts in commercial banks or directly to the employers' accounts in the banks. Pensions are paid either in cash or settled through payment cards.

Figure 1: Operation of Government Payments in Azerbaijan

There are currently several projects underway aimed at developing the Treasury system in Azerbaijan including:

- Consolidation of all collections and disbursements to/from the single Treasury account at the NBA without temporary settlements through Bank-agents.
- Introduction of classification codes for budget payments with mandatory identification in the body of the payment message. It is being considered to introduce a new field in the message formats.

4 PAYMENTS: INTERBANK EXCHANGE AND SETTLEMENT CIRCUITS

4.1 LOW VALUE PAYMENT TRANSFER SYSTEMS

The BCSS operated by the NBA is a designated system for electronic retail payments. Electronic funds transfers of small amounts can also be made through the AZIPS as this last system allows for third-party payment details to be included in the payment message and there is no minimum amount threshold. In 2005, the system processed 754,490 transactions for the total value USD 1.32 billion.

The BCSS was introduced in December 2002. To access the BCSS, the NBA distributes software to participants free of charge, and the system runs on a private telecommunications network. The number of bulk payments inside one batch is unlimited, as well as the number of individual messages inside one bulk payment. The maximum amount of a single payment message is approximately USD 45,000. Each bulk payment must contain payments with the same value date. On the other hand, the system accepts payment instructions with a value date of up to T+10.

Regarding settlement between system participants, the BCSS features several elements that are typical of real time gross settlement. Liquidity (balances) needs to be transferred by participants from their AZIPS accounts to BCSS sub-accounts at the start of the operating day which is 9:30 a.m. Batches are processed immediately as they arrive on a gross basis with this available liquidity as follows: i) the full amount of the batch is debited from the originator's BCSS account; ii) the beneficiary bank receives confirmation of incoming funds credited on its account; and, iii) the batch payment becomes final and irrevocable.

If sufficient liquidity for the whole batch is not available, the payment is kept in a waiting queue. Batches in the queue are processed according to the FIFO principle. The BCSS allows canceling either the full batch or single payment messages within the batch from the queue.

There are two settlement sessions during the day. During the first session the system accepts and processes customer payments until 1:00 p.m. From 1:00 and until 1:10 p.m. the participants can provide additional liquidity to settle their payments in the queue. From 1:10 and until 1:35 p.m. the BCSS clears the settled batches. Only the final bilateral balances of the session are posted in the General Ledger at this time, but settlement in itself is gross in nature. If additional liquidity is unavailable, the batches in the queue are automatically kept for the second session, which goes from 1:40 until 3:05 p.m. From 3:05 until 3:35 p.m. participants can provide additional liquidity to settle their payments in the queue. The payments remaining in the queue after 4:10 p.m. are cancelled. At this time the remaining balances of BCSS participants are transferred back to the AZIPS.

The NBA monitors participants' balances, volumes, and values of settled and cancelled transactions during a day.

4.1.1 Pricing

The NBA charges 0.005 percent of the amount of each individual payment.

4.2 LARGE VALUE PAYMENT TRANSFER SYSTEMS

4.2.1 AZIPS

In Azerbaijan there is one large-value payment system, the Azerbaijan Interbank Payment System (AZIPS) operated by the NBA. The AZIPS is a real time gross settlement (RTGS) system. It processes payments fully electronically through the participants' correspondent accounts at the NBA. Immediate finality and irrevocability are technically achieved and further broadly supported by regulatory provisions. AZIPS accepts payments with a future value date of up to T+10. In 2005, more than 316,000 transactions for a total value of about USD 14.7 billion were processed through the AZIPS.

The architecture of the system is Y-shaped and system design allows for straight through processing (STP) for both interbank payments as well as for payments on behalf of third parties. Although the AZIPS is intended for large-value and time-critical payments, there is no maximum or minimum limits set on the value of the payments.

Transactions are delivered through the SWIFT network. The NBA only receives information that is relevant for the interbank settlement, i.e., value date, amount, sender bank, and beneficiary bank. If sufficient funds are available for settlement, the system transfers money from the sender bank account to the beneficiary bank account and generates a settlement confirmation to SWIFT, which then automatically generates debit and credit confirmations and delivers the payment details to the beneficiary bank. Each payment is processed on a gross basis with immediate recording of information in the General Ledger of the NBA.

Currently there are 43 participants, including 40 commercial banks and the NBA itself, with access to the AZIPS. Non-banking participants include the Treasury of the Ministry of Finance and AgrarKredit, a non-bank financial corporation.

To become a participant, the holding of a current account at the NBA and SWIFT membership are mandatory. These and other membership requirements are documented in the Collective Agreements which are signed bilaterally between the NBA and each commercial bank. Additional membership requirements include: i) technical requirements like installation of specific software and hardware, ii) availability of special responsible and trained personnel. The events by which participants may be excluded from participating in AZIPS are not explicitly regulated.

The operational day starts at 10:00 a.m. and payments are processed in real time if sufficient balances on their AZIPS accounts are available. Otherwise payments remain pending in the queue. Customer payments are accepted until 4:30 p.m. During the next half hour, participants may initiate only interbank payments. Transactions remaining in the queue at the end of the day are deleted from the system.

The end of the operational day is 5:20 p.m. After the closing of the operating day participants receive the following electronic reports: i) a report on executed payments; ii) a report on cancelled payments and, iii) billing report.

4.2.1.1 Liquidity Risk Management

During the operating day participants are able to monitor their liquidity positions, incoming and outgoing payments in the queues in real time through electronic requests to the system. If sufficient funds are not available to cover a payment order, the transaction is kept in a waiting queue. Payments in the queue are processed according to priority codes (1-99). In case two or more payment orders have the same priority code, the FIFO principle is applied.

AZIPS has a gridlock resolution mechanism that automatically processes transactions placed on the queue as additional funds become available. Transactions remaining in the queue at the end of the day are deleted from the system. After 5:20pm, all the payments in the queue are cancelled.

Minimum reserve requirements can be used throughout the day for payment system purposes. The NBA provides free-of-charge intraday and overnight repos for payment system purposes with the NBA notes and T-bills as underlying securities. This facility is not automated; the NBA's Market Operations Department analyzes and eventually authorizes these transactions on a case-by-case basis upon receiving a request by the relevant participant. The Baku Interbank Currency Exchange (BICEX) also provides a money market service in which a total of 26 banks participate. This market is not very active.

4.2.1.2 Operational Risk Management

Regarding operational risks and business continuity, if system connectivity is lost the participants can still bring their payment instructions in paper form to the NBA for processing. These documents are digitalized before processing.

The NBA also has a back-up site for its computer systems, situated in the city of Sumgayit which is located more than 40 kilometers away from Baku. This site does not operate in hot standby mode. Archiving and data replication occur at the end of each operational day. The availability of the service is furthermore supported by the existence of an independent electricity generation facility. A well-documented business continuity plan is in place and most relevant aspects of this Plan are tested on quarterly basis by the Security Department of the NBA.

4.2.1.3 Pricing

The basic tariff for transaction settlement in the AZIPS is 0.043 percent of the payment value, with the minimum charge of 0.1 AZN (approximately USD 0.10) and maximum of 43 AZN.

4.3 CROSS-BORDER PAYMENT SETTLEMENT SYSTEMS

Cross-border payment instructions are normally sent and received through SWIFT and are settled through foreign correspondents. At present 40 commercial banks and financial institutions in the country are SWIFT members.

Remittances, a particular type of cross-border retail payment, are very relevant to Azerbaijan both in terms of the number of residents that receive remittances from relatives living abroad, mainly in the Russian Federation, and as a percentage of the GDP.

4.4 FOREIGN EXCHANGE SETTLEMENT SYSTEMS

Approximately 40 percent of foreign exchange (FX) trades in the domestic market are made in the formal market and the rest in the OTC market.

The formal trading and settlement system is operated by the Baku Interbank Currency Exchange (BICEX). BICEX was established in 1993 and is managed by the Board and the general meeting of its shareholders which are the NBA and three commercial banks, each holding an identical percentage of total shares. Participation in BICEX is possible only for

banks that are licensed to enter into foreign currency transactions. At present there are 40 participants in this system.

The currencies that are traded at BICEX are the US dollar, the Euro and the Russian Ruble, although the US dollar represents 98 percent of total market volume. Trading takes place via the Bourse Electronic System of Trade (BEST). Currency trades are settled the same day and are subject to a trading limit for both buyers and sellers. Participant can make trades without having to pre-fund their settlement accounts in either *manats* or foreign currency up to a certain limit. In case the amount of the trade exceeds the limit, the difference must then be pre-funded.

There are two trading sessions. The first one goes from 10:00 a.m. to noon and the second one, generally the most active, from 2:15 p.m. to 4:15 p.m. At the end of each session BICEX calculates the multilateral net positions in each currency for trades with same-day value and the settlement process begins. Obligations must be fulfilled by 5:30 p.m. The manat leg is settled through the NBA, while the foreign currency leg is settled through the NBA, International Bank of Azerbaijan, Deutsche Bank Trust Americas in New York, Moscow Interbank Currency Exchange Settlement Chamber. For the latter purpose, BICEX holds an account in Russian rubles with the Moscow Interbank Currency Exchange Settlement Chamber, and in US dollars with Deutsche Bank Trust Americas.

BICEX steps in the middle of the settlement process and transfers the amount corresponding to one of the legs if and only if it has received the counter amount in the other currency. BICEX informs the NBA the positions to be settled in *manat*. In most cases the NBA makes the transfers in the same day. For the foreign currency leg, BICEX monitors its account online by means of a special software application provided by Deutsche Bank of New York.

If a participant is unable to meet its settlement obligation, BICEX can delay the settlement or otherwise cancels the operation, and returns the leg it already received to the respective party. The party that failed must pay a penalty to its counterparty and BICEX reduces its unfunded trading limit to zero. BICEX does not act as a central counterparty as it cannot be held liable for occurring losses due to a failing party.

For the buyers and sellers of foreign currency the BICEX charges a 0.03 percent of the traded amount up to a maximum of USD 500.

The remaining part of the market corresponds to OTC trades which are settled through ordinary correspondent bank arrangements. Settlement of these transactions is based on private bilateral arrangements.

4.5 MAJOR PROJECTS AND POLICIES BEING IMPLEMENTED

According to a Presidential Decree, starting January 2006 the full public sector payroll will have to be channeled through bank accounts. In this regard, since the beginning of 2006 the NBA and the Treasury have been working on a project through which the latter would be given direct access to the BCSS. Another feature of this project is the integration of the unified codes of public budget payments into the BCSS to speed-up collections and money distribution between government agencies. Moreover, the Central Treasury is implementing SAP among its LTAs throughout the country, consolidating all of them into a single network to achieve STP for both disbursements and collections. A pilot run of the new SAP system was started in the Hachmas.

Small towns in Azerbaijan are generally not served by banks. Hence, access to financial services is not widespread beyond the major cities. Some basic payment services in Azerbaijan in such areas are provided mainly by the national postal service, Azeri Post, which has over 1,200 branches in areas outside the capital city of Baku. With assistance from The World Bank, the government has initiated a major project to modernize the infrastructure of Azeri Post to provide it with the necessary means to become a relevant player in the retail payments arena.

In line with the payment systems modernization, to broaden the usage of cashless payment instruments the NBA is working on the project for the implementation of an automated Centralized Information System for public utilities fee collection, which will be accompanied by innovations in essential interfaces to existing payment systems, security and communication components. The system is expected to provide the capabilities to enable every utility subscriber to view and print utility companies' invoices and account statements and make payments either by cash, payment card, or via bank account.

5 SECURITIES, MARKET STRUCTURE, AND TRADING INSTRUMENTS

5.1 FORMS OF SECURITIES

Securities may be issued in the following forms:

- Registered securities that are also evidenced by a document (registered documented securities). In this form, a central register is kept but the owners also possess physical certificates which states their name and the number of securities held. If further securities are purchased, than more certificates will be held or the certificate may be re-issued showing a larger holding.
- Registered securities in non-documentary form (registered non-documented securities). In this form owners do not possess any physical certificates and all ownership records are kept in a central register (book entry form).
- Securities in the documented form to the bearer (documented bearer securities). In this form, the only evidence of ownership is the possession of the security certificate. It will not carry an owners name and will be for a pre-determined nominal value.

Ninety-nine percent of all securities traded in the financial markets are held in dematerialized form, and all transfers are handled by electronic book entries. The remaining 1 percent is represented by paper securities.

5.2 TYPES OF SECURITIES

5.2.1 The NBA Notes

Short-term Notes have a 28-day maturity. The NBA Notes are issued through the regular weekly auctions held at the BSE. The NBA announces the issuance of notes in advance, and information is also made available at the BSE. Each issuance of Notes totaled AZM 20 to 30 billion.

The primary registrar of the NBA Notes is the SCS. These securities are traded by auctions at the BSE. Only Azerbaijan commercial banks are eligible to purchase the Notes.

5.2.2 Azerbaijan Treasury Bills

The Ministry of Finance issues the bills to raise money to finance the state budget. Bills are bought principally by commercial banks.

Brokers-dealers can bid for Treasury bills at auction. Private investors can participate in the primary placement of Treasury bills or trade them on the secondary market only through a broker and must have a bank account/broker account. Non-residents may also invest in Treasury bills.

Until recently these short-term securities were one of the main instruments traded in the securities markets. Starting 2004 the Ministry of Finance decided to reduce its domestic

borrowings and held only 4 T-bills auctions.⁶ In addition to reducing the number of auctions, the value of T-bills put up for sale was also reduced by AZM 415 billion or 83.4 percent in comparison to the 2003 level, thus totaling to only AZM 80 billion. As a result of this, while at the beginning of 2004 the market of T-bills totaled AZM 105 billion, by November 5, 2004 the Ministry of Finance had brought the amount of outstanding T-bills to zero.

5.2.3 Shares

Shares can only be issued after the full payment of their value. The nominal value of shares is not prescribed by Law and may be any value the company sees as appropriate to provide a marketable amount. To date many companies have favored AZM 10,000 but there are no restrictions on this figure.

Shares are indivisible and may not be divided into units of less than 1 share. On the other hand, while a share may be jointly owned, it will only confer one voting right in total to the parties that own the share.

Shares can be registered or payable to the bearer. The shareholder of a publicly traded joint stock company has the opportunity to freely liquidate his shares by selling them at the stock exchange. Shareholders of closed companies can transfer their shares to other persons only with the approval of the majority of the company's members. If a shareholder is refused the right to transfer his shares he can take away his share value from the company

Sales of shares to non-residents of Azerbaijan in banking and insurance areas which exceed certain limits can only be carried out with, respectively, the permission of the NBA and the Ministry of Finance. Residents of Azerbaijan willing to acquire foreign securities should obtain permission from the NBA in order to make proper money transfers.

5.2.3.1 Common/ordinary shares

Ordinary shares can only be redeemed under terms stated by the Civil Code. These are returned in the form of dividends, and if the company prospers and its future growth prospects are seen as good, the share price should rise. If the company is unsuccessful, the loss is limited to the nominal value of the share, including any unpaid parts, or the amount paid for the share in the market.

The shareholders own the company and make certain decisions such as who to appoint as directors. The directors will propose the level of dividends but the shareholders will approve this at the general meeting of the shareholders. Dividends may be paid quarterly.

The shareholder in an open joint stock company also has the opportunity to freely liquidate his shares by selling them on the stock exchange.

5.2.3.2 Preferred shares

Preference shares rank above ordinary shares in priority of entitlement to dividends and the company's assets. The shares usually carry rights to a fixed level of dividend. Preference share owners have no votes unless specified by the articles of association.

The preference shares of a joint stock company cannot exceed 25 percent of ownership capital of a society.

⁶ A total of 14 auctions of T-bills were held in 2003.

5.2.4 Corporate Debt Securities

Companies may issue securities either as a single one-off issue or as part of a serial program of bond issues. These securities may be issued with maturities ranging from less than one year (short-term), one to five years (medium-term), or over five years (long-term).

These securities must pay interest no less than once in every six months, and may be issued in AZM or in any freely convertible currency and for any maturity

Medium and long term securities ("bonds") may be issued with a recall facility, recalling by serial number, and providing a pre-defined bonus. This bonus must no be less than the interest to be paid in the end of the current year. Recalling of short term corporate securities (i.e. bills and promissory notes) is not permitted.

The amount of bonds that a company may issue in total is legally restricted to no more than 100 percent of the amount of the paid-in capital unless a guarantee is provided by a third party.

5.3 SECURITIES IDENTIFICATION CODE

The SCS is Azerbaijan's numbering agency, and the only institution authorized to assign securities identification codes.

The code combines alphabetic words and digits. International ISIN codes are not used at present.

5.4 TRANSFER OF OWNERSHIP

The Securities Markets Law (SML) outlines the transfer of different forms of securities.

For *bearer securities* in certificate (physical) form, no other person than the holder knows who owns a bearer security. The legal transfer of ownership takes place at the moment the securities are transferred into the hands of the purchaser.

In the case of *registered securities in physical form*, documented for the bearer and (or) account of rights for such securities in the depository or registry (registered certificates), transfer takes place at the moment the securities depository or registrar records the change of ownership in the account or entry of the purchaser.

In the case of accounts for rights for securities of their purchaser in the register, ownership is transferred at the moment of handing the certificate to the purchaser after completing the record of acceptance on the personal account of the purchaser.

In the case of account of rights for securities of their purchaser with the placing of the securities certificates in the depository by the person undertaking the deposit activity, ownership is transferred at the moment of the record of acceptance in the deposit account of the purchaser.

The transfer of ownership of dematerialized securities occurs as follows:

- In the case of securities being accounted by a CSD, at the moment the depository accepts the record on the personal deposit account of the purchaser.
- In the case of securities accounted for by a Central Registry, once the Registry accepts the change in the record of ownership.

A document transferring ownership of securities must be signed by the original owner. The authenticity of the signature must be confirmed and this can only be done by (i) a securities market professional or (ii) a notary public. The securities market professional or notary public can certify the authenticity of an individual's signature in documents relating to the transfer of securities and rights assigned by the securities.

5.5 PLEDGE OF SECURITIES AS COLLATERAL

The existing procedure to pledge securities as collateral is inefficient and time consuming. In order to get a loan collateralized with securities, a potential creditor must go through the following steps:

- Obtain the official stamped list of available securities at the BSE that guarantees that particular securities are free of any pledges or other obligations and could be used as a pledge.
- If corporate shares are going to be pledged, a creditor must obtain a certificate from the depository--either the BSE or NDC.
- Obtained records or certificates and the pledge request are forwarded to the SCS.
- During the next three days, the SCS reviews the request. If government securities are going to be pledged, then the SCS makes a separate request to the BSE to check the availability of the securities on the accounts of the potential creditor. After a positive decision has been made, the SCS registers the pledge and sends a confirmation to either the BSE or NDC with a request to transfer securities to the pledge account.

Since the procedure is time consuming, securities market participants use repo and reverse repo operations that do not require registration at the SCS.

5.6 TREATMENT OF LOST, STOLEN, OR DESTROYED SECURITIES

Ninety nine percent of all securities in Azerbaijan are dematerialized. In case a paper security is lost or stolen, it becomes the property of the new owner, as properties rights for such securities cannot be proved by the registrar or depository.

In case of destruction or damage of securities, a bearer needs to address a particular issuer or depository with an appropriate request of restoration. As soon as there is confirmation of the validity of destroyed or damaged paper, new certificates are issued.

5.7 LEGAL MATTERS CONCERNING CUSTODY

The BSE and NDC are the only custodians in Azerbaijan. Custody matters are regulated by the Civil Law and the standards of depository activities issued by the SCS.

Securities holdings in the licensed securities depositories are protected from claims of third parties as stated in the Civil Code, Section 1078-33-5. The Civil Code also indicates that the

legal ownership of the securities is registered in the securities depository. In order to reduce custody risk in the current system of double registration of securities ownership (i.e. with the securities depository and with a registrar), the securities depositories appear as the nominal holders of the securities with the relevant registrar. In practice, the NDC itself is the registrar of all securities with the exception of a few issuances of small size.

MARKET STRUCTURE AND TRADING SYSTEMS

5.8 PRIMARY MARKET

5.8.1 Issuance of Government and NBA Securities

Both the NBA Notes and the T-bills issued by the Ministry of Finance are offered in the primary market through auctions held by the BSE. T-bills and corporate securities are traded at the BSE without limitations.

The NBA Notes are issued through the regular weekly auctions held at the BSE. The NBA announces the issuance of notes in advance, and information is also made available at the BSE. Recently, each issuance of Notes totaled AZM 20 to 30 billion.

The primary registrar of the NBA Notes is the SCS. Only Azerbaijan commercial banks are eligible to purchase the Notes, although through brokerage companies, as commercial banks cannot be brokers by law.

The SCS is responsible for the prospectus and issuance details of Azerbaijan T-bills. These securities are issued through competitive auctions managed by the BSE. Prior to the auction, all bills intended for issue are deposited with the BSE depository and all participants deposit their funds to be used to make purchases in a special account opened by the exchange. It is not possible for bidders to make bids that exceed the amount deposited in advance.

All bids must be made by or through a member of the BSE. Two types of bid are permitted:

- Competitive bids (most likely from market professionals) are bids at a price and for a stated nominal amount of the issue.
- Non-competitive bids (most likely from smaller institutions and individuals) are bids for an amount of the issue only and do not bid a price. These are allotted at the weighted average price.

On the basis of the competitive and non-competitive bids submitted, the issuer determines the minimum price of the bills to be issued and the average weighted price of the competitive bids. The bids of competitive bidders are ranked in order of price first and then by the time the bid was received. The sequence of execution of bids is not dependent upon the size of the bid.

If during an auction a part of a bid is executed, then the rest of the bid is considered as a separate bid. The issuer is entitled to resell or write off any portion of bonds that have not been sold during the auction through a selected mediator. Following an auction, a bidder cannot sell more bills than are in its deposit account. A bidder cannot "sell short".

On the payment date, the issuer transfers the nominal value of bonds to the BSE account and the BSE makes a payment to the issuer. The BSE then ensures settlements with the bill purchasers.

5.8.2 Issuance of Corporate Securities

In order to issue securities, the issuer must first pass a *resolution* to undertake the issue and register it with the SCS. To obtain the registration, it must send the following to the SCS:

- An application;
- A company prospectus or equivalent document;
- Copies of the company charter, certificate on registration and articles of association of the issuer;
- Sample security certificate if securities issued in paper form;
- A confirmation of payment of state duty for registration of the prospectus.

The SCS may refuse the registration if any of the information or documents above contradict or breach existing Laws, if incorrect information was provided, or if the allocation of previous security issues was not fully completed. The next steps are as follows:

- The resolution must be registered with the SCS;
- The prospectus must be registered with the SCS (if the securities issue is accompanied by a prospectus of issue);
- The securities are distributed;
- The SCS registers the securities;
- The issuer registers a report about the results of securities issue.

The only exception to this occurs with the registration of shares of joint stock companies that have been incorporated during the privatization of state property.

There is no minimum amount that can be issued, but state registration of shares and bonds cannot be carried out simultaneously. The equity capital of the joint stock company must be fully formed first. Non-government securities must be placed in the primary market through brokerage companies.

Table 4: Private and Local Government Debt Issuances
(value in AZM million)

	2004	2005*
T-bills	79,106	27,256
The NBA Notes	182,766	217,303
REPO	1,499	66,977
Corporate debt securities	61,394	1,510
Corporate shares	101,216	76,046
TOTAL	425,982	389,092

Source: BSE.

* From January 1 to May 26.

5.9 SECONDARY MARKET

Currently, trades of the NBA Notes constitute approximately 80 percent of the total transaction volume at the BSE. Corporate securities market is still low but growing.

At present, dealers cannot be designated as nominees. The NDC holds accounts for all individual holders of securities. If the latter wish to make a transaction, they must deliver to the NDC and agreement between the buyer and the seller for the relevant securities to be transferred at the NDC.

Table 5: Private and Local Government Debt Secondary Market Trades
(value in AZM million)

	2004	2005*
T-bills	6,380	...
NBA Notes	99.7	51,648
Corporate bonds	28,874	4,156
Corporate shares	6,911.3	11,489
TOTAL	42,266	67,294

Source: BSE.

* From January 1 to May 26.

5.10 STOCK EXCHANGE TRADING

According to the Civil Law, only brokerage companies may directly participate in trades at the BSE. There are 12 brokerage companies in Azerbaijan.

Trading sessions on the BSE are held every working day, Monday through Friday from 10:00 a.m. until 5:00 p.m. In the event of a change, BSE members are informed two days prior to the trading session.

Government securities auctions take place only once a day from 11:00 a.m. until 12:30 p.m. at the BSE. During this time, dealers submit their bids and can cancel them in case of an error. At 12:30 p.m., a summary of all bids is sent to the Ministry of Finance where the volume and placement price are defined. Secondary market trades of government securities occur twice a day. The morning session takes place from 10:30 until 11:00 a.m. and afternoon session from 2:00 until 3:30 p.m. Corporate securities trades on the secondary market also occur twice a day from 10:30 until 11:00 a.m., and from 2:30 until 4:00 p.m. Repo operations are traded from 10:30 a.m. until 4:00 p.m.

Trades take place on the trading floor of the BSE. Only the NBA has remote access to the electronic trading system. Brokers' places are equipped with personal computers and telecommunication facilities to notify clients about the market situation on a timely basis. If a broker is acting on behalf of investors giving instructions in writing or by the telephone, investors can personally attend trades and control the dealer activities, and if necessary, submit corrections.

Trading sessions are conducted on the trading floor of the BSE via an automated electronic order matching trading system. Orders submitted by traders into the BSE trading system are accepted automatically, provided that sufficient funds are available in the accounts of the traders. Orders submitted by traders into the trading system must include the following:

- Code of the BSE member;
- Type of order, to buy (bid) or sell (ask);
- Security code;
- Number of securities described in lots;
- Price for one lot.

The trading system automatically matches and executes bid and ask orders at the same prices:

- Where there are several orders entered at the same price, those orders that were submitted first take priority.
- If orders are submitted at exactly the same time, the order in the larger size takes priority.
- Where a bid order is submitted into the trading system at a price greater than an existing sell order, the transaction is processed automatically at the average of the two prices.
- Where an ask order is submitted into the trading system at a lower price than an existing bid order, the transaction is processed automatically at the average of the two prices.

Control and supervision of the trading sessions is performed by floor specialists employed by the BSE. The duties of floor specialist include:

- Executing orders given by the management of the BSE;
- Exercising control over the activities of traders during trading sessions;
- Taking necessary actions to maintain stability of trading;
- Ensuring the timely beginning and ending of trading sessions;
- Informing the BSE management of extraordinary situations;
- Registering and storing all documents produced showing the result of each trading session.

Trades are settled following the BIS Delivery Versus Payment (DVP) model 1.⁷ Settlement risks are managed by means of pre-funding. In the case of the securities deposited at the BSE, pre-funding of cash in the account of the BSE at the NBA is required. Securities, on the other hand, are blocked automatically at the moment the trade is matched.

In the case of securities deposited at the NDC, the relevant securities must be blocked in advance to the trading. Moreover, before making any securities transfers the NDC must receive a notice of an agreement signed by both the buyer and the seller indicating the transaction is valid.

⁷ "Delivery versus Payment in Securities Settlement Systems", Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten Countries of the Bank for International Settlements, September 1992.

5.11 OVER THE COUNTER MARKET

The over the counter (OTC) market represents nearly 70 percent of the total market for securities in Azerbaijan. In some cases trades are made in the presence of both the seller and buyer through brokers on the over the counter market, which afterwards are registered in existing Registrars. In order to transfer ownership, the broker provides the NDC with documents confirming that the deal has been signed by the both parties.

5.12 RECENT TRENDS IN THE MARKET

The securities market in Azerbaijan is relatively new and still developing. Recent trends in the market include the following:

- Currently major participants of the securities market like the BSE and the NDC do not have direct access to the payment systems operated by the NBA. Direct participation in AZIPS imposes additional financial costs because new participant has to become a SWIFT member and purchase necessary software to get the access to the system. At present the BSE is considering the case and negotiating various aspects with appropriate authorities.
- In the short term, the BSE is planning to rebuild its current trading system and digitalize all processes with the NDC. Moreover, the BSE is planning to extend its own network to other regions of the country by opening branches, which should be interconnected to the single trading system of the NDC.

6 SECURITIES CLEARANCE AND SETTLEMENT SYSTEMS

6.1 ORGANIZATIONS AND INSTITUTIONS

6.1.1 Baku Stock Exchange (BSE)

The BSE has its own CSD with the ability to keep securities either in paper or dematerialized form. The BSE acts as central depository for T-Bills and NBA Notes, which in practice is almost exclusively a wholesale market for financial institutions.

The depository is not a separate subsidiary but an integral part of the BSE. Therefore, the decision-making for CSD activities is based on the same overall ownership structure of the BSE. The BSE has a total of 18 shareholders, and the number of shares is equally distributed among them.

6.1.2 National Depository Center (NDC)

The first securities depository in Azerbaijan was created in 1997. With one exception, the NDC holds all securities issued by the private sector. The NDC is a non-for-profit entity solely owned by its regulator, the SCS.

The main task of the NDC is the primary registration of corporate securities. However, the NDC provides deposit, custody, administration, settlement and transfer of securities services. More than 1,000 companies have signed agreements with NDC and use its services and more than 100,000 accounts are managed by NDC.

Any interested investor may open an account, and although trades at the stock exchange must be conducted through brokers, the NDC does not perform any securities transfers unless it receives written confirmation by both the final buyer and seller that the trade must be performed.

6.2 SECURITIES REGISTRATION AND CUSTODY PROCEDURES

Ninety-nine percent of all securities traded in the financial markets of Azerbaijan are held in dematerialized form, and all transfers are handled by electronic book entries. The remaining one percent is represented by paper securities.

Dealers are not entitled to perform nominal holding of securities, and thus can only hold an account of securities on own behalf. Beneficial owners are identified at the individual level. Securities must also be registered with one of the two authorized registrars, one of which is the NDC itself. For corporate securities, the records of the NDC as depository and registrar are the same. For other types of securities the depositories appear as nominal holders with the Registrars.

6.2.1 Record Keeping⁸

The broker must keep separate accounts for its own transactions and those it may perform on behalf of customers. Each customer account must be accounted for separately.

⁸ Brokers' rule 3.6.

6.2.2 Customer Accounts⁹

Brokers may undertake dealings in securities for clients but must ensure that these deals are identified as being on behalf of the customer. After the conclusion of a customer agreement, a broker may open a customer account on the broker's internal system to account for cash and securities holdings. Customers may transfer cash to their account with a broker by remittance or by paying cash directly to the broker's cash office.

6.2.3 Confidentiality¹⁰

Except as prescribed by the Law of Azerbaijan, all details of customer accounts must be kept confidential and shall not be disclosed to other persons unless the customer permits the disclosure by written instructions.

6.2.4 Holding of Client Assets¹¹

Customers have the right to withdraw all or a part of the assets which they own by written instruction. The contract signed with the broker remains valid unless otherwise requested.

Upon receipt of such an instruction, unless otherwise provided in the broker agreement, the broker must return the assets to the customer within three working days.

In the case the broker agreement is cancelled, or if the broker's license is cancelled, the broker must return to the customer all the assets on the customer's account once the expenses concerning the execution of the broker agreement and the customer's obligations are deducted.

6.3 SECURITIES CLEARANCE AND SETTLEMENT PROCESS

Trades are settled following DVP model 1. Settlement risks are managed by means of pre-funding. In the case of the securities deposited at the BSE, pre-funding of cash in the account of the BSE at the NBA is required. Securities, on the other hand, are blocked automatically at the moment the trade is matched.

In the case of securities deposited at the NDC, the relevant securities must be blocked in advance to the trading. The seller must instruct a broker to transfer securities from its deposit account to the trading account. Information will be delivered by paper to the BSE prior to the trade. Information about available for trades securities is delivered to the BSE by the two depositories.

Moreover, before making any securities transfers the NDC must receive a notice of an agreement signed by both the buyer and the seller indicating the transaction is valid. Also, before a trade the buyer of securities has to arrange for the necessary funds to be transferred to the account the BSE holds at the NBA. The buyer should arrange this transaction either directly or through a broker-dealer. Information about incoming funds is provided to the BSE by fax. The latter does not allow trades to be performed before it receives such a confirmation.

All transactions with T-bills and NBA notes are settled on T. Transactions with corporate

⁹ Brokers' rules 3.5 and 7.2-7.3.

¹⁰ Brokers' rule 3.8.

¹¹ Brokers' rules 3.7 and 8.

securities are usually settled on T+1, although in some cases this period can be extended up to T+3 to allow time to complete all the required paper work.

After each trading session, the BSE produces a list of executed trades which is forwarded to the NDC to make the securities transfers. For those securities held at the BSE depository, the securities are transferred automatically from the seller to the buyer trading accounts. To complete the settlements, the BSE prepares a cash settlement report for the NBA to transfer the amounts from the account of the BSE to that of the seller (or its agent bank).

Government securities are settled by the same scheme with the only difference that they can not be deposited within NDC. The BSE depository is used for government securities.

Corporate securities are usually transferred on T+1. In most cases cash positions are settled through on T+0 through AZIPS. The only exception to the latter is the corporate securities that are traded in the afternoon session which goes from 4:30 p.m. until 5:30 p.m., since the AZIPS closing time is 5:00 p.m.

On the other hand, nearly two thirds of the total volume of transactions with corporate securities is executed not through the BSE but through bilateral addressed transactions through brokers and partly through public notaries.

6.3.1 Business Continuity

The NDC has a back-up server in the same building where it has its headquarters. This back-up server operates in hot mode, although its processing capacity is substantially smaller than that of the main server. The NDC records its transactions in tapes twice a day. At the end of the day, a back-up copy is produced and is stored in the same building. The building where the NDC (and the BSE) is located has a secondary electric power supply which can provide a back-up in case of a blackout for a period of 3 to 4 hours.

In the case of the BSE, arrangements for contingencies are similar to those of the NDC. Neither institution has a written Business Continuity Plan in place. Other sources of operational risk are the existence of several manual procedures due mainly to extensive paper work requirements.

6.3.2 Pricing

Regarding cost effectiveness, the NDC makes the following charges:

- 0.05 percent of the face value of deposited securities per year for custody.
- A fee of 10 AZN (approximately USD 11) is applied to firms opening a securities account. In the case of individuals the fee is 5 AZN.
- For each securities transfer (excluding state privatization cheque and options), a charge of 0.2 percent is applied to the buyer with a maximum of approximately USD 400.

6.4 GUARANTEE SCHEMES

The BSE requires pre-funding of cash and securities prior to the trade. Counterparty risk exposure between participants is low as the BSE provides almost simultaneous settlement involving the pre-funding of cash accounts and deposit of securities prior to trade.

6.5 SECURITIES LENDING

The BSE does not have an automated securities lending facility in place. Securities lending operations must be registered in the SCS in the same way as pledge operations.¹²

6.6 INTERNATIONAL LINKS AMONG CLEARANCE AND SETTLEMENT INSTITUTIONS

At present, the depositories in Azerbaijan do not hold accounts with foreign CSD. Neither do other CDS hold an account with local depositories.

At present, however, the NDC is under negotiations with the CSD of the Russian Federation for the latter to open an account at the NDC.

¹² For details, please refer to Section 5.5.

7 THE ROLE OF THE CENTRAL BANK IN CLEARANCE AND SETTLEMENT SYSTEMS

7.1 RESPONSIBILITIES

The NBA has been closely involved in the development of payment systems. It developed and operates two settlement systems, the AZIPS and the BCSS, and has been active in the development of securities settlement system. It has also been a major promoter of establishing a national processing center for payment cards. At present, efforts are being devoted to improve utilities payments and retail payments development, and the implementation of the payment system oversight function.

7.2 RISK CONTROL POLICY

The NBA continually manages its exposure to risk through a variety of risk management techniques. The NBA's risk management is regulated by internal instructions and closely monitored by the Board of Governors and various designated working groups at the NBA.

The NBA's management conducts risk management activities in collaboration with the internal audit department of the NBA. The internal audit department has prepared a Risk Assessment Methodology, based on the business activity of the large European central banks. The methodology differentiates between two types of risks:

- the risk inherently related to the business which is not directly correlated to the management of operations (financial risks, reputation risk, and human risk), and
- the risk managed through the implementation of internal controls for conducting business activities.

In order to manage liquidity risk, the NBA performs daily monitoring of expected future cash flow related to banking operations, which is an element of assets and liabilities management. The NBA Board of Governors sets limits on the minimum proportion of maturing funds available to meet withdrawals and on the minimum level on interbank and other borrowing facilities that should be in place to cover withdrawals at unexpected levels of demand.

The NBA conducts assets liquidity management as follows:

- By maintaining a certain level of liquid assets to meet short-term cash needs that may occur as a result of a decrease in commercial banks' obligatory reserves.
- The Operational Investment Strategy Policy prepared by the Investment Committee and approved by the Board of Governors requires a minimum volume of daily liquid assets of at least 6 percent of total manageable monetary assets. The maximum monthly liquidity rate is 50 percent of total manageable monetary assets.

The NBA's market operations department is responsible for implementing the relevant credit risk management procedures imposed by the Board of Governors in the form of internal rules on loan transactions, classification of loans, and creation of provision against loan losses and assessment of collateral.

7.3 SETTLEMENT

The settlement accounts at the NBA are the principal means through which large value payments are transferred among financial intermediaries and other account holders at the NBA. The BSE, the Treasury, and all the banks hold settlement accounts within the NBA.

7.4 MONETARY POLICY AND PAYMENT SYSTEMS

The NBA's current monetary policy aims to maintain a low inflation level appropriate for macroeconomic stability and promote the stability of banking and payment systems. In addition, the monetary policy framework also supports other objectives of ensuring country's international competitiveness and rapid development of the non-oil sector.

Broad monetization will also promote the banking system's intermediary function and greatly enhance its ability to take deposits and grant loans on this basis. Considering this, deposits are expected to grow by 30-35 percent in 2005, including household deposits by 50-60 percent and loans by 30-35 percent.

Monetary policy tools were applied in 2005 in accordance with implementation targets and the need to manage bank liquidity as effectively as possible. Monetary policy tools were applied also in accordance with the money aggregate growth scenarios. Thus, when sterilization efforts were needed, the NBA issued Notes, received national currency-denominated deposits from banks, and conducted transactions involving government-issued securities.

The NBA also supports the development of financial markets both as a regulator and a market participant and is actively involved in improving the regulatory and infrastructure framework of this market.

7.5 PRICING POLICY

The NBA's pricing policies for the payment services it provides are designed to recover all costs incurred. The NBA charges participants *ad valorem* tariffs as follows:

- The basic tariff for transaction settlement in the AZIPS is 0.043 percent of the payment value, with the minimum charge of 0.1 AZN (approximately USD 0.11) and maximum of 43 AZN (approximately USD 49).
- As regards BCSS tariffs, the NBA charges 0.005 percent of the amount of each individual payment.

8 SUPERVISION OF SECURITIES CLEARANCE AND SETTLEMENT SYSTEMS

8.1 SECURITIES REGULATOR SUPERVISORY AND STATUTORY RESPONSIBILITIES

The SCS is responsible for development and carrying out the state policy, regulation and control provision for the country's securities market. Creation of favorable environment for investments, competition, and protection rights for market participants are the priorities. The daily duties of the SCS include the following:

Monitoring and investigations

Monitoring is one of the main responsibilities of the SCS. The BSE forwards the results of all trades to the SCS and securities market participants involved into the trades. The specific responsibilities in this area include:

- Enter and inspect the work premises of a securities market participant.
- Audit the operations of a market participant.
- Question, analyze documents and report on participants in the securities markets.
- Take reports, other documents and information from securities market participants. Conduct controls over the issues connected with the rights of investors and activities in the markets.
- Obtain explanations of matters from senior persons.

Following an investigation a report (act) is produced and signed by the commission. One copy is provided to the market participant who must sign it and may add their own comments. This report is then submitted to the SCS chairman or his deputies for further action.

Protective intervention and directions

- Provide compulsory directions to participants in the markets.

Imposing penalties

- Hold persons in violation of the Law responsible in the administrative manner;
- Raise property complaints against persons responsible for violation of the Law;
- Suspend the license of companies and professionals in the market;
- Close down securities market companies;
- Limit the activities of securities market participants;
- Send commission reports and documents to Law enforcement and judiciary bodies for further action.

8.2 SELF REGULATORY ORGANIZATIONS SUPERVISORY AND STATUTORY RESPONSIBILITY

The BSE is considered a self-regulatory organization (SROs) in Azerbaijan. Licensed securities depositories are also considered SROs.

APPENDIX: STATISTICAL TABLES

Series A tables are statistics on payments and securities clearance and settlement in Azerbaijan and were completed following a standard model prepared in the context of the CISPI. They slightly differ from the model due to data availability constraints.

SERIES A

Payments and Securities Clearance and Settlement Statistics

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Table A1: Basic Statistical Data*

	2000	2001	2002	2003	2004
Population (in thousands)	n.a.	7,980	8,052	8,115	8,187
GDP (AZM billion)	23,591	26,578	30,312	35,733	41,873
GDP per Capita (USD)	665	715	775	897	1,041
Exchange rate manat vs. USD					
<i>Year end</i>	n.a.	4,763	4,894	4,920	4,903
<i>Average</i>	n.a.	4,657	4,861	4,911	4,913

Source: NBA.

**Table A2: Settlement Media used by Non-banks
(in AZM billion)**

	2000	2001	2002	2003	2004
Total notes and coins	n.a.	n.a.	1,759.5	2,631.0	2,168.5
<i>Held by the public</i>	1,135.8	1,349.8	1,469.0	1,668.7	2,040.9
Transferable deposits in domestic currency	268.5	279.3	286.7	357.1	551.3
Narrow money supply M1	1,390.0	1,577.5	1,687.5	1,967.4	2,499.1
Transferable deposits in foreign currency	688.2	n.a.	1,678.5	1,899.9	2,501.6
Broad money aggregates					
M2	1,404.3	1,629.1	1,755.6	2,025.8	2,592.2
M3	2,092.5	2,548.7	3,434.1	3,925.8	5,093.8

Source: NBA.

**Table A3: Settlement Media Used by Credit/Deposit Taking Institutions
(in AZM billion)**

	2001	2002	2003	2004
Required reserves at the Central Bank	148.3	221.2	237.8	508.8
<i>In domestic currency</i>	28.6	36.9	49.3	99.8
<i>In foreign currency</i>	119.7	184.3	224.5	409.0
Excess reserves at the Central Bank:	n.a.	66.1	124.1	1,028.2
Institutions' borrowing from the Central Bank	n.a.	68.9	217.9	298.3
Transferable deposits at other institutions*	...	...	...	...

Source: NBA.

* Correspondent accounts with domestic banks are prohibited in Azerbaijan

* The following conventions for notation are used throughout the Appendix: "n.a." indicates data that are not available; "..." stands for data that are not applicable; "neg" indicates where data are very small relative to other relevant data in the table concerned.

Table A4: Institutional Framework
(as of year-end 2005)

	<i>Number of Institutions</i>	<i>Number of branches</i>	<i>Value of accounts (AZM billion)</i>
Central Bank	1	11	2,118
Commercial Banks	41	356	n.a.
<i>Of which:</i>			
<i>Private banks</i>	26	n.a.	n.a.
<i>Foreign banks</i>	15	n.a.	n.a.
Non-bank financial institutions	77	n.a.	n.a.
Postal Office	1	1,200	...

Source: NBA.

Table A5: Bank Notes and Coins
(in AZM million)

	<i>2003</i>	<i>2004</i>
Total currency issued	2,168,520	2,631,036
Total banknotes issued	2,168,515	2,631,031
<i>of which:</i>		
50'000 manats	1,217,918	1,706,080
10'000 manats	826,507	799,800
1'000 manats	106,379	109,259
500 manats	10,528	8,767
250 manats	2,643	2,584
100 manats	2,951	2,954
50 manats	1,247	1,245
10 manats	260	260
5 manats	63	63
1 manat	19	19
Coins issued	5	5
Notes and coins held by banks	499,813	488,942
Notes and coins circulating outside banks	1,668,700	2,040,900

Source: NBA.

Table A6: Cash dispensers, ATMs and EFTPOS Terminals

	<i>2005</i>
<u>Cash dispensers and ATMs</u>	
Number of networks	2
<i>National</i>	2
<i>Regional</i>	...
Number of terminals	869
<u>EFTPOS:</u>	
Number of networks	2
Number of terminals (estimate)	2,000

Source: Interviews with card operators AzeriCard and MilliKart.

Table A7: Number of Payment Cards in Circulation

	<i>2005</i>
Cards with a cash function	-
Cards with a debit/credit function	790,000
of which:	
<i>Debit cards</i>	690,000
<i>Credit cards</i>	100,000
Cards with a cheque-guarantee function	...
Retailer and fidelity cards	n.a.
Stored-value cards	n.a.

Source: Interviews with card operators AzeriCard and MilliKart.

Table A8: Indicators of Use of Various Cashless Payment Instruments
(volume of transactions)

	2002	2003	2004
Payments with cards			
<i>In local currency</i>	-	1,429,760	4,604,294
<i>In foreign currency</i>	-	522,108	713,418
Paperless credit transfers	436,000	698,000	907,000
Direct debits	...	...	...

Source: NBA.

Table A9: Indicators of Use of Various Cashless Payment Instruments
(value of transactions, in AZM billion)

	2002	2003	2004
Payments with cards			
<i>In local currency</i>	n.a.	493.9	1,216.1
<i>In foreign currency</i>	-	540.9	765.3
Paperless credit transfers	28,870	40,490	54,220
Direct debits	...	...	...

Source: NBA.

Table A10: Payment Instructions Handled by Selected Interbank Transfer Systems
(volume of transactions)

	2002	2003	2004
Low value systems BCSS			
<i>in domestic currency</i>	20,000	338,000	539,000
Large value system AZIPS			
<i>in domestic currency</i>	416,000	360,000	368,000

Source: NBA.

Table A11: Payment Instructions Handled by Selected Interbank Transfer Systems
(value of transactions, in AZM billion)

	2002	2003	2004
Low value systems BCSS			
<i>in domestic currency</i>	43	1,390	3,396
Large value system AZIPS			
<i>in domestic currency</i>	28,827	39,101	50,824

Source: NBA.

Table A12: Securities and Accounts Registered in Central Securities Depositories

	2000	2001	2002	2003	2004
Number of securities registered	822	992	1,147	1,265	1,344
Number of participants	55,007	62,874	78,304	89,607	95,945
Number of accounts	n.a.	n.a.	n.a.	n.a.	108,200
Number of foreign investors	...	...	...	...	48

Source: NDC.

Table A13: Securities Holdings in Central Securities Depositories
(in AZM billion)

	2000	2001	2002	2003	2004
T-bills	295.12	467.71	505.14	455.34	79.1
NBA Notes	n.a.	n.a.	n.a.	n.a.	182.8
Corporate Shares	n.a.	n.a.	n.a.	n.a.	2,965.2
Corporate Bonds	n.a.	n.a.	n.a.	n.a.	61.4

Sources: NBA, BSE and NDC.

Table A14: Transfer Instructions Handled by Securities Settlement Systems
(volume of transactions)

	2001	2002	2003	2004
Corporate Shares	2,930	4,139	4,962	6,945

Sources: BSE and NDC.

Table A15: Transfer Instructions Handled by Securities Settlement Systems
(value of transactions, in AZM billion)

	2001	2002	2003	2004
Corporate Shares	149.3	99.7	218.7	252.6

Sources: BSE and NDC.

Table A16: Participation in SWIFT by Domestic Institutions

	2000	2001	2002	2003	2004
Domestic SWIFT users	26	37	47	45	43
<i>Of which</i>					
Members	24	31	39	37	39
Sub members	2	2	3	3	2
Participants	0	4	5	5	2
Worldwide SWIFT users	7,125	7,199	7,466	7,527	7,667
<i>Of which</i>					
Members	3,542	3,847	4,006	4,085	4,224
Sub members	2,978	3,027	3,079	3,051	3,019
Participants	605	325	381	391	424

Source: SWIFT.

Table A17: SWIFT Message Flows To/From Domestic Users

	2000	2001	2002	2003	2004
Total messages sent	460,431	1,051,406	1,097,135	981,759	1,031,993
<i>Of which</i>					
Category I	44,140	409,839	480,673	405,731	429,485
Category II	18,900	27,628	35,428	44,749	52,289
Total messages received	519,027	1,117,565	1,191,523	1,117,868	1,198,804
<i>Of which</i>					
Category I	46,602	426,269	513,755	462,033	495,409
Category II	7,163	13,896	21,408	30,124	31,973
Global SWIFT sent traffic	1,274,856,642	1,533,906,047	1,817,443,994	2,047,564,360	2,299,074,199

Source: SWIFT.