Azerbaijan: Systemic Risk Response Framework

Rustam Tahirov
Head of Bank Supervision Methodology Division
Bank Supervision Department
Central Bank of Azerbaijan
rustam_tahirov@cbar.az

FIRST Consultative Group Meeting
May 25, London
Content

1. Overview of Azerbaijan financial system
2. Project objectives
3. Project implementation, major outputs/outcomes
4. Experience with FIRST and future cooperation
1.1. Overview of Azerbaijan Financial Sector

- Sound bank legislation in accordance with best international practices
- Banking sector is the key segment of the AZ financial system
- Central Bank of Azerbaijan (CBA) is a supervisor of credit institutions, including banks and non-bank credit institutions
- In late 2009, World Bank mission assessed AZ banking sector vulnerabilities. Based on assessment findings the WB has recommended a number of short, medium and long term actions to be undertaken in order to strengthen supervisory framework.
- CBA has asked FIRST to assist with eliminating one of the gaps (developing a systemic risk response framework) identified during the assessment
1.2. Overview of Azerbaijan Financial Sector

- 44 banks, divided into 4 groups:
  - Group I - 1 state-owned bank
  - Group II - sound and developing private banks
  - Group III – weak banks
  - Group IV – outsider banks

- Risk-based supervision based on Basel Committee principles on effective bank supervision

- CBA’s supervisory approach is more conservative than European and other regulators

- Well capitalized and profitable

- No “toxic” assets

- Low NPL ratio

- Sufficient liquidity in the system
1.3. CBA role in designing financial stability framework

- CBA is responsible for both monetary policy and regulation and supervision of the Azerbaijan banking sector. As such, the CBA was seeking a tool to bring together different data sets to model change.
- Establishing a systemic risk response framework was part of the CBA’s strengthening banking sector financial stability and supervision strategy.
- The previous scope of the monitoring exercises implied by CBA was too narrow and the full impact of a range of scenarios cannot be assessed.
- Current data limitations constrain CBA’s undertakings in this area.
2.1. Project objectives

- Project Information

- The main purpose of the project was to assist to CBA:
  - in developing a systemic risk response framework (SRRF) that addresses key vulnerabilities in the risk assessment and response framework of Azerbaijan.

- Total Project Cost: US$ 243,000

- FIRST Funding: US$ 213,000

- The SRRF project became effective in April 2010
2.2. Project objectives

- To design a tailor-made computer model (which is called multi-factor scenario analysis) for Azerbaijan financial system to diagnose weaknesses, generated by exceptional but plausible shocks, to individual institutions, but also to the banking system as a whole;

- To provide a tool for CBA to improve their supervisory process;

- To assess systemic risk using econometric analysis and close gaps to the extent possible in financial system of Azerbaijan; and

- To prepare a report on the findings of the model which may help CBA to improve their prudential reporting requirements, to determine the areas of focus in their supervisory strategy and plans.
2.3. Specific project activities

- Evaluation of Azerbaijan’s financial/banking system and simulate how changes to policies or economic fundamentals affect the system;

- Design and execution of a multi-factor scenario analysis;

- Use of system-of-systems analytic approaches to model the flow of systemic risk through the banking system;

- Identification of weaknesses in supervisory framework and provide recommendations where necessary.
3.1 Project implementation

- Booz Allen Hamilton, management consulting company, was contacted by FIRST to assist in project implementation

- 3 missions by BAH and FIRST team to Baku

- Highly qualified expertise by BAH involved to project implementation

- Project implementation stages:
  - Project assumptions document prepared
  - Development and test of the model
  - Delivery of user-manual that guides the full details of implementing the scenario analysis
  - Training to CBA staff
3.2 Project output

- The project has basically achieved its objectives.

**Major outputs:**
- a unified systemic response framework, a quantitative methodology,
- a functioning multi-factor scenario analysis, including instruction manual that guides the full details of implementing the scenario analysis, and
- a report on weaknesses in legal and regulatory framework (*in progress*).

**Major outcomes:**
- use of multi-factor scenario analysis on formulating policy framework and measures (*in progress*);
- actions taken by the authorities to eliminate the weaknesses identified in supervisory framework (*in progress*); and
- improved capacity of CBA (*in progress*).
3.3 Project implementation: follow-up and challenges

- SRRF model is evolving gradually;
- Numerous issues/errors were detected while using/testing the SRRF model;
- BAH and FIRST team are very reactive in addressing the identified gaps in the model,
- However, progress is slow mainly because of distant communication (additional on-site visits by BAH team is becoming increasingly important)
- Model improvement still continues…
- In addition to model improvement process, enhanced training to CBA staff would strengthen the efficiency of model use
4.1. Overall experience in dealing with FIRST

- Good project management and coordination
  - Leadership of Michael Edwards (World Bank) and Shebnem Sener (FIRST)

- High expertise of BAH consultants

- FIRST flexibility and support

- Only shortcomings is that project did not include sufficient resources for follow-up support and training (on-site visits)
4.2. AZ bank supervision framework: challenges and future cooperation

- Action Plan has been drafted to eliminate other supervisory gaps identified in World Bank banking sector vulnerabilities report.
- New project is initiated to introduce Risk Assessment System (RAS).
- New methodology for assessment of risk area (credit, operational, liquidity, etc);
- Quality assurance system to monitor effectiveness of supervision processes;
- Corporate Governance and risk management in banks;
- Introduction of counter cyclical approach (in provisioning, liquidity, capital);
- Introduction of consolidated supervision;
- FIRST TA support to any of above-listed area would be highly appreciated.
Thank you for your attention!