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# Azerbaijan: Systemic Risk Response Framework

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## 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
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## 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
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## 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 the 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.
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## 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
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## 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.
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## 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.
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## 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
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## 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*).
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## 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
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## 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)
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## 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.
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**Thank you for your attention!**