How did Azerbaijani banks face a ‘test’ of devaluation?

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A retrospective view on the banking sector for the past five years

Oil prices decline in global commodity markets from end-2014 exposed macroeconomic stability to a great risk in oil-dependent countries. Unlike the countries that achieved significant diversification in their economies such as the US, the United Kingdom, Norway, and Canada, countries heavily depending on oil have fallen into the economic downturn in the light of the decline in oil revenues. Countries such as Russia, Venezuela, Kazakhstan, Saudi Arabia, Azerbaijan faced a great deal of difficulty: national currencies collapsed, inflation was out of control, the financial sector lost its stability, foreign exchange reserves ‘melted down’, etc. These countries initially spent foreign exchange reserves to protect their national currencies and macroeconomic stability, and then had to devaluate their national currencies to maintain currency reserves.

In Azerbaijan, having obliged to effect severe devaluation twice, the national currency depreciated by 50%, going down from $ 1.28 per 1 manat to $ 0.65 per 1 manat. Although, the transfer of national currency to floating exchange rate was declined subsequently and its soft depreciation continued, from April 2017, the actual official exchange rate of 1 manat stabilized at $ 0.59.

The emerged devaluation firstly exposed loss to the banking sector. The difficulty in repaying foreign-currency loans led to deterioration of the banking sector assets. Every third bank operating in the country and every fifth non-bank credit organization closed their offices and left the market. The International Bank of Azerbaijan (IBA), which is the country’s largest bank and accounts for 40% of the banking sector, faced a bankruptcy threat. The considerable part of its assets was recovered through the government's billions of dollars, and the state took over the commitment for bank's foreign debt liabilities. Even though the government had certain support for banks, it left the issue of repayment for dollar loans to customers and banks, hence resulting in fast increasing of non-performing loans and leading the financial sector to a challenging situation.

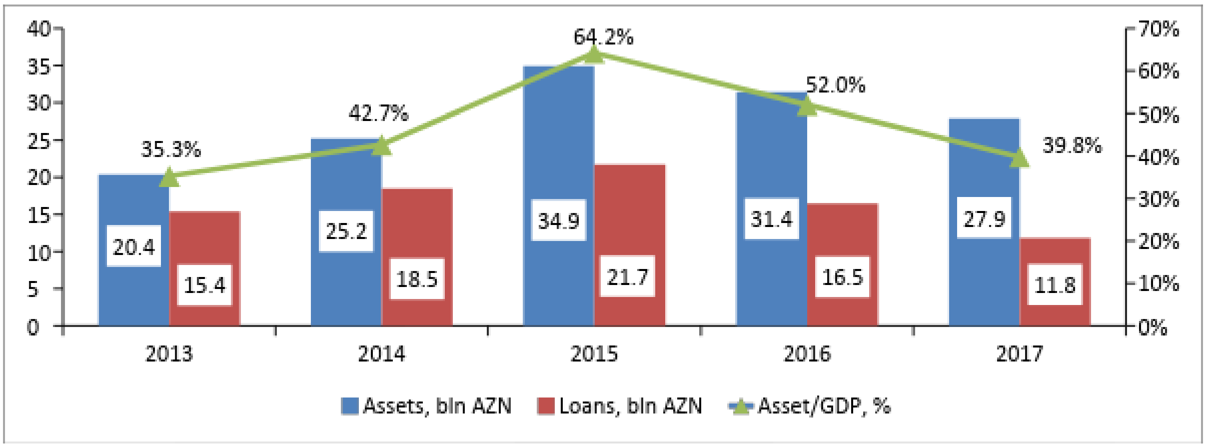
In the analysis provided for your attention, we will analyze the current situation by assessing the last five years of the banking sector, including previous years of devaluation. In light of the decline in oil revenues and emerging devaluation, it is possible to group challenges across the banking sector into the following areas:

Banks' function to finance the economy and population has decreased.

Let's look at banks' total assets and lending level to justify such a conclusion.

The volume of banking assets has decreased. The decline in banks' deposits and loans has led to deterioration of their assets as well as a drop in their volume. Statistical data provided by the Central Bank of Azerbaijan and Financial Market Supervisory Authority (FIMSA) found that banks' assets increased by 71.2% within two years of the pre-devaluation period, while their assets decreased by 20% in two years after the devaluation. The main reason for this had been the transfer of International Bank of Azerbaijan's (IBA) distressed assets to the state-owned non-banking credit organization Agracredit as part of rehabilitation measures, and the closure of some banks. Banks's total assets reached a peak level, touching AZN 35 billion at end-2015. The reason for the peak in 2015 (38.6%) had been revaluation of assets due to a nominal depreciation of the manat (Figure 1).

Figure 1. Assets of the banking system (*2013-2017), bln AZN*



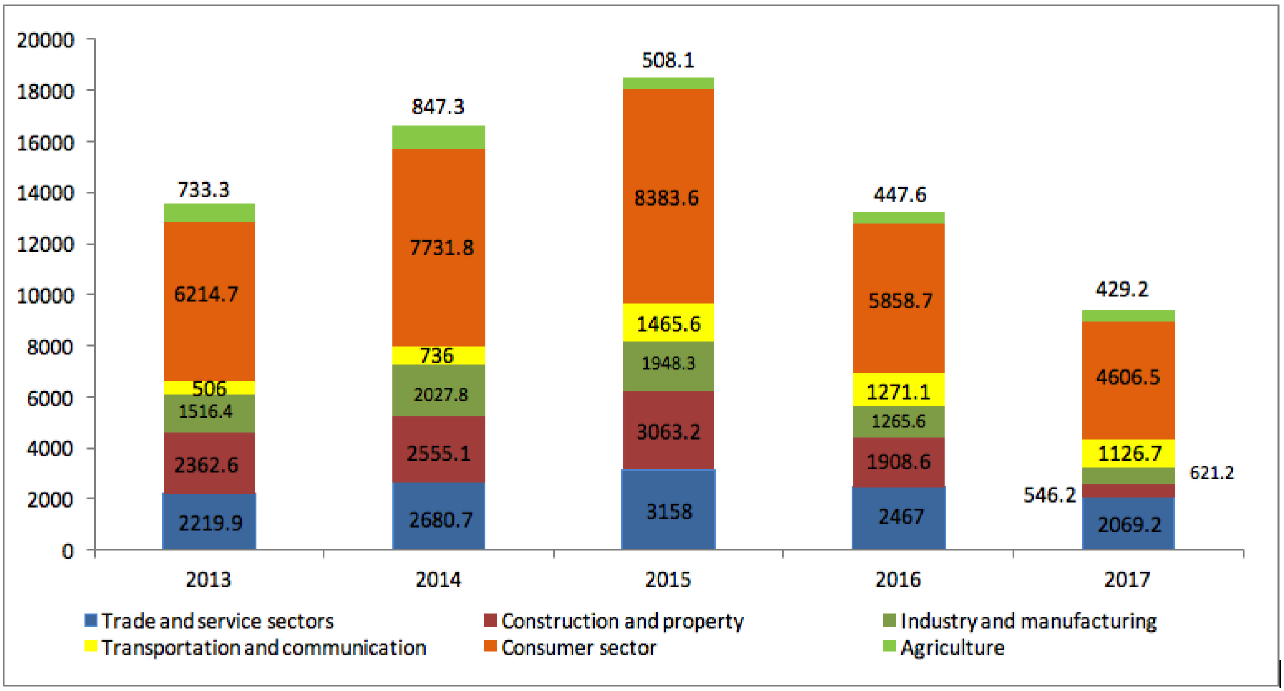
Sources: CBA; FIMSA

Although the fall in nominal GDP in a context of dollarization of the bank system significantly increased the share of banking assets in GDP, the growth has not been long-lasting and durable. Since bank assets with a 35.3% share in GDP in 2013, rose to its highest level ever, reaching 64.2% in the year after devaluation. However, the bank assets reversed an upward trend, falling to 39.8% in 2017. The surge in the share of assets in the year after devaluation was due to the increase in the level of dollarization of assets (Figure 1).

The credit outreach to entrepreneurs and population has significantly. A statistical lending analysis for 2013-17 found that deterioration of banks' assets after the devaluation prompted them to discourage lending growth. The growth rate of loans observed in mid-2000 not only slowed in following years, but also declined, encompassing sectors of the economy. Lending reached a record of AZN 21.7 billion in 2015, but was 45.9% down to AZN 11.8 billion within two years after devaluation. The decline was attributable to the transfer of the International Bank of Azerbaijan's (IBA) distressed assets to a credit organization… and another cause was limited credit to the economy provided by the bank **(Figure 1).**

Figure 2. Dynamics of lending by sectors, AZN million,

2013-2017



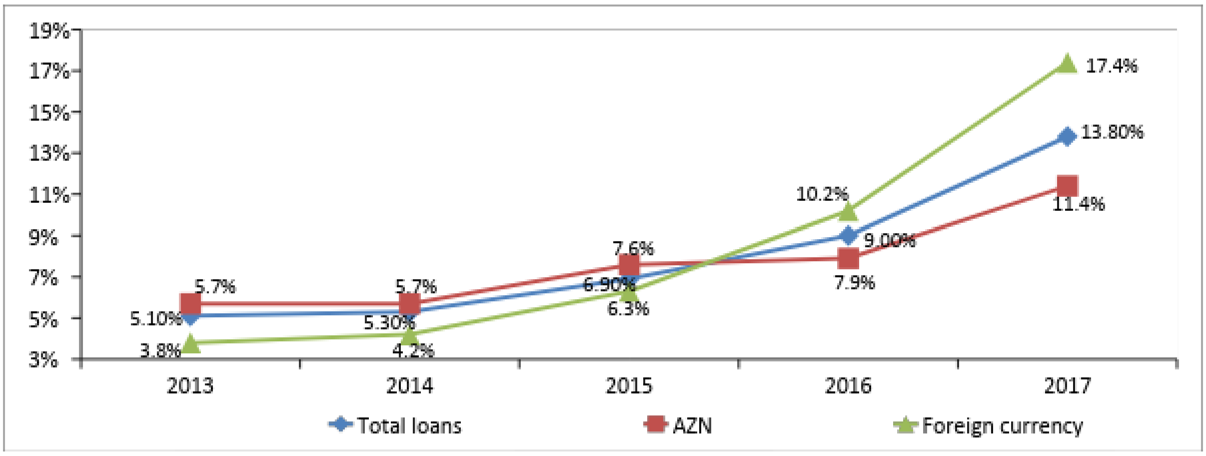
Source: CBA.

The pre-devaluation credit growth level further showed a downward trend. The growth not only involved the dollarization of the currency structure, but also strong funding provided by the banks. The downward trend, however, was attributable to the non-working banking assets due to a surge in non-performing bank loans, the waning interest of customers in dollar loans, and the minor appreciation of the manat against the dollar. For example, the share of lending to *trade and service sectors* fell to 34.5%, while *construction and property* 82.2%, *industry and manufacturing* 68.1%, *transportation and communication* 23.1%, *agriculture and processing* 15.5%, and *consumer loans* 45.1% **(Figure 2).**

There has been a decline in both local-currency and foreign-currency loans. Widespread devaluation expectations prompted banks to constrain the extension of local-currency loans. Manat loans declined at end-2014 and this fall reached a dramatic peak. Although the dollarization of loans first tended to increase foreign-currency lending, the deterioration of banks' assets after the devaluation prompted them to discourage lending growth. Plus FIMSA prohibited financial institutions from extending foreign-currency loans. Decreasing loans, bank's main source of income, led to a decline in banks' profits. The share of loans in total assets decreased from 73.5% in 2013 to 41.5% in 2017. And that means if banks invested AZN 73.50 per AZN 100 in lending to the economy in the pre-evaluation period, this indicator has currently dropped to AZN 41.50. The sharp decline in loan-to-asset-asset ratios has shown banks' restricted potential to contribute to economic development and remain strong enough to support real sector.

The overdue loans that brought to the non-working banking assets, their limitation on loans, and closure of several banks has sharply increased after devaluation. According to the CBA, the share of problem loans in total loans rose from 5.1% in 2013 to 13.8% in 2017, exceeding the critical limit for the banking system. The problem with foreign – currency loan payments is even deeper. It has been impossible to revive AZN 17.4 per AZN 100 of the dollar loans. Data provided by a variety of international institutions are often different from official data. According to Fitch's recent press release, for example, non-performing loans in Azerbaijan have stabilised at about 20% of total loans **(Figure 3).**

Figure 3. Share of overdue loans, 2013-17



Source: CBA.

There has been a reduction in people's access to banking services.

It extends to changes in the number of banks and their branches, ATMs and POS terminals providing services to the population.

The number of banks has considerably decreased, leading to a potential reduction in banking services. One of the negative impacts of the devaluation of the manat was the closure of banks, leading to a reduction in the number of their service points. The worsening situation in the banking sector, massive bank losses and defaults by some banks shattered confidence in the banking system. The Central Bank's call for consolidation, despite some attempts, failed. This prompted the Government to take harsh measures. The Central Bank and then Financial Market Supervisory Authority (FIMSA) revoked the licenses of the banks posing no threat to the system. 14 commercial banks in total were shut down after the initial devaluations, including 2 and 12, respectively, after the first and second major devaluations. Only two banks – ATABANK and Caspian Development Bank (CDB) decided to merge.

Table 1

Banks	**2014**	**2017**	**Change (+ increase, – decrease)**
Number of banks	**43**	**30**	**– 13**
• Banks with foreign capital, including:	22	15	– 7
with the share of foreign capital ranging from 50 to 100 percent	*7*	*8*	*+1*
with the share of foreign capital not exceeding 50 percent	*13*	*7*	*– 6*
local branches of foreign banks	*2*	*2*	*0*

• Local bank branches	700	509	– 191
• Local bank departments	148	142	– 6

Sources: CBA; FIMSA.

Whereas the number of banks had reached 45 as of early 2015, they reduced in size (about 30 percent) between 2013 and 2017. If the number of customers accessing banking services was 220,000 per bank and 13,500 per bank branch, on average, in 2015, currently these figures currently surged to 330,000 and 19,500, respectively. As of early April 2018, there are 30 banks across the country (2 state-owned and 28 private banks), 15 of which are with foreign capital, including 2 local branches of foreign banks. The number of local bank branches and departments was respectively 568 and 129 (Table 1).

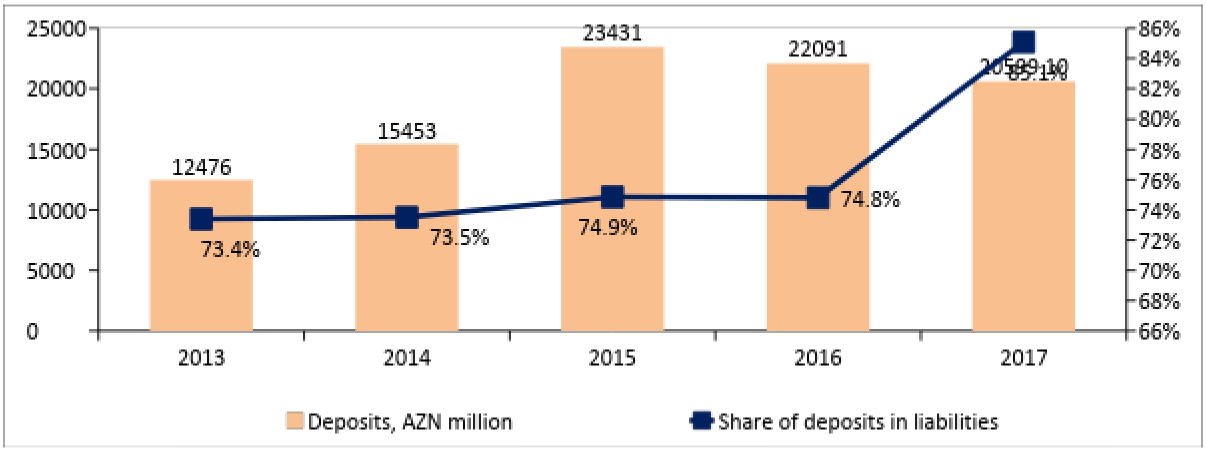
The population lack the opportunity to withdraw money from the accounts and make cashless payments. Although the number of ATMs and POS terminals rose sharply starting in 2015, as part of the measures to encourage cashless payments. But there has been a clear downward trend since the major devaluation of the manat. According to the CBA, the number of ATMs rose from 2,422 to 2,694 before the devaluation, but then started to decline shrinking to 2,431. And same with POS terminals, rising from 33,285 to 80,301 until 2015, but dropping to 65,471 in subsequent years. The number of credit cards rose from 942,000 to 1,000,000, dropping to 623,000 beyond 2015.

The dependence of banks on deposits has also accelerated.

Despite a shrinkage of the deposit market, the dependence of banks on deposits has accelerated over the past five years. The share of deposits in total liabilities rose to 85.1% at end-2017 from 73.4% in 2013, mainly due to an increase in bank deposits on the one hand, while, on the other hand, increasing exchange rates of dollarized deposits to the local currency, the banks’ refusal to roll over external liabilities, and progressively tightened restrictions to get loans from credit institutions (Figure 4).

Between 2013 and 2017, [according to official data,]() foreign liabilities of banks fell from $5.3 billion to $1.6 billion.

Figure 4. Dynamics of the volume of deposits and share of banking sector liabilities, 2013-2017



Source: CBA.

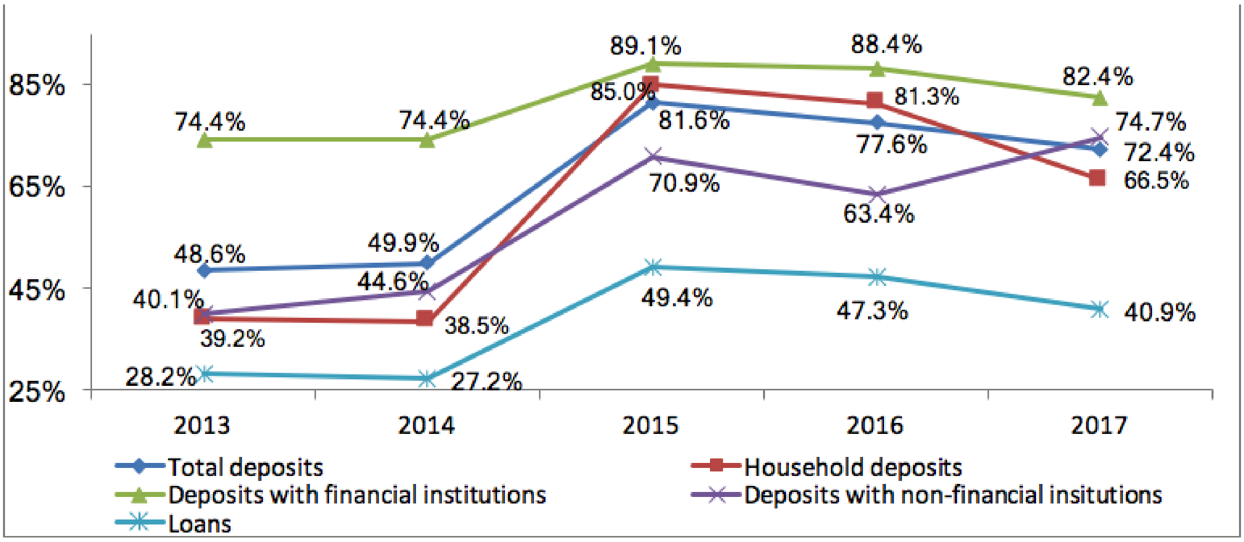
Reduced trust in the banking sector in the aftermath of the closure of banks and decreasing annual returns on foreign - currency deposits have led to a reduction in deposits as a whole. The volume of deposits dropped to AZN 2.6 billion in 2017, compared to AZN 23.4 billion in 2015.

Dollarization of the domestic banking system is high.

Devaluation expectations have accelerated the dollarization of the banking sector between the end of 2014 and today. While, on the one hand, individuals started converting their deposits to dollars, on the other the banks preferred to provide loans in dollars instead of providing local-currency loans, to insure themselves against any eventuality (Figure 5).

As a result of the dollarization, the share of foreign-currency denominated loans in total loans of the banking sector increased from 28.2% in 2013 to 40.9% in 2017. Despite a 27% drop before the first devaluation of the national currency, foreign-currency loans were 40.4% up from 27% after the first devaluation, while 49.4% up from 39.2% after the second major devaluation. This process has slowed slightly since 2016, dropping to 40.9% as of late 2017. This is due to the fact that the growth rate of lending exceeds that of dollar loans and certain restrictions on foreign-currency loans (Figure 5).

Figure 5. Dynamics of the share of foreign currencies in loans and deposits, 2013-2017



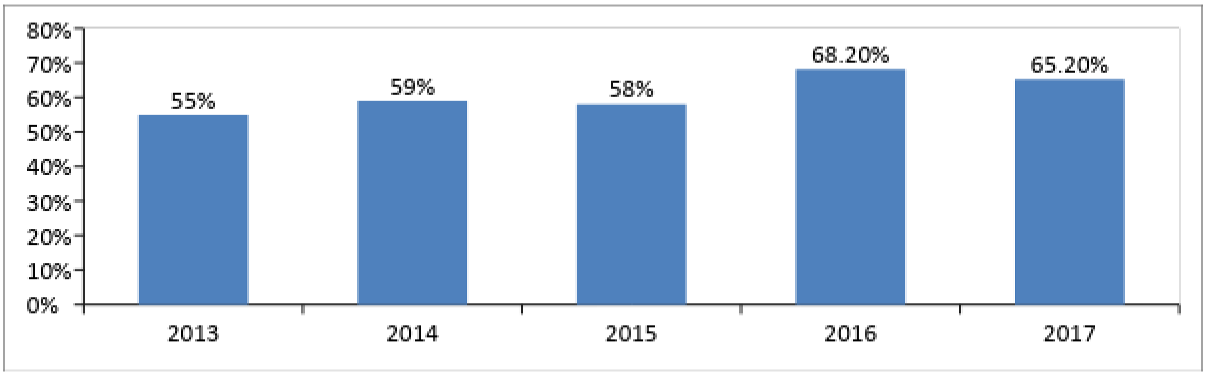
Source: CBA.

The level of *deposits* dollarization has been higher that of loans dollarization. The share of foreign currencies in deposits decreased until 2014, with an upward trend recorded in subsequent years. Deposit dollarization peaked 81.6% in 2015 for the first time, with a further downward trend in 2016, dropping to 72.4% through the end of 2017. Currently, the highest dollarization level is observed in *deposits with financial institutions* (82.4%), whereas the lowest level in *household deposits* (66.5%). The recent decline in dollarization level is subject to the stability of the national currency and low-interest returns on foreign-currency deposits offered by the banks (Figure 5).

Concentration in the banking industry is high.

One of the problems in the banking industry caused by devaluation is a concentration of resources. This process was mainly fueled by the banks' departure. It has been impossible to prevent concentration, even though some major banks (Bank Standart, Bank Technique) have also been liquidated. This is due mainly to a fear of individuals and companies for the closure of banks, prompting them to redeposit their funds in supposedly most reliable and largest banks.

Figure 6. Share of top 5 banks, *2013-2017*



The statistical analyses of the banking sector show that the share of top 5 banks in terms of the size of assets increased to 65.2% over the year, compared to 55% in 2013, while peaking 68.2% in 2016 (Figure 6).

The **Herfindahl–Hirschman Index**, an index widely deployed internationally to assess industry concentration, displays the concentration of 1382.3 in the banking sector according to results of 2017, which is a medium concentration level. Notably, a Herfindahl index of 0 to 1,000 is commonly interpreted as an industry with *low concentration*, 1,000 to 1,800 percent with *medium concentration* and 1,800 to 10,000 percent as *highly concentration*.

In order to solve existing problems, the Government adopted certain measures in providing full support to banks between 2015 and 2017. These measures can be systematized as following:

Providing liquidity to banks through a slight loosening of *prudential requirements for them*

Rehabilitating the banking sector through the closure of weak and troubled banks

Providing individual support to banks of systemic significance.

Building the people's confidence in the banking system

Providing certain incentives to the banking sector

Tightening lending requirements

Plus, the Government has brought about adequate institutional changes to cope successfully with the problems posed by financial coordination in the initial low-oil-price period, and to control the banking sector. Thus, it established the Financial Markets Supervision Chamber, a public legal entity, in February 2016 and the Financial Stability Board in July 2016, to target enhanced coordination in the financial sector. While these moves are welcome, it has been impossible to fully meet the challenges to shore up and stabilize the banking sector.