The Azerbaijani Banking Sector During Pandemic and War

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As it was for other sectors of Azerbaijan's economy, 2020 was full of hardships for the banking sector. On the one hand, the reduction of economic activity to a minimum under the yearlong COVID-19 pandemic restrictions did not spare the banking sector, and on the other hand, nor did the declaration of a state of emergency during the 44-day Patriotic War. As a result, banking's contribution to the economy became more limited, and due to declining incomes access to banking resources became more difficult.

The most memorable event in the banking sector in 2020 was the closure of four banks at the beginning of the year. On April 27, the Board of the Central Bank issued several decisions transferring all powers over the management of Atabank OJSC, AGBank OJSC, NBCBank OJSC and Amrah Bank OJSC, including the general meetings of bank shareholders, to a provisional administrator. The Central Bank revoked the licenses of Atabank OJSC and Amrah Bank OJSC on April 28, and the licenses of AGBank OJSC and NBCBank OJSC soon thereafter on May 12.

After those closures, the number of banks operating in Azerbaijan fell to 26. Although the event coincided with the pandemic, the root of the problem actually stems from the sharp currency devaluation that took place in 2015. Banks were hit hard and about a third of them were forced to leave the market. Some of the remaining banks subsequently failed over the next five years in their attempts to stay afloat. The Central Bank stated that the total capital of all four banks fell not only below the minimum norm set by the Central Bank – AZN 50 million – but actually into the negative. In other words, at least AZN 677 million is required for these banks to operate in accordance with the law. This problem remained unresolved in the post-devaluation period, a result of the failure of the Financial Market Supervisory Authority, which acted as a regulatory body in 2016-2019, to intervene in a timely manner.

The Central Bank set out to strengthen the banking sector after its regulatory powers were returned in November 2019. It was impossible to extend the Law on Full Deposit Insurance after early parliamentary elections were called, and the decision to close the abovementioned banks had to be delayed since the failure to extend this law would have left the majority of depositors without compensation. In March, following the formation of the new parliament, the law was extended for another nine months and the four banks were closed in April. From this point of view, it is difficult to link the decision to close the 4 banks with the effects of the pandemic.

It would be absurd, however, not to recognize the impact of the pandemic on the banking sector. Official statistics and bank reports clearly show that the banking sector, which just recovered from the effects of the devaluation, is facing new challenges. In particular, the positive trend observed in the banking sector in 2018-2019 and the return to a negative trend in 2020 support this hypothesis.

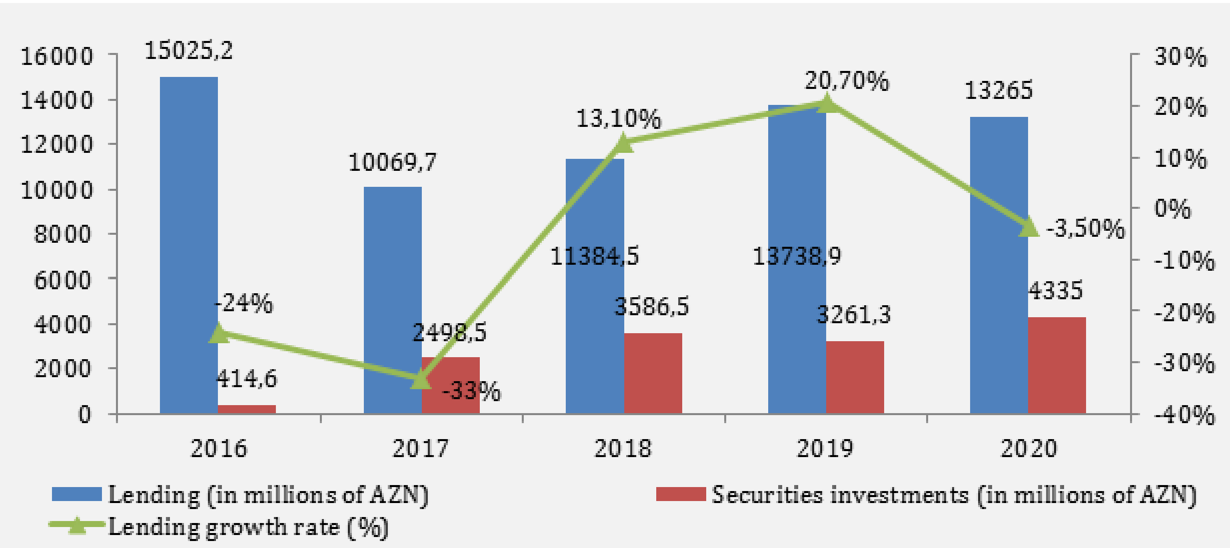
What were the negative effects of the pandemic and, at least in part, the war on Azerbaijani banks?

Decrease in banks' credit activity

After recovering from the 2015 devaluation, banks increased their lending activity starting in 2018, and even managed to increase their total lending by 36.4% in 2018-2019. The following year, however, marked a new credit crunch. According to the Central Bank, in 2020, the net lending of Azerbaijani banks decreased by 3.5% from AZN 13.7 billion to AZN 13.3

billion (*Graph 1*).

Within the framework of strict quarantine measures, a mechanism of state support was instituted to prevent a sharp decline in lending. The support for lending was [provided]() by the Cabinet of Ministers' July 9, 2020 Resolution #249 *On a number of measures to provide state support for loans to businesses to reduce the negative impact of the coronavirus (COVID-19) pandemic on the country's economy*. These rules provide a state guarantee on bank loans to be received by entrepreneurs and a subsidy for a portion of the interest accrued on these loans. As part of the state support program, in 2020 banks [restructured]() AZN 1.2 billion in loans due to the pandemic.



Graph 1. Banks' net lending and investment in securities in 2016-2020
Source: Central Bank

In 2020, the growth rate of lending was unstable. In the first quarter of the year, i.e. before the quarantine was declared, there was a 2.6% increase in lending, while in the second quarter during the period of strict quarantine restrictions there was a decrease of 7%. The relative increase (2.3%) observed again in the summer months was replaced by a decrease (1.1%) in the final quarter.

The main support for lending came from state-owned banks. Against the backdrop of an 8.4% increase in lending by state banks, lending by private banks decreased by 7.8%. As a result, **the market share of state banks in total lending increased from 16.7% to 19.1%**. The International Bank of Azerbaijan (9.9%) alone accounted for the increase among state-owned banks. Another state-owned bank, Azer Turk Bank, decreased lending by 10.2%. An analysis of specific banks shows that the impact of the pandemic on bank lending activity varied. The main banks that reduced lending in Azerbaijan in 2020 are AFB Bank (decrease of 61.3%), Bank VTB (47.1%), Xalqbank (19.4%), Yapi Kredi Bank (20.2%), and Accessbank (17.7%). Only Kapital Bank (19.5%), Pasha Bank (16.5%), Gunay Bank (20.1%), and Rabitabank (12.3%) managed to significantly increase their loan portfolios. Overall, half of the country's banks increased lending and half decreased it.

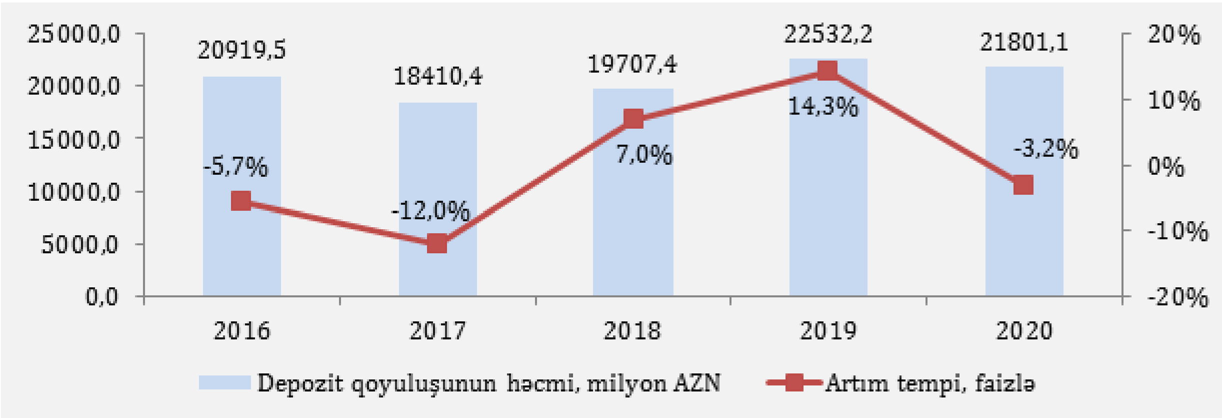
An increased risk of devaluation did not lead to a dollarization of lending. On the contrary, over the course of 2020 the share of loans in the national currency increased from 65.4% to 70.2%. The reason for the decline in dollarization is the Cabinet of Ministers' Resolution #249 *On a number of measures to provide state support for loans to businesses to reduce the negative impact of the coronavirus (COVID-19) pandemic on the country's economy*. These rules apply only to bank loans that entrepreneurs take out in the national currency. With this in mind, banks continued to issue loans in AZN to obtain state guarantees and interest subsidies.

In particular, banks have continued the policy of the past 5 years of not lending, preferring to invest the funds "saved" in securities. The attractiveness of investing in securities for banks has increased significantly in recent years, with about 10-13% of their assets going in that direction. In 2016-2020, banks' investments in securities increased more than tenfold. Investment in this area decreased by 9.1% in 2019, but increased again by 32.9% last year (*Graph 1*). This shows that in order to protect their funds, banks preferred passively rather than actively financing the population and business, investing their funds mainly in the securities of the Ministry of Finance and the Central Bank, which are more reliable.

Decrease in deposits

In March 2020, against the backdrop of a sharp drop in oil prices on world markets, the increased likelihood of a currency devaluation prompted the population to withdraw a certain amount of their money from banks, and to exchange a certain amount for dollars. The decision to close four banks the following month shook the deposit market a second time. Despite all these shocks, last year’s decline in deposits was only 3.2% (Graph 2).

In fact, the year started well for the deposit market, and in January-February there was an increase in deposits by AZN 474.7 million. In March, however, rumors of a devaluation prompted the withdrawal of deposits from banks. Against this backdrop, the deposit portfolio of banks decreased by AZN 981.7 million in March and AZN 619.3 million in April. The decrease continued in May (AZN 26.7 million) and June (AZN 810 million). Rising oil prices on world markets boosted confidence in exchange rate stability, which led to a relative calm in the deposit market. In July-August, there was even an increase of AZN 161.5 million. The increase in these months can be attributed to the redepositing of the compensation received from the bank closures at other banks. In September-November, however, during the war in Karabakh, deposits again fled the banks. During this period, the volume of deposits withdrawn from banks amounted to about AZN 300 million. There was a noteworthy increase in deposits by 6.1% or AZN 1.4 billion in December of last year.



Graph 2. Fluctuations in the banking sector's deposit portfolio in 2016-2020
Source: Central Bank

If we look at the structure of deposits, we can see that there was a decrease of 10.6% in the deposits of financial institutions, 5.5% in the deposits of the population, and 1.1% in the deposits of legal entities. The probability of a currency devaluation and restrictions on the sale of dollars in Azerbaijan did not have a negative impact on the currency structure of deposits. Despite short-term tension in the foreign exchange market, the share of the national currency in total deposits increased in 2020 from 39% to 43.6% thanks to the funds of the population and legal entities. During this period, the level of dollarization in financial institutions' deposits increased from 66% to 68%. Deposits in the national currency remain attractive thanks to full insurance and low annual interest rates on foreign currency deposits. The main factor is the low probability of devaluation.

Last year, some Azerbaijani banks increased their deposit portfolio, while others were forced to reduce it. Along with huge banks such as Pasha Bank (12%), Kapital Bank (17.6%), and Rabitabank (9%), local banks such as Nakhchivanbank (48.8%) and Gunay Bank (15.8%), and banks with foreign capital such as Ziraat Bank (77.3%) and VTB Bank (27.7%), also managed to increase their portfolios. The deposit portfolio of the Baku branch of the National Bank of Pakistan – the smallest in the country – grew sevenfold.

The largest deposit losses occurred at AFB Bank (70.9%), Bank Respublika (37.3%), Expressbank (31.9%), Yelo Bank (25.2%), Eurasia Bank (18.2%), and Muganbank (16.7%). Overall, the deposit portfolios of 16 banks decreased, while those of 10 banks increased.

The banks remain dependent on deposits. The share of deposits in the total liabilities of banks decreased in 2020 from 80.1% to 79.3%. However, there has been an upward trend in the last 5 years.

Even greater concentration of resources

One striking feature of the pandemic is the increase in concentration in the banking sector. Concentration has increased in bank assets, lending, and deposits.

Last year, the total assets of banks decreased by 2%, but concentration increased. The market share of the five largest banks in the country increased from 67.2% to 72%. *This is the highest that figure has been in recent years.* Kapital Bank (26.2%) and Pasha Bank (15.6%) managed to significantly increase their assets and played a key role in increasing concentration. These banks are among the five largest banks in the country in terms of market share in the banking sector. The decline in assets of the other three banks in the top five (International Bank of Azerbaijan, Xalq Bank, Bank Respublika) could not prevent the increase in concentration.

The level of concentration in deposits increased from 67.8% to 71.8%. Against a backdrop of declining total deposits, the increase in deposits in large banks strengthened concentration. For example, four large banks (International Bank of Azerbaijan, Pashabank, Kapital Bank, and Xalq Bank) accounted for 84.6% of the total increase in deposits of 6.1%, or AZN 1,369.8 million, recorded in December last year.

The level of concentration in lending increased from 61.4% to 67.3%. Despite the decline in lending across the country, the five largest banks’ lending increased by AZN 422 million, which increased their market share.

Some seemingly positive trends

Looking at the details, it can be seen that last year there were many positive trends in the banking sector: banks increased their capital by 2.5%, the number of bank branches increased from 439 to 455, the number of employees increased from 18,391 to 18,708, etc. Of course, it would be nice to think that these tendencies stem directly from the activities of the banks, but an analysis shows that sometimes these tendencies are products of government support. For example, the net profit of banks increased by 5.8% compared to the previous year. However, during this period, the net profit of only seven banks increased, and one bank was able to reduce losses. The net profit of 18 banks decreased. The increase in net profit was due to a significant decrease (60%) in the amount of special reserves created to cover possible losses on assets. Because compared to 2019, the operating profit of banks decreased by 5.3%. The decrease in special reserves is due to the relative easing of credit restructuring and asset classification requirements as a result of the state support plan.

Conclusion

This article considered the indicators for 2020 to assess the impact of the pandemic on the banking sector. This assessment covers primarily the initial effects because the pandemic is not over yet. We are already four months into 2021, and the pandemic continues to hurt both people and economies. It is still unknown when the health care system will finally defeat the pandemic. This means that the banking sector will have to deal with its consequences for some time. The increase in economic activity against the backdrop of easing quarantine restrictions has sparked a certain revival in the banking sector, and there has been a slight growth in banks’ lending and deposits. However, in addition to the pandemic, Azerbaijani banks face technological challenges. The introduction of digital currencies may present more severe challenges for the banking sector than either the pandemic or oil.