

# The Initial Impact of the Russia-Ukraine War on Azerbaijan's Banking System

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A raft of further [sanctions](#) has been imposed on Russia over its invasion of Ukraine. Already by the time of its invasion of Ukraine, Russia had *tasted the force* of sanctions. Before the invasion, Russia was already subject to nearly 2.700 sanctions. But after February 22, that figure expanded to fantastic proportions, rising to 13.072. Currently, sanctions are imposed by the US, Canada, Switzerland, Australia and Japan, as well as EU countries and the UK. These sanctions have many implications for various sectors of the country, including the economy and the banking sector. The United Kingdom and the United States have imposed restrictions on the correspondent accounts of Russian banks. Other countries, except Australia, have restricted Russian banks' access to SWIFT. Plus, Russia has been deprived of its status as a most favorable country for trade, and its access to finance has been restricted by the IMF and the World Bank. All of this has, to varying degrees, affected both Russia's economy as a whole and the countries that are among its main trading partners.

In the early weeks of Russia's invasion of Ukraine, [experts](#) predicted that the entire global economy would feel the effects of slower growth and faster inflation. In their view, impacts will flow through three main channels. *One*, higher prices for commodities like food and energy will push up inflation further, in turn eroding the value of incomes and weighing on demand. *Two*, neighboring economies in particular will grapple with disrupted trade, supply chains, and remittances as well as an historic surge in refugee flows. *And three*, reduced business confidence and higher investor

uncertainty will weigh on asset prices, tightening financial conditions and potentially spurring capital outflows from emerging markets.

Other forecasts predict that, unlike Europe, neighboring countries will feel a stronger impact of the recession Russia will face, and of the sanctions imposed on it. Russia is not only Azerbaijan's northern neighbor, but also one of its main foreign trade partners. [In 2021](#), Russia was the largest importing country, accounting for 17,7% of imports from Azerbaijan. And our northern neighbor is the 3rd largest country with a 4,15% share of Azerbaijani exports. Russia is also Azerbaijan's [largest non-oil exporter](#).

While assessing the impact of sanctions imposed against Russia's economy on the banking system of Azerbaijan, we are primarily concerned about the fate of correspondent accounts domestic banks hold in Russian banks. Because not all banks could at one time open correspondent accounts in US and European banks, some of them had to access to international settlements through Russian banks. In particular, they used Russian banks to open ruble accounts. Now, when leading Russian banks are subjected to sanctions and excluded from the SWIFT system by Western countries, the prospect of the future expansion of the scope of anti-Russian sanctions has also put Azerbaijani banks in a difficult dilemma. Preliminary estimates show that Azerbaijani losses so far are not significant.

Referring to the Geopolitical Risk Index developed by Dario Caldara and Matteo Lacoviello, the CBA in its [Financial Stability Report](#) has categorized the potential impact of the developments created by the regional geopolitical tension caused by the Russian invasion of Ukraine on financial system stability with five threats: high global inflation, disruptions in foreign trade relations, surges in global energy prices, risks bank assets are exposed to, and challenges in the execution of bank operations. The CBA

believes that since Azerbaijani banks have few funds in Russian sanctioned banks, the effects of sanctions on the financial stability of the Azerbaijani banking system are limited. Although domestic banks face certain hindrances in operations with correspondent accounts due to the Russia-Ukraine conflict, the impact of this conflict on operations of Azerbaijan-based banks with correspondent accounts has so far been limited.

The International Monetary Fund (IMF) said in its [Statement](#) of the 2022 Article IV consultation from 25 May to 7 June 2022, that: “The sanctions on Russia have thus far had a limited impact on Azerbaijan’s banking sector. However, as Azerbaijan’s exposure to Russia is non-negligible given Russia’s role as an important trading partner, Azerbaijani banks may turn to alternative systems. The authorities should closely monitor banks’ usage of alternative payment systems or crypto currencies. **There appear to be some challenges with correspondent banking.** The authorities do not currently see any serious problems with correspondent banks in Russia and they are monitoring the situation closely. However, there appear to be some challenges with the correspondent banks in the United States and Europe, including delays in processing payments. While two thirds of Azerbaijan’s banks have correspondent account in the U.S. and European banks, some banks continue to have problems with accessing correspondent banking services.”

*The Events After the Balance Sheet Date* section of 2021 audit reports of banks holding correspondent accounts with Russian banks, published in mid-2022, contains the following opinion: “We hold bank accounts with Russian banks and have continued to conduct banking transactions through these accounts. Currently, our management is unable to assess the impact of the conflict on the bank’s financial statements. However, negotiations are underway with other banks to open alternative nostro accounts.”

The situation is more sensitive in banks with Russian capital. For example, *Yelo Bank* OJSC in its 2021 [Audit Report](#) additionally noted that “the share of revenue from payments through nostro accounts is not significant, and cannot have a significant impact on the bank.” According to VTB Bank’s [Audit Report](#), “the main impact of the sanctions imposed on Russia encompassed restrictions on the operational functionality of the bank in U.S. dollars and euros, including its payment cards outside the Republic of Azerbaijan, and blocking Russia from the SWIFT system.” With a view to minimizing the negative impact of sanctions on the Bank’s operations, VTB Bank [announced](#) that it connected to [the Financial Messaging System of the Bank of Russia \(SPFS\)](#), an alternative to the SWIFT system created by the Central Bank of Russia. This is due to the fact that SPFS enables money transfers between the Russian Federation and the countries that have connected to this system.

While negotiating with other banks to open alternative nostro accounts, Azerbaijani banks did not forget to withdraw their funds from correspondent banks. According to Central Bank official [data](#), nostro accounts, that is funds in a foreign currency on correspondent accounts with other banks, plummeted by 31,6% over the first 11 months of 2022. The amount of foreign currency in nostro accounts shrank to AZN 4,6 billion at end-2021, compared to AZN 3,2 billion in November 2022. This decline began to manifest itself amid the outbreak of war. Another notable point was that foreign currency funds placed in Loro accounts have more than tripled. Over the first 11 months of 2022, foreign currency funds increased from AZN 141,8 million to AZN 438,5 million.

Most, if not all, Azerbaijani banks have posted on their website information about their correspondent accounts. Our study using open data showed that out of 25 banks operating in the country, at least 13 have correspondent accounts in Russian banks. Nine banks also have ruble correspondent accounts in [ABB-Moscow](#), a subsidiary of the International Bank

of Azerbaijan in the Russian Federation. We can assume that most of these banks transferred their correspondent accounts to ABB-Moscow exactly after February 22. Apparently, the IBA subsidiary bank in Russia has become a place of hope for Azerbaijani banks.

The main consequences of the sanctions against Russia in Azerbaijan's financial sector were recorded in the savings market. Since the beginning of the war, the savings market has seen a substantial increase, with noticeable changes in savings structure. Deposit holders preferred short and medium-term investments with the right to withdraw money at any time.

According to official information, [over 11 months of 2022](#) savings investment of individuals increased 25,5% to 11,6 billion manats, setting a historic record. I would like to point out that the growth rate of savings in 2011 was lower than that of 2022. The only increase, an increase of 31,8%, was recorded in 2015, which was not due to an increase in savings investment, but to the devaluation that occurred in that year. There was a sharp increase in the value of foreign currency savings denominated in national currency after the devaluation of the manat in 2015. On the other hand, there were decreases of 21,4% in 2016 and 5,3% in 2020.

Another [change](#) that draws attention to the savings market is *the increase in savings of non-resident individuals*. Over 11 months of 2022 the savings of foreign citizens increased by 3,5 times from 301,3 million manats to 1,1 billion manats, which is the highest figure since February 2016. With that, the share of non-residents in total savings increased from 3,3% to 9,2%. *The increase in savings of non-residents was mainly due to foreign currencies*. Thus, the manat savings of non-residents increased by 117,9%, from 139,2 million manats to 303,3 million manats and foreign currency savings by 370,1%, from 162,1 million manats to 762 million manats.

An analysis of the maturity of savings of individuals [shows](#)

that *deposited funds were mainly short-term*. Long-term savings surged by 9,1%, while short-term savings by 31%. For this reason, there was a decrease in the annual interest rates of short-term savings. Over 12 months of 2022, the annual interest rate of one-month national currency-denominated savings decreased to 2,92% from 5,01%; of 1-3-month savings to 2,22% from 4,0% to 2,22%; and of 3-6 -month savings to 5,08% from 5,82%, while the annual interest rate of 6-9- month savings decreased from 5,98% to 3,87% and the annual interest rate of 9-12- month savings increased from 8,86% to 9,07%. Different reactions were observed in foreign currency denominated savings. The annual interest rate of 1-month savings decreased from 4,53% to 0,68%, but the annual interest rate of 1-3-month savings increased from 1,06% to 1,28%, of 3-6-month savings from 0,49% to 2,4% and of 6–9-month savings from 0,66% to 0,68%.

Another point observed in the deposits structure is that the growth rate of demand deposits exceeded the growth rate of term deposits. In the first 11 months of last year, demand deposits of households increased by 42,2%. Such type of deposits of financial institutions increased by 71,5%, and those of non-financial institutions by 20,3%. The growth rate of demand deposits in foreign currency was higher. The growth rate for this type of currency made up 52,6%, 127,7% and 25,5%, respectively.

Another consequence of the Russian invasion of Ukraine is a *significant increase in the inflow of money into Azerbaijan*. According to the Jan-Sep 2022 [Monetary Policy Report](#) by the Central Bank, money remittances to the country by individuals YOY were up 3,6 times to \$2,8B from \$409,4M. The growth has been driven mainly by money remittances from Russia. Money remittances from Russia to Azerbaijan YOY increased 5,5 times from 772,5M to 2,3B, with the share of total remittances from Russia increasing from 53% to 81,6%. In contrast, money remittances from Ukraine decreased by 3,4 times, down to \$6M from \$20,5M. The share of this latter source fell to 0,2% from

2,7%.

During the first nine months of 2022, Azerbaijan [recorded](#) a 30% increase in remittances outside the country. Total amounts of money remittances compared to the same period last year increased from \$402,3 million to \$521,5 million. Unlike the inflow of funds into the country, here the picture is different. There was a 20% decrease in remittances to Russia, but a 21,2% increase to Ukraine, decreasing to \$68,2 million from \$85,5 million and increasing to \$22,2 million from \$18,3 million, respectively.

In [January-September](#) 2022, Russia's investments in direct foreign investments to the Azerbaijani economy increased 10,5 times YOY from \$35,9 million to \$377,7 million, with its share in direct foreign investments surging from 1% to 8,3%. On the other hand, Azerbaijan's share in the Russian economy fell to \$9,6 million from \$11,6 million. Russia's share in direct investments to the foreign economy fell to 1,3% from 2,3%.

Various ways of alleviating the adverse effects of sanctions for Russia today are actively discussed in neighboring and partner countries with Russia. One of such ways is the use of Mir cards in partner countries, including Azerbaijan, and another is the possibility of connecting banks from partner countries to the [System for transfer of financial messages \(SPFS\)](#).

The SWIFT ban against a number of key Russian banks has limited their exchange of information with other financial institutions, hindered Russia's ability to trade in non-sanctioned goods.

In March 2022, Visa Inc. and Mastercard Inc. announced the suspension of all operations in Russia. Shoppers will still be able to use the cards for purchases within Russia until they reach their expiry dates, but clients, who are citizens of Russia, have limited opportunities to use them at foreign online shops, and are unable to withdraw money from the card



in foreign countries. To replace these cards, the Russian government is seeking to expand the Mir payment network. By August 2022, Mir cards were accepted in [11 countries](#), but since October, six countries (Kazakhstan, Vietnam, Armenia, Uzbekistan, Turkey, Kyrgyzstan) had to fully or partially suspend transactions through the Russian payment system Mir. The reason for this was that the [U.S. Department of the Treasury](#) in a September 15 release stated that “those non-U.S. financial institutions that enter into new or expanded agreements with NSPK, the operator of Russia’s Mir national payment system, risk supporting Russia’s efforts to evade U.S. sanctions through the expanded use of the Mir national payment system outside the territory of the Russian Federation.” Last year, the press reported that Russia is negotiating the use of Mir cards with 15 countries, including [Azerbaijan](#).

The governor of the Azerbaijani central bank Taleh Kazimov told an [online press conference](#) on 28 October that cards issued by Russia’s Mir national payment system are not accepted in Azerbaijan, and the central bank observes the sanctions imposed against Russia by Western countries. However, Russian Foreign Minister Sergey Lavrov [said](#) on 5 December at a joint press conference after talks with his Azerbaijani counterpart Ceyhun Bayramov that Azerbaijan is interested in using the Mir National Payment System. In addition, three Azerbaijani banks are already operating on the basis of SPFS. The press [reported](#) that VTB Bank is already carrying out financial transactions through SPFS, yet the names of the two other banks have not been publicly revealed. Payments using Mir cards are currently accepted by more than 400 [entities](#) from 12 countries, including Azerbaijan.

Some Azerbaijani banks have invested in investment securities in Russia and have announced that these assets are under threat. According to Kapital Bank OJSC’s [Audit Report](#) published in mid-2022, volumes of investments to investment securities and current accounts are estimated at 14,8 million manats and those of [Paşa Bank OJSC](#) at 73,8 million manats.



[Yapı Kredi Bank Azerbaijan CJSC](#) reported that on 31 March 2022, it could withdraw its deposits to the extent of 6,12 million manats placed in İşbank's Russian banking subsidiary (JSC İşbank). Ziraat Bank Azerbaijan OJSC [Audit Report](#) says it has no correspondent accounts in Russian banks and does not expect risks associated with sanctioned banks. However, the bank has a number of customers with business operations and deposits as collateral in Ukraine, which may be affected by the current situation.

Despite the various methods detailed above for dealing with anti-Russian sanction, Azerbaijani banks have not yet been able to fully assess the impact of the conflict on them and their assets. Both the central bank and the banks themselves say they face some obstacles in their financial statements while conducting transactions with correspondent accounts in the aftermath of conflict, yet they maintain that the sanctions' impact on transactions is limited. But the main task set by them is not only to eliminate difficulties arising in the correspondent accounts of the banks but also to protect Azerbaijan-based companies, including banks, from falling under sanctions for cooperation with Russian banks and companies in violation of the sanctions regime. In particular, the introduction of Russia's Mir payment system in Azerbaijan can expose our banks to sanctions.