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## **Financial Sector Stability Program in Azerbaijan**

September 2007 – February 2011

### **FINAL REPORT**

**This report also incorporates the activities in the last quarter (Jan and Feb 2011) in lieu of a separate report for the period to allow for seamless reporting.**

Submitted to:

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# Financial Sector Stability Program in Azerbaijan

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# Financial Sector Stability Program in Azerbaijan

## 1. Overview

The United States Agency for International Development (USAID) awarded Bankworld Inc. a two-year project to address certain key weaknesses evident in the financial markets in Azerbaijan. The Financial Sector Support Program in Azerbaijan (FSSP) commenced September 2007. Subsequent to this, USAID awarded Bankworld an extension to the project, which started December 2009 and ended February 2011. For the purpose of this report, we will refer to the first two years of the project as FSSP I and the extension as FSSP II.

The major tracks under FSSP I were Bank Supervision and Commercial Banks. Other tracks were Monetary Policy at the CBA, Human Resources Management Information Systems, Cash Management and the Azerbaijan Investment Company.

During FSSP II, Anti-Money Laundering (AML)/Financial Monitoring Service (FMS) and Cash Operations Management were the major tracks, while work under Bank Supervision, Budgeting and Risk Management were the minor tracks.

Given below is an overview of each track, consolidated for FSSP I and FSSP II. The detailed objectives and accomplishments under each track are discussed in Section 3.

### 1. Bank Supervision

- Building institutional capacity at the Central Bank of Azerbaijan (CBA, formerly, National Bank of Azerbaijan)
- Developing staff skills for onsite and offsite supervision
- Promoting effective communication of inspection findings to the commercial banks
- Providing high-quality on-the-job and formal training

This track underwent some minor modifications and enhancements within the scope of work to meet the emerging needs of CBA (especially, in light of the global financial crisis in 2008-2009). This included significant methodological framework advice, development of recommendations/policies that would govern the implementation of a risk-based approach, and establishment of a framework for consolidated supervision.

Additionally, work focused on the development and implementation of methodologies that would integrate the risk-oriented approach to supervision and assist CBA's transition to the Basel II capital adequacy framework. Under FSSP II, the focus of the work was to develop and expand work on regulation, policy and procedural issues related to consolidated supervision.

### 2. Anti-Money Laundering

Originally, this track encompassed the design of a best practices-based legal, regulatory, monitoring and enforcement regime for anti-money laundering. Project

tasks under this component were completed during the first year of project implementation. (Under FSSP I, AML was just a subtrack under Bank Supervision, as were CBA Budgeting, CBA Credit Registry and CBA Risk Management subtracks.)

During FSSP II, this track, along with Cash Management Center track, became the major focus of the project. AML track covered development and implementation of an international best practice compliant anti-money laundering regulatory and institutional framework in Azerbaijan. It also included support to the Financial Monitoring Service (FMS). The track covered:

- Training a large number of AML/CFT stakeholders
- Supporting the establishment of IT systems at the FMS
- Assistance in preparation of regulations
- Assistance in development of mid-term strategic plans for FMS

Additionally, the following specialized short-term technical assistance was provided:

- Advisory services regarding application of International Financial Reporting Standards (IFRS) and IPSAS to the FMS
- Human Resource Management advisory services covering review of individual employee development plans, staff job descriptions and training strategies for systemic organizational development of the FMS
- A detailed analysis on developing an approach for e-learning and training for FMS
- Assessment of selected commercial banks' AML monitoring capabilities

### **3. Human Resource Management**

This component of the project directed activities toward:

- Developing an HR strategy for a fundamental restructuring of CBA's HR Department
- Assisting with the restructuring of the HR department
- Developing a staffing and recruitment plan
- Designing new training and development system
- Consulting on and assisting with the implementation of the proposed Performance Management System
- Defining the requirements for an HR Information System
- Developing new policies and practices in response to changing environment/employee needs
- Preparing and delivering short courses on HR development components to HR and management personnel
- Modernizing the recruitment, promotion, retention and compensation framework
- Creation and installation of a computerized examination system to simplify and streamline the conduct and scoring of employee testing process

#### **4. Management Information System**

This project component encompassed the development of specifications and recommendations for procurement of an integrated Management Information System potentially for supporting the Bank Supervision Department and the Monetary Policy area. Tasks under this component related to the Supervision MIS were completed; however, Monetary Policy MIS was not undertaken in consultation with CBA and USAID, there being no imminent need for it. Resources available for this sub-track were utilized toward dealing with emerging economic and financial system issues that derived from the turmoil in international financial markets, within the overall scope of work.

#### **5. Macro/Monetary Policy**

This project component envisioned:

- Developing a monetary management and research strategy for the CBA
- Developing and implementing a financial programming and forecasting model
- Building technical capacity at the CBA, particularly in analysis, policy initiatives and modeling
- Assisting in the introduction and application of improved indirect instruments of monetary policy and monetary control conducive to the more rigorous conduct of an inflation targeting-based monetary management policy framework

Tasks under this component were accomplished via quarterly visits by the project's Monetary Policy Advisor. During the latter few quarters of the project, the work of the advisor focused on systemic issues arising from the turmoil in international financial markets and recommending appropriate CBA responses to live issues.

#### **6. Commercial Banks**

This component entailed selection of five privately-owned commercial banks in Azerbaijan, and assisting them in improving quality, cost effectiveness, and operational efficiency of core financial services offered to SME clients as well as related risk management functions.

Tasks under this project component were accomplished via one resident, three intermittent experts and one local professional.

#### **7. Investment Funds & Second Tier SME Loan Financing**

The work under this track focused on the Azerbaijan Investment Company (AIC), a private equity management company owned by the Government of Azerbaijan and funded by the State Oil Fund (SOFAR). The goal was to improve AIC's governance structures, operating efficiency and market friendliness, helping AIC to diversify its funding sources away from the government, and enabling it to grow and become self-sustaining. With \$100 million of capital to invest, AIC's mission was to (i) make equity investments in companies in non-oil sectors of Azerbaijan, facilitate foreign direct investment into Azerbaijan, via co-investment arrangements with AIC, and (ii)

encourage an increase in exports or decrease in imports as a result of the business activities of its investee companies.

## **8. Cash Management**

This was a minor sub-track under the Bank Supervision track of FSSP I. During FSSP II it was a major track. Its objectives included a comprehensive support to the Cash Management Department of the CBA for the design of a state-of-the-art cash center with a highly modern material handling system including an automated storage and retrieval system, and an electronic security system that incorporates best practices in central bank security systems. This track also covered development of specifications for an integrated software package for handling the orders, movements and tracking of currency through the central bank network in real time.

The work done in this major track under FSSP II were proclaimed as a major success, as were the other FSSP II major track of AML.

## **9. Budgeting and Financial Planning**

Continued as a minor track under FSSP II, it was designed to cover better understanding of budgeting process and evaluation of IFRS implementation at the nation's commercial banks, and culminated with the development of a financial planning methodology.

## **10. Risk Management**

The first part of this track covered a study of identification and cataloging all possible risks inherent to CBA's operations.

The second part covered:

- Preparation of recommendations for new organization structure, functions, responsibilities and reporting lines of CBA units, which are already or should in the future be involved in risk management processes
- Preparation of documentation on new organization structure of the units involved in the risk management process

Bankworld sub-contracted the local PricewaterhouseCoopers, in Azerbaijan, to conduct work on this track.

## **11. Training**

Under all of the tracks, collectively, the project delivered extensive classroom and on-the-job training to a multitude of stakeholders. Additionally, it provided training for CBA staff and managers, such as those in the monetary policy and banking supervision areas, in the United States and Europe. FSSP contributed toward the establishment of the Risk Managers Association in Azerbaijan, and risk management training was provided to 15 CBA participants and approximately 85 bankers.

## 2. HIGHLIGHTS AND SUCCESS STORIES

Given its multifarious nature, the most noteworthy aspects of the project that collectively led to a successful completion of the project were the high level of technical competence of the project staff, diligence of project management, cooperation and active participation by the counterparts, and close guidance and active support by USAID. Over and above successful completion of the individual tasks, the project's flexibility and creativity in working around counterpart constraints, and its ability to be responsive to the emerging needs, albeit within the overall scope of the project – such as those during the global financial crisis and those to meet the needs of establishing a robust anti-money laundering regime – were deemed of great value by the counterparts.

Given below are some of the project's highlights and success stories.

First-ever cost-sharing arrangements with the central bank and all the participating commercial banks.

While unprecedented for USAID and the counterparts in Baku, the Central Bank of Azerbaijan and five selected commercial banks entered into an individualized cost-sharing agreement under FSSP. Not only did this reduce the net cost of the project for USAID, it also resulted in more active utilization of the project by CBA and the banks in the TA process, a crucial aspect to the overall success of the assistance we provided.

### **Anti-Money Laundering**

- Review of the new law and drafting of rules and regulations to meet special FATF recommendations, among others, were completed, approved and disseminated to the required reporting entities on or ahead of schedule.
- Removal of Azerbaijan from FATF's monitoring list. This feat was accomplished in a record nine months' time. This is a significant achievement for the country, therefore, won much appreciation from the counterparts.
- Training that offered introductory and intermediate instructions in over 37 AML related separate areas related with law enforcement, banking supervision, commercial banking and non-bank institutions and was conducted as planned or ahead of schedule.
- Assistance to the Financial Monitoring Service in organizing the first ever AML Regional Conference.

### **Cash Management**

Several key milestones were achieved towards creating a world class, efficient and secure cash management center in Azerbaijan.

- Designing of a fully modern, efficient and secure cash operations facility that meets or exceeds international standards. The facility layout includes valuables storage and automated currency processing and destruction systems, and will securely interface with the commercial banks in the country.

- Development of the design and specifications for an automated cash-handling system to be installed in the new cash operations facility. The system will use an automated storage and retrieval system within a high-rise “people-less” vault to store containers of currency and a state-of-the-art automated guided vehicle system to securely and efficiently move security-sealed cash containers within the facility. The system will utilize technologically advanced software to track and control the containers in real time at all stages of the process.
- Completion of specifications for a world-class modern security system to protect the site, the facility and the valuables to ensure that the new facility will include the latest protection methodologies and equipment.
- Recommendations for an integrated Cash Management Information System for implementation across the nation’s entire banking network. The system is intended to enable the Central Bank to have real-time data concerning all aspects of currency operations at the new headquarters facility and all the branches. This system will also help manage the interactions and relationships between the Central Bank and the commercial banks.

### **Commercial Banking**

Overall, the target banks were substantially transformed in various aspects as repeated noted by the banks’ management.

New products development to meet the needs of SMEs supported by advanced marketing and sales techniques, attaining loans and deposits growth of 50% to 100% to within a short duration of the first year of FSSP’s support.

- The Risk Rating and Risk Scoring Systems developed for some of the banks were a major success, being regarded as highly practical, capable of improving the credit function including risk identification and portfolio risk management.
- Successful adaptation of a financial projection tool, FINPRO, allowing term lending generally considered a risky proposition by the banking sector. Ability to project financials based on relevant assumptions to simulate risk and provide basis for covenants that would ensure cash flows availability for repayment. Coupled with its ability to permit effective monitoring, it is deemed as a powerful tool.
- Implementation of profit centers and performance measurement approaches were touted as evidence of one of FSSP’s lasting “footprints”.
- Implementation highly practical robust management information systems, especially supporting risk monitoring and decision making with respect to bank loans and deposits.

### **Consolidated Supervision**

Provided technical assistance for implementation of Consolidated Supervision, overcome CBA’s vulnerability in supervising holding companies that include banks or

banking groups, as well as affiliations worldwide. Case-based training was provided in reporting, analysis, cross-border supervision and prudential requirements.

### **Establishment of a Risk Management Association in Azerbaijan**

The project supported establishment of the Association of Risk Managers in Azerbaijan toward providing risk management training and certification to over 100 risk managers in Azerbaijan including those from CBA and commercial banks.

### **Capacity Building Activities**

FSSP provided a vast number of training courses during the course of the project covering topics such as risk-based supervision, risk management, liquidity risk management, asset liability management, Bank Exec, IFRS accounting and internal audit, anti-money laundering, human resources management, foreign exchange, lending, marketing and sales, to name a few. The courses were very well received overall, as reflected in the course evaluations completed by the participants, despite the diversity and backgrounds of participants. On-the-job training/mentoring supplemented and reinforced the formal classroom training.

### **Multi-tasking by the Advisors**

Whenever possible, the project utilized competent advisors to undertake multiple tasks, allowing cost containment. One example of such a situation was that FSSP's Risk Management Advisors on the commercial bank track also were utilized to deliver Risk Management Training and FOREX Management Training courses to the Bank Supervision Department of the NBA under a separate track.

The Supervision MIS STTA Advisor also supported the Human Resources (HR) Advisor in the design of human resources information systems, while the HR Advisor assisted the Commercial Banking track on HR related issues at one of the project partner banks.

What follows are a few testimonials received by FSSP:

- Letter from the First Deputy Governor of the Central Bank indicating the client's happiness with the FSSP project
- Letter from the Director of Financial Monitoring Service that acknowledged the valuable support we provided to the development of this department
- An article in Azerbaijani about USAID assistance to the FMS, with a photo of CTO Sheila Young (far right) and our Chief of Party, Marc Alix (far left)
- A USAID Case Study on Financial Crimes. Much of the recent work related to this subject was part of our project.
- An article about a regional AML conference



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"17" *March* 2011 year

No *14/41-141*

**Mr. Bharat Bhargava  
Chairman,  
Bankworld Inc.**

**Dear Mr. Bhargava,**

The Central Bank of the Republic of Azerbaijan acknowledges the value of technical assistance we received from the USAID within the framework of Financial Sector Stability Program and highly appreciates the support of Bankworld Inc. in this context.

These projects helped us to apply the best international practice, increase the quality of our work, reveal the gaps and adopt necessary preventive measures against these gaps.

We sincerely regret that you conclude your activity in Azerbaijan and believe that in future we will have opportunities for further cooperation.

Once again, we would like to express our most profound thanks and appreciation to you for your invaluable collaboration and wish you further success in your future endeavors.

**Yours sincerely,**

**First Deputy Governor**

A handwritten signature in black ink, appearing to read 'A. Guliev'.

**A. Guliev**



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**Mr. Bharat Bhargava  
Chairman, Bankworld Inc.**

« d » « March » 2011

№ 08/01-5/011

Dear Mr. Bhargava,

First and foremost let me express my deep appreciation for your kind letter and warm words. We are very proud and satisfied by cooperation with Bankworld Inc. which is considered to be one of the most valuable partners of the Financial Monitoring Service (FMS) actively involved in its development.

It should be stressed that Bankworld's support and assistance initiatives are always reflected in the progress of the FMS. One of these proofs is the First AML/CFT Regional Conference held this February in Baku which was organized with assistance of highly qualified Bankworld's local team. Due to their professionalism, ability to react on challenges and make decisions rapidly, we have reached our goals and achieved the success.

Additionally the role of advanced and experienced experts that Bankworld has provided so far should be underlined and is highly appreciated. Their training courses aimed not only at the FMS capacity building but also local state institutions involved in AML/CFT area.

Once again, I would like to show my deep gratitude for your support and assistance and inform you of our full readiness for further strengthening our cooperation.

Best regards,

**Mr. Adishirin F. GASIMOV  
Director**

## AZƏRBAYCAN RESPUBLİKASININ MƏRKƏZİ BANKI YANINDA MALİYYƏ MONİTORİNQİ XİDMƏTİNİN

### MƏLUMATI

**Azərbaycan Respublikasının Mərkəzi Bankı yanında Maliyyə Monitorinqi Xidmətinin kollektivi USAID-in “Uğur Sertifikatı” ilə mükafatlandırıldı - 5 noyabr 2010**



Bu gün ABŞ-ın Beynəlxalq İnkişaf Agentliyinin (USAID) ölkə üzrə koordinatoru cənab Kiif Simmonsun və İqtisadi İnkişaf Ofisinin rəhbəri xanım Şila Yanqın başçılıq etdiyi nümayəndə heyəti Azərbaycan Respublikasının Mərkəzi Bankı yanında Maliyyə Monitorinqi Xidmətində olub.

Nümayəndə heyətinin Maliyyə Monitorinqi Xidmətinin rəhbərliyi və əməkdaşları ilə görüşündə ikitərəfli əməkdaşlığın nəticələrinə dair qarşılıqlı fikir mübadiləsi aparılıb. Hər iki tərəf birgə əməkdaşlıqdan məmnunluqlarını bildiriblər.

USAID-in ölkə üzrə koordinatoru cənab K. Simmons Maliyyə Monitorinqi Xidmətinin kollektivinə “Uğur Sertifikatı”nı təqdim edərək bildirib ki, xidmət bu mükafata pulların yuyulması və terrorizmin maliyyələşdirilməsinə qarşı mübarizə sahəsində effektiv təlim proqramlarını həyata keçirdiyinə, beynəlxalq standartların tətbiqində qazandığı nailiyyətlərə görə layiq görülür.

Maliyyə Monitorinqi Xidmətinin direktoru cənab Adışirin Qasımov Xidmətin işinə verilən yüksək qiymətə görə dərin təşəkkürünü bildirərək qeyd edib ki, ölkəmizdə pulların yuyulmasına və terrorçuluğun maliyyələşdirilməsinə qarşı mübarizə sisteminin inkişafı istiqamətində tədbirlər ardıcıl xarakter daşıyır. Azərbaycan dövləti bu sahənin inkişafını ölkədə şəffaflığın artırılması, sabitliyin davamlı olaraq təmin edilməsi və təhlükəsizliyin gücləndirilməsinin vacib şərtlərindən biri kimi qəbul edir. Təsadüfi deyil ki, FATF və digər beynəlxalq təşkilatlar pulların yuyulmasına və terrorçuluğun maliyyələşdirilməsinə qarşı mübarizə sahəsində ölkədə yüksək siyasi iradənin mövcudluğunu vurğulayırlar.

Cənab A.Qasımov bildirdi ki, Azərbaycan Respublikasında pulların yuyulmasına və terrorçuluğun maliyyələşdirilməsinə qarşı mübarizə sahəsində beynəlxalq

standartlara uyğun milli qanunvericilik bazası formalaşdırılaraq inkişaf etdirilir. Ölkəmiz global çağırışlara qoşulmaqla mütəşəkkil cinayətkarlıq, terrorçuluğun maliyyələşdirilməsi və pulların yuyulması ilə mübarizədə müxtəlif ölkələr və beynəlxalq təşkilatlarla effektiv əməkdaşlığa nail olub.

Maliyyə Monitorinqi Xidmətinin əldə etdiyi uğurlarda USAID ilə səmərəli və məqsədyönlü əməkdaşlığın mühüm rol oynadığını vurğulayan cənab A.Qasimov agentliyin ölkəmizdəki ofisinin rəhbərliyinə və əməkdaşlarına səmimi təşəkkürünü bildirib.

Görüşün sonunda Maliyyə Monitorinqi Xidmətinin və USAID-in Azərbaycan ofisinin əməkdaşları birgə xatirə şəkili çəkdiriblər.



## CASE STUDY

# Azerbaijan Joins Fight on Financial Crime

Bankers learn to implement new anti-money laundering and terror financing law



On October 5<sup>th</sup>, 2010, bankers, post office workers, and wire transfer service representatives from northwestern Azerbaijan participate in a USAID-supported training by the Financial Monitoring Service to socialize the financial crime law across the country.

Photo: Amanda Fong, USAID Azerbaijan

The Central Bank of Azerbaijan is working hard to modernize the country's financial sector. In 2009, an important milestone was achieved when USAID assisted it in drafting legislation that met international standards in combatting serious financial crime. The Anti-Money Laundering and Combating the Financing of Terrorism bill was successfully passed and established a Financial Monitoring Service (FMS) that was charged with enforcing the new financial sector requirements.

A well-functioning regime to combat financial crime is a necessity in today's global marketplace. However, this was not achieved with the mere passing of the law. The FMS was faced with the challenge of enforcing legislation that was poorly understood by the majority of the country's bankers, especially those outside of the capital city of Baku.

With assistance from USAID, the FMS has undertaken a series of trainings to socialize the new law, both in Baku and around the country. The second such training was held on October 5<sup>th</sup>, 2010, in the regional city of Sheki in northwestern Azerbaijan. Thirty representatives attended from institutions that provide financial services in this region, such as banks, post offices, and money transfer services. Three representatives of the FMS, including Mr. Rauf Kerimov, Head of the Analytical Department, trained participants on key aspects of the new legislation, such as recognizing suspicious transactions, fulfilling new "know-your-customer" requirements, understanding the link between money laundering and criminal or terrorist activity, and discerning when to report transactions to the national authorities. Mr. Kerimov described aggressive plans to continue trainings in all major cities of Azerbaijan.

Participants in Sheki expressed great relief to have gained an understanding of what is required of them under the new law. Mr. Abdullali, Head Accountant of Gunay Bank's Sheki branch, stated, "Today we learned about very strict identification requirements for customers and their representatives. Now we understand our responsibility. We did not realize the seriousness of these procedures. It is very important for Azerbaijan to have such a fight against money laundering."

Due to this work, on October 22, 2010 Azerbaijan was removed from the inter-governmental Financial Action Task Force's watch list, just ten months after its first Financial Monitoring Service was created.

Telling Our Story  
U.S. Agency for International Development  
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<http://stories.usaid.gov>

The Republic of Azerbaijan with the help of the USAID FSSP, Baku Coordinated a First of its Kind AML/CFT Caucasus Regional Conference to Discuss and Establish Working Relationships and Positive Steps Forward in the Fight against Money Laundering and Financing of Terrorism

This week in the Caucasus city of Baku, Azerbaijan, the Partners for Financial Stability Program (PFS) supported and participated in a regional conference on Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) implemented and coordinated by USAID Financial Sector Stability Project ('FSSP'), Baku, Azerbaijan ('AZ'). The conference was hosted by Azerbaijan's Financial Monitoring Service (AZ's FIU), the main government entity tasked with detecting and pursuing the crimes of money laundering and terrorism financing in the country, and in cooperation with international and regional bodies. The outcome of the Baku event served as a "roadmap" for additional AML/CFT partnerships and experience-sharing activities for Caucasus and PFS countries.

The first ever Regional AML conference in the caucas region was held as a start in sharing experiences and building alliances from across the region on the challenges and best practices in combating money laundering and the financing of terrorism. The conference took place February 17<sup>th</sup> - 18<sup>th</sup>, 2011 with additional keynote representations and speakers from the Egmont Group, Basel Institute, UNODC, MoneyVal and many Financial Intelligence Units ('FIU') from across the region.

**Roadmap for Partnerships and Experience Sharing on AML/CFT in the PFS Countries**

*Regional experience-sharing on FIU' information technology best practices and platforms*  
*Regional workshops to share experience on training of AML/CFT "reporting entities" (financial institutions, real estate agencies, lawyers, public notaries, etc.*  
*Regional workshops on detecting and pursuing financing of terrorism*  
*PFS role in donor coordination and providing an online forum for FIUs to discuss and share latest challenges and best practices ([www.pfsprogram.org](http://www.pfsprogram.org))*  
*Cost sharing and leveraging of regional and international events and activities*

The Caucasus and PFS countries in attendance are working hard to implement best practices commensurate up with the most advanced AML/CFT FIU systems globally. In representing the Caucasus Region, Azerbaijan has made rapid progress in developing its AML/CFT program over the past two years, and was supported in that effort by the USAID FSSP Project and Mission in Baku, with its implementing partner Bankworld Inc. The conference provided an opportunity for Azerbaijan to highlight its progress and commitment to working with the international community in the fight against money laundering and terrorist financing. High level FIU officials from twenty countries attended the experience-sharing event. FIU representative countries in attendance included: Estonia, Bulgaria, Hungary, Georgia, Kyrgyzstan, Latvia, Lithuania, Moldova, Poland, Romania, Russia Federation, Serbia, Tajikistan, Turkey, Ukraine, United Arab Emirates, Czech Republic, Slovenia, Uzbekistan – and made presentations on the successes and challenges faced by the intelligence units and law enforcement bodies needed to combat money laundering and terrorist financing.

Key international organizations from the AML/CFT arena also participated in the Baku event. The Council of Europe's MONEYVAL Committee's Executive Secretary, a Senior Advisor from the United Nations Office on Drugs and Crime, and the Executive Director of the Basel Institute discussed ways to meet the challenges in combating

money laundering and terrorism financing. The OSCE and the Swiss development agency also supported the event.

In preparation for the conference, PFS prepared a background study about the challenges facing FIU's in the six PFS countries in Eurasia. PFS' AML/CFT expert, Kenneth Volandes, presented the conclusions of that study along with proposals for additional regional knowledge-sharing activities which would help address the challenges. The main issues that the FIU's face involve information technology, training, and developing skills for detecting terrorist refinancing.

### 3. Accomplishments

#### 1. BANK SUPERVISION

##### Broad Goal

Establishment of international best practice-consistent prudential oversight, monitoring, analysis and enforcement capabilities.

##### Accomplishments

The onsite supervision advisor developed and provided technical assistance and training – and mentored CBA staff – toward the implementation of the following:

- A risk-oriented supervision policy to prioritize and integrate supervisory work processes
- A documented model “supervisory strategy” to facilitate and prioritize supervision activities for the financial institutions
- Establishment of a “supervision committee” and its duties and responsibilities, generally to ensure consistent decisions in the supervisory processes
- Updated Onsite Inspection Procedures Manual for certain inspection-related processes to orient it more closely to a risk-based approach:
  - Correspondent Bank Accounts
  - Internal Audit
  - External Audit
  - Loan Portfolio Assessment
  - Governance (Management, Supervisory Board Chapters)
  - Earnings
  - Liquidity/Asset and Liability Management
  - Pre-Inspection Review and Planning
  - Overall Conclusions
  - Report of Inspection
- Model checklists, risk matrices, work papers and other guidance materials, where appropriate, to assist the implementation of the recommended changes
- Changes in format and content to the Report of Inspection that would summarize onsite inspection findings and recommendations
- Changes to the Onsite Inspection Regulation to make it consistent with the recommended supervision policy
- Changes to the Risk Rating System Regulation to further refine and expand CAMELS evaluation processes
- Revisions to the:
  - Corporate Governance Regulation
  - Capital Adequacy Regulation
  - Lending Guidelines Regulation
  - Risk Management Regulation
  - Liquidity Risk Management Regulation
  - Asset Classification Regulation
  - Repossessed Assets Regulation

- Model Enforcement Policy to assist equitable and consistent invocation of supervisory actions against troubled/noncompliant banks
- Model enforcement document to be used to obtain corrective/rehabilitative actions in a troubled/noncompliant bank

The offsite supervision advisor reviewed offsite processes in a number of areas and helped establish/revise:

- The set of periodic prudential reports – new/revised formats
- The early warning scoring system – methodologies and ratios
- The stress testing methodology
- The Uniform Bank Performance Report – periodic analytic time series for each bank and comparison with peer results

Together with the STTA Legal Expert, the project’s resident advisors recommended changes in the approach and framework for consolidated supervision regarding:

- Revision to the Law on Banks
- Revision to the Consolidated Supervision Regulation
- Revision to the Onsite Inspection procedures manual chapter for consolidated supervision

The STTA Legal Advisor also developed revised “fit and proper” standards for bank administrators for inclusion in the Law on Banks.

**Deliverables:** Deliverables for the Bank Supervision component are provided under Annexes Volume I.

### **Bank Examinations**

Onsite Supervision advisor helped the Banking Supervision Department conduct examinations of eleven banks under his advisory guidance. He enhanced the approach to “training” to that of “mentoring,” which means that during the inspections, the advisor coached the assigned CBA inspectors in major areas of risk exposure and to implement a “top-down” approach to the inspections, giving initial priority to established governance structures, policies and procedures in each bank that would serve to manage risk, and to relate these to international best practice. The advisor also guided in the analyses of inspected areas and in summarizing the findings. During the process, the advisor introduced a number of “tools” and a significant amount of guidance material. Subsequent to each inspection, the advisor assisted in the drafting of the report, quantification of the risk profile/CAMELS rating, and recommended changes to the Onsite Inspection Procedures Manual, as appropriate. He further provided advice to the Department management recommending process changes.

The advisors recommended the following to CBA management for improved inspection process:

- The inspectors’ improved use the inspection manual
- Time allocation in the inspection schedule for pre-inspection review and planning

- The inspection schedule be risk-oriented
- The inspection schedule be not modified/compromised due to time overruns by inspectors in banks, training events or other intervening workload
- Inspection activities be prioritized according to risk; a standard work plan be used for almost every comprehensive inspection. The targets for “thematic” inspections be oriented to the results of the preceding inspection or interim offsite analyses.
- Offsite analyses be prepared or furnished to onsite supervision staff;
- Stress test and EWS scoring results be provided to onsite supervision staff.
- Set up inspection teams and banks assigned to lead inspectors on a “portfolio” basis

## **Training**

Training was provided to the bank supervision staff in eight core areas. Since the Banking Supervision Department did not have enough staff to meet production requirements and to send its entire staff to 20 weeks of training, courses were delivered in two-week, half-day sessions to two different groups, thus enabling workload requirements to be met.

The project provided experts to train supervision staff, but many of the courses were also open to staff of other departments. The core courses were:

- Asset-Liability Management
- Bank Exec (Bank Simulation)
- Foreign Exchange Operations and Risks
- International Financial Reporting Standards
- Risk-based Supervision
- Risk Management
- Liquidity Risk Management

Additional supervision training was provided to small groups of supervisors as follows:

- Orientation of New Banking Supervision Staff
- Onsite Inspection Processes (for new staff)
- Offsite Analyses

The project supported in establishment of the Association of Risk Managers in Azerbaijan (ARPA) courses toward a certification in risk management, using materials developed by the Global Association of Risk Managers (GARP). Fifteen supervision staff members participated in the initial training that took place near the conclusion of the project and sat for the examination. As of the writing of this report, the examination results have not yet been disclosed.

The project also provided foreign-based training to bank supervisors.

## **Assistance in implementation of IAS/IFRS consistent regulatory guidelines**

The advisors helped draft regulations, generally consistent with IFRS/IAS and as always consistent with international best practices for supervision. Stakeholders of banks and banking groups have available to them IFRS-based financial statements and disclosures.

## **Assistance in the development and approval of critical regulatory reforms**

The major contributions of the project, briefly reiterated, were:

- For regulatory reforms:
  - Review and commenting upon the draft regulations specified under the first deliverable
- For financial monitoring:
  - Review and commenting upon the prudential reporting system, the Uniform Bank Performance Report, Early Warning Scoring System and Stress Testing design
- For enforcement:
  - Development of an Enforcement Policy
  - Development of a Penalty Matrix
  - Development of a model enforcement document
- For conflict of interest-avoidance:
  - Proposed new “fit and proper” standards for inclusion in the Law on Banks and in the licensing process.

## **CBA Credit Registry**

Work on development of the credit registry was begun under another USAID-funded project that was terminated before all work needed was completed. FSSP completed the task, which was essential to the development of a functioning credit registry.

## **2. ANTI-MONEY LAUNDERING**

**Broad Goal under FSSP I:** Support toward the establishment of an AML regime consistent with international best practices.

### **Accomplishments**

Early in the project, the AML advisor did the following:

- Ascertained the status of the draft AML legislation
- Evaluated draft AML law and provide recommendations for revision
- Reviewed the AML function at CBA
- Prepared recommendations for future plan of action

The draft AML law had been prepared with the assistance of experts provided by the United States, the European Union and other donors. It had undergone a review by the

Office of the President prior to its submission to the Parliament. FSSP advisor also reviewed the law and offered his opinions.

After the changes that also were reviewed and commented upon by the advisor, the draft law was passed, which called for the establishment of a Financial Reporting Unit. Ensuing debate focused on whether that unit should be part of CBA or external. The decision finally was made to establish the Financial Reporting Unit within CBA.

Additionally, the advisor performed the following tasks:

- Reviewed the relevant provisions of the Azerbaijan criminal code, as well as several other provisions of Azerbaijan law
- Reviewed other relevant existing laws that complemented the draft AML law. The CBA had issued a number of directives to banks regarding issues important to prevent money laundering, such as Know Your Customer guidelines, and prohibition of certain transactions in suspect countries or with suspect persons or organizations.
- Assessed the AML Unit of CBA as to its role, operation, and functions. The Unit served as a contact with international AML organizations, such as MONEYVAL as well as a clearinghouse for information received from banks and other financial institutions. This AML Unit also received suspicious transaction reports and cash transaction reports, which on several occasions had been referred to law enforcement officials.

**Broad Goal under FSSP II:** Establishment of best practices-compliant anti-money laundering, including Financial Monitoring Services (FMS), regulatory, institutional framework and system be developed and implemented.

### **Accomplishments**

The activities consisted of:

- 1) Support to the Financial Monitoring Service under the Central Bank of Azerbaijan
- 2) Support the establishment of information technologies system of the FMS
- 3) Assist in preparation of regulations
- 4) Assist in the development of the middle-term strategic plan for the FMS
- 5) Other areas of institutional development

**Deliverables:** Deliverables for the Anti-Money Laundering component are provided under Annexes Volume I.

### **Training**

- Trained FMS personnel, in particular employees of data processing, analytical and supervision departments, on international experience, application of best practice of international counterparts in the AML/CFT sphere
- Trained all reporting entities (banking sector, non-banking financial sector and DNFBP) on new developments, current techniques, methods and trends of the

legalization of criminally obtained funds or other property and the financing of terrorism

- Trained supervision authorities to align their activity with international standards in the AML/CFT area
- Trained law enforcement bodies to successfully investigate all money laundering and financing of terrorism cases.

The first round of training covering “Support to the Financial Monitoring Service” in the work plan was completed successfully in mid March 2010 and covered:

1. High Risk and Non-Cooperating Countries
2. Customer Due Diligence
3. Customer Account Risk Assessments
4. New Technologies and Non Face-to-Face
5. Record Keeping
6. Politically Exposed Persons
7. Sanctions
8. Shell Banks
9. Wire Transfer Rules
10. Informal Value Transfer Services
11. Concentration Accounts
12. Private Accounts

The training was intensive, and in response to the excellent feedback from FMS staff, the FSSP and FMS agreed to start preparing for the next stage of training and resulted in new training curriculum planned by the FSSP that included introductory and intermediate instruction for over 37 separate topics (listed below) for law enforcement, banking supervision, commercial banking and non-bank institutions through November 2010, as necessary. The training as planned is the first of its kind in Azerbaijan.

1. FATF 40 + 9
2. Recent AML Trends
3. Terrorist Financing
4. STR Completion and Analysis
5. Unusual Transactions
6. Mutual Legal Assistance
7. Asset Tracing and Recovery
8. Information Sharing
9. Data Security & Confidentiality
10. Internal Controls
11. Correspondent Banking
12. Money Laundering Laws and Enforcement Actions
13. Training Programs
14. Code of Ethics
15. Fraud and Corruption
16. The Role of the Compliance Officer
17. AML CFT Laws, Policies, Procedures and Controls
18. Alternate Remittance Systems
19. Case File Management Systems
20. Transaction Monitoring Controls
21. Potential Red Flags
22. Terrorist Financing Methods
23. Terrorist Financing Control and Management
24. STR Completion and Analysis
25. Currency Transaction Monitoring
26. High Risk and Non-Cooperating Countries
27. Customer Due Diligence
28. Customer Account Risk Assessments
29. New Technologies and Non Face-to-Face
30. Record Keeping
31. Politically Exposed Persons
32. Sanctions
33. Shell Banks
34. Wire Transfer Rules
35. Informal Value Transfer Services
36. Concentration Accounts
37. Private Accounts

Consultations were held with the Director of the FMS and IMF representative to support the establishment of information technologies systems of the FMS, in order to ensure there would be no duplicate efforts and to determine the expected time frame for the completion of the IMF's report of recommendation for the expected needs of the FMS management information systems. FSSP recommended the best available solution to the FMS in selecting the GOAML system vendor and ensured continued support with development and implementation, where necessary.

Assistance in preparation of regulation included completion of the following:

- (a) The draft special regulations under (a) on bringing the national legislation on freezing of assets in line with the FATF Special Recommendations III and other International instruments were completed and submitted to the Central Bank for distribution to the banking sector.
- (b) The draft regulation under (b) to identify "red flags" was completed and submitted to the Central Bank for distribution to the banking sector.
- (c) The draft regulation under (c) "Rules on reporting to the Financial Monitoring Service by supervisory authorities and law enforcement agencies" was completed and is included as part of the approval of the country's first Anti-Money Laundering and Anti-Terrorist Financing Legislation.
- (d) The draft regulation on "Drawing up a list of non-cooperative countries jurisdictions" was completed and submitted to the Central Bank for distribution to the banking sector.
- (e) The draft "Requirements on the preparation and arrangements on internal controls system, as well as the requirements on the specialization and experience of compliance officers" was completed and approved by the Director of the FMS before being finalized and submitted to the Central Bank for distribution to the banking sector.
- (f) The draft regulation "Appropriate supervision procedures over pawn shops and real estate agents" was completed and approved by the Director of the FMS before being finalized and submitted to the Central Bank for distribution to the banking Sector.
- (g) The draft regulation "Appropriate supervision procedures over other financial institutions and DNFBP" was completed, approved and included as part of the recent approval of the country's first Anti-Money Laundering and Anti-Terrorist Financing Legislation.

#### **Other**

- Assisted in the development of the mid-term strategic plan for the FMS.
- The final version of the Code of Ethical Conduct for FMS personnel was completed for approval and disbursement to all staff by the end April 2010.
- Technical assistance was provided as follows:
  - Human Resources Review by William Campbell
  - Accounting Department Review by Susan Thetford

- E-Learning Review by Gary Waissi
  - Banks IT Consulting and Reporting Review by Alan Cole
  - Technical Assistance on SAR Analysis by Arthur Mendez
- Assisted the FMS with international best practices-based guidelines and legislation for use in developing Azerbaijan’s first Listing and Delisting Procedures and Regulations for Asset Freezing.
  - In continuing to strengthen the FMS’s growth in serving as a responsible global partner in sharing and cooperating internationally, successfully provided useful sustainable guidance in assisting the FIU in developing both international and domestic memorandums of understanding for cooperation for investigative case development.
  - Assisted and retained a local subject matter expert to assist the FMS in developing a public relations policy and methodology. At the recommendation of the Advisor the FMS developed a Public Relations Strategy Plan that will be used to communicate its private and government constituents of its needs and purpose to The Republic of Azerbaijan. Part of the deliverable included a strategic session for the inclusion of training materials and news success stories for public awareness <http://fiu.az/en/news>.
  - Helped complete the new FMS Internet website.
  - Conducted additional due diligence training with the assistance of Dow Jones FACTIVA.

### **First Regional AML Conference**

Coordinated a first-of-its-kind in the region “First Regional AML/CFT Conference” to be held in Baku, Azerbaijan <http://fiu.az/en/news/230-21-02-2011-01>. The conference proved to be a very large undertaking given the complexity, timing and coordination with another USAID project PFS as well as other donors: the OSCE and SECO.

The Republic of Azerbaijan and its AML/CFT regime, centered in the Caucasus city of Baku, supported and participated in the regional conference on Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT), implemented and coordinated by FSSP. The conference was hosted by Azerbaijan’s Financial Monitoring Service, the main government entity tasked with detecting and pursuing the crimes of money laundering and terrorism financing in the country, and in cooperation with international and regional bodies. The outcome of the event was a “roadmap” for additional AML/CFT partnerships and experience-sharing activities for Caucasus and PFS countries.

Key international organizations from the AML/CFT arena also participated in the Baku event. The Council of Europe’s MONEYVAL Committee’s Executive Secretary, a Senior Advisor from the United Nations Office on Drugs and Crime, and the Executive Director of the Basel Institute discussed ways to meet the challenges in combating money laundering and terrorism financing. The OSCE and the Swiss development agency also supported the event. The main issues that the FIUs face involve information technology, training and developing skills for detecting terrorist financing.

Among the many achievements of this track, the delisting of the Republic of Azerbaijan from the FATF’s ‘Ongoing Process’ monitoring list, was of the greatest importance to the country. This feat was accomplished in the record and unprecedented time of less than 10 months

from the point of inception and the start of the agency <http://fiu.az/en/news/204-27-10-2010-01>.

### **3. HUMAN RESOURCE MANAGEMENT**

#### **Broad Goal**

A modern and functioning recruitment, promotion and retention, and compensation structure and overall personnel management system and a proven track record in promoting strong motivated employee performance in key areas of its operations

#### **Accomplishments**

Over a series of visits, two HR experts helped establish a comprehensive Human Resources function at CBA.

During the early stage of the project, Bankworld:

- Interviewed all staff within HR Department He also met the Governor of the CBA and members of the HR Committee to determine their views on HR needs. A broad consensus was reached within the CBA of the need to redefine the HR function and restructure the HR Department with the long-term goal to transform the HR function to conform to modern practices.
- Designed a detailed restructuring plan, including a revised mission statement for the HR Department and descriptions of its core functions. He proposed an organizational structure and outlined key tasks for each division and the knowledge and skills required for the department director and division heads. The plan was submitted to the HR Committee for discussion.
- Reviewed the proposed Job Grading and Basic Salary System, which appeared logical and appropriate to the needs of CBA. The number of “steps” for each job level was discussed as a possible limitation on increasing base pay over time. The CBA implemented the system on March 1, 2008, and salaries for positions were adjusted to be more comparable to their private sector equivalents.
- Prepared and delivered short courses on HR development components to HR management and other selected staff members in order to increase their understanding of and support for successful implementation of the recommendations.

During two subsequent visits, the advisor provided assistance to CBA in the following areas:

- Implementation of the recruitment plan
- Design of a new training and development system
- Design of a performance management and motivation system

**Deliverables:** Deliverables for the Human Resource Management component are provided under Annexes Volume I.

#### **Recruitment**

The recruitment plan was originally developed by the HR Department with guidance and comments from the HR advisor. The intention was to involve the HR Department in defining the tasks necessary to be completed for any change in HR functions, so that they would take ownership in completing the tasks on their own. After several iterations, the plan was adopted.

To facilitate the examination design process and meet the CBA's immediate needs, the HR consultant prepared an initial draft of a 100-question examination to serve as a starting point for development of a candidate examination for those applicants whose CVs pass an initial screening by HR.

In addition, several organizations specializing in test preparation and administration were interviewed – the Azerbaijan Bank Training Center (ABTC) and the Alliance Group – as additional potential sources of questions and actual administration of the examination. Subsequently, ABTC was subcontracted to develop an automated database of questions and to administer the screening examinations.

A panel of department heads was organized by HR to interview those successfully passing a “cut-off grade” of the examination. The HR consultant developed a set of recommended questions for the panel and an accompanying score sheet.

A Recruitment Manager was hired by CBA. Late in the project he was dismissed for having given away or sold test questions to candidates. This also led to the reassignment of the HR Department Director to a less sensitive position within CBA.

The first recruitment drive by CBA was assisted by the advisor and involved advertising, testing, short-listing and interviews as recommended. The result was modest and that only 18 candidates were offered employment by CBA.

### **Training and development**

The HR Advisor made recommendations to help frame the structure of the training strategy with the following components and their attendant specifics:

- Training needs assessment
- Training program design
- Identifying and selecting training sources
- Training delivery mechanisms
- Training evaluation

### **Performance evaluation and motivation**

The HR consultant provided the Head of the Performance Evaluation and Motivation Division with a set of model documents, forms, presentations and a 14-step process for implementing a new performance management system, from announcement of the system through summary reports to senior management. The HR consultant also provided guidance on the utilization and customization of the proposed system.

Using those models suggested by the HR Advisor, the Performance Management Division Director produced a set of forms to use for the NBA Performance Management System (PMS). These included:

- Job descriptions
- Position knowledge/skill requirements
- Department/division/individual goals/targets
- Performance evaluation form

- Evaluation discussion guidelines

#### **Additional activities**

- Initiation of the design for a tender for HR information system
- Review of the staff handbook draft
- Creation of a code of conduct

### **4. MANAGEMENT INFORMATION SYSTEM**

#### **Broad Goal**

An efficient information gathering, tracking, monitoring and management system to facilitate sound monetary management and prudential oversight decisions and practices.

#### **Accomplishments**

These requirements were satisfied with respect to the Banking Supervision Department through the work of the project's IT/MIS advisor, who worked closely with the resident advisors for banking supervision and with all levels within the Banking Supervision Department to identify needs and provide a solution. Through a series of visits and structured meetings and presentations, the advisor clarified needs, developed and refined system requirements based upon the stated needs by both management and staff for their specific purposes. The result was a sophisticated system design that had adaptability and expansion capabilities to suit changes in the marketplace and in supervisory approaches.

**Deliverables:** Deliverables for the Management Information System component are provided under Annexes Volume I.

#### **Tender solicitation and further progress**

Understandably, the tender for the system was issued by CBA. CBA had been in the process of reviewing the proposals in response to the solicitation at the conclusion of the project.

The development of a similar IT system for the macro-monetary area was not pursued by CBA.

The advisor also contributed toward the design of the Human Resources Information System.

### **5. MACRO/MONETARY POLICY**

#### **Broad Goal**

A fully functional, staffed and equipped monetary research and management unit which had a strong established track record in sound macro and financial policy formulation and implementation

#### **Accomplishments**

During the course of the assignment, local and international financial conditions overtook the Azerbaijan economy and financial market place. Emerging issues needed urgent attention. As a result, the monetary policy advisor included tasks based on emerging issues concerning CBA, as requested by CBA, which were within the broad scope of work for the project.

**Deliverables:** Deliverables for the Macro/Monetary Policy component are provided under Annexes Volume I.

### **Initial work**

- Evaluated the CBA’s monetary and exchange policy strategies;
- Evaluated the basket-peg exchange rate regime
- Evaluated the impact of government expenditure on the non-oil economy; and
- Assessed the competitiveness of the non-oil economy and symptoms of “Dutch Disease.

Conclusions were that fiscal policy dominated monetary policy and that inflation containment was not successful due to foreign price inflation, excessive monetary expansion and excessive increases in public sector wages. Inflation was aggravated due to lack of coordination between fiscal and monetary policies.

The advisor also concluded and CBA agreed that manat appreciation was unavoidable in order to contain imported inflation and that fiscal dominance was the main force of inflation.

Later in the FSSP I project, as market issues took hold, the monetary policy advisor was asked to:

- Evaluate the long run simulations for fiscal and external sustainability;
- Evaluate the medium-term macro-fiscal framework assumptions and projections;
- Assist in assessing the real equilibrium exchange rate (REER) for possible distortions.

In the process of performing these evaluations, the advisor was able to:

- Develop a conceptual framework for institutionalizing the medium term expenditure framework;
- Develop detailed procedures for enhancing coordination of fiscal and monetary policies during in-year budget implementation;
- Assist assessment of the REER impact and associated distortions;
- Outline the assessment of competitiveness of the non-oil economy and symptoms of Dutch Disease;
- Analyze the implication of global risk factors on the Azerbaijan economy. This facet of TA was continued on the next and subsequent visits. The advisor indicated risks and impact on the banking system and the central bank and recommended options to deal with these.

### **Macroeconomic Modeling**

The macroeconomic advisor with statistical expertise developed and provided to CBA:

- An inflation model
- A monetary demand model
- An inflation forecasting model

He also provided advice to enhance CBA’s econometric modeling and provided training in modeling methodologies.

## **6. COMMERCIAL BANKS**

### **Broad Goal**

A core group of five commercial banks offering an international best practices-consistent set of financial intermediation services to the SME sector and to other traditionally under-served groups, and achieving a significant increase in their client coverage base through the provision of these services.

Within these broad goals, specific objectives were set up in discussion with management of each of the five commercial banks in each of the areas such as MIS/IT, Credit, Deposit Mobilization and Risk Management. These were detailed objectives which are provided in the next several pages followed by accomplishments.

**Deliverables:** Deliverables for the Commercial Banks component are provided under Annexes Volume II.

### **ATRA Bank: MIS/IT Objectives**

1. Create on-line MIS for each partner bank consisting of four (4) reports. The content of these reports was based on interviews conducted with bank staff during the assessment period. The reports are:
  - a. Loan Summary Report
  - b. Loan Payment issues Report
  - c. Portfolio Analysis Report
  - d. Loan Pipeline Report
2. Conduct a systems design seminar to teach the basics of how a system project should be conducted
3. Conduct a design workshop in order for a bank team to apply the seminar lessons to the specifics of the MIS reports
4. Review build plans with bank management
5. Local bank IT staff build the system
6. The Advisor and bank staff would update build activities with any required changes and troubleshooting
7. Test and debug the systems
8. Implement the loan reports and train staff in their use
9. Analyze collateral management needs
10. Design and implement a Deposits MIS
11. Provide follow-up support for implementation

### **ATRA Bank: Credit and Lending Objectives**

To assist ATRA Bank in strengthening its credit analytical skills that are based on an applicant's financial performance, e.g. cash-flow, by developing and conducting classroom training and on-the-job mentoring to enhance the skills of its credit and customer care staff, providing financial services to and oriented toward the SME (small and medium enterprise) sector. Focus on strengthening credit analysis, risk assessment, customer interviews and business site visit skills.

1. Develop and Implement SME Credit Policies & Procedures
2. Clearly define roles and job descriptions of Loan Officers, including key performance indicators, division of responsibilities and administrative activities
3. Develop SME Credit Policy manual

4. Develop SME Credit Procedures manual/Credit Handbook
5. Draft SME credit application form(s)
6. Adapt/Draft separate procedures for working capital loans and investment loans

#### **Financial Intermediation and Sales Skills**

1. Develop and conduct training program reflecting Best practices for SME lending: emphasis on determining ability to repay by cash-flow analysis and character assessment of applicant
2. Improve the process of financial analysis that is based on analysis of the borrower's financial performance, e.g. cash-flow, industry, norms, etc.
3. Develop and conduct an interactive workshop designed to help loan officers watch over and control credit exposure to individual borrowers. Emphasis is on detecting early warning signs of trouble and then initiating prompt remedial action through persuasion, negotiation or assertiveness
4. Loan Officer Coaching and Mentoring

#### **ATRA Bank: Marketing/Deposit Mobilization Objectives**

The Advisor will assist ATRA Bank in improving its domestic deposit gathering capability by evaluating and providing recommendations for the following:

1. Identifying the impediments and opportunities for deposit mobilization in areas such as strengths and weaknesses regarding the present markets; opportunity to reach new markets, (e.g. customer groupings, e.g. physical, business, and governmental or expand attractive ones;
2. Deposit product features (strong or weak features i.e. maturities, market suitability or product gaps)
3. Deposit product pricing (attractiveness in the face of inflation and the market needs)
4. Physical and electronic delivery systems (present and potential)
5. Service quality, and staff product knowledge, service skills, and sales skills
6. Bank image and both customer and non-customer awareness and reputation

The result is expected to provide a clear mandate for the Marketing Department and with the departmental budget it would allow the Marketing Department to more effectively plan promotional/advertising activities. Moreover, Marketing Department staff is expected to attain the relevant and necessary skills and demonstrated competence in customer survey design, conduct, data collection and analysis and effective data presentation.

#### **ATRA Bank: Original Risk Management Objectives**

1. Establish and staff a RM Department in bank
2. Create lists of skills for a risk management function: e.g. Risk Manager
3. Conduct detailed review of existing policies and procedures with a view to refine and strengthen Risk Management policies and procedures that are consonant with the NBA standards
4. Create an action plan including developing risk reports, ongoing collection and analysis of data, setting risk limits, assigning roles and responsibilities and creating a Risk Management Committee using senior management
5. Develop standards to control market, operational and security risks

#### **ATRA Bank: Realigned Risk Management Objectives**

1. Assess organizational issues and independence of RM; roles and responsibilities

2. Identify key performance indicators and key risk indicators
3. Develop Presentation to Management Board/Supervisory Board to provide overview of risk management and current risk positions;
4. Recommend risk tolerance levels
5. Revise 2009 Plan and finalize reporting template
6. Develop model for monitoring of deposit levels
7. Develop presentation for Management Board to be delivered by Chief Risk Officer (CRO) to provide overview of risk management roles and responsibilities, present current risk position of the Bank, and set out implementation steps
8. Address non-compliance issues with respect to CBA's Risk Management Standard
9. Provide tutoring as necessary in support of GARP Risk Management training

#### **Azerdemiryol Bank: MIS/IT Objectives**

It should be noted that at the time of the initial MIS assessment Azerdemiryol Bank was under contract to purchase an SAP® banking system which was expected to provide them with robust MIS capabilities in the near future. Therefore, the bank determined that the MIS/IT recommendations under FSSP would be redundant and they opted to decline the MIS assistance and instead requested to allocate more effort toward the other TA areas identified as a result of the assessment.

#### **Azerdemiryol Bank: Credit, Lending and Risk Rating Objectives**

The overall Credit and lending objectives for both Azerdemiryol Bank (ADB) and Mugan Bank were generally the same. ADB is a larger, more sophisticated bank but the Advisor considered initial training requirements as well as outcomes as essentially similar. Specifically:

1. Improvements in risk identification and quality of credit analyses
2. Revised analytical procedures requiring consistent and correct calculation of cash flows
3. Use of two balance sheets and comparative ratios, common sizing, debt coverage ratios
4. Changes to legal documentation for term loans
5. Incorporation of financial covenants and risk related terms and conditions in loan agreements
6. Ability of participants to use TA materials to benefit other non-participating lending officers
7. Changes in Credit Committee procedures, and improvement in monitoring procedures

Other qualitative objectives were expressed in the work plan as follows:

8. Credit Volume and number of SME loans outstanding bank-wide increase according to the bank's annual projections
9. PaR < 90 days of total SME portfolio not to exceed 4%

#### **Azerdemiryol Bank: Training Objectives**

1. Practical Analytical tools:  
Improve risk identification practices such as Sources and Uses of funds analysis, the ABA 'Big Four' approach to understanding use of business' financial resources, related case studies, working capital and depreciation analysis, building financial statements, financial projections and alternative cash flow techniques. Due to ADB's

scheduling requirements, and due somewhat to the need for including loan officers from the regions for items 1 and 2, training started in early September 2008 and was completed in late November 2008.

2. Training in Best Practices for SME Lending:  
Use of additional analytical tools to improve identification and reduction of risk, improvement of loan quality, guidelines for credit investigation (structured interviews) and credit assessment using comparative analysis, common sizing, and other analytical techniques with emphasis on proper structuring of lending proposals.
3. Term Lending and Documentation seminar:  
Term Lending techniques and use of Loan Agreements, financial covenants and other terms and conditions to control and mitigate risk over the life of a loan.
4. Credit Administration practices:  
Introduce Loan Monitoring techniques and plans, use of 'six key indicators' to identify risk trends.
5. Risk Rating System:  
The essential objective of designing a Risk rating System for ADB was the design and implementation of a Risk Rating system which is a component of the origination steps in the lending process requiring 'credit experts' to risk rate loans based on risk-related definitional elements to establish base line portfolio risk profiles. Develop policy and procedure to communicate to lending staff. Take steps to link the Risk Rating System with MIS.

#### **Azerdemiryol Bank: Marketing/Deposit Mobilization Objectives**

The Advisor will assist Azerdemiryol Bank in identifying the impediments and opportunities for deposit mobilization in the following areas:

1. Identifying strengths and weaknesses regarding the present markets; opportunities to reach new markets e.g. customer groupings: physical, business, and governmental or expand attractive ones
2. Identification of ADB Bank's target market(s) in order to focus marketing efforts to increase deposit base
3. Deposit product features (strong or weak features, e.g. maturities, market suitability or product gaps)
4. Deposit product pricing (attractiveness in the face of inflationary environment, etc. and market demands)
5. Physical and electronic delivery systems (present and potential)
6. Service quality and staff product knowledge, service skills, and sales skills
7. Bank image, reputation for both customers and non-customers and awareness among non-customers

#### **Azerdemiryol Bank: Original Risk Management Objectives**

1. Development of Risk Management Policies and Procedures that is not only consonant with the CBA standards but germane to the operations of the bank
2. Initiate steps to identify all risk management parameters in the area of asset and liability management and foreign exchange exposure that can be linked with MIS
3. Detailed audit of existing Policies and Procedures

4. Revised Policies and Procedures to fully comply with CBA standards, completion of new procedures related to liquidity and asset/liability management, FX risk, operational risk
5. Identification of key risk parameters and link with MIS reporting system
6. Assist in production of 'Stress Testing' and 'Early Warning' systems
7. In the absence of fully functional new SAP Operating system, insure MIS Reports available to senior management

#### **Azerdemiryol Bank: Re-aligned Risk Management Objectives**

1. Assess compliance with CBA Risk Management Standard per Checklist
2. Assess current organizational issues and stature of RM for independence and effectiveness
3. Recommend potential outsource or software solutions for risk measurements
4. Examine feasibility of establishing profit centers for risk adjusted performance evaluation and associated incentive system, including branch profitability model
5. Develop Presentation to Management Board/Supervisory Board to provide overview of risk management and current risk positions and recommend risk tolerance level
6. Differentiate between compliance, internal control, internal audit and risk management
7. Develop risk measurement tools: spreadsheet model for IRR; spread analysis report; gap report; spreadsheet model for FX VaR; spreadsheet model for Deposit volatility and liquidity plan

#### **Mugan Bank: MIS/IT Objectives**

1. Create on-line MIS for each partner bank consisting of four (4) reports. The content of these reports was based on interviews conducted with bank staff during the assessment period. The reports are:
  - a. Loan Summary Report
  - b. Loan Payment issues Report
  - c. Portfolio Analysis Report
  - d. Loan Pipeline Report
2. Conduct a systems design seminar to teach the basics of how a system project should be conducted
3. Conduct a design workshop in order for a bank team to apply the seminar lessons to the specifics of the MIS reports
4. Review build plans with bank management
5. Local bank IT staff build the system
6. The Advisor and bank staff would update build activities with any required changes and troubleshooting
7. Test and debug the systems
8. Implement the loan reports and train staff in their use
9. Analyze collateral management needs
10. Design and implement a Deposits MIS
11. Provide follow-up support for implementation

#### **Mugan Bank: Credit, Lending and Risk Rating Objectives**

The overall Credit and Lending objectives for Mugan Bank were:

1. Improvements in risk Identification and quality of credit analyses
2. Revised Analytical procedures requiring consistent and correct calculation of cash flows

3. Use of two balance sheets and comparative ratios, common sizing, debt coverage ratios
4. Changes to legal documentation for term loans
5. Incorporation of financial covenants and risk related terms and conditions in loan agreements
6. Ability of participants to use TA materials to benefit other non-participating lending officers
7. Changes in Credit Committee procedures, and improvement in monitoring procedures

Quantitative targets as expressed in the work plan:

1. Credit Volume and number of SME loans outstanding bank-wide increase according to Mugan Bank's annual projections
2. PaR < 90 days of total SME portfolio not to exceed 4%

### **Mugan Bank: Training Objectives**

1. Practical Analytical tools:  
Improve risk identification practices such as Sources and Uses of funds analysis, the ABA 'Big Four' approach to understanding use of business' financial resources, related case studies, working capital and depreciation analysis, building financial statements, financial projections and alternative cash flow techniques. Mugan Bank's schedule was based on half-day programs due the need to insure loan officer coverage in their respective branches. Training was therefore coordinated, not without considerable difficulty, with ADB's schedule. Training began in October 2008 and was not completed until very early April 2009.
2. Training in Best Practices for SME Lending:  
Use of additional analytical tools to improve identification and reduction of risk, improvement of loan quality, guidelines for credit investigation (structured interviews) and credit assessment using comparative analysis, common sizing, and other analytical techniques with emphasis on proper structuring of lending proposals.
3. Term Lending and Documentation seminar:  
Term Lending techniques and use of Loan Agreements, financial covenants and other terms and conditions to control and mitigate risk over the life of a loan
4. Credit Administration practices:  
Introduce Loan Monitoring techniques and plans, use of 'six key indicators' to identify risk trends.
5. Risk Rating System:  
The essential objective of designing a Risk rating System for Mugan Bank was the design and implementation of a Risk Rating system which is a component of the origination steps in the lending process requiring 'credit experts' to risk rate loans based on risk-related definitional elements to establish base line portfolio risk profiles. Develop policy and procedure to communicate to lending staff. Take steps to link the Risk Rating System with MIS.

### **Mugan Bank: Marketing/Deposit Mobilization Objectives**

The Advisor will assist Mugan Bank in identifying the impediments and opportunities for deposit mobilization in the following key areas:

1. Identifying strengths and weaknesses regarding the present markets; opportunities to reach new markets e.g. customer groupings: physical, business, and governmental or expand attractive ones
2. Identification of Mugan Bank's target market(s) in order to focus marketing efforts to increase deposit base
3. Deposit product features (strong or weak features, e.g. maturities, market suitability or product gaps)
4. Deposit product pricing (attractiveness in the face of inflationary environment, etc. and market demands)
5. Physical and electronic delivery systems (present and potential)
6. Service quality and staff product knowledge, service skills, and sales skills
7. Bank image, reputation for both customers and non-customers and awareness among non-customers
8. The transfer of technical knowledge to bank individual(s) responsible for marketing research. Ensure that the type of data being collected is relevant for the bank to integrate into their promotional efforts and be able to target market their promotional efforts to particular segments which would enhance their market share and deposit base
9. Change in the early withdrawal penalty to be more in line with the maturity of the term deposit;
10. To assist the bank to increase term deposit volumes by 20% y-o-y from Dec 31, 2008 levels (*N.B. this target was rescinded per joint agreement between Mugan Bank and USAID in February 2009 as part of a work plan re-alignment for the Marketing sub-component*)

#### **Mugan Bank: Original Risk Management Objectives**

1. Conduct detailed study of existing policies and procedures
2. Development of appropriate Risk Management policies and procedures that is not only consonant with the CBA standards but germane to the operations of Mugan Bank
3. Initiate steps to further identify risk management parameters in the area of asset and liability management, market, operations, and foreign exchange exposure that can be linked with MIS
4. Detailed audit of existing policies and procedures, mapping out next steps
5. A revised Policy Manual for FX, Liquidity, Operational, and IT/MIS risks
6. Stress-testing model review and recommendations
7. On the job Training for RM Staff to develop risk management methodology
8. Development of linkage with MIS

#### **Mugan Bank: Re-aligned Risk Management Objectives**

1. Recommend risk tolerance level and submit for Supervisory Board approval;
2. Recommend risk limits based on tolerance level
3. Provide recommendations on how to institutionalize risk management into the Bank's work flow, including roles and responsibilities of RM, Internal Control, Compliance and Internal Audit
4. Implement annual planning process and regular reporting template relative to plan
5. Set up stress-tests and structure documentation
6. Recommend profit and cost centers for performance measurement and management
7. Provide training in general risk management principles, FX and liquidity risk measurement tools

8. Continue assistance with liquidity risk management process
9. Assist Bank in filling out CBA Risk Management Standard Checklist
10. Develop presentation for Management Board to be delivered by CRO to provide overview of risk management roles and responsibilities, present current risk position of the Bank, and set out implementation steps
11. Provide tutoring as necessary in support of GARP Risk Management training

#### **NBC Bank: MIS/IT Objectives**

1. Create on-line MIS for each partner bank consisting of four (4) reports. The content of these reports was based on interviews conducted with bank staff during the assessment period. The reports are:
  - a. Loan Summary Report
  - b. Loan Payment issues Report
  - c. Portfolio Analysis Report
  - d. Loan Pipeline Report
2. Conduct a systems design seminar to teach the basics of how a system project should be conducted
3. Conduct a design workshop in order for a bank team to apply the seminar lessons to the specifics of the MIS reports
4. Review build plans with bank management
5. Local bank IT staff build the system
6. The Advisor and bank staff would update build activities with any required changes and troubleshooting
7. Test and debug the systems
8. Implement the loan reports and train staff in their use
9. Analyze collateral management needs
10. Design and implement a Deposits MIS
11. Provide follow-up support for implementation

#### **NBC Bank: Credit and Lending Objectives**

To assist NBC Bank in strengthening its credit analytical skills that are based on an applicant's financial performance, e.g. cash-flow, by developing and conducting classroom training and on-the-job mentoring to enhance the skills of its credit and customer care staff providing financial services to and oriented toward the SME (small and medium enterprise) sector. Focus on strengthening credit analysis, risk assessment, customer interviews and business site visit skills while also developing a Relationship Manager Concept among the Loan Officers by building trust through a growing inter-personal relationship with the client by anticipating and offering a wide array of financial services to SME customers with a high level of customer service.

#### **Skills Audit/Incentive Schemes**

1. Conduct a skills audit of existing credit and customer care staff based on established pre-defined skill-set required by NBC Bank
2. Clearly define roles and job descriptions of Loan Officers, including key performance indicators, division of responsibilities and administrative activities
3. Review bank's existing bank-wide motivation/incentive programs and provide recommendations for improvements according to Best Practices focusing on the following:

- a. Review the existing monetary and non-monetary incentives schemes in order to ascertain the bank's current incentive programs and to ensure uniformity to current HR systems in place
- b. Conduct a series of interviews/discussions with the relevant HR staff/senior management in order to ascertain the bank's planned or expected incentive strategies, determine the expected scope and scale of said incentive programs and explore opportunities and/or applicability to expand both monetary and non-monetary incentives to include a broader range of bank staff including back office personnel
- c. Develop written recommendations that provide an assessment of the effectiveness of existing incentive strategies, recommendations for modifications/enhancements, as well as concrete recommendations and specific guidance on how to expand the scope of existing monetary and/or nonmonetary incentive strategies to encompass all bank employees

#### Financial Intermediation and Sales Skills

1. Develop and conduct training program reflecting Best practices for SME lending: emphasis on determining ability to repay by cash-flow analysis and character assessment of applicant
2. Develop and conduct a seminar course to strengthen the sales skills of the existing Loan officers and Customer Service Personnel
3. Develop and conduct an interactive workshop designed to help loan officers watch over and control credit exposure to individual borrowers. Emphasis is on detecting early warning signs of trouble and then initiating prompt remedial action through persuasion, negotiation or assertiveness
4. Loan Officer Mentoring

#### **NBC Bank: Marketing/Deposit Mobilization Objectives**

The Advisor will assist NBC Bank in improving its domestic deposit gathering capability by evaluating and providing recommendations in the following areas:

1. Identifying the impediments and opportunities for deposit mobilization in areas such as strengths and weaknesses regarding the present markets; opportunity to reach new markets, (e.g. customer groupings physical, business, and governmental or expand attractive ones
2. Deposit product features (strong or weak features i.e. maturities, market suitability or product gaps)
3. Deposit product pricing (attractiveness in the face of inflation and the market needs)
4. Physical and electronic delivery systems (present and potential)
5. Service quality, and staff product knowledge, service skills, and sales skills
6. Bank image and both customer and non-customer awareness and reputation
7. Identification of NBC Bank's target market(s) in order to focus marketing efforts to increase deposit base

#### **NBC Bank: Original Risk Management Objectives**

1. Design and facilitate a "Best Practice" Risk management course for bank senior and middle management to cover Credit, Foreign Exchange, Interest Rate, Liquidity, and Operational risks

### **NBC Bank: Re-aligned Risk Management Objectives**

1. Develop stress testing procedures
2. Establish risk measures such as Value at Risk
3. Establish risk tolerance level (Supervisory Board)

### **Royal Bank: MIS/IT Objectives**

1. Create on-line MIS for each partner bank consisting of four (4) reports. The content of these reports was based on interviews conducted with bank staff during the assessment period. The reports are:
  - a. Loan Summary Report
  - b. Loan Payment issues Report
  - c. Portfolio Analysis Report
  - d. Loan Pipeline Report
2. Conduct a systems design seminar to teach the basics of how a system project should be conducted
3. Conduct a design workshop in order for a bank team to apply the seminar lessons to the specifics of the MIS reports
4. Review build plans with bank management
5. Local bank IT staff build the system
6. The Advisor and bank staff would update build activities with any required changes and troubleshooting
7. Test and debug the systems
8. Implement the loan reports and train staff in their use
9. Analyze collateral management needs
10. Design and implement a Deposits MIS
11. Provide follow-up support for implementation

### **Royal Bank: Credit and Lending Objectives**

To assist Royal Bank in strengthening its credit analytical skills that are based on an applicant's financial performance, e.g. cash-flow, by developing and conducting classroom training and on-the-job mentoring to enhance the skills of its credit and customer care staff, providing financial services to and oriented toward the SME (small and medium enterprise) sector. Focus on strengthening credit analysis, risk assessment, customer interviews and business site visit skills.

#### **Develop and Implement SME Credit Policies & Procedures**

1. Clearly define roles and job descriptions of Loan Officers, including key performance indicators, division of responsibilities and administrative activities
2. Develop SME Credit Policy manual
3. Develop SME Credit Procedures manual/Credit Handbook
4. Draft SME credit application form(s)
5. Adapt/Draft separate procedures for working capital loans and investment loans

#### **Financial Intermediation and Sales Skills**

1. Develop and conduct training program reflecting Best practices for SME lending: emphasis on determining ability to repay by cash-flow analysis and character assessment of applicant
2. Improve the process of financial analysis that is based on analysis of the borrower's financial performance, e.g. cash-flow, industry, norms, etc.

3. Develop and conduct an interactive workshop designed to help loan officers watch over and control credit exposure to individual borrowers. Emphasis is on detecting early warning signs of trouble and then initiating prompt remedial action through persuasion, negotiation or assertiveness
4. Loan Officer Coaching and Mentoring

**Royal Bank: Marketing/Deposit Mobilization Objectives**

The Advisor will assist Royal Bank in improving its domestic deposit gathering capability by evaluating and providing recommendations in the following areas:

1. Identifying the impediments and opportunities for deposit mobilization in areas such as strengths and weaknesses regarding the present markets; opportunity to reach new markets, (e.g. customer groupings (physical, business, and governmental) or expand attractive ones;
2. Deposit product features (strong or weak features i.e. maturities, market suitability or product gaps)
3. Deposit product pricing (attractiveness in the face of inflation and the market needs)

Results of these activities would provide a clear mandate for the Marketing Department and with the departmental budget it would allow the Marketing Department to more effectively plan promotional/advertising activities.

**Specific Quantitative Targets:**

1. Marketing Department staff attains skills and demonstrated competence in customer survey design, survey conduct, data collection and analysis and effective survey data presentation
2. At least 1 customer and 1 non-customer survey designed, executed and analyzed
3. The re-design of at least one existing deposit product or introduction of an attractive deposit product
4. To assist the bank to increase term deposit volumes 30% from Dec 31, 2008 to end Sept 2009

**Royal Bank: Original Risk Management Objectives**

1. Conduct detailed review of existing policies and procedures with a view to refine and strengthen Risk Management policies and procedures that are consonant with the CBA standards
2. Develop standards to control operational and security risks
3. Initiate steps to identify risk management parameters in the area of asset and liability management, market, operations, and foreign exchange exposure that can be linked with MIS

**Royal Bank: Re-aligned Risk Management Objectives**

1. Revised Risk Management Policy Manual
2. Develop branch profitability model for monitoring branch performance
3. Hands-on training/coaching of CEO
4. Provide bank-wide training in integrated RM principles

## **MIS Accomplishments: All Participating FSSP Banks**

### **Design Seminars & Design Workshops**

Designed and conducted Design Seminars for each partner bank that included a collaborative group of bank participants (aka the Project Team) that was responsible for designing the required systems, processes, and reports that enabled the banks to successfully implement these changes and also instructed them to extend this activity in the future for other projects. The Design Seminar elements included:

1. Design as a business tool;
2. Prototyping functional design;
3. MIS Reporting: what, why, how;
4. Establishing performance measures

Designed and conducted Design Workshops with respective bank Project Teams to design MIS reports, including goal setting, element definitions, sources, uses, and report formats. The reporting template pro-forma reports included the following:

1. Loan Pipeline;
2. Loan Reporting;
3. Loan Payments Issues;
4. Portfolio Analysis

The Advisor then held final feedback on the Design Workshop to ensure that the goals were met, MIS build schedules were finalized and funding and planning issues were resolved. This phase included a presentation to senior bank management.

The Advisor created pro-forma report templates of each of the four reports to be designed. Each bank then modified the reports to meet their individual needs. As a result, no two bank report designs were exactly the same for any of the reports. Essentially 16 separate reports were designed, all based on the same foundation but modified to meet the needs of the users as defined by the respective bank project teams. Feedback workshops were held at each bank that included senior management. Final modifications were memorialized and the results were then accepted by each bank and handed off to their respective development staffs.

### **MIS Build**

The bank project teams built the MIS reports with the resources purchased and applied, and using skills learned through the Design Seminar and Workshop. They also executed their own Unit and Integration testing led by their IT developers. All MIS Build update activities took place as per schedule between October 30, 2008 and November 6<sup>th</sup>, 2008. Mugan Bank determined they would postpone the build of all reports until January 2009. Routine updates were held with Royal Bank and ATRA Bank. NBC Bank determined that their internal IT staff was not capable of the report development, but were uncertain as to how to proceed. The Advisor and FSSP COP worked with NBC Bank to insure that an appropriate external party was engaged for the development work.

All three banks, ATRA, NBC, and Royal Bank, had completed a draft of the MIS reports as scheduled on January 9. None of the three banks had completed the Pipeline report. It was determined to address this later. Mugan Bank assigned a new developer and requested that the project review all reports with a new team. This was agreed to and effectively new screen

formats were designed. Generally all three banks had put in a good effort to accomplish the tasks assigned.

### **Testing and Implementation Period**

Once the initial testing was complete, a Beta test was performed and then the MIS process was implemented upon the success of the Beta test. The Advisor assisted the developers to de-bug all programs. The next objective was to validate all data against the core banking systems to ensure accuracy. Lastly, a training process needed to be established with each bank. Two of the banks completed implementation of their MIS systems in late January and early February of 2009. Royal Bank had the most re-work to do, but put in a herculean effort by three staff to complete it. The Advisor completed training and the bank implemented their Loan MIS reports on February 23.

Mugan Bank fell behind development. They completed the seminars in a timely manner in the fall of 2008, but felt that they could not focus on development until after they moved their headquarters to a new building. While development work resumed with Mugan Bank in February and March of 2009, the rest of the banks focused on implementing the MIS Pipeline reports. This was the most difficult report for the banks as it required data entry by Branch staff, so it had been pushed back until the other query-based reports were implemented. Mugan assigned a new developer to the task, and by working with this individual daily, rapid progress was made and the bank implemented their core reports on April 17, 2009.

### **Collateral Management/Deposits MIS**

The initial work plans called for the Advisor to determine needs and capabilities for development and integration of a loan and collateral management. However, when the Advisor and FSSP Management began to hold discussions with individual banks in late February and March 2009, their experience gained with the Loan MIS reports, the deteriorating economic situation resulted in a shift of needs.

All of the partner banks determined to defer any analysis of collateral needs and they requested the Advisor to assist them to design a Deposits MIS Reporting module to complement the Loan MIS reports. Specifically, the banks wanted the reports to 1) provide an analysis report to include deposit types and depositor types, 2) provide a report that would incorporate the flow of deposits over time and, 3) provide a report that focused on the remaining periods of time to maturity for their current deposit portfolio. This was discussed and approved by USAID and the work plans were realigned accordingly to focus on the additional development work while the analysis of collateral and enhancements to the loan systems were superseded.

The Advisor developed the Deposits MIS pro-forma reports and these were discussed and agreed with the respective banks' senior management whereby the developers began to program them immediately. The MIS/IT work plans were supplemented and modified to include a Deposits MIS module as follows:

1. Report definition;
2. Report design;
3. Review of Build plans with management;
4. The actual Build by bank staff;
5. Testing and debugging the reports by bank staff and the Advisor;
6. Implement Deposits MIS reports

The Advisor returned at the end of June 2009 and with the assistance of the developers began to debug the programs. This was an efficient process due to the experience of the local technical staff on the Loan MIS system, so this was completed quickly and staff was the trained on the use of the Deposits MIS module and was completed in July 2009.

Two of the banks decided to incorporate the ability to see every deposit that makes up a particular group of deposits. This ability was not specified by the Advisor, but was incorporated from specifications made as part of the Loan MIS process. Additionally, the ability to offload any result to Excel has been incorporated for those who need hard copy for any purpose. For the two banks who did not choose to display detailed deposit data from their core system, the Advisor added this to the “next steps” provided to senior management as part of the Deposits MIS training.

### **Implementation Status**

Each partner bank has operational Loan MIS and Deposits MIS on-line reports in their banks. These reports are all similar, but have been specifically modified by the bank development teams to reflect their priorities and the software with which they chose to create the reports.

### **Training**

In all, 41 staff in the four banks attended the Design Seminar and Design Workshops. 192 loan officers, department heads and senior staff were trained in the use of the Loan MIS. All four Chairmen attended training and have access to the reports from their office PCs. 83 branch accountants, risk staff, and senior staff were trained in the use of the Deposits MIS. There was no staff formally trained in Deposits MIS at NBC Bank as their reports required additional corrections by their programming Advisor.

### **Security and Permissions**

Every bank has implemented the use of “permissions” passwords and user IDs that restrict access to information if not required for their positions. The Loan MIS has four levels of permission and the Deposits MIS has three levels.

### **The Reports Implemented**

The Loan MIS reports themselves are extremely flexible. One can query at either the summary or detailed level; at the detailed level, the individual contracts that make up the detail can be viewed. The users also have the ability (through input by Systems Administration) to add forecasts to the reports. This was not required at implementation, but urged as a “next step” for the banks.

### **ATRA Bank: MIS Accomplishments**

The Credit MIS Reports were fully implemented in ATRA Bank in February and include the following core reports:

1. The **Loan Summary Report** can be viewed by Branch, or Home Office, All Branches or All (representing the total portfolio). Reports can be viewed by Currency, although all currencies are converted to the local currency for consistency (Manat). Loans can also be accessed by Loan category;
2. The **Loan Payment Issues Report** provides a few of late payments in time segments (0-10 days, 11-30 days, 31-90 days, etc. This report also shows payments that are coming due so it shows the user the future as well as the past;

3. The **Portfolio Analysis Report** shows the entire portfolio by concentration e.g. by interest rate, by branch, by largest customers, by region, etc., with slight variances based on the perceived needs of the users. The portfolio can effectively be divided into more than 1000 slices depending on the criteria selected;
4. The **Pipeline Report** tracks loan applications online as they proceed through loan stages from Application to Funds Disbursement. A Pipeline Procedure was also developed, training provided and distributed.

All Deposits Reports coding bugs within the software were corrected and verified, 13 bank staff was trained in Deposit MIS use and functionality. The Deposits MIS Reports are fully implemented in ATRA Bank and include the following three major reports:

1. **The Funds Analysis Report** displays all deposits by Branch, by Currency, by Deposit type, and/or by Concentration. The output display of the report changes based on the criteria selected by the user. Deposits can be viewed from Original term as well as Remaining term;
2. **The Funds by Maturity Report** allows the user to select a time period or two concurrent time periods (0-30 days and/or 31-90 days) to view the deposits remaining term. This information can be viewed from the bank level down to the smallest deposit type;
3. **The Funds Flow Report** enables the user to select time frames and view deposit activity during the timeframe by Depositor Type (Source). If the user selects a particular quarter, let's say the first quarter of 2009, the user will see the deposit balances as of the beginning of the quarter, deposits added during the quarter, withdrawals and maturities during the quarter, and finally the closing balance. All will be displayed showing the source of the funds.

A key feature of the Deposits reports is the use of Weighted Annual Percentage Rate so that the true cost of funds can be viewed as different slices of the deposits portfolio are selected by a user. All calculations are based on a deposits matrix using the Central Bank of Azerbaijan's chart of accounts with "Deposit Types" on one axis, and "Depositor Types" (Deposit Sources) on the other. The resulting tables are easy to update and easy to maintain.

#### **ATRA Bank: Credit and Lending Accomplishments**

1. Developed and conducted a training program reflecting Best practices for SME lending: emphasis was on determining ability to repay by cash-flow analysis and character assessment of applicant: 16 Loan Officers participated;
2. Significantly improved the process of financial analysis that is based on analysis of the borrower's financial performance, e.g. cash-flow, industry, norms, etc;
3. Developed and conducted an interactive workshop designed to help loan officers watch over and control credit exposure to individual borrowers. Emphasis was on detecting early warning signs of trouble and then initiating prompt remedial action through persuasion, negotiation or assertiveness: 11 Loan Officers participated;
4. Daily Loan Officer Coaching and Mentoring;
5. Written job description were developed for business loan officers with key performance expectations;
6. An SME Policy Manual and Procedures were developed and implemented;
7. Credit Handbook reflecting Best Practice in SME Lending developed as addendum to Procedures Manual;

8. New SME Loan Application Form, Credit Memorandum, Site Visit Questionnaire Form were developed and implemented;
9. 16 credit staff in 11 branches were trained in cash-flow based/character lending and advanced credit analysis topics including: working Capital Financing, Ratio and Trend Analysis, Cash Flow Statements, and Interdependence of Financial Statements;
10. 11 Credit Officers were trained in loan monitoring and control, focusing on: how to determine early warning signs of financial distress, Remedial actions;
11. Five loan officers have developed and demonstrated skills conducting effective client interviews, business site visits, credit analysis, loan structuring, and credit presentations to credit committee.
12. Credit volumes of new Micro loans outstanding grew to reach 135,000 AZN via 37 loans by 25 September 2009. 14 credits for 44,000 AZN were disbursed in August alone. This represents a monthly growth rate in loans outstanding of nearly 50% since May 2009 however this growth rate is expected to stabilize at 15-20% per month through the remainder of 2009. All loans are currently performing with no incidences of late payments beyond 30 days. The decision to roll out the Pilot was taken based on results achieved with expansion initiated in the 'Baku Branch.'

The Pilot SME Lending Program launched in the Home Office in mid April 2009 concluded in mid July 2009. Three Loan Officers were selected to participate in the HO Pilot and all three have made significant progress and continue in their capacity as Loan Officers today. The purpose of the pilot program was to introduce, test and evaluate the following:

1. Introduce a "Best Practice" SME 'credit technology' applying new credit procedures and methodologies;
2. Streamlined Micro and SME loan documentation;
3. To achieve a consistent and accurate analysis of business loan applicants;
4. Increase outreach of bank in SME lending to those customers that are currently declined or not considered because of lack of sufficient financial data;
5. Reduce default risk by correctly assessing the ability of the customer to repay the loan;

#### **ATRA Bank: Note on FSSP Introduced MSME Credit Methodology**

Generally speaking, the term "credit technology" covers the entire range of activities carried out by ATRA Bank which have to do with selecting borrowers, determining the type of loan to be granted, the loan amount and maturity and the way in which it is to be secured, as well as the monitoring and recovery of loans. More specifically, a particular credit technology is a *specific configuration* of the features mentioned above, such as the borrower selection mechanism, loan sizes and maturities, security requirements and administration and recovery mechanisms. The credit technology has been adapted to the special situation of borrowers from the small and micro business sector but is tailored to the situation of the individual borrower and makes a conscious attempt to acquire more information about the borrower by direct inspection rather than by studying documents.

Loan securities are used wherever they are available, but the range of acceptable collateral/security options is not as narrow as practiced in the past with an overreliance on tangible collateral such as real estate and vehicles. With this technology the loan officer endeavors, by carrying out a credit analysis and by visiting the loan applicant's business premises as well as his residence, to understand the true nature of the prospective borrower's economic situation. In this effort, the responsible officer concentrates on an assessment of the

applicant's character and personality and on obtaining a comprehensive picture of the cash-flow of both his business and his household.

A key factor in limiting risk is the ability to correctly assess the ability of the customer to repay the loan. This task is made all the more difficult in the case of most small and micro enterprises by the absence of business accounts, the lack of separation between business and family finances, and the unclear definition of what constitutes the "family". The credit analysis takes these problems into account by considering the "family enterprise" in its totality. It focuses not so much on assessing the value of the borrower's assets, which is in any case likely to be rather low, but on establishing the extent of the "cash-flow" of the family enterprise.

The Credit technology also provides for the utilization of *rigorous credit monitoring and recovery procedures* in the case of arrears. As soon as it is clear that a given borrower has missed a payment, he is contacted by "his" loan officer. This quick response to arrears problems underscores the seriousness of the bank's commitment to recovering the loan and enables it to minimize defaults and delinquencies due to a simple unwillingness to repay. If a borrower nonetheless falls into arrears without being able to provide a satisfactory explanation for his failure to meet his obligations, and does not settle his accounts even after receiving two reminders, legal proceedings are initiated once the payment has become more than 30 days overdue. If, on the other hand, a client who is in arrears can demonstrate that he has not been able to meet his payment obligations for reasons which are truly beyond his control, the loan officer can confer with him and devise a solution to the problem which is then submitted to the credit committee for its approval.

By taking this approach to credit monitoring, ATRA Bank is able to efficiently offset the increased risk which it incurs in its small and micro lending operations by accepting items as collateral whose resale value would be less than the credit amount.

### **ATRA Bank: Marketing and Deposit Mobilization Accomplishments**

1. The bank's Marketing Director and Advisor completed a 3-year Strategic Marketing plan based on the bank's strategic plan. The plan was approved by senior management and Chairman in May 2009, and stands as the guide for marketing activities through 2011. A part of the approved strategic plan included defining the Marketing Department to include product development, customer care norms, marketing research and analysis, web site positioning, PR/communications, and training;
2. The Marketing Director and Advisor created a questionnaire and methodology for an image and bank usage survey of Baku consumers. An independent research company administered the survey in February 2009. The results were analyzed by the Dept Director and Advisor, and presented to Management, in April 2009. This survey became the basis for the subsequent 3-year Marketing Department Plan; an additional in-house survey was created by the Director and launched in August 2009. As of this writing, the responses are too few to be meaningful;
3. Based on local market gaps and Bank's capabilities, potential market niches were defined and presented to management in January and February 2009. These are continually being refined, first via the survey results and then via feedback from customers as products are launched;

Term deposits YTD 31 August 2009 were up over 10%, primarily on the strength of new deposit products introduced in July. The Bank chairman is confident that the 30% targeted increase will be met by 31 December;

4. The new term deposit products launched in July 2009 featured shorter maturities than ever before, with commensurately lower rates, to accommodate customers and reduce the incidence of premature withdrawals. Deposits can now be made for as little as 30 days. In addition, there are now back-end bonuses for time deposits that are maintained through original maturity.
5. Based on the Bank's funding needs and results of the consumer survey, three new term deposit vehicles (outlined below) were created and launched in July 2009. These vehicles are now the only term deposit types offered by the Bank.
6. Based on results of the consumer survey, and the realization that the Bank could not afford a meaningful mass media blitz in a crowded marketplace, new promotional tactics were authorized. A concerted drive-time radio campaign ran for four weeks ending 25 September. SMS messaging was tried to 5,000 BakuCell customers, based on various demographics, over 10 business days surrounding 1 September. On Advisor's final day in Baku (11 September), the Chairman authorized funds to experiment with direct mail to business executives, which will begin in early October 2009.
7. Improved sales aids were introduced with the new deposit products, in the form of an enhanced product brochure for general distribution. More importantly, and in conjunction with #6 above, the Bank's web site was totally revised and rewritten in three languages, with the re-launch coming in mid-September, 2009. Deposit product features and benefits were prominent so that the site ([www.atrabank.az](http://www.atrabank.az)) can serve as a sales aid for ATRA Bank staff that is not familiar with the deposit products.

The consumer research noted above in #2 was presented to bank management with recommendations that were almost entirely accepted. Based on the research, anticipated funding needs, and competition three products were prepared: New-Term (new time deposit), Freedom of Choice (new short-term savings), and Maximum (retooled term account). The main product features of these products follows:

New-Term:

- Deposit terms from 3 to 36 months, interest rates range from 7% to 18% APR;
- Currency AZN or USD;
- Minimum deposit amount 100 AZN;
- Interests payment – monthly, at maturity;
- Every customer receives a Visa plastic card (<1 000 AZN – Electron, from 1 000 to 10 000 AZN or Classic >10 000 AZN - Gold);

Freedom of Choice:

- Deposit terms range from 1 day to no maximum, interest rates range from 2% to 12% APR depending on term selected;
- Currency AZN or USD;
- Interest payments monthly;
- Maturity – customer's choice (open-ended);

- Extra deposit – during the period of the original deposit term the customer may add funds to the account up to 20% of the sum of the original deposit once only. The annual rates for this additional deposit are according to the original deposit terms;
- Visa Electron to each customer

Maximum:

- Deposit terms from 12 to 24 months;
- Interest rates for 12 month deposit are 15% APR if interest paid monthly or 16% if interest paid at maturity. Rates for 24 months deposits are 16% interest paid monthly and to 18% paid at maturity;
- Currency AZN or USD;
- Minimum amount 500;
- Each customer can receive a Visa plastic Card (<1 000 AZN – Electron, from 1 000 to 10 000 AZN – Classic, >10 000 AZN - Gold);
- A credit line may be issued up to 90% of the total amount of deposit up to 30 days interest free, beyond 30 days rates apply.

### **Deposit Goals**

Term deposit growth in ATRA Bank has been volatile over the period of FSSP technical assistance but did experience a net growth of 350,000 AZN to reach 3,366 million AZN which is a 12% growth rate for the period ending August 2009 from December 2008 levels. As a result of a 6 week promo campaign, the expected attracted deposits are estimated to reach 900,000 AZN: 400,000 AZN from new customers, and 500,000 AZN from current customers. This increase, if achieved, would represent nearly a 50% increase over the amount of total term deposits as of end Quarter II 2009.

The new accounts, along with the June/July promotional plan, were presented to management and approved. A product promotion budget of 3,000 AZN was approved in early July. The current Director of Marketing is leaving on 18 July to take over a new branch and he will be replaced starting 1 August. The initial meeting with the new Marketing Director on 24 June resulted in some good discussion, and she has committed to return on 1 July with some concrete ideas for promoting the products in July without overspending.

The final proposal to support the three new deposit products is:

- 1 month duration, 2 radio stations, 75:15 second spots;
- SMS experiment to 10,000 Azercell customers segmented by age, income, home, and monthly bill;
- 1,000 brochures
- Web site redesign and key word purchases

ATRA Bank's new Marketing Director has prepared the following for the expected launch of the promotional campaign in early August:

- media schedules and costs from six local radio stations
- brochure production and printing costs;
- costs and segmentation variables for SMS via Azercell and Bakcell;
- final radio recommendation;
- radio copy and production quotes;
- SMS message copy
- Brochure quotes and preliminary copy

### **ATRA Bank: Risk Management Accomplishments**

Although ATRA Bank has a complete set of risk documents required by the CBA, the actual implementation of the risk management department has not commenced. In fact, the three department staff continued in their other bank capacities during the course of the technical assistance. The CRO<sup>1</sup> (essentially the head of the Risk Management Department) lacked basic understanding of simple bank ratios (ROA and ROE) and basic financial analysis. In addition to individualized training in these financial concepts, other accomplishments included the following:

1. Developed branch profitability model for monitoring monthly risk-adjusted performance. The IT manager will write a program to extract information from the core banking system, incorporating the Credit and Deposit MIS developed in other FSSP component, and expanding it to allocate funding and administration costs;
2. Facilitated the Presentation that was made to the Supervisory/Management Board and several branch managers and department heads, including specific recommendations as follows:
  - a. Establish risk tolerance level in terms of earnings and economic capital at risk (needs to be approved by Supervisory Board)
  - b. Centralize funding in HQ Treasury with branches not maintaining correspondent accounts independently of HQ
  - c. Establish branch profitability model, including transfer pricing of funds and administrative costs, to monitor risk-adjusted performance of branches. Capital to be allocated based on Basel risk weights for assets or 12%.
  - d. Develop incentive system to support risk strategy;
  - e. Develop risk limits for credit, liquidity, interest rate risk and FX risk;
  - f. Institutionalize risk management in decision-making process as business partner of line units.
3. The Presentation was well received by the audience. The Chairman indicated that as of January 2010, he will centralize Treasury operations in HQ, allocate indirect costs to branches, provide target returns and begin to monitor their performance. (See Appendices for the “Risk Management Review for ATRA Bank” Presentation.)

### **Azerdemiryol Bank: MIS Accomplishments**

As was previously mentioned Azerdemiryol Bank opted to decline the MIS recommendations and assistance offered by FSSP because they had previously contracted to purchase an SAP® banking system which was expected to provide them with robust MIS capabilities in the near future. Alternatively, the bank requested FSSP to allocate the expected MIS effort toward the remaining TA areas identified.

### **Azerdemiryol Bank: Credit, Lending and Risk Rating Accomplishments**

#### 1. Practical Analytical tools

ADB responded well to the Credit and Lending Technical Assistance. Initially an average of 18 participants was available for the first 7 training elements, including 6 staff from regional branches. Due to a variety of factors this number declined to 14 for training element 8, and 11

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<sup>1</sup> Will refer to the Head of the Risk Management Department throughout this Report.

for elements 9 and 10. In general, the participants were receptive and participated actively in the training despite occasional distractions from their client related business pressures;

## 2. Training in Best Practices for SME Lending

As noted above, training in SME best practices encompassed the fundamentals of credit origination, analytical techniques, loan and lease structuring, alternative collateral instruments and loan/lease products, bank portfolio management, marketing, and business planning. Case studies were employed (see Appendices) to provide practical application of techniques;

## 3. Mentoring Activity

As part of the Best Practices training, credit mentoring was carried out with identified participants in a number of branches and the Advisor sat in on Credit Committee meetings. The hands-on work with participants involved review of their analytical work to determine the extent to which best practices aspects of the training had been incorporated in previous loan recommendations and suggestions for improvement to that end where deficiencies were noted for future loan recommendations. The Advisor's participation in Credit Committees provided some special insight into the culmination of the approval process and the application of policies and procedures. Loan officers from 6 Baku branches, the Sumgayit Branch, and Ganca Branch were mentored;

## 4. Term Lending and Documentation seminar

The volume of term loans at ADB has been steadily increasing in recent years, yet the basic approach to term lending differs little from short-term lending. The inclusion of term lending training (see Appendices) was an effort to introduce a best practices approach. During this phase of training an excel based financial projection tool, FINPRO, was provided to the bank to assist in cash flow projections, balance sheets, income statements, and simulations. FINPRO was originally used in Bosnia Herzegovina in the USAID Business Finance project. While complicated and based on the Manual that was given to ADB, ADB officers managed to adapt the tool for their own use. It was actively used during April-May training of ADB loan officers in Baku and the field (see Appendices). ADB Loan Officers are well aware of the importance of cash flow projections and the use of documentation and loan agreement covenants to control risk as a result of this training. The FINPRO derived tool requires loan officers to generate good cash flow projections, calculate financial ratios, etc.

## 5. Credit Administration practices

The several training modules offered here had a positive impact on ADB (See Appendices). As a result, ADB has instituted a new Monitoring program and is considering breaking the loan work-out function from Legal and setting up a separate section in the Credit Department to make the process more efficient. In June of 2008, the Advisor edited a new Credit Policy Manual for ADB and another is in the works. The Advisor has furnished ADB with some related materials to assist in this update effort;

## 6. Risk Rating

The objective in the SOW stated for Risk Rating was "A best practices RR system will complement the NBA's classification system and profile risk in the portfolio from loan inception, and require lending officers to analyze and articulate elements of risk based on established Policy criteria. Management can monitor changes in the risk profile over time through MIS that will also provide management with a tool for problem loan 'early warning' purposes, portfolio analysis and policy changes relative to loan terms and conditions, product

lines etc. The System will be linked to MIS for reporting on lending officer performance, branch performance, and bank performance at senior management levels”.

The system was introduced bank-wide, in Baku and in the regions, accompanied by additional credit and monitoring training. It is Excel based only, but Scores will be captured in a global report for tracking purposes.

The “Risk Scoring System” designed for ADB resulted in a ‘hybrid’, but reflects ADB’s need for simplicity. It was ‘validated’ in a number of team exercises in early April 2009 and in May (see Appendices, Final Risk Rating Report) following Board approval. The Risk Rating/Scoring System was introduced virtually Bank-wide. In the field, lending staff and branch managers from 11 branches, totaling 56, were training in the use of the System and the Procedures that support it. Risk Scoring will provide some of the criteria for monitoring activity in accordance with the new monitoring system (see Appendices, Follow-up). In fact, ADB management reports that more than 100 loans have been monitored in accordance with the new system since early June 2009 and more than 50 new Risk Scored loans have been submitted to the Credit Committee. The new Monitoring program and Procedures developed by ADB were consequently presented to all participants in the program. This joint Bank – FSSP training activity also focused on a variety of Client Relationship issues which frequently surface in the origination and analytical phases of the credit Process. New Excel based analytical tools were introduced and Credit and lending training, reinforcing the 16 Risk Rating parameters used in the System, was emphasized.

This was the first ADB internal Credit related training conducted in the field with a view to not only introducing new Risk Rating/Scoring and Monitoring programs, but also providing basic credit training for loan officers that need to develop new knowledge and skills. To the extent that the effort was deemed successful in accomplishing that purpose, a new training syllabus and curriculum was subsequently developed to support similar efforts. Specialized training for three categories of staff were developed – for new loan officers, experienced loan officers, and Branch managers.

### **Changes in Credit Policy and Procedures**

The following recommendations were presented, discussed and agreed with bank senior management and ultimately approved and implemented as part of the bank’s 2009 tactical plan:

<b>Recommendations</b>	<b>Recommendations approved and implemented</b>
Improvement of credit policy and procedures	Development of procedures for all credit products and related business processes has been included into the current year work plan, and according to the plan prior to setting final date of implementation thereof all procedures and regulations shall be revised. These measures shall serve the purpose of adding efficiency and transparency to the work. At the same time, we bring to your attention that drafts of some regulations have already been developed and submitted to the Management Board for being discussed. Moreover, it is planned from April till December to start holding in-the-job (theoretical) and field (practical) training courses on credit analysis. Thereafter, there shall be conducted exams [tests] for checking to what extent these trainings were efficient and to check the level of loan

	administrators. The trainings shall form a basis for improvement of the level of credit analysis.
Requirements with regard to monitorings to be conducted in connection with use of funds	For that purpose “Regulations on conduct of loan monitorings” has been developed and shall be submitted to the Board for being discussed.
Increase of number of loans and opening of lines of credits should be justified from the standpoint of their purpose	Upon request of a customer, the bank shall check whether there is a need to increase the loan amount or open a line of credit for the customer. Based on conducted analysis it is prescribed to set restrictional conditions (covenants) and consultations were provided by the bank’s legal department on inclusion thereof to their loan agreement and practical implementation thereof shall be in the first half of 2009.
When providing loan recommendations there shall be used information from the balance for last 2 years indicating ratios	<p><b>For the purpose of conducting comprehensive analysis of business loans over AZN 20 000</b> there were prepared new forms of report and sent them to branches. In the process of preparation of these reports EBRD and SME forms of analysis were taken as basis. When loan administrators collect knowledge and skills on analysing projects and it is prescribe to apply a more advanced tools and forms or methods analysing.</p> <p><b>The first form</b> (in the Word format) covers all main sides of the customers’ business, new business history, main buyers and senders of goods, collateral, the management’s skills, forecast, competition, field inspection and loan administrator’s recommendation. Comprehensive description of the projects makes it easier to monitor loans in future. All departments used questions for instructing loan administrators, and this in it’s turn helps cover all topics. It is expected that this report will play a main mediator role in helping the loan officers to start analytical thinking [analytical approach].</p> <p><b>The second financial analysis</b> (in Excel format) includes a customer’s cash flow, income statement and balance sheet. Separate pages were included to cover all major items in detail. Calculation of cash flow and sale related forecast during the loan repayment, as well as other financial ratios (DSCR, ROA, ROE, liquidity, inventory turnover, debt to equity and etc.) shall be automated.</p> <p>When these form of analyses apply to old loans a comparative analysis of all financial indicators will be possible and will create conditions to determine the trend of ratios.</p>
Loan recommendations should use information Income statement for 2 years	
To require current liquidity ratio, ratio of debt to capital, and other financial ratios	
Branches located in regions must provide verbal recommendations to the Credit Committee by means of speaker phones	For the purpose of increasing the efficiency of discussions at the Credit Committee loan officers have started conducting project presentations. First of all, this applies to loans officers of the branch “operational department”. It is planned to do it in Baku and Sumgayit branches by on the job

For the purpose of protecting the transparency of lending process – to inform loan officers and branches	training, whereas in other regional branches – to do it selectively. Implementation of these is expected till the end of 2009. At the same time, for the purpose of improvement of the lending activity and increasing it's efficiency there was established a Credit Committee.
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ADB's internal Credit Training capability, partly as a result of the Technical Assistance and other credit related shared materials, is impressive. In fact, with the exception of some advanced training in the area of term lending and the use of alternative loan and collateral products, it is felt that basic training can be provided to new and existing loan officers (for remedial purposes) by the bank's Credit department staff.

Due largely to the International credit and economic crisis, as previously noted, most banks in Azerbaijan sharply curtailed new loan growth as early as October of 2008. In fact ADB stopped lending entirely for a period. Most submissions to their respective Credit Committees were recommendations for loan extensions and restructures suggesting that past dues were running at a potential rate of well over the above the 4% threshold. As a result, credit volumes of SME loans outstanding bank-wide reached 11,748,000 AZN by end June 2009 which represented a 20% y-o-y decline. PaR < 90 days for the bank's SME portfolio reached 2.96% from .27% a year earlier.

The above notwithstanding, credit growth is beginning to recover with third quarter 2009 outstanding volumes reaching nearly 13.5 million AZN with PaR <90 days at 2.5%. The obvious credit problems were largely a consequence of torrid loan growth experienced in 2007-2008 and it will be some time before meaningful data about portfolio that can be correlated with the TA provided will be available however initial indications are positive whereby credits disbursed applying the improved procedures introduced via FSSP TA are estimated to amount to over 3 million AZN with non-performing loans < 90days comprising less than 1%.

### **Azerdemiryol Bank: Marketing and Deposit Mobilization Accomplishments**

1. Based on knowledge of the Azerbaijani market and the bank's stated objectives and abilities, the Advisor identified ideal and potential target markets in October 2008;
2. The Marketing Director and Product Manager were trained in survey design, methodology, and analysis. Two separate surveys were initiated in October and November 2008 – one a large image and bank usage survey of Baku consumers, and the other a service usage and image survey of ADB customers. Analysis was done on both by Advisor, and presented to Bank, in January 2009;
3. The yield curve on longer-term deposits was maintained by the Bank, even with a planned (October 2009) across-the-board reduction in interest rates. One rate is being left deliberately high in the yield curve to attract deposits to match against like-termed assets the Bank already has. Yield curves are also being adjusted by maintaining nominally high rates but extending maturities, ensuring that funds remain in accounts.
3. (SIC) YTD through 31 August, Bank has increased individual term deposits some 38%, to an all-time high of 55 million AZN.

4. In anticipation of an extended period of lower inflation in Azerbaijan, the bank was preparing in September 2009 to introduce longer maturities on the primary term deposit vehicle, requiring a change from 24 to 36 months to obtain 15% APR. Rates on other vehicles were to drop, along with a reduction in the AZN/USD spread. This proposal is awaiting formal approval by the Management Board.

ADB is in need of increasing, and stabilizing, its funding sources. The 2009 plan calls for an increase in consumer time deposits of 15 million AZN, to an end-of-year level of 60 million AZN. Accordingly, the Marketing Department proposes to introduce a new time deposit product that features competitive interest rates, penalty-free withdrawals at the end of each year, and flexibility for the consumer. At the same time, the structure of the account prevents the Bank from promising long-term rates that may seem attractive today, but which may be onerously high as the term account ages.

In addition to gaining net 15 million AZN of deposits for ADB, it expects the new product to attract a new customer base, particularly among “new married” and pre-retirement adults. This will carry additional cross-selling opportunities the Bank.

The product introduction is being timed to coincide with the celebration of the Bank’s 20<sup>th</sup> anniversary in October, and thus is targeted for a late September launch.

- The Advisor provided hands-on guidance and construction of a new product and launch plan;
- The new product proposal and launch plan written by the Advisor was approved by management during the Advisor’s last break in June, with a slightly higher budget than the requested of 25000 AZN. However, management has elected to hold off on the formal introduction to avoid the summer doldrums and tie in with the Bank’s name change and 20<sup>th</sup> anniversary celebration in October;

Against this background, the Advisor together with the bank’s Marketing Department has created a new long-term deposit vehicle. Critical features of this product follow:

- The product is multi-year, for a minimum of one year;
- The maximum term can be overtly set by the customer, with no outside limit. Alternatively, the customer can set the term to just one year and let automatic renewals occur each year;
- There is a seven-day grace period on each anniversary when withdrawals can be made from the account, without penalty, in any amount;
- ADB will determine the account’s rate for the year at the time of opening or renewal, using the Bank’s then-official 12-month deposit rate. If renewed, the seven day penalty-free withdrawal period will start on the first day of that renewal term;
- Interest is posted to the account monthly, with earnings compounded. Customers also have the ability to have their interest transferred automatically to another account or a debit card

The new product is called Purple Account, fitting into ADB’s current theme of color-designated accounts that have won compliments from competitors because of their simplicity. The target market for the Purple account, from a psychological view, consists of those consumers who have a major future purchase goal, but who are adverse to or unable to borrow to finance that purchase today.

From the more easily-identified demographic aspect, the prime targets for this are:

- “Young married couples”, primarily from ages 25 – 35, who are often shut out of credit markets. They are, however, interested in buying a new (or larger) home or an auto in the future, of in establishing a fund for their children to use upon reaching adulthood;
- “Pre-retired couples”, typically from ages 45 and up. Children will be out of the home by now, or well on their way, and these workers can start fixating on a comfortable retirement. This might require savings to augment a meager pension, or simply saving to purchase a retirement home. In addition, disposable cash should be particularly high in this target group.

These targets also fit into those who are generally cynical about the use of banks, or about locking funds in at fixed rates in an uncertain environment. The ability to withdraw funds annually without penalty should help overcome such suspicions.

### **Azerdemiryol Bank: Risk Management Accomplishments**

Although there were introductory meetings held in May 2009, the RM TA for ADB did not commence until July 2009. During the course of the TA the current CRO resigned and a relatively inexperienced individual assumed the responsibilities.<sup>2</sup> While the momentum for the TA was not significantly interrupted, the focus of the TA became the Supervisory Board presentation.

Specific accomplishments were as follows:

1. Provided training in general risk management principles; Market and Treasury risks; Liquidity Risk Management; Capital Allocation (Risk and Treasury staff participated);
2. Provided supplemental training/explanations in support of GARP training (risk terminology including leverage, economic capital, RAROC and RORAC, EL);
3. Analyzed peer group performance through May and June;
4. Provided sample reports for monitoring liquidity and interest rate risks and business process maps for management of these risks;
5. Developed Deposit Modeling tool to monitor “core” non-volatile deposits;
6. Developed Value at Risk Modeling tool to measure FX risk;
7. Developed interest rate risk model to measure earnings at risk given changes in interest rates;
8. Reviewed Branch Assessment report that should be revised to reflect risk-adjusted performance;
9. Delivered primer on standard deviation and duration analysis;
10. Provided Matrix of Roles and Responsibilities of Internal Control, Risk Management, Compliance and Internal Audit; Risk Culture Indicators; and Components of Internal Control System;

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<sup>2</sup> The individual is a “contract” employee of ADB due to nationality. The Advisor recommended a more senior person be designated the CRO.

Although the presentation to the Executive Committee (including Chairman of Supervisory Board) did not occur during the Advisor’s TA, it has been approved and will take place sometime in September. ADB’s interest is to have a much shorter presentation with a focus on 1) what risk management is; 2) what ADB has done to date; 3) what more needs to be done; and, 4) the different roles of risk management and internal audit. In addition to a full presentation that was developed and provided to the bank for such purpose, the Advisor submitted a “Review of Risk Management Technical Assistance” presentation report to ADB that summarizes the results of the TA and recommended next steps. See Appendices for the presentation.

### Mugan Bank: MIS Accomplishments

The Credit MIS Reports were fully implemented in Mugan Bank in April 2009 and include the following core reports:

1. **The Loan Summary Report** (screenshot below) can be viewed by Branch, or Home Office, All Branches or All (representing the total portfolio). Reports can be viewed by Currency, although all currencies are converted to the local currency for consistency (Manat). Loans can also be accessed by Loan category;

The screenshot shows the 'Loan Summary Report' window. At the top, it displays 'Balance Account Group Summary' with filters for date (23-04-2009), Branch (All), Loan category (All), and CCY (All). Summary statistics show 'Loans Outstanding Summary: No. Loans: 4494, Total Amt: 65967522'. A table lists loans by balance account, including columns for No. loans, Port %, Loan Amount, Port %, Outstg Bal., Prin. Due, Int. Due, W. Avg int %, and Fcst %. A callout box explains that sub-codes are 'nested' under main codes and that the Weighted Average is for the parent code.

Loans By Bal Acct:	No. loans	Port %	Loan Amount	Port %	Outstg Bal.	Prin. Due	Int. Due	W. Avg int %	Fcst %	%^
+ 180	1246	27,73%	12840452	17,18%	11333737	11186780	146957	13,79		
- 181	600	13,35%	8000591	9%	5938393	5663304	275089	22,24		
+ 1811	584	13%	6400891	7,71%	5089106	4830720	258386			
+ 1813	13	0,29%	1264948	1,11%	734571	722619	11952			
+ 1815	1	0,02%	81650	0,11%	69981	69887	94			
+ 1816	1	0,02%	12053	0,02%	16252	12053	4200			
+ 1817	1	0,02%	241050	0,04%	28483	28026	457			
<b>Total</b>	<b>600</b>	<b>13,35%</b>	<b>8000591</b>	<b>9%</b>	<b>5938393</b>	<b>5663304</b>	<b>275089</b>	<b>22,24</b>		
+ 182	64	1,42%	1350357	1,95%	1287022	1266418	20604	20,13		
+ 184	44	0,98%	2280470	2,89%	1908088	1874552	33536	16,49		
+ 185	1879	41,81%	31298235	37,48%	24721420	24270648	450772	14,55		
+ 186	372	8,28%	26105185	29,68%	19579017	18274768	1304249	18,92		
<b>Total-18</b>	<b>4205</b>	<b>93,57%</b>	<b>81875290</b>	<b>98,18%</b>	<b>64767677</b>	<b>62536470</b>	<b>2231207</b>			
+ 190	15	0,33%	127508	0,18%	119061	97415	21646	39,31		
+ 191	2	0,04%	6428	0,01%	5167	4691	476	32,27		
+ 195	1	0,02%	81650	0,01%	69981	69887	94			

New Loans This Month:  No. Loans 273 Loan  
 New Loans Last Month:  No. Loans 157 Loan

The sub-codes are “nested” under the main codes; the balances and Portfolio %’s follow but you can see the Weighted Average is for the parent code.

2. **The Loan Payment Issues Report** provides a few of late payments in time segments (0-10 days, 11-30 days, 31-90 days, etc. This report also shows payments that are coming due so it shows the user the future as well as the past;

3. **The Portfolio Analysis Report** (screen shot below) shows the entire portfolio by concentration e.g. by interest rate, by branch, by largest customers, by region, etc., with slight variances based on the perceived needs of the users. The portfolio can effectively be divided into more than 1000 slices depending on the criteria selected;

**Portfelin Tahlili Hesabati**

**Portfolio Analysis Summary Report**

23-04-2009 Branch: Head Office Loan category: All CCY: All Hesab Excel Çıxış

Loans Outstanding Summary: Portfolio Status: All

No. Loans: 1388 Total Amt: 46315744 Concentration: Filial

Weighted Avg. APR%: 13,85

Display: Filial	No loans	Port %	Term	Interest %	Region	Currency	Clients	Fest %	%^
0 <= 30 Day	6	0,43							
>30 <= 60 Day	2	0,14							
>60 Day <= 6 Month	21	1,51							
>6 <= 12 Month	734	52,88	10325015					22,29	
>12 <= 18 Month	337	24,28	4451666					9,61	
>18 <= 24 Month	123	8,86	2671582					5,77	
>24 <= 48 Month	31	2,23	6420944					13,86	
>48 <= 72 Month	83	5,98	13678996					29,53	
>72 Month	51	3,67	4051141					8,75	
Gami									
1388 100% 46315744 100%									

4. **The Pipeline Report** tracks loan applications online as they proceed through loan stages from Application to Funds Disbursement. A Pipeline Procedure was also developed, training provided and distributed.

All Deposits Reports coding bugs within the software were corrected and verified, 27 bank staff was trained in Deposit MIS use and functionality. The Deposits MIS Reports are fully implemented in Mugan Bank and include the following three major reports:

1. **The Funds Analysis Report** (see screenshot below) displays all deposits by Branch, by Currency, by Deposit type, and/or by Concentration. The output display of the report changes based on the criteria selected by the user. Deposits can be viewed from Original term as well as Remaining term;

**Maliyyə Təhlili Hesabatı**

03-07-2009 Branch ALL Maliyyə Mənbəyi All CCY: All  Hesab  
 Konsentrasiya Əsas Müddət   
 №№: 1581 Balans: 30 028 608 Ödəniləcək Faiz: 493 676

Portfelə Baxış	Nə	Port.%	Balans	Port.%	Ödən. Faiz	Port.%	Ölçü OFD
0 - 30 Qün	143	9,04 %	3 425 282	11,41 %	16 895	3,42 %	16,53
31 - 90 Qün	201	12,71 %	8 666 591	28,86 %	113 658	23,02 %	13,34
91 - 180 Qün	406	25,68 %	7 905 791	26,33 %	127 772	25,86 %	14,78
181 Qün - 1 il	455	28,78 %	4 576 163	15,24 %	183 068	37,08 %	17,67
1 - 2 il	331	20,94 %	5 226 816	17,41 %	48 579	9,84 %	15,28
2 - 3 il	37	2,34 %	207 925	0,69 %	2 630	0,53 %	16,84
3 - 5 il	7	0,44 %	1 174	0,00 %	173	0,03 %	7,80
5 İldən artıq	1	0,06 %	18 865	0,06 %	902	0,18 %	5,00

The Funds Analysis Report shows the “Concentration” of Original Term for entire bank portfolio. Note the Weighted APR field on Far Right.

Port.%	Ödən. Faiz	Port.%
100 %	493 676	100 %

2. **The Funds by Maturity Report** allows the user to select a time period or two concurrent time periods (0-30 days and/or 31-90 days) to view the deposits remaining term. This information can be viewed from the bank level down to the smallest deposit type;
3. **The Funds Flow Report** enables the user to select time frames and view deposit activity during the timeframe by Depositor Type (Source). If the user selects a particular quarter, let’s say the first quarter of 2009, the user will see the deposit balances as of the beginning of the quarter, deposits added during the quarter, withdrawals and maturities during the quarter, and finally the closing balance. All will be displayed showing the source of the funds.

A key feature of the Deposits reports is the use of Weighted Annual Percentage Rate so that the true cost of funds can be viewed as different slices of the deposits portfolio are selected by a user. All calculations are based on a deposits matrix using the Central Bank of Azerbaijan’s chart of accounts with “Deposit Types” on one axis, and “Depositor Types” (Deposit Sources) on the other. The resulting tables are easy to update and easy to maintain.

### Mugan Bank: Credit, Lending and Risk Rating Accomplishments

#### 1. Practical Analytical tools

In total 22 participants were involved in most phases of the training. At the request of Management, an evaluation of the performance of each loan officer was made and verbally reported. 5 received an outstanding report and are being ‘fast tracked’ into more responsible positions in the Bank.

#### 2. Training in Best Practices for SME Lending

As noted above, training in SME best practices encompassed the fundamentals of credit origination, analytical techniques, loan and lease structuring, alternative collateral instruments and loan/lease products, bank portfolio management, marketing, and business

planning. Case studies were employed (see Appendices) to provide practical application of techniques.

### 3. Mentoring Activity

As part of the Best Practices training, credit mentoring was carried out with identified participants in a number of branches and the Advisor sat in on Credit Committee meetings. The hands-on work with participants involved review of their analytical work to determine the extent to which best practices aspects of the training had been incorporated in previous loan recommendations and suggestions for improvement to that end where deficiencies were noted for future loan recommendations. The Advisor's participation in Credit Committees provided some special insight into the culmination of the approval process and the application of policies and procedures. 18 loan officers from Mugan's Baku branches were mentored. In fact, a particular credit (Miri Gran) surfaced in the mentoring process, and in the Advisor's opinion was possibly very problematic and was illustrative of some of the basic mistakes that can be made and was referred to in training frequently as a case study.

### 4. Term Lending and Documentation seminar

Management recognizes the value of a more disciplined approach to term lending involving better projected cash flows and incorporating financial and other covenants in loan documentation. They also accept that at the moment the EBRD procedures constitute the best level of term lending practice in Azerbaijan. Term loan training was valuable, as it introduced loan officers to new techniques and concepts that support even better practices in this area. However, as noted above, Management, and specifically Credit management, has taken no concrete steps to recognize these techniques and concepts in policies and procedures for non-EBRD or GAF funded term credits.

### 5. Credit Administration practices

Mugan Bank has to a large degree centralized its monitoring activity in an effort to make it more efficient and set-up a Credit Control Department with responsibilities for coordinating and improving Monitoring activity Bank-wide and a Loan Work Out Department. This action appears to be directly attributed to the Advisor's findings and the visibility given to them pursuant to mentoring a Loan Officer and a credit named "Miri Gran". While 'Miri Gran' exhibited the consequences of many poor credit practices, failure to monitor no doubt led importantly to the credit's problems. The Bank has also established a 'Loan Workout' department.

### 6. Risk Rating

The objective in the SOW stated for Risk Rating was "A best practices RR system will complement the NBA's classification system and profile risk in the portfolio from loan inception, and require lending officers to analyze and articulate elements of risk based on established Policy criteria. Management can monitor changes in the risk profile over time through MIS that will also provide management with a tool for problem loan 'early warning' purposes, portfolio analysis and policy changes relative to loan terms and conditions, product lines etc. The System will be linked to MIS for reporting on lending officer performance, branch performance, and bank performance at senior management levels"

Mugan Bank's Risk Rating System is robust and coupled with the MIS platform is ideal in helping the bank identify risks inherent in its lending and future leasing activities, profiling that risk, and managing that risk. The system is also supported by comprehensive policy and written procedures that for ease of reference are embedded in the MIS component of the

System. These have been approved by the Board and 5 members of the Supervisory Board have received training in its application.

During the June-July training period, several suggestions were made to improve the system. These are listed in the supplemental Risk Rating Report (see Appendices). Notwithstanding, it is up to management to follow through effectively, insure that the steps outlined to roll the System out are observed, and give Mugan Bank's Risk Management Department the support it needs to insure that the system is in use by all bank staff involved in the credit process.

### **Mugan Bank: Recommendations in Credit Policies and Procedures**

There are areas where improvements in credit and lending processes can be made and these are detailed below. Management's implementation of new Policies and Procedures is essential in any event and appropriate changes must be required of lending staff in practicing these. Subsequent to presenting and discussing the recommendations below, Mugan Bank senior management stated that many of the recommendations are already reflected in the Credit Policy but that enforcement has been the issue especially at the branch level. Internal controls are in place to ensure compliance going forward. Moreover, a follow up meeting with bank senior management by the CBT Team leader confirmed that all the FSSP credit recommendations below that are not currently reflecting in the bank's Credit Policy are to be formally incorporated and approved by the Management Board before the end 2009.

1. Virtually all loan recommendations should provide the Credit Committee with information from two balance sheets for the period under review with comparative ratios, and common sizing of the statements would also be helpful to assist loan officers to analyze risk instead of merely describing the numbers. A single balance sheet is meaningless in determining past financial condition from which future performance may be extrapolated. Also, many balance sheets do not display liabilities and do not 'balance'. The acceptance of this practice makes any good analytical work virtually impossible. The Advisor recognizes the difficulties in obtaining acceptable financial information from SMEs in many instances. However, Mugan training provided participants trainees with a number of 'tools' which, if used, can help remedy this problem.
2. EBRD funded loans require comparative balance sheets and income statements and these can be the basis for designing covenants in loan agreements such as those required in Kerem Group LLC". In fact, despite some technical omissions in analysis, Kerem is an excellent model for Mugan to follow.
3. The bank should require in all business loan proposals, as a minimum, a Profit and loss statement covering a period of at least a year. Two years would be best. The practice of showing the P&L results for the past three months and using the average of those numbers to provide a basis for measuring future debt coverage for both short and long term loans is inadequate. This approach overlooks the possibility of seasonality in cash flows as well as cyclicity over the period covering the life of the loan. Furthermore, in an inflationary environment, this approach is flawed. Even the EBRD term loan projections are mostly "straight-lined", that is, virtually the same sales and cost numbers are projected into a two to three year future without any changes in assumptions related to either anticipated performance or an inflation factor. From having examined GAF credits, it is seen that a retrospective cash budget as opposed to a prospective cash budget for the period covering the loan, is flawed for the same reason.

4. This practice, especially in the case of EBRD loans, is defended as “conservative” However, in fact, inflation can distort real projected cash flows and generate high levels of redundant cash that, if not controlled by the appropriate covenants in Loan Contracts, can result in ‘leakages’ or misuses of financial resources. The Advisor understands that the EBRD may have at its disposal some financial projection programs that forecast not only cash flows, but also income statements and balance sheets for term lending. Taken together, these can be used to design covenants to control borrower’s use of financial resources in connection with good monitoring techniques and thereby help protect Mugan Bank’s loan repayments.
5. All loan proposals should contain clear and specific statements of purpose for the use of funds. Since misuse of loan funds is generally a default covenant in loan agreements, it is legally prudent to be as precise as possible. Monitoring requirements, as relates to the purpose of a loan, should be spelled out as well in each loan proposal. In most cases monitoring will be ‘standard’ but the exceptions, where purpose of borrowing and covenants must be closely monitored, have to be spelled out.
6. Increases in loans and extensions of lines of credit need to be fully justified as to need and purpose. Too many loan proposals are vague in this regard and due to lack of analytical content (the “Big Four” analytical tool [see Attachment 1, ‘Capital is King’] used with at least two balance sheets can be useful here) it is frequently difficult to tell how a customer has used the bank’s funds. “Knowing a customer”, even one with long working experience with Mugan, is no substitute for good analysis which identifies potential risks.
7. It is a good practice, especially in larger business loans to require, at a minimum, the observance of financial ratios such as current assets to current liabilities, debt to worth, and the regular provision of financial statements. The themes in attachment 2 suggest additional ratios that can be used in conjunction with good monitoring to control risk. The case study of “Safco” (name has been changed from the actual borrower – trainees have copies of the Loan Recommendation) and the loan agreement covenants stipulated by the Apex Lender (“Black Sea Investment”) was well understood and appreciated by training participants given the identified risks; good analysis will provide the basis for good covenants.
8. In general, to the extent practicable, the above should be required in larger SME loans. Loan contracts should REQUIRE periodic submission of financial information, not merely indicate that the bank CAN ask for this information. In practice, the request rarely seems to be made.
9. The Advisor would suggest that the Credit Committee receive hard copy recommendations 2 -3days before Committee presentations are made to give each member an opportunity to review, digest, and formulate questions. Once the initial logistics of this practice are overcome, the process is fairly easy.
10. The practice of having Loan Officers make verbal presentations to the Committee for loan proposals is very good. However it appears that some considerable time is lost by having Loan Officers physically deliver Loan recommendation packages to the Credit Officer. Soft copies should suffice, hard copies can be made.

11. All credit issues should be dealt with at the Committee level and communicated to Loan Officers and Branches to preserve transparency of process and avoid “hidden policies”. This should be done on a timely basis.
12. As a matter of Policy and Procedure improved Monitoring standards should be given top priority by Management. Collection of loans begins at disbursement. Banking is the business of managing risk and early identification of potential problem loans will enable the bank to possibly reduce the loss potential and therefore reduce the provision for loan losses. Use of Risk Ratings as a monitoring tool will move Mugan from looking only at past dues to detect problems to the continuing review of the financial condition and valuation of the collateral, quality and performance of management, etc. Monitoring of compliance with Loan Agreement covenants will also detect early on problems. Covenant violations are triggers for defaults and can be used judiciously as controls for borrower performance.
13. Early detection of problem loans allows the bank to act before assets of the borrower disappear or lose additional value. Remedial action taken to correct collateral deficiencies or financial deterioration of the borrower will allow the bank to assist the borrower and reduce the ultimate cost to the bank. Early establishment of a plan of action for the bank and borrower may strengthen the loyalty to the bank by the borrower.
14. Repayment structuring can be improved. A loan officer should recognize as part of his/her analysis that short-term loans are normally repaid from asset conversion during the ‘cash to cash cycle’ of the business. The analysis should focus on turnover of working assets on a period-comparison basis. Seasonality factors MUST be taken into consideration.
15. On the other hand long term loans are repaid from revenues generated from the assets purchased, i.e. machinery and other fixed assets, and the financial projections should focus on repayment capacity based on the incremental revenues from the investment to measure debt repayment. The repayment schedule must conform to projected cash flow availability.
16. Each loan recommendation should also focus on documentation. If special covenants are required, financial documentation required, etc. these should be highlighted, as is the case in EBRD loans.
17. It is vital that if other banks have loans to a Mugan Bank borrower, that a copy of the loan agreement from that bank be reviewed. Other bank loan repayment schedules must be incorporated in Mugan Bank cash budgets and financial projections to measure TOTAL debt repayment capacity. Another bank’s loan agreement should also be reviewed to ascertain that it gives no priority repayment rights over Mugan Bank’s loan.
18. Prolongations/Restructurings – Unless there is a prior agreement in a loan contract to prolong payments, approval of prolongations or extensions of maturities should observe the following CBA ‘Watch Asset’ classification -“prolongation of the loan should not be due to deterioration in the obligor's financial position. To this end the bank should keep financial statements to confirm the obligor's sound financial position”.

Prolongations should not therefore be ‘automatic’. Prolongation requests are most frequently indications of greater problems and there should be an analysis of the reasons for the request, in writing, presented to the Credit Committee. Monitoring of prolonged credits should be stepped up.

19. Experience suggests that many prolonged loans become candidates for restructuring and perhaps should have been restructured in the first instance instead of merely prolonged. CBA regulations should be observed in the case of all restructured loans.
20. Above all, as soon as a true ‘problem loan’ is identified, a Plan of Action must be drawn up and the person who will implement the plan identified. The Plan will become the basis for Mugan’s follow up procedures based on a fresh analysis, new cash budgets or new cash projections and monitoring must be enhanced.
21. Loan Agreement Closings - Besides merely signing of loan contracts, the purpose of the “Closing”, (as indicated in the Lending Procedure in Attachment 3) is to insure that all parties understand the important elements of the Loan Agreement Contract. The Closing should therefore serve to review all key points of the Contract, which will highlight the terms and conditions of the loan. In many cases, borrowers are negligent and do not read carefully the Loan Agreement. The Closing process serves to remedy this and perhaps prevent future misunderstandings.

#### **Mugan Bank: Quantitative Lending Results**

Due largely to the International credit and economic crisis, as previously noted most banks in Azerbaijan sharply curtailed new loan growth as early as October of 2008 and Mugan Bank was no exception. As a result, credit volumes of SME loans outstanding bank-wide reached 30,320,000 AZN by end August 2009 which reflects a 10% decline y-o-y. PaR < 90 days for the bank’s SME portfolio reached .77% from .28% a year earlier but well within the 4% threshold. The obvious credit problems were largely a consequence of torrid loan growth experienced in 2007-2008 and it will be some time before meaningful data about portfolio that can be correlated with the TA provided will be available however initial indications are positive whereby credits disbursed applying improved procedures introduced via FSSP are estimated to amount to 3.5 million AZN with non-performing loans < 90days comprising less than 1%.

#### **Mugan Bank: Marketing and Deposit Mobilization Accomplishments**

1. Advisor prepared several papers for previous and current Marketing Directors, as well as for current CEO. Pertinent to this question were recommendations on what data to track in the marketing portion of the Bank’s Customer Relationship Management system, how to analyze consumer desires and trends from the current Bank data base, and how to create, administer, and interpret consumer research surveys.
2. Bank has been advised by Advisor of an enhanced way to administer early withdrawal penalties. These are currently being held in abeyance as Bank is no longer in need of deposits – consumer assets are the immediate concern.

The focus and direction of TA for Mugan Bank changed several times during the contract year. The Advisor spent much time analyzing and presenting the Bank CEO with recommendations on advertising positioning, leveraging the headquarters location, and the like; along with a critique of the consumer loan function and tactics for increasing loan

volume. Bank and USAID agreed that success at Mugan Bank would be measured more by the quality of recommendations than anything else. Some of the key recommendations and analyses follow:

1. Retail promotion tactics for the new HQ, deposit recommendations, and advertising positioning analyses and recommendations were created and submitted to bank senior management;
2. The Advisor also submitted 9 consumer loan recommendations;
3. The Advisor created a product description/plan for a new loan product, as well as a detailed launch plan that the bank can implement when it feels the timing is right;
4. Based on recommendations made by the Advisor, the Bank has revamped its web site into one of the most comprehensive in the Baku banking community;
5. Data mining recommendations were submitted by the Advisor;

Additional analyses and recommendations not explicitly outlined in the original work plan but subsequently requested by the bank are listed below and are included in the Appendices of this report.

1. CRM Recommendations
2. Market Foci Recommendations
3. Deposit Vehicle Recommendations
4. Strategic Plan Review
5. Deposit Positioning
6. Retail Strategy
7. Loan Generation Ideas
8. Advertising Positioning
9. Consumer loan analysis

### **Mugan Bank: Risk Management Accomplishments**

The Risk Management Department was established in response to the CBA's requirement and the CRO has a credit background. There are four people in the Department, two of which are charged with loan verifications. The CRO attended less than half the TA sessions and reportedly confessed to another FSSP Advisor that he does not want to be the CRO. The Risk Management Department is not perceived as important and is not afforded the level of authority for access to information in the bank, a necessary ingredient for any basic risk management oversight.

Technical assistance activities included training and development of risk measurement tools, including the following accomplishments:

1. Developed a credit stress test model for submission to CBA;
2. Provided training in general Risk Management principles;
3. Provided training in Liquidity Risk Management, including providing a deposit modeling tool,<sup>3</sup> and sample reports<sup>4</sup>;
4. Provided basic training in interest rate risk and FX risk, including risk measurement tools;
5. Analyzed Peer Group performance through May and June 2009;

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<sup>3</sup> Note that limited data was used, but the model can be expanded easily for longer-term data.

<sup>4</sup> RM was supposed to fill out reports for analysis but did not provide.

6. Drafted Supervisory Board/Management Board presentation to provide overview of risk management principles, risk positions at Mugan Bank, and recommendations to institutionalize risk management, including:
  - a. Establish risk tolerance level in terms of earnings and economic capital at risk
  - b. Establish branch profitability model, including centralizing funding and transfer pricing of funds and administrative costs, to monitor risk-adjusted performance of branches. Capital to be allocated based on Basel risk weights for assets or 12%.
  - c. Develop incentive system to support risk strategy
  - d. Develop risk limits for credit, liquidity, interest rate risk and FX risk.
  - e. Institutionalize risk management in decision-making process as business partner of line units

The TA sessions that were to be used to rehearse the Presentation to be given by the CRO to the Chairman of the Management Board as well as the planned presentation were cancelled due to other activities. In his stead, the Advisor met with the Chairman and delivered a presentation that reviews the results of the Risk Management TA and her impression that the function is not important to Mugan Bank. The “Risk Management Technical Assistance Review” for Mugan Bank includes the draft Supervisory Board presentation and can be found in the Appendices.<sup>5</sup>

#### **NBC Bank: MIS Accomplishments**

The Credit MIS Reports were fully implemented in NBC Bank in January 2009 and include the following core reports:

1. **The Loan Summary Report** can be viewed by Branch, or Home Office, All Branches or All (representing the total portfolio). Reports can be viewed by Currency, although all currencies are converted to the local currency for consistency (Manat). Loans can also be accessed by Loan category;
2. **The Loan Payment Issues Report** provides a few of late payments in time segments (0-10 days, 11-30 days, 31-90 days, etc. This report also shows payments that are coming due so it shows the user the future as well as the past;
3. **The Portfolio Analysis Report** shows the entire portfolio by concentration e.g. by interest rate, by branch, by largest customers, by region, etc., with slight variances based on the perceived needs of the users. The portfolio can effectively be divided into more than 1000 slices depending on the criteria selected;
4. **The Pipeline Report** tracks loan applications online as they proceed through loan stages from Application to Funds Disbursement. A Pipeline Procedure was also developed, training provided and distributed.

The MIS Director and leading force behind the development of all MIS activities at NBC Bank resigned during the development period of Deposits MIS. The actual development of the reports has been completed, however the debugging of the reports was incomplete and the MIS Director’s replacement received no transition training. The Advisor used the time

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<sup>5</sup> Note that the draft Supervisory Board presentation will include the Mugan-specific information reported separately in the Mugan Bank Review of Risk Management Technical Assistance.”

available to define the coding errors that needed to be fixed, and to familiarize the newly appointed MIS Director in the use of both the Loan MIS and the Deposits MIS reports.

However, unfortunately there was no time remaining to complete training for the branches and to ensure this module is fully completed and implemented. Just before the Advisor's departure in mid July 2009, all reporting bugs had been identified and provided to the developer and the bank's Head of MIS had reviewed the system in detail and agreed to check corrections himself and bank management agreed to identify an appropriate individual to conduct training. The FSSP Team Leader conducted a close out meeting with bank management on September 25 and received an update that the necessary coding was completed by the developer, checked by the MIS Department and training in the Deposits MIS was completed by the MIS Department in late July 2009. As a result, the Deposits MIS Reports are now fully implemented in NBC Bank and include the following three major reports:

1. **The Funds Analysis Report** displays all deposits by Branch, by Currency, by Deposit type, and/or by Concentration. The output display of the report changes based on the criteria selected by the user. Deposits can be viewed from Original term as well as Remaining term;
2. **The Funds by Maturity Report** allows the user to select a time period or two concurrent time periods (0-30 days and/or 31-90 days) to view the deposits remaining term. This information can be viewed from the bank level down to the smallest deposit type;
3. **The Funds Flow Report** enables the user to select time frames and view deposit activity during the timeframe by Depositor Type (Source). If the user selects a particular quarter, let's say the first quarter of 2009, the user will see the deposit balances as of the beginning of the quarter, deposits added during the quarter, withdrawals and maturities during the quarter, and finally the closing balance. All will be displayed showing the source of the funds.

### **NBC Bank: Credit and Lending Accomplishments**

As a result of the credit crises in late 2008, NBC Bank also cut back sharply on new lending activity and Credit Committees seemed to be looking at requests for loan maturity extensions and in some cases restructures as borrowers seemed to be feeling the pinch as well. Indeed, NBC Bank suspended business lending in late October 2008 and picked up again in early 2009 only to suspend lending again in June largely due to a major fraud in several key branches. As a result, several Branch Managers were replaced as were nearly half of the loan officers. Subsequently, the bank hired 5 new loan officers, provided both classroom and on-the-job training with assistance of the Advisors. Moreover, improved Business loan procedures were introduced and business lending was reactivated in mid September 2009. This above event notwithstanding, all the work plan tasks were accomplished as follows:

### **Skills Audit/Incentive Schemes**

1. Conducted a skills audit of existing credit and customer care staff and was used as a Training Needs Assessments;
2. Developed clearly defined roles and job descriptions for Loan Officers, including key performance indicators, division of responsibilities and administrative activities;
3. Reviewed bank's existing bank-wide motivation/incentive programs and provide recommendations for improvements according to Best Practices focusing on the following:

- a. Reviewed the existing monetary and non-monetary incentives schemes in order to ascertain the bank's current incentive programs and to ensure uniformity to current HR systems in place;
- b. Conducted a series of interviews/discussions with the relevant HR staff/senior management in order to ascertain the bank's planned or expected incentive strategies, determine the expected scope and scale of said incentive programs and explore opportunities and/or applicability to expand both monetary and non-monetary incentives to include a broader range of bank staff including back office personnel;
- c. Developed written recommendations that provide an assessment of the effectiveness of existing incentive strategies, recommendations for modifications/enhancements, as well as concrete recommendations and specific guidance on how to expand the scope of existing monetary and/or nonmonetary incentive strategies to encompass all bank employees.

### **Financial Intermediation and Sales Skills**

4. Revised SME Credit Procedures with a new loan monitoring procedure was approved and implemented in all branches;
5. Developed and conducted a training program reflecting Best practices for SME lending: emphasis on determining ability to repay by cash-flow analysis and character assessment of applicant;
6. The development of a seminar course to strengthen the sales skills of the existing Loan officers and Customer Service Personnel was conducted by the bank itself and therefore the work plan was re-aligned at the request of the bank and approval of USAID to allocate this time to Loan Officer Mentoring activities;
7. Developed and conducted an interactive workshop designed to help loan officers watch over and control credit exposure to individual borrowers. Emphasis was on detecting early warning signs of trouble and then initiating prompt remedial action through persuasion, negotiation or assertiveness;
8. A Business Loan Officer Performance based pay scheme was approved;
9. Provided extensive (25 full days) Loan Officer Mentoring for all seven bank branches in both credit analysis and loan monitoring.

### **Other Accomplishments**

1. A set of standard skills was produced and included in job descriptions for loan officers and customer care staff;
2. Written Job descriptions were developed for loan officers with key performance expectations;
3. An employee incentive program was benchmarked against Best Practice in order to improve existing employee incentive and motivation system;
4. All 7 bank credit staff attained skills and demonstrated competence in cash-flow based/character lending and advanced credit analysis topics including: working capital financing, ratio and trend analysis, cash flow statements/cash budgets, understanding the interdependence of Financial Statements;
5. All 7 Loan Officers have attained and demonstrated skills focusing on the following areas: Relationship Management, Targeting Clients, Identifying Needs/Purpose of loan, Interview Skills;
6. All 7 Loan Officers have developed and demonstrated skill in loan monitoring and control: Compliance to loan covenants, how to determine early warning signs of financial distress, remedial actions;

7. The bank's SME portfolio quality reached 7.8% PaR <90days as of end September 2009 from a high of 16% as of end QIV 2008. A major revision and improvement to loan underwriting standards as well as improved loan monitoring procedures have been instrumental in improving SME portfolio quality in an environment where new SME lending was suspended. SME portfolio PaR > 90 days reached 22% as of end September 2009 from a high 37.8% at the end of QII, 2009;
8. At least 7 loan officers at the branch level (both in Baku and Ganja Branch) have developed and demonstrated skills to include conducting effective client interviews, business site visits, credit analysis, loan structuring, and credit presentations to credit committee.

At the onset of the Project in September 2008, NBC Bank's outstanding MSME portfolio amounted to 947 thousand AZN with credit growth declining over the next two quarters falling to an outstanding balance of 772 thousand as of end September 2009 reflecting a 23% decrease y-o-y. The decline is largely attributed to the suspension of lending activities in beginning early October 2008 and continuing into mid 2009 due to both external (crisis) and internal (fraud) issues affecting the bank. The bank's SME portfolio also experienced a significant deterioration in quality over the same period whereby non-performing loans < 90days reached 7.8% as of end August 2009 from a level of 5.4% a year earlier and >90 days swelled to 22% from a low of .68% in June 2008. As a result, a major focus of Project assistance for NBC Bank was directed toward improving loan monitoring and recovery efforts. A revised Credit Monitoring Procedure was developed and approved and a Loan Monitoring Course was conducted in April 2009 and followed up with intensive individual coaching of loan officers at the branch level. It should be noted that since the implementation of revised loan monitoring procedures and strengthening training efforts, loan delinquency rates are improving, e.g. PaR < 90days fell to 7.8% from 16% at the end of 2008 and PaR > 90 days, although still very high at 22%, has improved from a high of 37.8% at the end of June 2009. This demonstrates the effectiveness of the procedural changes and training efforts in light of a suspension in any new lending activity. In addition, the introduction of improved Business Loan underwriting practices by FSSP has shown that lending to the SME segment can be done successfully given that the nearly 300 thousand in new SME loans done since September 2008 applying improved loan underwriting procedures has a non-performance rate < 90days of 2.3%.

The credit technology introduced by the Advisors provides for *rigorous credit monitoring and recovery procedures* in the case of arrears. As soon as it is clear that a given borrower has missed a payment, "his" loan officer contacts him. This quick response to arrears problems underscores the seriousness of the bank's commitment to recovering the loan and enables it to minimize defaults and delinquencies due to a simple unwillingness to repay. If a borrower nonetheless falls into arrears without being able to provide a satisfactory explanation for his failure to meet his obligations, and does not settle his accounts even after receiving two reminders, legal proceedings are initiated once the payment has become more than 30 days overdue. If, on the other hand, a client who is in arrears can demonstrate that he has not been able to meet his payment obligations for reasons which are truly beyond his control, the loan officer can confer with him and devise a solution to the problem which is then submitted to the credit committee for its approval. By taking this approach to credit monitoring, NBC Bank is able to efficiently offset the increased risk which it incurs in its small and micro lending operations by accepting items as collateral whose resale value would be less than the credit amount.

The components of the credit technology which are designed to minimize default and the "moral hazard" problem would fail to have their desired effect if they were not backed up by control and organizational structures which ensure incentive-compatible implementation. In contrast to the way in which most banks organize their lending activities - which involves a separation between the credit analysis and extension process on the one hand and monitoring and recovery operations on the other - an institution utilizing the individual-based credit technology will make a single loan officer responsible for the entire loan-granting process as well as its relationship with the client after disbursement of the funds. Thus, the officer develops a quasi-personal relationship with his borrowers, which gives him access to significantly more information about them and their businesses.

Two factors serve to minimize the risk that the credit analysis will therefore be overly subjective: first, a credit analysis form is used which is largely standardized, and this helps to make the data obtained more objective; and second, the decision as to whether or not a given loan application will be approved is taken by a credit committee. The loan officer has to present - and justify - to this committee the data he has collected as well as his credit analysis and recommendation for or against approval. If he feels at a later stage that it has become necessary to amend the terms of the loan, or defer repayment or remit a debt altogether, he again has to justify his proposals before the committee. In other words, his work is constantly monitored by the institution.

The effectiveness of this internal control structure can be enhanced by introducing an incentive-compatible, *i.e.* performance-based, pay scale for the lending staff. If a significant percentage (say, 50%) of a loan officer's salary is calculated using criteria which include the delinquency and default rate of "his" clients, then this will further reduce the risk of loans being granted on the basis of staff members' personal wishes or preferences rather than solid economic considerations.

#### **NBC Bank: Human Resources/Incentives**

The HR Advisor met with senior NBC staff several times, and then presented an overview of team rewards, with long and short-term recommendations for back office staff, and suggestions for non-monetary rewards. NBC has approximately 124 employees. There are 24 loan officers (for whom an incentive scheme has been designed), with 60 employees identified as back office staff.

At the request of NBC, the HR Advisor provided a job description template adapted from the loan office job description developed by the Credit and Lending Advisor, which did include specific targets. The HR Advisor also provided additional job description templates for marketing, HR, and treasury positions.

#### **NBC Bank: Marketing and Deposit Mobilization**

1. Based on knowledge of Azerbaijan market and Bank's stated objectives and abilities, Advisor identified ideal and potential target markets in October 2008;
2. Marketing Director, Research Manager, and department assistant were trained in survey design, methodology, and analysis. An extensive survey was initiated in October and November 2008 – a large image and bank usage survey of Baku consumers. Analysis was done on both by Advisor, and presented to Bank, in January 2009. A further in-house customer survey, aimed towards finding out what media best attract customers, is still underway during the current (September 2009) deposit campaign;

3. NBC is unique in that the high level of non-repayments in its auto loan portfolio has caused a liquidity crunch. Therefore, it can almost be said that the cost of deposits is irrelevant – it is more important just to keep them coming in. Based on the survey and the Bank’s funding needs, a new deposit vehicle was created with high rates and a back-end bonus to incent term deposits to remain as contracted. The Marketing Director also developed a clever promotional campaign based on James Bond – the 007 Campaign.
4. YTD through 25 September, term deposits had increased from approx. 3.25 million AZN to 3.61 million, or approximately 11%. The new deposit launched on July 1, with a stated goal of attracting 600,000 AZN in net new money by EOY has in fact already attracted more than 1,000,000 AZN net in the first three months which is a 30% growth rate y-o-y and it appears the bank is well on track to grow term deposit volumes by more than 50% with the success of this new deposit product which is now being replicated by several other banks.

“007” Deposit Product Features:

1. Up to 20.5% annual interest;
  2. Ability to replenish the account depending on the amount of replenishment, the deposit interest rate can increase by 2% or 4%;
  3. Ability to reduce the amount of contribution without reducing percent on the deposit;
  4. Ability to receive an interest-free demand line of credit for 35 days;
  5. Issuance of a free plastic card;
  6. Free travel insurance;
  7. Free Medical insurance
  8. Possibility to receive numerous gifts
  9. Ability to transfer account ownership to a third party
5. See #3 above.
  6. In conjunction with the 007 campaign, the Marketing Department of NBC introduced an internal incentive in lieu of extensive advertising. Components of the internal incentive include awards in December (NBC’s 17<sup>th</sup> anniversary) to the top selling branch and individual, in both accounts and Manat categories. A new weekly newsletter is sent out highlighting success stories in the campaign. Also, the department has instituted an Employee of the Month award for the associate who sells the most 007 deposits. The success of the campaign speaks well to these creative approaches, and this is the first time that NBC has actively sought customers instead of waiting for business to walk in the door.
  7. An associate in Marketing has been instrumental in changing the Bank’s web site so it can be used as a sales tool and prompter. He and the Director have also created a series of monthly seminars for all contact personnel, focusing on sales skills, financial “counseling”, product knowledge, and the like. These are expected to continue and expand even after the campaign ends.

### **NBC Bank: Risk Management Accomplishments**

The Risk Management Department is essentially a one-man department reporting to a Deputy Chairman who also has responsibility for Finance and Treasury. The Credit Committee (CC) makes all commercial loan decisions and the Supervisory Board makes all pricing decisions.

The branches essentially compete with each other, which the bank thinks “should improve credit decisions.” There are no profit centers and the CRO thought that it is “unfair” to allocate HQ costs to the branches since it would affect their profitability. There is no centralized Treasury function; all branches fund themselves as they can and borrow (lend) difference from (to) HQ. All expenses are centrally “paid” from HQ.

The CRO sits on ALCO and CC and has veto power, both of which can undermine his independence. The CRO produces Risk Reports that monitor seven risks (Interest rate; currency; liquidity; credit (level of diversification measured as % car loans in portfolio and repayment risk as % loans overdue more than 30 days); operational; technology; strategic; and legal. None of the criteria are associated with any level of income volatility measurement other than the strategic risk that compares “actual income/planned income.”

The focus on the TA was on general training in integrated risk management principles and the use of risk-adjusted profitability performance measurement to ensure shareholder value added. A RAROC model was developed for Branch profitability to highlight differences that should inform strategic decisions.

Other accomplishments include the following:

1. Developed Value at Risk measurement tool for measuring FX risk;
2. Analyzed Peer Group performance through May and June;
3. Introduced concepts of Expected Loss; Unexpected Loss; differences in capital definitions; how to allocate capital for risk adjusted performance evaluation and how to translate operational and market risks into risk-weighted assets for capital adequacy purposes;
4. Drafted Supervisory Board/Management Board presentation to provide overview of risk management principles, risk positions at NBC, and recommendations to institutionalize risk management:
  - a. Establish risk tolerance level in terms of earnings and economic capital at risk
  - b. Develop risk policies and limits for liquidity, interest rate and FX risks
  - c. Establish branches as profit centers and refine branch profitability model to monitor performance and eliminate competition among branches
  - d. Institutionalize risk management in decision-making process as business partner of line units
5. The presentation outline was provided to the CRO and he added the information on current risk positions and what NBC needs to do to obtain a higher international credit rating and thereby be able to attract foreign investors. The presentation was delivered to two members of the Management Board on August 27 and included recommendations made for improvements in risk management. See Appendices for the “Risk Management for NBC Management Board” presentation.

### **Royal Bank: MIS Accomplishments**

The Credit MIS Reports were fully implemented in Royal Bank in February 2009 and include the following core reports:

1. **The Loan Summary Report** can be viewed by Branch, or Home Office, All Branches or All (representing the total portfolio). Reports can be viewed by Currency,

although all currencies are converted to the local currency for consistency (Manat). Loans can also be accessed by Loan category;

2. **The Loan Payment Issues Report** provides a few of late payments in time segments (0-10 days, 11-30 days, 31-90 days, etc. This report also shows payments that are coming due so it shows the user the future as well as the past;
3. **The Portfolio Analysis Report** (see screen shot below) shows the entire portfolio by concentration e.g. by interest rate, by branch, by largest customers, by region, etc., with slight variances based on the perceived needs of the users. The portfolio can effectively be divided into more than 1000 slices depending on the criteria selected;

ROYAL BANK MIS Loan Reports USAID

Portfolio Analysis Summary Report

Concentration: Sector Branch: BAŞ OFIS CCY: All Portfolio Status: All

Loans Outstanding Summary:  
 No. Loans: 4 875 Total Amt.: 25 215 851  
 Weighted Avg. APR%: 19.54 Date: 16-02-2009

Display	No. loans	Port%	Total Bal. Due	Port%	Fcst%	%As
1. Agriculture	1	0.02	101 057	0.40		
2. Consumer	4 365	89.33	21 267 176	84.34		
4. Energy, Chem, Nat Resource	441	9.05	1 178 944	4.68		
5. Industry	3	0.06	178 148	0.71		
6. Trade & Services	12	0.25	1 332 498	5.28		
7. Transport & Comm.	3	0.06	966 825	3.79		
8. Other	60	1.23	201 203	0.80		
	4 875	100	25 215 851	100		

Execute Back

4. **The Pipeline Report** tracks loan applications online as they proceed through loan stages from Application to Funds Disbursement. A Pipeline Procedure was also developed, training provided and distributed.

All Deposits Reports coding bugs within the software were corrected and verified, 35 bank staff was trained in Deposit MIS use and functionality. The Deposits MIS Reports are fully implemented in Royal Bank and include the following three major reports:

1. **The Funds Analysis Report** displays all deposits by Branch, by Currency, by Deposit type, and/or by Concentration. The output display of the report changes based on the criteria selected by the user. Deposits can be viewed from Original term as well as Remaining term;
2. **The Funds by Maturity Report** allows the user to select a time period or two concurrent time periods (0-30 days and/or 31-90 days) to view the deposits remaining term. This information can be viewed from the bank level down to the smallest deposit type;
3. **The Funds Flow Report** enables the user to select time frames and view deposit activity during the timeframe by Depositor Type (Source). If the user selects a particular quarter, let's say the first quarter of 2009, the user will see the deposit balances as of the beginning of the quarter, deposits added during the quarter, withdrawals and maturities during the quarter, and finally the closing balance. All will be displayed showing the source of the funds.

A key feature of the Deposits reports is the use of Weighted Annual Percentage Rate so that the true cost of funds can be viewed as different slices of the deposits portfolio are selected by a user. All calculations are based on a deposits matrix using the Central Bank of Azerbaijan's chart of accounts with "Deposit Types" on one axis, and "Depositor Types" (Deposit Sources) on the other. The resulting tables are easy to update and easy to maintain.

### **Royal Bank: Credit and Lending Accomplishments**

The Pilot SME Lending Program launched in the Home Office in mid May 2009 concluded in mid September 2009. Four branches were included in the Pilot: Home Office, Branch #7 Baku, Lerik and the Ganja Branch. Two Loan Officers were selected to participate in the HO and 1 LO each in the 3 other branches. All five of the Loan Officers have made significant progress and continue in their capacity as Loan Officers. The purpose of the pilot program was to introduce, test and evaluate the following:

1. Introduce a "Best Practice" SME 'credit technology' applying new credit procedures and methodologies;
2. Streamlined Micro and SME loan documentation;
3. To achieve a consistent and accurate analysis of business loan applicants;
4. Increase outreach of bank in SME lending to those customers that are currently declined or not considered because of lack of sufficient financial data;
5. Reduce default risk by correctly assessing the ability of the customer to repay the loan;

In addition, the following key objectives per work plan were achieved in Royal Bank:

1. Developed and conducted a training program reflecting Best practices for SME lending: emphasis was on determining ability to repay by cash-flow analysis and character assessment of applicant: 23 Loan Officers participated;
2. Significantly improved the process of financial analysis that is based on analysis of the borrower's financial performance, e.g. cash-flow, industry, norms, etc;
3. Developed and conducted an interactive workshop designed to help loan officers watch over and control credit exposure to individual borrowers. Emphasis was on detecting early warning signs of trouble and then initiating prompt remedial action through persuasion, negotiation or assertiveness: 18 Loan Officers participated;
4. Daily Loan Officer Coaching and Mentoring;
5. An SME Policy Manual and Procedures were developed and implemented;
6. Credit Handbook reflecting Best Practice in SME Lending developed as addendum to Procedures Manual;
7. New SME Loan Application Form, Credit Memorandum, Site Visit Questionnaire Form were developed and implemented;
8. 23 credit staff in 20 branches were trained in cash-flow based/character lending and advanced credit analysis topics including: working Capital Financing, Ratio and Trend Analysis, Cash Flow Statements, and Interdependence of Financial Statements;
9. Five loan officers have developed and demonstrated skills conducting effective client interviews, business site visits, credit analysis, loan structuring, and credit presentations to credit committee.
10. Credit volumes of new SME/Micro loans outstanding grew to reach 233,600 AZN via 39 loans by end September 2009. 12 loans for AZN 42,000 were disbursed in the Lerik Branch and the remaining out of the Home Office. This growth is expected to continue and stabilize at 20-25% per month through the remainder of 2009 as several new branches

are activated. All loans are currently performing with no incidences of late payments beyond 30 days.

### **Royal Bank: Marketing and Deposit Mobilization Accomplishments**

1. Advisor reached agreement with Royal Bank personnel and CEO to allocate marketing duties among three identified associates to ensure that ongoing updates do not fall through the cracks. Bank CEO, however, has declined to authorize a specific expenditure for 2010, preferring to see how the current financial crisis evolves first.
2. Head of International Relations was trained in survey design, methodology, and analysis. A large survey was initiated in February 2009, focusing on bank image and product usage. Unlike other banks, this survey was deliberately selective among wealthier areas of Baku, leading to somewhat different results. Analysis was done on both by Advisor, and presented to Bank, in March 2009.
3. In a multi-month effort, the entire retail term deposit lineup was revamped with attractive benefits, and renamed under the “Royal” umbrella. While finished since June, approval to implement the changes was not obtained by Advisor from CEO until 11 September.
4. Term Deposits at Royal Bank have grown significantly the first two quarters of 2009 after a decline in late 2008 as panic hit the banking sector and many consumers withdrew their savings due to the uncertain economic environment. Term deposit volumes fell to 20.2 million AZN in the fourth quarter of 2008 from a high of 37.7 million the previous quarter. From December 2008 to end March 2009 term deposit levels recovered and grew over 275% to reach 55.7 million AZN and then grew another 17.5% over the next quarter to reach 65.4 million AZN as of end June 2009. This represents overall growth in term deposits of over 100% y-o-y ending June 2009.
5. Five Deposit products were re-branded along a “Royal” theme and re-launched in July, specific product features outlined below;

#### **Royal Family Account**

Ideal for couples – both people can use the account  
Low minimum deposit of 500 AZN/USD/EUR  
Customer selects the term of 12, 24, or 36 months  
Interest is credited to the account monthly  
FREE credit card for up to 70% of your deposit

#### **Royal Prince/Princess Account**

Ideal for building a college or other fund for children  
Minimum term of 36 months helps you meet long-term savings goals  
Minimum deposit of only 200 AZN/USD/EUR  
Annual interest is capitalized  
FREE GIFT for account owner’s child on each birthday

#### **Royal Treasury Account**

The most flexible account option – unlimited deposits and withdrawals  
No set deposit term  
Minimum balance of only 200 AZN/USD/EUR

Monthly interest

### **Royal Standard Account**

The typical time deposit account to meet most long-term needs

You select the term from 9 – 24 months

Low minimum balance of 200 AZN/USD/EUR

FREE credit card if the balance is at least 5.000 AZN/USD

### **Royal Crown Account**

For premium customers who deserve extra care and service

Deposit term of 12 months

Free Visa Gold card up to 70% of the deposit amount

Interest paid monthly

Premium rates starting with deposits of 30.000 AZN/USD/EUR

Private area from which to conduct banking business

6. The English version of the bank's web site has been completely rewritten by the Advisor and is live as of 15 July. This will be used as the basis for Bank to translate into Azeri and Russian, and is the core of the bank's planned electronics-based promo effort going forward. IT deputy is now tracking site performance and SEO with Google Analytics monthly for use in key word positioning and possible purchase;
7. All English versions of deposit brochures and deposit contracts have been rewritten by Advisor;

### **Royal Bank: Risk Management Accomplishments**

The RM Department has been essentially a workout department and the TA "opened the bank's eyes"<sup>6</sup> in terms of what international best practice in risk management is. Although general risk management training was provided to Royal Bank staff during the May trip, most of the TA was focused on advising Mr. Jam on general bank management practices and developing a branch profitability model for him to manage the autonomous branches. His objective was to educate himself and key staff (Internal Auditor and Chief Accountant) in risk management before it was "rolled out" to bank personnel in general.

Primary accomplishments include the following:

1. Risk Management training delivered to 20 staff
2. Branch profitability model developed for risk-adjusted performance monitoring
3. Provided examples of allocation of capital and calculation of Shareholder Value Added (SVA) for pricing and performance monitoring
4. Meeting with USAID's CTO and Chairman of Bankworld Inc. to review results of TA

There is no planned presentation to the Supervisory Board or Management Board given the direct involvement with the Chairmen, Mr. Jam. The new Chairman has also been involved in previous risk management TA sessions and training, and understands the proper role of risk management. The branch profitability model has been further refined to allocate different expenses depending on the type of expense and indirect overhead expenses have been allocated to risk-taking (income generating) units of HQ.

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<sup>6</sup> Remarks of Ali Jam, Chairman and majority shareholder.

A Risk Management Policy template was provided Royal for their use in developing their own policies. It has also been recommended that a hurdle rate should be established.

## **7. INVESTMENT FUNDS AND SECOND TIER SME LOAN FINANCING**

### **Broad Goal**

A significant improvement in the design and operation of major Government of Azerbaijan-supported equity investment and second-tier SME loan financing vehicles from an efficiency and sustainability perspective.

### **Accomplishments:**

The advisor achieved the objectives and, in fact, provided more assistance than in the original scope of work to ensure that AIC was well set to reach its stated mission. Therefore, no further activity was planned in this track beyond the first project year. Tasks and achievements for this component are as follows:

- Reviewed the indicated materials and met with ABTC; reviewed a first draft proposal for the work. Based on AIC feedback and further discussion, a revised proposal was approved and ABTC was engaged by Bankworld. Work commenced on July 3. The Advisor held several more meetings with ABTC and shared information about AIC's organizational structure and business practices. The advisor reviewed ABTC's Interim Report and Completion Report, and assisted with English language and other edits prior to finalization. The report was submitted and the task completed.
- Reviewed manual template for Ministry of Economic Development for public investment projects. A draft manual for AIC was completed and circulated among AIC's Executive Management, Analytical Department, and the Director of Investor Relations. Feedback was positive. The Executive Director was very enthusiastic and decided to have the manual translated into Azerbaijani. This advisor also met with members of AIC's subfund CIIC (Caspian International Investment Company–JV with the Islamic Development Bank), and they expressed strong interest to be given a copy for their use. The manual contains sample reports and analytical templates.
- The advisor completed the Procedures Manual for Investment for AIC. The chapters in the manual were: Investment Procedures, Elements of Investment Analysis and Due Diligence, Other Considerations Relevant to Making Investments, and Procedures for Investment Monitoring and reporting. Annexes to the manual provided checklists, models, and calculators among other information. The manual was provided to AIC.
- Received the 2007 and 2008 budgets from management and initial work done for preparing projections for business plan. However, because of change in priorities, the advisor was requested to help develop strategy alternatives and on governance matters in collaboration with the TIRS Project, and in agreement with USAID and AIC management.
- The advisor and the TIRS Project advisor submitted a Strategic Options document. The document included the following: Classification of AIC Activities, Decision Criteria, Application of Decision Criteria, and Examples.

- Delivered a well-received presentation to the staff, per email received from Head of Investor Relations Department.
- Received and reviewed a business plan for an iron & steel works facility sponsored by a British based firm. When in the process of requesting additional information, that firm decided to change its proposal and pursue an investment in an aluminum production facility rather than iron & steel. The advisor prepared three valuation templates and turned them over to the analysts in the analytical department. Their use was discussed, and was applied at an appropriate time for each deal. This advisor also reviewed and commented on IRR calculation for the revised investment terms of salt production facility for which an AIC investment has already closed.
- The advisor, along with support from the TIRSP (another USAID project in Baku) advisor, created a Weekly Deals List and populated it with live data on all deals, both present and past that have been subject to AIC review. This list was intended to be updated weekly and be distributed internally to all relevant staff. It would serve as an internal information tool to inform all who need to know the status of various deals (management, investment analysts, investor relations staff, etc) and it would also serve as a management tool to help monitor and manage company activities. As a potential source of deals, the advisor introduced AIC to an ACDI/VOCA project that represented British Petroleum in Azerbaijan and was looking for potential local suppliers in a variety of areas such as manufacturing, logistics, and business services.

**Deliverables:** Deliverables for the Investment Funds and Second Tier SME Loan Financing component are provided under Annexes Volume II.

## 8. CASH MANAGEMENT

### Broad Goals

During FSSP I, the following seven major areas were identified by the CBA for assessment, development of recommendations, and preliminary review:

- Cash storage and handling
- Assessment of efficiency of valuables transportation
- Cash sorting and destruction
- New notes and coins circulation
- Assessment of creation of a new Cash Center
- Assessment of creation of a unified information sharing system
- Departmental assessment

### Accomplishments

The FSSP advisor investigated all seven of the above major areas and the relevant sub-areas, and provided an initial assessment and preliminary recommendations for each area. The advisor made a PowerPoint presentation summarizing the work and showing examples of international best practices in cash operations.

The advisor found the CBA cash operations to be well organized, quite secure and quite efficient. Operations in Baku utilize state-of-the-art processing equipment, modern bulk destruction and briquetting systems, and semi-automated vault storage systems. The cash

operations management has, however, established higher goals for the operations and desired support enable CBA to meet the highest international standards. CBA intends to build a new headquarters building and cash center in Baku, implement new integrated cash operations control systems, and improve the branch operations by reducing the number of branches while increasing efficiency and security at each location. The advisor was engaged to assist the design of the cash center.

Recommendations addressed improvements to be made in existing facilities to increase security and efficiency. The advisor identified possible improvements in security systems, standardization of containers for storage and handling between CBA facilities, note quality and authenticity in circulation, and development and integration of cash control systems. He advised on the practicality of making some changes in cash custody rules to provide more flexibility and efficiency in the existing operations, and for modification of cashier areas at one of the Baku cash centers.

Some of the recommended improvements would require changes in existing regulations and policies that were creating inefficiencies and potential security issues in the existing operations. One of the most important areas identified for change was the regulation that defines the requirements for banknote destruction.

Another area identified for major improvement was the design and implementation of a Cash Management System (“CMS”) that would provide a comprehensive tool for management of all cash operations and provide real-time tracking of cash in all NBA facilities. The CMS would interface with the CBA General Ledger system to provide overall cash operations visibility throughout the CBA. The system would be designed to also interface with a real time equipment control system, when needed for automated vault and cash handling applications. The CMS was recommended to be developed and installed prior to the start-up of operations in the new Baku cash center, and that it should be used in all NBA cash locations.

Recommendations for the new Baku cash center included concepts for a simple linear flow of cash through the operations, an automated “people-less” storage vault, automated handling systems, standardized cash containers and a completely integrated real-time Cash Management System for control and tracking of all cash. Manual handling of cash would only take place in highly secure Paying and Receiving and cash Processing Rooms. Security systems would meet the latest international standards, including provisions for securing the site perimeter and screening all vehicles and personnel entering high security areas.

A detailed description of these and other concepts including the recommendations were provided to CBA senior management. The most critical areas for implementation were/are utilization of efficient standardized storage and handling containers, revision of existing regulations to allow for on-line destruction of unfit banknotes, implementation of recommendations for CBA branches, specification and development of a comprehensive Cash Management System, and design of the concepts and plans for the new Baku cash center.

The project funded a study tour for CBA cash management and treasury officers to the Federal Reserve Bank of Atlanta to further their understanding of the procedures used there and to view the facility’s design.

Later in the project, a group of three Bankworld advisors assisted in the design specifications for the new cash center in consultation with CBA officials and the architect for the project, including the material handling system, security system and MIS system. What follows are the objectives and accomplishments under FSSP II.

**Deliverables:** Deliverables for the Cash Management component are provided under Annexes Volume III. (Due to the nature of the files that comprise this Annex, they have been submitted as a Zipped file.)

## **Cash Center Materials Handling Systems**

### **Broad Goal**

The Materials Handling Systems aspect of the project includes the physical facility layouts, space planning, cash operations equipment layouts and automated currency movement equipment. The scope of services for materials handling design criteria and specifications consisted of the following:

- Develop a narrative (Schematic Design Presentation) describing the basic facility layouts, room space planning sheets and equipment layouts for the Cash Center with the automated systems for the new Headquarters Building.
- Recommend specific automated equipment for vault storage and retrieval and for movements within the facility.
- Develop specifications for the automated equipment and the control systems for the equipment. These included: ASRS, AGV, conveyor, palletizing robots, forklifts and containers.
- Work with the architects to ensure proper room sizes and materials flow routing.

### **Accomplishments**

This required meetings with the project team on a regular basis. These meetings involved both Cash Operations personnel and the project architects. Most meetings took place at the CBA headquarters facility in Baku, Azerbaijan, but a few of the meetings were conducted at the offices of Coop Himmelblau in Vienna, Austria.

1. Completion of the facility layout on the site and then on the revised site.
2. Completion of vehicle flow routing on the site for VIP, employees, general deliveries and secure deliveries. This also included the vehicle inspection areas and methodologies.
3. Completion of the Cash Operations building layouts including all the necessary spaces for an efficient and secure facility.
4. Completion of the vault storage racking layouts and associated stacker cranes for the movement and storage of the specialized standard containers.

5. Container design including removable wheel-bases.
6. Completion of the automated guided vehicle system design for transporting containers to and from the vault and the operations areas.
7. Completion of the control system software logic to command the automated systems to make the requested movements in the facility.
8. Completion of the specifications to be used in the request for proposals during the procurement process. Specifications include layout drawings and detailed written descriptions of the functionality for the ASRS, AGV, conveyor and palletizing systems as well as the electronic control systems for these pieces of equipment.

The systems defined in the documents represent best practices in the industry that we have observed in or designed for other central banks. The primary equipment recommendations include:

1. Vault: Automated Storage and Retrieval system. These large vehicles move up and down a track in between high-rise rack structures containing containers of currency. They are able to store and retrieve loads from any position in the vault at any time. The containers are arranged four loads deep in the rack and the ASRS can retrieve up to two loads at a time. There are two ASRS machines in dedicated aisles and the rack system is nine tier levels high. Current estimations for the vault capacity are nearly one billion notes.
2. AGV: The automated guided vehicles will move the containers from the vault to the operations areas and from the operations areas back to the vault. They will also transport loads to the vertical transport systems to move some loads into the Tower for public functions. We are currently planning to utilize four AGVs with the capacity to handle up to six in the future. Vehicles are laser-guided utilizing a network of reflectors in the operations areas for location reference.
3. Control System: The Equipment Control System (ECS) will be used to command the automated vehicles for storage, retrieval and movement of containers throughout the facility. The system will use wireless technology to transmit commands.
4. Conveyor: Short conveyor spurs are planned to assist with the loading and unloading of packages from the truck docks to the Paying and Receiving rooms. A short section of non-powered, flexible and extendable conveyor will reach into the vehicles as needed where loads can be easily positioned and moved. A section of powered conveyor will penetrate the transfer room walls and convey the packages to and from the dock.
5. Primary Building Areas: The following areas were part of the overall systems design:
  - a. Secure Truck Docks
  - b. Transfer Rooms

- |                               |                                  |
|-------------------------------|----------------------------------|
| c. Paying and Receiving Rooms | j. Suspect Note Inspection Room  |
| d. Movement Hallways          | k. Bulk Destruction Room         |
| e. Automated Storage Vault    | l. AGV Maintenance Room          |
| f. Manual Gold Vault(s)       | m. Support Spaces                |
| g. Automated Processing rooms | n. Offices                       |
| h. Manual Processing Room     | o. Visitor Tour Route and Museum |
| i. Coin Processing Room       |                                  |

6. Palletizers: A new addition to the project involves automated palletizer robots at the end of the processing line to move processed bundles of fit notes out of the shrink-wrap stations and into the containers without human intervention. This was just added and is in development.

**Additional Comments**

The specifications provided are sufficient to procure the materials handling systems from a Design-Build Contractor, where the Design-Build Contractor is responsible for providing the detailed engineering. Any request for bids or request for proposals should only be issued to pre-qualified systems integrators. Potential systems integrators should be prequalified with the following items to be considered in the pre-qualification process:

1. Experience with facilities of similar type and size, as well as personnel’s experience.
2. Financial strength and bonding capacity
3. Quality assurance processes and plans
4. Technology (features and deviations from specifications)
5. Support (availability, project management, training, continual support and coordination with other trades)
6. References (general quality and workmanship, system performance, maintenance, completion date performance and client/contractor working relationship)
7. Cost (proposed system pricing, optional components pricing, unit pricing and terms and conditions).

Files covering the topics corresponding to Materials Handling Systems, are provided in Annexes Volume III, files 8.8 – 8.17.

**Cash Center Security**

**Broad Goal**

The project consists of a new Central Bank of Azerbaijan (CBA) Cash Center of approximately 4000 m<sup>2</sup>, and associated screening buildings that will serve to screen vehicles destined for the general delivery dock, the cash delivery dock or the parking facilities. Our

scope of services consisted of the development of design criteria and specifications for the security system for the new Baku Cash Center for the CBA. Specific objectives consisted of the following:

- Develop a narrative (Security Report) describing the basic plan for integrating security systems for the Cash Center with the security systems for the new Headquarters Building and the overall planned exterior access control system, for use by the Baku Architectural-Engineering team and the Bank's Security Consultant.
- Recommend general locations and sizes for security spaces for the new Cash Center. Recommend locations where bullet resistant glazing and pass-through devices should be provided as well as the specific level of bullet-resistance these elements should achieve based on European standards.
- Develop specifications for major electronic security components. Develop a matrix, cross referencing equipment types to locations (room names or numbers). Provide a list of major security components and indicate the quantities of these components.
- Mark-up site and floor plans to indicate locations and general location of security components in plan-view.

### **Accomplishments**

1. Developed a narrative (Security Report) describing the basic plan for integrating security systems for the Cash Center with the security systems for the new Headquarters Building and the overall planned exterior access control system.
2. Provided recommendations for general locations and sizes for security spaces for the new Cash Center. We recommended locations where bullet resistant glazing and pass-through devices should be provided as well as the specific level of bullet-resistance these elements should achieve based on European standards. This information was provided in the security report and is reflected in the Architects' plans.
3. Prepared specifications for major electronic security components.
4. Provided a list of major security components and indicated the quantities of these components.
5. Prepared and delivered site and floor plans indicating locations of security components.

The systems defined in the documents represent best practices we have observed in central bank security systems. The electronic systems include state-of-the-art electronic security systems, including the following:

1. Operable barriers meeting ASTM International F 2656-07 Perimeter Barrier Vehicle Crash Test Standard M30, M40 or M50 crash-ratings.

2. A high-energy gantry type X-ray system, with an under-vehicle camera system in the truck screening lane, and an X-ray screening workstation (remotely located away from the X-ray systems).
3. A comprehensive access control system to allow authorized persons (employees, contractors and visitors) entry to the site, building and to restricted areas within the facility via card readers and biometric readers.
4. Screening systems to screen people, their bags and luggage for weapons and explosives, to include a walk-through metal detector (magnetometer) and X-ray scanners at the main entrance, and a larger X-ray scanner in the receiving area for inspection of boxes, medium-sized containers and other packages brought into the facilities.
5. An intrusion detection system (IDS) to include magnetic switches, motion detectors, and vibration sensors as necessary to protect selected doors and hatches; sensitive interior spaces (cash processing, etc.), hallways, and rooms; and additional critical structures on site, such as currency and gold vaults.
6. A perimeter IDS to include active infrared sensors and high definition video cameras.
7. A comprehensive video surveillance system to provide video surveillance and assessment over the site. Video cameras are located to provide effective coverage of the grounds and perimeter of the property, including all entrances and exits for the site and facility, pedestrian and vehicle screening locations. They are positioned to observe all screening activity, all cash-handling activity, including cash-destruction activity, duress or panic pushbuttons, emergency call stations, loading docks and receiving areas, security posts and general reception areas, and emergency exits.
8. Network video recorders (NVRs) or video file servers and network storage to record and archive the video activity collected by the video surveillance system.
9. Emergency call stations in the staff parking areas to allow employees, contractors and visitors to quickly communicate the need for emergency assistance, or to report suspicious activity.
10. An intercom system that permits personal two-way communication with security from strategic locations on the property. This system will allow for more efficient use of security personnel (accepting deliveries and remotely unlocking doors).

### **Additional Comments**

The documents provided are generally sufficient to procure the electronic security systems from a Design-Build Contractor, where the Design-Build Contractor is responsible for providing the detailed engineering. Any request for bids or request for proposals should only be issued to pre-qualified security integrators.

Potential security integrators should be prequalified with the following items to be considered in the pre-qualification process:

1. Experience with facilities of similar type and size, as well as personnel's experience
2. Financial strength and bonding capacity
3. Quality assurance processes and plans
4. Technology (features and deviations from specifications)
5. Support (availability, project management, training, continual support and coordination with other trades)
6. References (general quality and workmanship, system performance, maintenance, completion date performance and client/contractor working relationship)
7. Cost (proposed system pricing, optional components pricing, unit pricing, and terms and conditions).

In addition to the electronic security systems defined above, the Bank should take a layered protection approach to securing the facility and its assets involving the use of various protection resources, including:

1. Ongoing communications with local and national sources of security intelligence.
2. Effective use of site property, terrain and interface with public access and thoroughfares.
3. Effective use of administrative control, vehicle and personal identification, and vehicle, pedestrian and package screening.
4. Incorporation of physical barriers for vehicles and personnel.
5. Incorporation of protection features into building component design and construction.
6. Effective use of protection staff in conjunction with protective measures.

Additional files relating to this component are provided as files 8.18 – 8.28 in the Annexes Volume III Zip file.)

## **Cash Center: Cash Management System**

### **Broad Goal**

The Cash Management System (CMS) subtrack of the project consists of developing the specifications for a software package that can handle the orders, movements and tracking of currency throughout the central bank network in real time. Our scope of services consisted of the development of design criteria and specifications for the new system at the CBA. The

package will be installed at the headquarters facility and in all the branches and will have interfaces with all commercial banks in the country as well as the future third-party logistics providers. Specific objectives consisted of the following:

- Meet with the Cash Operations department and the Information Technology department of the Central Bank to establish benchmarks based on the existing operations as well as data collection of functions, volumes and modules to be considered for the new system.
- A General Systems Design Report defines the modules and functions of the CMS, the data requirements, the number of locations served, the number of expected networked PCs at each facility, and the number of system users and estimated transaction requirements.
- An interface between the CMS and the new ECS to be defined in the General System Design Report, including the responsibilities for each system in regard to functionalities such as the following:
  - Remote order entry
  - Advanced Deposit notification
  - Cash Receiving Operations
  - Cash Payment Operations
  - Order Picking Management
  - Load ID, Seal ID, and real-time location control and tracking
  - Rejected Load Management
  - Performance Measurement
  - Cash Destruction – Bulk and on-line
  - Rejects, count variances, and counterfeits analysis and tracking
  - Cash Processing Status and performance reporting
  - Commercial Bank Custodial Inventories
  - Commercial Bank Performance Monitoring
  - Fees, Penalties, Incentives Management
  - New Banknotes and Coin Orders Management
  - Physical Inventory/Cycle Inventory
  - Label Printing
  - Pre-load/Post-load Management
  - Storage Location Optimization
  - Empty Container Management
  - Employee Team Assignments
  - Custody Management
  - ERP Interface Control/Reconciliation
  - ECS Interface Control/Reconciliation
  - Auditing
  - Miscellaneous Issues/Receipts/Reporting/Archiving
- Develop a detailed Procurement Specification for the CMS with sufficient detail to allow potential suppliers to provide proposals for CMS development, implementation and future support. The Procurement Specification to include requirements for

documentation, submittals, progress reviews, installation, testing, demonstrations, training and support. The consultants to review the Procurement Specifications with the CBA Team and make changes as required to meet the CBA requirements.

- Survey the industry to determine which potential CMS suppliers have the necessary qualifications and experience to participate in the CMS procurement for the CBA.

### **Accomplishments**

Our accomplishments mirror our objectives (scope of services) and include the following:

1. Completion of survey of existing systems and conditions
2. Completion of data collection to establish the requirements and needs of the new system.
3. Completion of the modules-definition exercise. This helps to establish which existing components will be replaced and which will be interfaced.
4. Completion of the Functions, Features and Structure report which was submitted and presented to management and IT
5. Completion of system business process flow charts and modeling
6. Completion of the draft specification for procurement
7. Presentation of the concept and progress to the Governor of the CBA for comment and approval.

The systems defined in the documents represent best practices we have observed in central bank cash management systems. The systems include state-of-the-art cash management concepts, including the following:

1. The CMS will interface with the following systems:
  - a. CBA Management Information System – for updating the overall CBA MIS system (system provided by CBA)
  - b. Accounting/General Ledger System – to provide balance updates to the new GL System (system provided by CBA)
  - c. Equipment Control System – to direct and control cash movements within the Baku Cash Center and in all other CBA cash locations (system provided by material handling systems contractor)
  - d. Cash Processing Information System – to receive information on the automated processing and destruction of cash in the automated processing machines (system provided by the processing machine supplier, currently G&D)
  - e. Courier Tracking and Custodial Inventory System – to create orders for cash, provide information on cash deposits, courier deliveries and pickups, and to support future Custodial Inventories at commercial banks.

2. System Modules – Cash Administration
  - a. Pre-Load and Post-Load Planning facilitates the selection of cash to be moved from vaults at the beginning of the work day and back to the vaults at the end of the day.
  - b. Order Entry provides advanced visibility of the orders for shipment from the facilities and Advanced Deposit Notification summarizes the expected cash receipts from commercial banks, CBA branches, and future Cash In Transit companies.
  - c. Custody Management provides real-time visibility of the cash assigned to custody teams within the CBA operations and defines the responsibility for cash at all times in all locations.
  - d. Performance Monitoring provides real-time visibility of the performance of personnel in the cash operations and compares current performance to past performance and established standards.
  - e. Video Surveillance Monitoring and Auditing records video camera images and related time line and personnel assignment records and inventories for security and performance analysis.
  - f. Commercial Bank and Branch Operations provides data and order entry capability to facilitate commercial bank and CBA branch cash transfers.
3. System Modules – Paying and Receiving
  - a. Orders include banknotes, coin, commemorative coin and banknotes, gold and other valuables.
  - b. Order Receiving Operations are controlled through specific instructions to operators including barcode scanning of bags, boxes, containers and bundles of cash, verification of strap and bundle counts, and placement of cash in specific containers. CMS checks all deposits against “expected receipts” data and identifies any variances.
  - c. Order Paying Operations are controlled through specific cash order preparation instructions to operators including barcode scanning of bundles, bags, boxes, containers of cash, verification of strap and bundle counts, and placement of cash in specific packages or containers for shipment. CMS checks all payments against order data and identifies any variances.
  - d. Order Transfer Operations are controlled through secure transfer rooms and electronic and physical signature verification of cash transfers.
4. System Modules – Cash Processing
  - a. Automated Banknote Processing systems will be used for most banknote processing, including integrated on-line shredding of unfit banknotes, conveying of fit banknotes through automated bundle shrink wrapping systems, and management of rejected and suspected counterfeit notes.
  - b. Data Collection for Automated Note Processing will be managed by the G&D processing machine data collection system with the addition of barcode scanning of each bundle input into the system and automatic barcode labeling of each fit cash bundle.
  - c. The Deposit Tracking and Proof System within CMS will collect data on each component of each cash deposit and balance the deposits with the initial deposit notification and receiving balances.

- d. Similar barcode scanning and tracking procedures will be used for manual banknote processing, foreign banknote processing, coin processing and destruction, and bulk banknote destruction.
5. System Modules – Equipment Control System
- a. ECS will control vault storage location selection, provide automatic or manual direction of movements of cash in the vaults, and real-time information on the location of cash within the vaults. ECS will also manage manual vaults, including CBA cash reserve vaults.
  - b. ECS will provide real-time inventory and location control and manage all cash movements within CBA facilities, and also keep track of cash movements to and from locations outside CBA facilities. (Global Positioning System (GPS) tracking could be integrated with ECS control in the future.)
  - c. ECS will control Automated Guided Vehicle System (AGVS) movements, including automated door controls, load sizing and seal scanning, and empty container management.
  - d. ECS will also collect and maintain paying and receiving data and facilitate inventory cycle counting operations.
6. The CMS makes extensive use of automated data capture solutions including 2D barcodes and Radio Frequency Identification Tags (RFID).

#### **Additional Comments**

The specification documents provided are in draft form and require comments from the user groups and revisions before they are ready for release and procurement. However, the functional diagrams and specification components form the basis of the entire system. Once completed, the documents will be sufficient to procure the cash management system from a single contractor, where the Contractor is responsible for providing the detailed coding of the software and supplying the hardware. Any request for bids or request for proposals should only be issued to pre-qualified security integrators.

Potential system suppliers should be prequalified with the following items to be considered in the pre-qualification process:

1. Experience with installation of systems of similar type and size, as well as personnel's experience.
2. Financial strength and bonding capacity
3. Quality assurance processes and plans
4. Technology (features and deviations from specifications)
5. Support (availability, project management, training, continual support and coordination with other trades)
6. References (general quality and workmanship, system performance, maintenance, completion date performance and client/contractor working relationship)

7. Cost (proposed system pricing, optional components pricing, unit pricing, and terms and conditions).

Files relating to this component are provided as files 8.1 – 8.7 in the Annexes Volume III Zip file.)

## **9. BUDGETING AND FINANCIAL PLANNING**

### **Broad Goals**

The broad goal was to enhance the overall budgeting and financial forecasting processes of CBA, more specifically:

- Improving the budget planning process
- Strengthening the monitoring and controlling processes

### **Accomplishments**

The advisor introduced leading practices for budget formulation and management to be introduced into CBA's methodologies for Budget Year 2010. His advice centered on:

- Establishment of a bank-wide planning effort, to be founded in the strategic plan, annual business plan and the requirement for forecasting costs and revenues that implementation of these plans would require. The objectives-based forecasts would be assigned specific timelines, benchmarks and performance indicators.
- Reinstatement of a budgetary "kick-off" meeting to improve overall budget preparation communication.
- Strengthening coordination of departmental strategic plans and budgets

To strengthen the monitoring and controlling functions, the advisor recommended and provided input for enhanced high-level monthly management reporting, enhanced departmental monthly management reporting, and suggested additional means by which overruns and shortfalls can be recognized and accommodated in the controlling process

To enhance the IT and data collection/reporting processes, the advisor recommended several new report formats/capabilities and a data coding methodology.

During FSSP II, the advisor completed revising/creating three documents. The first two were the original deliverables addressing the issues requested by the Financial Management Department. The third one is an additional document provided by the STTA to facilitate better understanding of the evaluation of IFRS:

1. Roadmap to IFRS
2. IFRS Evaluation Methodology
3. Background Information to Understanding IFRS

At the request of the FMS, FSSP also provided a comprehensive methodology for financial planning by CBA to be able to prepare itself with the level of activities to be handled and the resources required to do so.

**Deliverables:** Deliverables for the Budgeting and Financial Planning component are provided under Annexes Volume II.

## 10. RISK MANAGEMENT

### Broad Goal

For FSSP I, the objective was to conduct a study for identification and cataloging all possible risks inherent to CBA's operations and activities.

### Accomplishments

FSSP engaged a local subcontractor, PricewaterhouseCoopers (PwC) Azerbaijan, to conduct this assignment. PwC conducted the following:

- Structured interviews for identifying risks
- Review of internal and external regulations
- Summarization of information obtained
- Updating the CBA-specific "risk register"
- Assessing the existing risk management structure

The team also conducted interviews with Heads of Departments who are members of CBA's Risk Committee. The purpose of these meetings was:

- To obtain the high-level understanding on business process organization
- To understand each Department's structure to assess key divisions and persons involved in the risk-management process
- To assess the key operations for monitoring and the "cross relations" with other Departments
- To gain understanding about CBA's existing risk-management and control procedures
- To identify the gaps in the existing risk-management process in comparison to best practice standards
- To plan the areas for further detailed risk assessment
- To request needed documents

Based on analysis of the above, PwC made the following observations:

- Risk-management processes in CBA are not structured and lacked a global risk methodology to manage the risks.
- Organization structure is not optimal, which causes duplication of some functions.
- Business process structure is not optimal which can lead to loss of information when performing control activities and post-control monitoring of action plans.
- Control procedures are not documented.

Based on the above, it was determined that there is a need to provide assistance for the risk-management function at CBA. This was to be looked at during the FSSP II period.

**Deliverables:** Deliverables for the Risk Management component are provided under Annexes Volume II.

### Broad Goal

As a continuation from FSSP I, under an agreement between Bankworld Inc. and PricewaterhouseCoopers Central Asia and Caucasus BV Azerbaijan, the following broad goal was established:

- Preparation of recommendations for new organizational structure, functions, responsibilities and reporting lines of CBA units, which are already or should in the future be involved in risk management processes
- Preparation of documentation on new organizational structure of the units involved in the risk management process