

Azerbaijan
Full Rating Report

Azerbaijan Mortgage Fund Under the Central Bank of Azerbaijan Republic

Ratings

Foreign Currency	
Long-Term Rating	BBB-
Local Currency	
Long-Term Rating	BBB-
Sovereign Risk	
Foreign-Currency Long-Term IDR	BBB-
Local-Currency Long-Term IDR	BBB-

Outlooks

Foreign-Currency Long-Term Rating	Stable
Local-Currency Long-Term Rating	Stable
Sovereign Foreign-Currency Long-Term IDR	Stable
Sovereign Local-Currency Long-Term IDR	Stable

Financial Data

Azerbaijan Mortgage Fund		
	31 Dec 09	31 Dec 08
Profit before extraordinary items (AZNm)	12.0	22.1
Net interest income on mortgages/gross income	14.6	4.5
Assets (AZNm)	138.7	68.9
Debt (AZNm)	49.1	0.0
Total debt/total equity (%)	0.6	0.0
Liquid assets/total assets (%)	16.9	12.9

Analysts

Turda Ozmen
+90 212 284 7882
turda.ozmen@fitchratings.com

Vladimir Redkin
+7 495 956 9901
vladimir.redkin@fitchratings.com

Related Research

Applicable Criteria

- *Tax-Supported Rating Criteria (August 2010)*
- *Ratings of Non-US Public Sector Entities (September 2009)*

Other Research

- *Azerbaijan (May 2010)*

Rating Rationale

- The upgrade of Azerbaijan Mortgage Fund under the Central Bank of Republic of Azerbaijan's (AMF) Foreign- and Local-Currency Long-Term Ratings is driven by Fitch Ratings' assessment of the improved robustness of the support framework in place for AMF from its sponsor (Central Bank of Republic of Azerbaijan) and evidenced by a written commitment from the former. AMF's ratings are equal and credit-linked to the sovereign rating of Azerbaijan, reflecting the entity's public-sector status, the tight control by the sovereign through the central bank and AMF's important role in the national government's housing finance policy.
- AMF reports directly to the central bank. It has no share capital and its reserves are primarily made up of retained earnings from state budget appropriations. The central bank's management board act as AMF's board of directors. The fund's administration is headed by an executive director, and employees (53 at end-June 2010) are civil servants.
- Although it has its own separate budget, AMF receives budget income appropriations and requires authorisation from the central bank for all strategic decisions including borrowing. The entity's accounts are audited by an independent auditor appointed by the central bank. AMF cannot go bankrupt and can only be liquidated by a decree from the President of Azerbaijan.
- Provision of affordable housing is a high priority for the state. Article 43 of the constitution recognises the need to respond to the country's housing demand, particularly in light of the increasing demand for higher-standard urban housing and a significant number of displaced people and refugees within the country.
- Established in 2005, AMF's residential mortgage portfolio reached AZN102.8m by end-2009, increasing to AZN173.9m at end-September 2010. This fast growth is backed by increasing borrowing from capital markets and consistent budget contributions by the state which is projected to continue.
- AMF started to borrow in 2009 and financial debt was AZN114m in September 2010. Projections of state budget allocations against the expected growth in activities indicate that AMF's borrowing may total AZN300m in 2011-2013.

Key Rating Drivers

- AMF's Long-Term Ratings are equalised with the sovereign rating. A rating upgrade would be triggered by an upgrade of the sovereign rating and continued strong implicit support, as AMF is credit-linked to the sovereign.
- A rating downgrade would be triggered by a downgrade of the sovereign or negative changes to legal status and/or public control that would lead to a dilution of its legal status or weakened control by the sovereign.

Profile

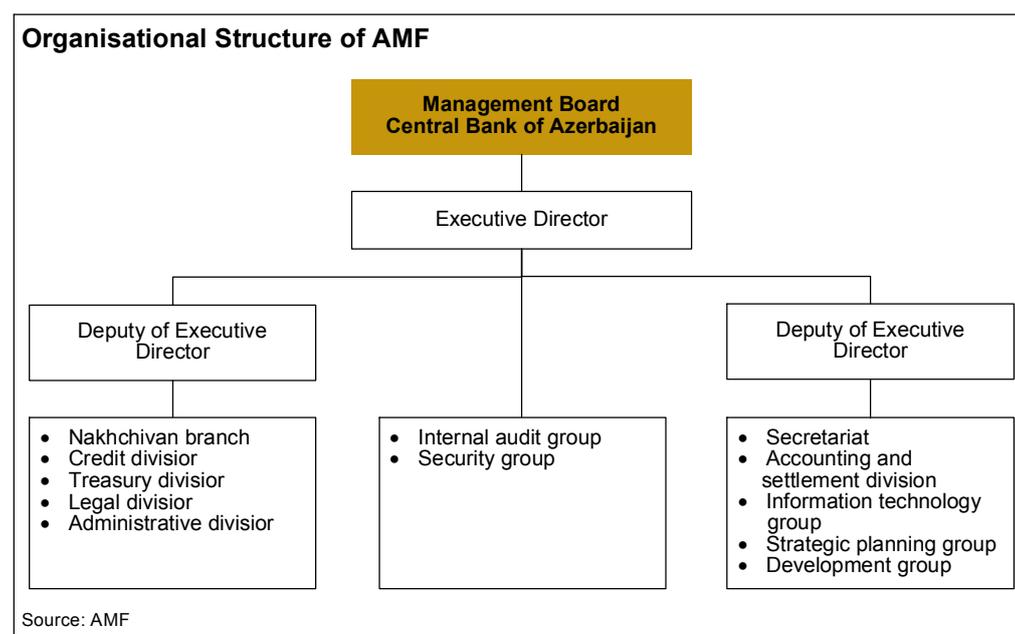
AMF was established as a PSE by decree No. 299 of the president of the Republic of Azerbaijan in September 2005. Its main purpose is to create funding mechanisms to provide Azerbaijani citizens access to home ownership through long-term financing, and attract domestic/foreign investment into mortgage financing. AMF mainly fulfils its role providing discounted housing loans. Profit maximisation is not a goal.

Public Sector Status

Important Role in Housing Finance

AMF has its own budget and no shareholders. Its employees are civil servants, and it operates as an expert government agency under the central bank. The entity's own property is under state ownership, and it has corresponding forms and stamps bearing the state emblem of the Republic of Azerbaijan.

Under its charter AMF is closely affiliated to the central bank, and conducts its day-to-day operations under the control and coordination of the latter. The executive director, Mr Fakhri Kazimov, was appointed in 2008 by the management board of the central bank. The management board of the central bank also serves as AMF's management board, and the control and coordination of the entity's daily activities are overseen by the bank's deputy governor. The executive director reports directly to the management board and does not have a fixed term of office.



Legal Framework

AMF was created by Decree No. 299 of the President of the Republic of Azerbaijan on the “Establishment of the Mortgage Credit System” dated September 2005. Its charter was approved by the decree on “Ratification of Charter of AMF under the Central Bank of Azerbaijan” in December 2005. The charter governs AMF’s legal status, its scope of activity and organisation. AMF cannot be liquidated or made bankrupt. It can only be dissolved by a separate decree issued by the President of the Republic of Azerbaijan, which would be likely to transfer the assets and liabilities to a new entity or to the central bank. The development of housing is a top priority for the state, as set out in the constitution.

In addition to the founding regulations, discount mortgage credits are governed by the executive orders of the President of the Republic of Azerbaijan on the “Youth State Programme” and on “Reinforcing Measures of Social Protection for Military Personnel of the Ministry of Defence”, and other acts. Under Decree No. 299, the Ministry of Finance allocates funds to AMF annually. The entity can also apply for state loans to meet its liquidity needs. Under a regulation issued by the central bank in May 2009, before AMF’s debut issuance of covered bonds, the bank established a buy-back guarantee for the bonds to support their liquidity.

In its regulatory capacity and to facilitate the establishment of a secondary market, the bank has also assigned high liquidity weightings to AMF covered bonds to be

held by banks. Under AMF charter, the central bank has the duty to finance AMF (including repayment of the covered bonds issued), should this be needed.

In assisting AMF's activities the bank determines the list of banks that can participate in lending, and approves the issuance of securities. Although legally independent from the government, the central bank regularly reports directly to the president (for details, see "*The Azerbaijani Banking System and Prudential Regulations*", published on 24 April 2009 and available at www.fitchratings.com).

Housing Finance Demand Fuelled by Strong Economic Growth

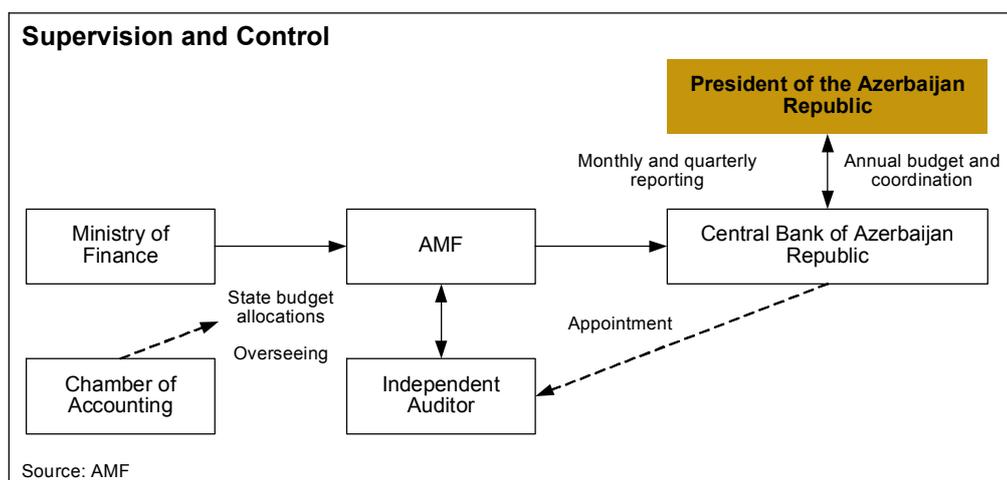
The country's population was nine million in 2009, of which the urban population was increasing, standing at above half of the total. At the beginning of 2009, 65% of the population was of working age, feeding housing demand. The country's annual real economic growth, fuelled by its hydrocarbon production, averaged in double digits during most of the 2000s, and GDP growth of 9.3% was the fastest among Fitch-rated countries in 2009. For further detail see Fitch's most recent Full Rating Report on Azerbaijan under *Related Research* on the first page.

Strong economic growth, the need to support the economically disadvantaged population and about one million refugees have created housing pressure. Private financial institutions' own funding resources have not been able to respond to borrowing demands at sufficiently long maturities to enable low- to medium-income earners to spread their loan repayments over an affordable period. The need for a public financing mechanism for housing is therefore acute.

Budget and Audit

Independent Budget with Tight State Control

AMF's budget is subject to approval of the management board, which also appoints the audit committee. The board of directors also annually approves AMF's annual report on financial results and economic activities, the prospectus of securities to be issued, and strategic plan. AMF reports quarterly on the implementation of the yearly strategic plan and carries out monthly financial reporting.



The financial report is audited by external auditors appointed by the central bank. According to the law "On the Chamber of Accounting", the chamber has financial control over the use of funds allocated from the state budget. AMF reports under IFRS, and the annual financial report is publicly published with the audit report. An annual report is made to the president of the republic.

Activities

AMF is focused on providing loans to individuals in collaboration with local banks acting as intermediary credit institutions. The entity's primary roles are:

- providing the population with mechanisms for long-term funding for home ownership;
- leading the establishment of market institutions that would help foster the availability of housing finance; and
- facilitating the attraction of local and foreign sources to housing finance.

AMF’s total own sources, fed from state budget-appropriated funds, are on-lent by the local banks as mortgage loans to the citizens of Azerbaijan who meet the eligibility criteria. In order to respond to demand far exceeding the supply of its funds, AMF also borrows from the capital markets through the issuance of debt securities. AMF provides funding under two schemes:

- normal (standard) mortgage loans; and
- social (discounted) mortgage loans.

Both loan schemes have below-market subsidised rates determined by the state. For its standard mortgage lending, AMF, as a government agency, focuses on low- and middle-income families who are not otherwise able to borrow with the long maturities that would enable small instalment amounts. The diagram “Mortgage Lending Process” below outlines the process of lending through intermediary credit institutions. Workers and civil servants are the main beneficiaries. Eligibility for social mortgage credits is narrowed to first-degree relatives of military personnel killed on duty, distinguished military personnel, internally displaced persons, academics and high-achieving sportsmen.

Loan Conditions

(At end-November 2010)

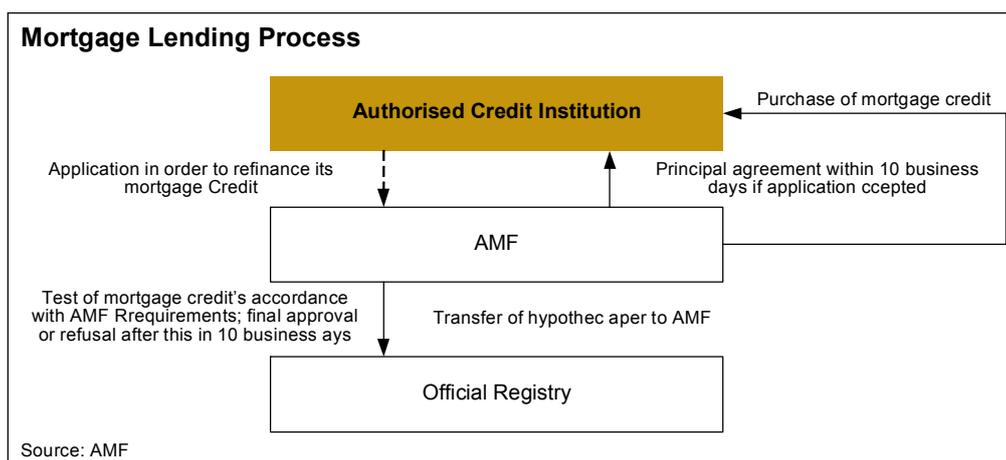
	Standard	Social
Credit collateral	Housing purchased	Housing purchased
Credit amount	AZN50,000	AZN35,000
Insurance	Property/life	Property/life
Maximum loan/value (%)	80	80
Maximum payment/income (%)	70	70
Type of rate	Fixed	Fixed
Interest rate (%)	Up to 8	Up to 4
Maturity period	Up to 25 years	Up to 30 years
Payment	Monthly instalment	Monthly instalment

Source: AMF

AMF’s loans are channelled to the borrowers by authorised credit institutions selected by the central bank. Upon authorisation, AMF signs a “main agreement” with the credit institution regulating the transfer of mortgage rights to AMF according to its requirements. Under a service contract with the parties, the payments by mortgage debtors are transferred to AMF. The entity checks the mortgage object (ie, the house) and provides other services. The authorised credit institution prepares credit background checks. AMF buys mortgage loans at the rates determined by the central bank.

The required loan conditions in the table “Loan Conditions” above regarding the credit amount, loan/value, payment/income, interest rate and maturity period reflect the maximum amounts applicable. The authorised credit institution pays expenses relating to the confirmation of contracts signed by AMF and additional state registration of mortgagee rights.

AMF can call back its credit by sending a notification to the authorised credit institution in cases where the debt remains overdue for more than 90 days or the loan no longer fulfils its eligibility requirement.



In these cases original documents are returned to the credit institution along with the mortgage rights and the loan is cancelled. To date there have been nine cases in which the loan was cancelled, involving coverage by insurance and the bank buying back the loan as credit risk ultimately belongs to the bank.

Financial Analysis

AMF produces financial reports in a corporate format (income statement, balance sheet and cash-flow statement) according to IFRS. State budget allocations are shown in the income statement under budget contributions and made up almost all the entity's net income in the start-up period. These are fed through to equity through retained earnings.

Capital Generation Still Reliant on State Budget Appropriations

AMF's revenue structure breaks down primarily into contributions from state budgets, which make up most of the total, and interest income on mortgage loans, which are exponentially increasing as core lending activities grow. The increase of interest revenue on mortgage loans remained limited due to the interruption of lending between 2007 and H109, since when it picked up to reach AZN0.8m. This has supported the net interest margin (NIM), which recorded a 30bp increase during the year. Nevertheless, the NIM remained significantly below that of 2007 due to increased earning assets and interest expenses arising from issued debt in H209.

AMF's expenditure is mainly geared toward administrative costs and is chiefly driven by personnel spending, which made up 64% of the total. According to management, the entity is adequately staffed and may respond to increasing activities with the addition of a small number of expert staff. Fitch expects the new office area transferred from the central bank also to enhance efficiency.

Net income remains mainly reliant on budget allocations but is set to be further influenced by interest income from loans as the size of the portfolio expands. The entity resumed its expansion of the portfolio from H209 and retained AZN1.6m of profit at year-end; nevertheless capital generation will be mainly driven by yearly budget contributions, which the entity projects at a minimum of AZN14m until 2013.

Despite its healthy portfolio, in 2010 AMF started to set aside loan provisions against possible losses in the face of a rapidly expanding portfolio. These may take up some of the net operating income from the main activity, depending on the provisioning policy adopted.

Fast-Growing Portfolio Set to Expand Further

The balance sheet essentially consists of long-term mortgage loans (74% of assets at end-2009), with the remainder mainly consisting of cash balances and treasury bills. Total assets expanded by 5.3x during 2006-2009, and Fitch expects this fast growth

to continue into 2012. Management considers that the total portfolio could achieve a compound annual growth rate (CAGR) of more than 55% during end-2009-2013. In this period expansion will be tied to continued state budget allocations and new funds from planned borrowing. AMF plans to use state budget allocations to fund social loans, while funds from new borrowing will be directed toward standard loans.

Increasingly Debt-Financed Loan Portfolio

(AZNm)	2006	2007	2008	2009	2010e
New refinanced mortgage loans	1.3	44.3	14.0	18.2	61.6
Borrowing through covered bond issuance	0.0	0.0	0.0	49.0	6.0
Borrowing through bond issuance	0.0	0.0	0.0	0.0	75.0
State budget contributions	20.0	20.0	22.0	14.0	14.0

e - Estimated

Source: Fitch calculations on AMF data

Intermediary credit institutions using AMF sources lend at their own risk. However, they are subject to stringent risk management requirements in order to maintain their authorisation to act as intermediaries. Within the portfolio, loans average about AZN40,036. As the average monthly salary of borrowers is AZN1,300, this results in a total debt/yearly income ratio of 2.6x. The average monthly salary size in the country is about AZN300, putting AMF borrowers primarily in the upper-middle income scale. The actual loan/value of the portfolio was 63%, with a payment/income ratio of 37%. The average period to maturity was 20 years. Social mortgage loans make up about 7% of the portfolio, and therefore their effect on the average loan size and their share in interest-earning assets is limited.

The credit committee consists of the executive director, his deputies and the heads of the legal and credit departments. Credit decisions are based on the suitability of the credit documents submitted by the authorised credit institution. Loan approvals are managed by the multiple-step (from dealer to executive director) authorisation process. Although about 23% of the loans finance newly constructed houses, most are directed toward purchases in the secondary market. AMF works with authorised appraisal companies and in some cases may make on-site inspections of the housing unit to be financed.

Debt and Liquidity

AMF's borrowing decisions are subject to central bank approval. Issuance of debt is subject to the guidelines of the State Securities Committee regulating the amount and specifics of debt issuance.

At end-2009 AMF had financial debt of AZN49m, which came from its planned AZN55m covered bond issuance. The maturity of the covered bond is seven years, with a 3% fixed rate with semi-annual interest payments and a bullet repayment at the end of the maturity. In 2010 the entity completed its covered bond issue by issuing AZN6m at end-September 2010, and a bond issue of AZN59m that it plans to increase to a total of AZN75m with fixed rate semi-annual interest payments and 10 years' maturity. Asset liquidity (liquid assets/total assets) was an adequate 17% at end-2009. This ratio may prove volatile as AMF tries to manage the high loan demand from its borrowers with its available funds, which mainly consist of own resources. AMF plans to complement fund availability with borrowing. The central bank provides full liquidity for the issued bonds through its buy-back guarantee for AMF's outstanding and future issues.

The asset, liability and risk-management committee is responsible for managing liquidity market and operational risk. In cooperation with outside consultants the entity has established a programme that runs scenario analysis and stress tests. The central bank also undertakes to service AMF's liabilities in case of need, underpinning Fitch's belief that liquidity support would be forthcoming if needed.

Appendix 1

Profit and Loss Account - Summary Data

(AZN 000)	Actual			
	31 Dec 2006	31 Dec 2007	31 Dec 2008	31 Dec 2009
Interest income on mortgage loans	14.5	636.4	1,044.5	1,976.0
Other interest income	587.2	560.8	253.9	882.9
Gross interest income	601.7	1,197.2	1,298.4	2,858.9
Interest expenses on borrowings	0.0	0.0	0.0	530.1
Other interest expenses	0.0	0.0	0.0	0.0
Net interest income	601.7	1,197.2	1,298.4	2,328.8
Commission expenses	71.5	13.8	1.4	38.0
Personnel expenses	189.8	435.1	717.4	985.9
Other operating expenses	97.5	375.6	-451.6	508.7
Net operating income/(loss)	242.9	372.7	128.0	796.2
Net other revenues/expenses	42.8	-3.5	15.6	10.3
Net income before state contribution	285.7	369.2	143.6	806.5
Contributions from state budgets	26,000.0	20,000.0	22,000.0	11,151.1
Profit before extraordinary items	26,285.7	20,369.2	22,143.6	11,963.6
Net extraordinary items	0.0	0.0	0.0	0.0
Taxation	0.0	0.0	0.0	0.0
Net profit	26,285.7	20,369.2	22,143.6	11,963.6

Source: Azerbaijan Mortgage Fund (AMF)

Appendix 2

Balance Sheet - Summary Data

(AZN 000)	Actual			
	31 Dec 2006	31 Dec 2007	31 Dec 2008	31 Dec 2009
A. Loans				
Residential mortgage loans	1,253.0	45,622.3	59,560.7	102,763.7
Other loans	0.0	0.0	0.0	0.0
B. Other earning assets				
Treasury bonds	24,941.5	0.0	7,994.3	3,931.3
Other earning assets	0.0	0.0	0.0	3,002.0
Total earning assets	26,194.5	45,622.3	67,555.0	109,697.0
C. Non-earning assets				
Cash and cash equivalents	24.9	682.5	872.4	19,561.5
Premises and equipment	121.2	384.1	326.0	9,372.3
Intangible assets	6.2	37.2	75.9	64.5
D. Other assets	62.5	47.1	57.5	32.7
E. Total assets (A+B+C+D)	26,409.3	46,773.2	68,886.8	138,728.0
F. Current liabilities				
Deferred Income	76.4	63.5	49.2	8,867.2
Other liabilities	47.4	54.9	39.3	25.3
G. Non-current liabilities				
Borrowings	0.0	0.0	0.0	0.0
Other financial debt	0.0	0.0	0.0	49,073.5
H. Total liabilities (F+G)	123.8	118.4	88.5	57,996.0
I. Net assets (E-H)	26,285.5	46,654.8	68,798.3	80,762.0
J. Capital and reserves				
Accumulated contributions from state	26,000.0	46,000.0	68,000.0	79,157.1
Other retained earnings	285.6	654.8	798.4	1,604.9
Debt maturity				
<1 year	0.0	0.0	0.0	0.0
1 to 2 years	0.0	0.0	0.0	0.0
2 to 5 years	0.0	0.0	0.0	0.0
>5 years	0.0	0.0	0.0	49,073.5
Total debt	0.0	0.0	0.0	49,073.5
Cash & deposits	-24.9	-682.5	-872.4	-19,561.5
Net debt	-24.9	-682.5	-872.4	29,512.0

Source: AMF and Fitch calculations

Appendix 3

Ratio Analysis

(%)	31 Dec 2006	31 Dec 2007	31 Dec 2008	31 Dec 2009
Performance				
Net interest income on mortgage/gross income	0.1	3.0	4.5	14.6
Net operating income/gross income	0.9	1.8	0.5	5.9
Interest income on mortgage/average mortgage loans	1.2	2.7	2.0	2.4
Interest expense/average borrowings	n.a.	n.a.	n.a.	n.a.
Net interest income/average earning assets	2.3	3.3	2.3	2.6
Net budget appropriation/gross income	97.6	94.4	94.4	82.7
Net income/average assets	99.5	27.8	19.1	5.8
Credit ratios				
Net income/interest expense on borrowings	n.a.	n.a.	n.a.	-2,256.9
Total debt/net income	0.0	0.0	0.0	410.2
Total debt/total equity	0.0	0.0	0.0	0.6
Liquidity ratios				
Liquid assets/total assets	94.5	1.5	12.9	16.9
Liquid assets/non-equity liabilities	20,151.6	31.4	9,118.9	12.1

n.a. - Not available

Source: AMF and Fitch calculations

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