



OJSC PASHA Bank

Consolidated financial statements

*Year ended 31 December 2018
together with independent auditor's report*

Contents

Independent auditor's report

Consolidated financial statements

Consolidated statement of financial position	1
Consolidated statement of profit or loss	2
Consolidated statement of comprehensive income	3
Consolidated statement of changes in equity	4
Consolidated statement of cash flows	5

Notes to the consolidated financial statements

1. Principal activities	6
2. Basis of preparation	6
3. Summary of significant accounting policies	7
4. Significant accounting judgments and estimates	22
5. Cash and cash equivalents	22
6. Trading securities	23
7. Amounts due from credit institutions	23
8. Investment securities	24
9. Loans to customers	25
10. Investment property	27
11. Property and equipment	28
12. Intangible assets	29
13. Other assets and liabilities	30
14. Amounts due to banks and government funds	31
15. Amounts due to customers	32
16. Other borrowed funds	32
17. Debt securities issued	32
18. Subordinated debt	32
19. Derivative financial instruments	33
20. Taxation	33
21. Equity	35
22. Commitments and contingencies	35
23. Credit loss expense and other impairment and provisions	37
24. Net fee and commission income	38
25. Personnel, general and administrative expenses	38
26. Risk management	39
27. Fair values measurement	50
28. Maturity analysis of assets and liabilities	53
29. Related party disclosures	53
30. Changes in liabilities arising from financing activities	55
31. Capital adequacy	55
32. Events after the reporting period	56



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Independent auditor's report

To the Shareholders and Supervisory Board of OJSC PASHA Bank

Opinion

We have audited the consolidated financial statements of OJSC PASHA Bank and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at 31 December 2018, and the consolidated statement of profit or loss, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Group as at 31 December 2018, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISA). Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the consolidated financial statements* section of our report. We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code), and we have fulfilled our other ethical responsibilities in accordance with the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of management and Audit Committee for the consolidated financial statements

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Audit Committee is responsible for overseeing the Group's financial reporting process.

Auditor's responsibilities for the audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- ▶ Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- ▶ Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.
- ▶ Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- ▶ Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- ▶ Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- ▶ Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Ernst & Young Holdings (CIS) B.V.

12 April 2019

Baku, Azerbaijan

CONSOLIDATED STATEMENT OF FINANCIAL POSITION**As at 31 December 2018***(Figures in tables are in thousands of Azerbaijani manats)*

	<i>Notes</i>	2018	2017
Assets			
Cash and cash equivalents	5	1,503,046	1,465,771
Trading securities	6	895	2,224
Amounts due from credit institutions	7	334,834	592,029
Investment securities	8	1,458,146	445,938
Derivative financial assets	19	2,050	1,665
Loans to customers	9	1,731,565	1,350,668
Investment property	10	71,719	1,668
Property and equipment	11	18,236	12,808
Intangible assets	12	49,754	48,954
Current income tax assets		-	2,154
Deferred income tax assets	20	4,003	640
Other assets	13	35,116	33,896
Total assets		5,209,364	3,958,415
Liabilities			
Amounts due to banks and government funds	14	524,975	399,973
Amounts due to customers	15	3,953,952	2,889,961
Other borrowed funds	16	-	39,105
Debt securities issued	17	102,300	81,765
Derivative financial liabilities	19	81	2,058
Current income tax liabilities		5,516	1,136
Deferred income tax liabilities	20	7,886	10,056
Provision for guarantees and other commitments	22	6,425	3,112
Subordinated debt	18	18,921	-
Other liabilities	13	41,299	32,100
Total liabilities		4,661,355	3,459,266
Equity			
Share capital	21	333,000	333,000
Retained earnings		114,930	113,601
Other reserves		1,983	-
Net unrealised gain/(loss) on investment securities		338	(24)
Foreign currency translation reserve		9,774	52,496
Total equity attributable to shareholders of the Bank		460,025	499,073
Non-controlling interests		87,984	76
Total equity		548,009	499,149
Total liabilities and equity		5,209,364	3,958,415

Signed and authorised for release on behalf of the Executive Board of the Bank:

Taleh Kazimov

Chairman of the Executive Board

Bahruz Nagiyev

Chief Financial Officer

12 April 2019



The accompanying notes on pages 6 to 56 are an integral part of these consolidated financial statements.

Consolidated statement of profit or loss**For the year ended 31 December 2018***(Figures in tables are in thousands of Azerbaijani manats)*

	<i>Notes</i>	2018	2017
Interest income			
Loans to customers		140,670	126,613
Investment securities		48,095	25,488
Cash and cash equivalents		27,665	16,740
Amounts due from credit institutions		11,985	59,096
Interest revenue calculated using effective interest rate		228,415	227,937
Trading securities			
		-	2,142
Finance lease receivables		1,151	1,032
Other interest revenue		1,151	3,174
Interest expense			
Amounts due to customers		(33,630)	(71,534)
Amounts due to banks and government funds		(12,969)	(12,066)
Debt securities issued		(7,536)	(4,715)
Other borrowed funds		(316)	(1,057)
Subordinated debt		(221)	-
		(54,672)	(89,372)
Net interest income		174,894	141,739
Credit (loss expense)/gain on financial assets	23	(4,296)	3,111
Net interest income after credit loss expense		170,598	144,850
Net fee and commission income			
	24	16,505	11,191
Net gains from trading securities		176	3,065
Net gains/(losses) from investment securities		23	(102)
Net gains/(losses) from foreign currencies			
- dealing		20,562	33,380
- translation differences		(2,819)	2,910
- operations with foreign currency derivatives		2,839	1,624
Other income		1,982	533
Non-interest income		39,268	52,601
Personnel expenses			
	25	(51,555)	(43,891)
General and administrative expenses	25	(35,652)	(30,927)
Depreciation and amortisation	10, 11, 12	(8,603)	(7,451)
Impairment of investment property	10	(13,546)	-
Impairment of license	12	(2,659)	(6,236)
(Provision)/reversal of provision for credit related commitments and other assets	23	(2,867)	3,844
Non-interest expenses		(114,882)	(84,661)
Profit before income tax expense		94,984	112,790
Income tax expense	20	(20,931)	(23,698)
Net profit for the year		74,053	89,092
Attributable to:			
- shareholders of the Bank		76,298	89,085
- non-controlling interests		(2,245)	7
		74,053	89,092

The accompanying notes on pages 6 to 56 are an integral part of these consolidated financial statements.

Consolidated statement of comprehensive income**For the year ended 31 December 2018***(Figures in tables are in thousands of Azerbaijani manats)*

	<i>Notes</i>	2018	2017
Net profit for the year		74,053	89,092
Other comprehensive income			
<i>Other comprehensive income to be reclassified to profit or loss in subsequent periods</i>			
Reclassification of cumulative gain/(loss) on disposal of investment securities at fair value through other comprehensive income to profit or loss		(23)	102
Net change in fair value of investment securities at fair value through other comprehensive income		(323)	(131)
Changes in allowance for expected credit losses of investment securities at fair value through other comprehensive income	23	756	-
Net unrealised gains/(losses) on investment securities at fair value through other comprehensive income	21	410	(29)
Income tax relating to components of other comprehensive income	20	(82)	6
Foreign currency translation differences	21	(65,612)	(18,550)
Net other comprehensive loss to be reclassified to profit or loss in subsequent periods		(65,284)	(18,573)
Total comprehensive income for the year		8,769	70,519
Attributable to:			
- shareholders of the Bank		37,120	70,512
- non-controlling interests		(28,351)	7
		8,769	70,519

The accompanying notes on pages 6 to 56 are an integral part of these consolidated financial statements.

Consolidated statement of changes in equity**For the year ended 31 December 2018***(Figures in tables are in thousands of Azerbaijani manats)*

	Attributable to shareholders of the Bank					Total	Non-controlling interests	Total equity
	Share capital	Retained earnings (accumulated deficit)	Net unrealised gain/(losses) on investment securities	Other reserves	Foreign currency translation reserve			
As at 31 December 2016	333,000	83,152	(1)	-	71,046	487,197	69	487,266
Net profit for the year	-	89,085	-	-	-	89,085	7	89,092
Other comprehensive income/(loss) for the year	-	-	(23)	-	(18,550)	(18,573)	-	(18,573)
Total comprehensive income/(loss) for the year	-	89,085	(23)	-	(18,550)	70,512	7	70,519
Dividends to shareholders of the Bank (Note 21)	-	(58,636)	-	-	-	(58,636)	-	(58,636)
As at 31 December 2017	333,000	113,601	(24)	-	52,496	499,073	76	499,149
Impact of adopting IFRS 9 (Note 3)	-	(147)	-	-	-	(147)	-	(147)
Restated opening balance under IFRS 9	333,000	113,454	(24)	-	52,496	498,926	76	499,002
Net profit for the year	-	76,298	-	-	-	76,298	(2,245)	74,053
Other comprehensive loss for the year	-	-	328	-	(39,506)	(39,178)	(26,106)	(65,284)
Total comprehensive income/(loss) for the year	-	76,298	328	-	(39,506)	37,120	(28,351)	8,769
Sale of non-controlling interests (Note 1)	-	(11,425)	34	-	(3,216)	(14,607)	116,259	101,652
Transfers to reserves	-	(1,983)	-	1,983	-	-	-	-
Dividends to shareholders of the Bank (Note 21)	-	(61,414)	-	-	-	(61,414)	-	(61,414)
As at 31 December 2018	333,000	114,930	338	1,983	9,774	460,025	87,984	548,009

The accompanying notes on pages 6 to 56 are an integral part of these consolidated financial statements.

Consolidated statement of cash flows**For the year ended 31 December 2018***(Figures in tables are in thousands of Azerbaijani manats)*

	<i>Notes</i>	2018	2017
Cash flows from operating activities			
Interest received		228,943	195,836
Interest paid		(54,722)	(53,321)
Fees and commissions received		33,415	24,545
Fees and commissions paid		(17,358)	(13,722)
Net realized gains/(losses) on sale of investment securities		23	(102)
Net realized gain from trading securities		-	2,849
Realised gains less losses from dealing in foreign currencies and operations with foreign currency derivatives		21,099	35,811
Personnel expenses paid		(48,481)	(40,869)
General and administrative expenses paid		(33,427)	(29,839)
Other operating income received		2,963	1,794
Cash flows from operating activities before changes in operating assets and liabilities		132,455	122,982
<i>Net (increase)/decrease in operating assets</i>			
Trading securities		100	20,428
Amounts due from credit institutions		237,877	138,964
Loans to customers		(489,145)	(270,754)
Other assets		7,596	(4,074)
<i>Net increase/(decrease) in operating liabilities</i>			
Amounts due to banks and government funds		169,706	96,099
Amounts due to customers		1,086,414	506,475
Other borrowed funds		(38,575)	(15,112)
Other liabilities		(7,441)	5,388
Net cash flows from operating activities before income tax		1,098,987	600,396
Income tax paid		(16,128)	(31,552)
Net cash from operating activities		1,082,859	568,844
Cash flows from investing activities			
Proceeds from sale and redemption of investment securities		6,696,415	1,672,006
Purchase of investment securities		(7,707,580)	(1,882,141)
Proceeds from sale of trading securities		711	-
Proceeds from sale of property and equipment		19	42
Purchase and prepayments for property and equipment		(42,709)	(5,685)
Acquisition of intangible assets		(15,743)	(6,562)
Purchase of investment property		(78,771)	-
Net cash used in investing activities		(1,147,658)	(222,340)
Cash flows from financing activities			
Sale of non-controlling interest		101,652	-
Proceeds from bonds issued	30	146,132	165,216
Redemption of bonds issued	30	(110,453)	(101,321)
Proceeds from subordinated loan	30	18,700	-
Dividends paid	21	(61,414)	(58,636)
Net cash from financing activities		94,617	5,259
Effect of exchange rates changes on cash and cash equivalents		7,449	8,239
Effect of expected credit losses on cash and cash equivalents		8	-
Net increase in cash and cash equivalents		37,275	360,002
Cash and cash equivalents, beginning	5	1,465,771	1,105,769
Cash and cash equivalents, ending	5	1,503,046	1,465,771

The accompanying notes on pages 6 to 56 are an integral part of these consolidated financial statements.

(Figures in tables are in thousands of Azerbaijani manats)

1. Principal activities

OJSC PASHA Bank ("the Bank") was established on 18 June 2007, as an open joint stock company under the laws of the Republic of Azerbaijan. The Bank operates under a banking licence No. 250 issued by the Central Bank of the Republic of Azerbaijan (the "CBAR") on 28 November 2007.

The Bank and its subsidiaries (together – "the Group") accept deposits from the public and extend credit, transfer payments, exchange currencies and provide other banking services to its commercial and private customers.

As at 31 December 2018, the Bank has five service points (2017: four), two branches (2017: two) in Azerbaijan and two subsidiaries (2017: two), JSC PASHA Bank Georgia located in the Republic of Georgia and PASHA Yatirim Bankasi A.Ş. (the "Subsidiaries") located in the Republic of Turkey.

The Bank's registered legal address is 15 Yusif Mammadaliyev Street, Baku, AZ1005, Azerbaijan.

As at 31 December 2018 and 2017, the following shareholders owned the outstanding shares of the Bank:

<i>Shareholders</i>	<i>2018, (%)</i>	<i>2017, (%)</i>
PASHA Holding Ltd.	60	60
Ador Ltd.	30	30
Mr. Arif Pashayev	10	10
Total	100	100

As at 31 December 2018 and 2017, the Group is ultimately owned by Mrs. Leyla Aliyeva and Mrs. Arzu Aliyeva, who exercise joint control over the Group.

PASHA Bank Georgia JSC, a wholly – owned subsidiary, is located in the Republic of Georgia, operating in the banking sector, with registered and paid up share capital of GEL 35,000 thousand as at 31 December 2013. In March 2014 share capital of subsidiary was increased and amounted to GEL 103,000 thousand as at 31 December 2018. PASHA Bank Georgia JSC operates under a banking licence issued by the National Bank of Georgia (the "NBG") on 17 January 2013.

Legal address of the PASHA Bank Georgia JSC is 15 Rustaveli Street, Tbilisi, GE 0108, Georgia.

TAIB Yatirim Bank A.Ş. was incorporated in 1987 as an investment bank in Turkey with the permission of the Council of Ministers decision no. 6224 which allows the transfer of the banks' net profit after statutory liabilities and in case of liquidation the transfer of capital to foreign shareholders. On 27 January 2015, the Bank acquired 79.47% of the voting common shares of TAIB Yatirim Bank A.Ş. and it was renamed to PASHA Yatirim Bankasi A.Ş. at the registration of the Bank as shareholder. In March 2015, investment in share capital of the subsidiary was increased by TRY 175,000 thousand to TRY 255,000 thousand increasing ownership in subsidiary to 99.92%. On 6 June 2018, share capital of subsidiary was increased by TRY 245,000 thousand to TRY 500,000 thousand. The increase was made based on decision of Supervisory Board of the Bank, according to which newly issued shares were acquired by PASHA Holding Ltd. As a result, the Bank's shares in the subsidiary decreased from 99.92% to 50.96% and PASHA Holding Ltd became a new non-controlling shareholder with ownership of 49% as at 31 December 2018. Head office of PASHA Yatirim Bankasi A.Ş. is located in Istanbul. The activities of the bank are regulated by the Central Bank of the Republic of Turkey (the "CBRT").

OJSC PASHA Bank and its Subsidiaries were consolidated in these financial statements.

2. Basis of preparation

General

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS").

The Azerbaijani manat is the functional and presentation currency of OJSC PASHA Bank as the majority of the transactions are denominated, measured, or funded in Azerbaijani manat. Transactions in other currencies are treated as transactions in foreign currencies. The Group is required to maintain its records and prepare its financial statements in Azerbaijani manat and in accordance with IFRS. These consolidated financial statements are presented in thousands of Azerbaijani manat ("AZN"), except when otherwise indicated. The consolidated financial statements have been prepared under the historical cost convention except for trading and certain investment securities and derivative financial instruments which have been measured at fair value.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies

Changes in accounting policies

IFRS 9 Financial Instruments

IFRS 9 replaces IAS 39 *Financial Instruments: Recognition and Measurement* for annual periods on or after 1 January 2018. The Group has not restated comparative information for 2017 for financial instruments in the scope of IFRS 9. Therefore, the comparative information for 2017 is reported under IAS 39 and is not comparable to the information presented for 2018. Differences arising from the adoption of IFRS 9 have been recognised directly in retained earnings as of 1 January 2018 and are disclosed below.

(a) *Classification and measurement*

Under IFRS 9, all debt financial assets that do not meet a "solely payment of principal and interest" (SPPI) criterion, are classified at initial recognition as fair value through profit or loss (FVPL). Under this criterion, debt instruments that do not correspond to a "basic lending arrangement", such as instruments containing embedded conversion options or "non-recourse" loans, are measured at FVPL. For debt financial assets that meet the SPPI criterion, classification at initial recognition is determined based on the business model, under which these instruments are managed:

- ▶ Instruments that are managed on a "hold to collect" basis are measured at amortised cost;
- ▶ Instruments that are managed on a "hold to collect and for sale" basis are measured at fair value through other comprehensive income (FVOCI);
- ▶ Instruments that are managed on other basis, including trading financial assets, will be measured at FVPL.

Equity financial assets are required to be classified at initial recognition as FVPL unless an irrevocable designation is made to classify the instrument as FVOCI. For equity investments classified as FVOCI, all realised and unrealised gains and losses, except for dividend income, are recognised in other comprehensive income with no subsequent reclassification to profit and loss.

The classification and measurement of financial liabilities remains largely unchanged from the current IAS 39 requirements. Derivatives will continue to be measured at FVPL. Embedded derivatives are no longer separated from a host financial asset.

(b) *Impairment*

The adoption of IFRS 9 has fundamentally changed the Group's accounting for loan impairment by replacing IAS 39 incurred loss approach with a forward-looking expected credit loss (ECL) approach. From 1 January 2018, the Group has been recording the allowance for expected credit losses for all loans and other debt financial assets not held at FVPL, together with loan commitments and financial guarantee contracts. Equity instruments are not subject to impairment under IFRS 9.

The allowance is based on the ECLs associated with the probability of default in the next twelve months unless there has been a significant increase in credit risk since origination. If the financial asset meets the definition of purchased or originated credit impaired (POCI), the allowance is based on the change in the ECLs over the life of the asset. Details of the Group's impairment method are disclosed in Note 26. The quantitative impact of applying IFRS 9 as at 1 January 2018 is disclosed in section (c) below.

(c) *Effect of transition to IFRS 9*

The following tables set out the impact of adopting IFRS 9 on the statement of financial position and retained earnings as at 1 January 2018 including the effect of replacing IAS 39 incurred credit loss calculations with IFRS 9 ECL.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Changes in accounting policies (continued)

A reconciliation between the carrying amounts under IAS 39 to the balances reported under IFRS 9 as at 1 January 2018 is as follows:

	Ref.	IAS 39 measurement		Reclassi- fication	Remeasurement		IFRS 9 Category	
		Category	Amount		ECL	Other		Amount
Financial assets								
Cash and cash equivalents	A	L&R ¹	1,465,771	-	-	-	1,465,771	Amortised cost
Trading securities		FVPL	2,224	-	-	-	2,224	FVPL
Amounts due from credit institutions	A	L&R	592,029	-	-	-	592,029	Amortised cost
Derivative financial assets		FVPL	1,665	-	-	-	1,665	(mandatory)
Loans to customers	A	L&R	1,350,668	-	2,176	(802)	1,352,042	Amortised cost
Investment securities at FVOCI		AFS ²	405,530	-	-	-	405,530	FVOCI
Investment securities at amortised cost	A	L&R	40,408	-	(403)	-	40,005	Amortised cost
Other financial assets	A	L&R	13,231	-	-	-	13,231	Amortised cost
Non-financial assets								
Deferred tax assets			640	-	-	-	640	
Total assets			3,872,166	-	1,773	(802)	3,873,137	
Provision for guarantees and other commitments			3,112	-	1,155	-	4,267	
Deferred tax liabilities			10,056	-	124	(161)	10,019	
Total liabilities			13,168	-	1,279	(161)	14,286	

¹ L&R: Loans and receivables.

² AFS: Available-for-sale.

A As of 1 January 2018, the Group's analysis highlighted that all financial assets except for trading securities and derivative financial assets meet the SPPI criterion. Therefore, this financial assets measured at amortised cost previously, under IAS 39, are classified by Bank as financial assets at amortized cost under IFRS 9.

The impact of transition to IFRS 9 on reserves and retained earnings is as follows:

Retained earnings	
Closing balance under IAS 39 (31 December 2017)	113,601
Recognition of IFRS 9 ECLs	618
Loss recognized from modification	(802)
Deferred tax in relation to the above	37
Restated opening balance under IFRS 9 (1 January 2018)	113,454
Total change in equity due to adopting IFRS 9	(147)

The following table reconciles the aggregate opening loan loss allowances under IAS 39 and provisions for loan commitments and financial guarantee contracts in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the ECL allowances under IFRS 9.

	Loan loss allowance/ provision under IAS 39/IAS 37 at 31 December 2017	Remeasurement	ECL under IFRS 9 at 1 January 2018
Impairment allowance for			
Due from credit institutions	(871)	-	(871)
Loans to customers at amortised cost	(63,324)	2,176	(61,148)
Investment securities: loans and receivables per IAS 39 and investment securities at amortised cost under IFRS 9	(160)	(403)	(563)
	(64,355)	1,773	(62,582)
Credit related commitments	(3,112)	(1,155)	(4,267)
	(67,467)	618	(66,849)

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Changes in accounting policies (continued)

IFRS 15 Revenue from Contracts with Customers

IFRS 15, issued in May 2014, and amended in April 2016, establishes a five-step model to account for revenue arising from contracts with customers. Under IFRS 15, revenue is recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. However, the standard does not apply to revenue associated with financial instruments and leases, and therefore, does not impact the majority of the Group's revenue including interest revenue, gains/(losses) on operations with securities, lease income which are covered by IFRS 9 *Financial Instruments* and IAS 17 *Leases*. As a result, the majority of the Group's income are not impacted by the adoption of this standard.

IFRIC Interpretation 22 Foreign Currency Transactions and Advance Considerations

The Interpretation clarifies that, in determining the spot exchange rate to use on initial recognition of the related asset, expense or income (or part of it) on the derecognition of a non-monetary asset or non-monetary liability relating to advance consideration, the date of the transaction is the date on which an entity initially recognises the non-monetary asset or non-monetary liability arising from the advance consideration. If there are multiple payments or receipts in advance, then the entity must determine the date of the transactions for each payment or receipt of advance consideration. This Interpretation does not have any impact on the Group's consolidated financial statements.

Basis of consolidation

Subsidiaries, which are those entities which are controlled by the Bank, are consolidated. Control is achieved when the Bank is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Specifically, the Bank controls an investee if, and only if, the Bank has:

- ▶ Power over the investee (i.e., existing rights that give it the current ability to direct the relevant activities of the investee);
- ▶ Exposure, or rights, to variable returns from its involvement with the investee;
- ▶ The ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights results in control. To support this presumption and when the Bank has less than a majority of the voting or similar rights of an investee, the Bank considers all relevant facts and circumstances in assessing whether it has power over an investee, including:

- ▶ The contractual arrangement(s) with the other vote holders of the investee;
- ▶ Rights arising from other contractual arrangements;
- ▶ The Bank's voting rights and potential voting rights.

Subsidiaries are consolidated from the date on which control is transferred to the Bank and are no longer consolidated from the date that control ceases. All intra-group transactions, balances and unrealised gains on transactions between group companies are eliminated in full; unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. Where necessary, accounting policies for subsidiaries have been changed to ensure consistency with the policies adopted by the Group.

A change in the ownership interest of a subsidiary, without a change of control, is accounted for as an equity transaction. Losses are attributed to the non-controlling interests even if that results in a deficit balance.

If the Bank loses control over a subsidiary, it derecognises the assets (including goodwill) and liabilities of the subsidiary, the carrying amount of any non-controlling interests, the cumulative translation differences, recorded in equity; recognises the fair value of the consideration received, the fair value of any investment retained and any surplus or deficit in profit or loss and reclassifies the parent's share of components previously recognised in other comprehensive income to profit or loss.

Business combinations

Business combinations are accounted for using the acquisition method. The cost of an acquisition is measured as the aggregate of the consideration transferred, measured at acquisition date fair value and the amount of any non-controlling interests in the acquiree. For each business combination, the acquirer measures the non-controlling interests in the acquiree that are present ownership interests either at fair value or at the proportionate share of the acquiree's identifiable net assets and other components of non-controlling interests at their acquisition date fair value. Acquisition costs incurred are expensed.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Business combinations (continued)

When acquires a business, it assesses the financial assets and liabilities assumed for appropriate classification and designation in accordance with the contractual terms, economic circumstances and pertinent conditions as at the acquisition date. This includes the separation of embedded derivatives in host contracts by the acquiree.

If the business combination is achieved in stages, the acquisition date fair value of the acquirer's previously held equity interest in the acquiree is remeasured to fair value as at the acquisition date through profit or loss.

Any contingent consideration to be transferred by the acquirer is recognised at fair value at the acquisition date. Subsequent changes to the fair value of the contingent consideration which is deemed to be an asset or liability, will be recognised in accordance with IAS 39 either in profit or loss or as change to other comprehensive income. If the contingent consideration is classified as equity, it shall not be remeasured until it is finally settled within equity.

Goodwill is initially measured at cost being the excess of the consideration transferred over the acquiree's net identifiable assets acquired and liabilities assumed. If this consideration is lower than the fair value of the net assets of the subsidiary acquired, the difference is recognised in profit or loss.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Group's cash generating units that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units. Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the cash-generating unit retained.

Fair value measurement

The Group measures financial instruments carried at FVPL and FVOCI at fair value at each balance sheet date.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurement is based on the presumption that the transaction to sell the asset or transfer the liability takes place either:

- ▶ In the principal market for the asset or liability; or
- ▶ In the absence of a principal market, in the most advantageous market for the asset or liability.

The principal or the most advantageous market must be accessible by the Group. The fair value of an asset or a liability is measured using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest. A fair value measurement of a non-financial asset takes into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant that would use the asset in its highest and best use.

The Group uses valuation techniques that are appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs.

All assets and liabilities for which fair value is measured or disclosed in the consolidated financial statements are categorized within the fair value hierarchy, described as follows, based on the lowest level input that is significant to the fair value measurement as a whole:

- ▶ Level 1 – quoted (unadjusted) market prices in active markets for identical assets or liabilities;
- ▶ Level 2 – valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable;
- ▶ Level 3 – valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable.

For assets and liabilities that are recognised in the consolidated financial statements on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Financial assets and liabilities

Initial recognition

Date of recognition

All regular way purchases and sales of financial assets are recognized on the trade date i.e. the date that the Group commits to purchase the asset. Regular way purchases or sales are purchases or sales of financial assets that require delivery of assets within the period generally established by regulation or convention in the market place.

Initial measurement

The classification of financial instruments at initial recognition depends on their contractual terms and the business model for managing the instruments. Financial instruments are initially measured at their fair value and, except in the case of financial assets and financial liabilities recorded at FVPL, transaction costs are added to, or subtracted from, this amount.

Measurement categories of financial assets and liabilities

From 1 January 2018, the Group classifies all of its financial assets based on the business model for managing the assets and the asset's contractual terms, measured at either:

- ▶ Amortised cost;
- ▶ FVOCI;
- ▶ FVPL.

The Group classifies and measures its derivative and trading portfolio at FVPL. The Group may designate financial instruments at FVPL, if so doing eliminates or significantly reduces measurement or recognition inconsistencies.

Before 1 January 2018, the Group classified its financial assets as loans and receivables (amortised cost), FVPL or available-for-sale.

Financial liabilities, other than loan commitments and financial guarantees, are measured at amortised cost or at FVPL when they are held for trading, are derivative instruments or the fair value designation is applied.

Amounts due from credit institutions, loans to customers, investments securities at amortised cost

Before 1 January 2018, amounts due from credit institutions, loans to customers and investment securities included non-derivative financial assets with fixed or determinable payments that were not quoted in an active market, other than those:

- ▶ That the Group intended to sell immediately or in the near term;
- ▶ That the Group, upon initial recognition, designated as at FVPL or as available-for-sale;
- ▶ For which the Group may not recover substantially all of its initial investment, other than because of credit deterioration, which were designated as available-for-sale.

From 1 January 2018, the Group only measures amounts due from credit institutions, loans to customers and investment securities at amortised cost if both of the following conditions are met:

- ▶ The financial asset is held within a business model with the objective to hold financial assets in order to collect contractual cash flows;
- ▶ The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (SPPI).

The details of these conditions are outlined on the next page.

Business model assessment

The Group determines its business model at the level that best reflects how it manages groups of financial assets to achieve its business objective.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Financial assets and liabilities (continued)

The Group's business model is not assessed on an instrument-by-instrument basis, but at a higher level of aggregated portfolios and is based on observable factors such as:

- ▶ How the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;
- ▶ The risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way those risks are managed;
- ▶ How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected);
- ▶ The expected frequency, value and timing of sales are also important aspects of the Group's assessment.

The business model assessment is based on reasonably expected scenarios without taking 'worst case' or 'stress case' scenarios into account. If cash flows after initial recognition are realised in a way that is different from the Group's original expectations, the Group does not change the classification of the remaining financial assets held in that business model, but incorporates such information when assessing newly originated or newly purchased financial assets going forward.

The SPPI test

As a second step of its classification process the Group assesses the contractual terms of financial asset to identify whether they meet the SPPI test.

'Principal' for the purpose of this test is defined as the fair value of the financial asset at initial recognition and may change over the life of the financial asset (for example, if there are repayments of principal or amortisation of the premium/discount).

The most significant elements of interest within a lending arrangement are typically the consideration for the time value of money and credit risk. To make the SPPI assessment, the Group applies judgement and considers relevant factors such as the currency in which the financial asset is denominated, and the period for which the interest rate is set.

In contrast, contractual terms that introduce a more than de minimis exposure to risks or volatility in the contractual cash flows that are unrelated to a basic lending arrangement do not give rise to contractual cash flows that are solely payments of principal and interest on the amount outstanding. In such cases, the financial asset is required to be measured at FVPL.

Debt instruments at FVOCI

From 1 January 2018, the Group applies the new category under IFRS 9 of debt instruments measured at FVOCI when both of the following conditions are met:

- ▶ The instrument is held within a business model, the objective of which is achieved by both collecting contractual cash flows and selling financial assets;
- ▶ The contractual terms of the financial asset meet the SPPI test.

FVOCI debt instruments are subsequently measured at fair value with gains and losses arising due to changes in fair value recognised in OCI. Interest revenue and foreign exchange gains and losses are recognised in profit or loss in the same manner as for financial assets measured at amortised cost. On derecognition, cumulative gains or losses previously recognised in OCI are reclassified from OCI to profit or loss.

The ECLs for debt instruments measured at FVOCI do not reduce the carrying amount of these financial assets in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the assets were measured at amortised cost is recognised in OCI as an accumulated impairment amount, with a corresponding charge to profit or loss. The accumulated loss recognised in OCI is recycled to the profit and loss upon derecognition of the asset.

Equity instruments at FVOCI

From 1 January 2018, upon initial recognition, the Group occasionally elects to classify irrevocably some of its equity investments as equity instruments at FVOCI when they meet the definition of equity under IAS 32 *Financial Instruments: Presentation* and are not held for trading. Such classification is determined on an instrument-by-instrument basis.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Financial assets and liabilities (continued)

Gains and losses on these equity instruments are never recycled to profit or loss. Dividends are recognised in profit or loss as other income when the right of the payment has been established, except when the Group benefits from such proceeds as a recovery of part of the cost of the instrument, in which case, such gains are recorded in OCI. Equity instruments at FVOCI are not subject to an impairment assessment. Upon disposal of these instruments, the accumulated revaluation reserve is transferred to retained earnings.

Financial guarantees, letters of credit and undrawn loan commitments

The Group issues financial guarantees, letters of credit and loan commitments. Financial guarantees are initially recognised in the financial statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognised less cumulative amortisation recognised in the consolidated statement of profit or loss, and – under IAS 37 (before 1 January 2018) – the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee, or – under IFRS 9 (from 1 January 2018) – an ECL provision.

Undrawn loan commitments and letters of credits are commitments under which, over the duration of the commitment, the Group is required to provide a loan with pre-specified terms to the customer. Similar to financial guarantee contracts, under IAS 39, a provision was made if they were an onerous contract but, from 1 January 2018, these contracts are in the scope of the ECL requirements.

The Group occasionally issues loan commitments at below market interest rates drawdown. Such commitments are initially recognized at fair value and subsequently measured at the higher of the amount of the ECL allowance and the amount initially recognised less, when appropriate, the cumulative amount of income recognised.

Performance guarantees

Performance guarantees are contracts that provide compensation if another party fails to perform a contractual obligation. Performance guarantees do not transfer credit risk. The risk under performance guarantee contracts is the possibility that the failure to perform the contractual obligation by another party occurs. Therefore, performance guarantees are not considered financial instruments and thus do not fall in scope of IFRS 9.

Loans and receivables

Before 1 January 2018, loans and receivables were non-derivative financial assets with fixed or determinable payments that were not quoted in an active market. They were not entered into with the intention of immediate or short-term resale and were not classified as trading securities or designated as investment securities available-for-sale. Such assets were carried at amortised cost using the effective interest method. Gains and losses were recognised in profit or loss when the loans and receivables were derecognised or impaired, as well as through the amortisation process.

Available-for-sale financial assets

Before 1 January 2018, available-for-sale financial assets were those non-derivative financial assets that were designated as available-for-sale or were not classified in any of the three preceding categories. After initial recognition available-for sale financial assets were measured at fair value with gains or losses being recognised in other comprehensive income until the investment was derecognised or until the investment was determined to be impaired at which time the cumulative gain or loss previously reported in other comprehensive income was reclassified to the consolidated statement of profit or loss. However, interest calculated using the effective interest method was recognised in profit or loss.

Reclassification of financial assets and liabilities

From 1 January 2018, Group does not reclassify its financial assets subsequent to their initial recognition, apart from the exceptional circumstances in which the Group changes the business model for managing financial assets. Financial liabilities are never reclassified. The Group did not reclassify any of its financial assets and liabilities in 2017.

Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, amounts due from the CBAR, NGB and CBRT, excluding obligatory reserves, and amounts due from credit institutions with due on demand or up to 3 months from the date of origination and that are free from contractual encumbrances.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Repurchase and reverse repurchase agreements

Sale and repurchase agreements ("repos") are treated as secured financing transactions. Securities sold under sale and repurchase agreements are retained in the consolidated statement of financial position and, in case the transferee has the right by contract or custom to sell or re-pledge them, reclassified as securities pledged under sale and repurchase agreements. The corresponding liability is presented within amounts due to credit institutions or customers. Securities purchased under agreements to resell ("reverse repo") are recorded as separate account on the consolidated statement of financial position if material or as cash and cash equivalents or loans to customers as appropriate. The difference between sale and repurchase price is treated as interest and accrued over the life of repo agreements using the effective yield method.

Derivative financial instruments

In the normal course of business, the Group enters into various derivative financial instruments including futures, forwards, swaps and options in the foreign exchange and capital markets. Such financial instruments are held for trading and are recorded at fair value. The fair values are estimated based on quoted market prices or pricing models that take into account the current market and contractual prices of the underlying instruments and other factors. Derivatives are carried as assets when their fair value is positive and as liabilities when it is negative. Gains and losses resulting from these instruments are included in the consolidated statement of profit or loss as net gains/(losses) from financial instruments at fair value through profit or loss or net gains/(losses) from foreign currencies, depending on the nature of the instrument.

An embedded derivative is a component of a hybrid instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided that, in the case of a non-financial variable, it is not specific to a party to the contract. A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

Under IAS 39, derivatives embedded in financial assets, liabilities and non-financial host contracts, were treated as separate derivatives and recorded at fair value if they met the definition of a derivative (as defined above), their economic characteristics and risks were not closely related to those of the host contract, and the host contract was not itself held for trading or designated at FVPL. The embedded derivatives separated from the host were carried at fair value in the trading portfolio with changes in fair value recognised in the consolidated statement of profit or loss.

From 1 January 2018, with the introduction of IFRS 9, the Group accounts in this way for derivatives embedded in financial liabilities and non-financial host contracts. Financial assets are classified based on the business model and SPPI assessments.

Borrowings

Issued financial instruments or their components are classified as liabilities, where the substance of the contractual arrangement results in the Group having an obligation either to deliver cash or another financial asset to the holder, or to satisfy the obligation other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of own equity instruments. Such instruments include Amounts due to banks and government funds, other borrowed funds and amounts due to customers. After initial recognition, borrowings are subsequently measured at amortised cost using the effective interest method. Gains and losses are recognised in profit or loss when the borrowings are derecognised as well as through the amortisation process.

If the Group purchases its own debt, it is removed from the statement of financial position and the difference between the carrying amount of the liability and the consideration paid is recognised in profit or loss.

Leases

Operating – Bank as lessee

Leases of assets under which the risks and rewards of ownership are effectively retained by the lessor are classified as operating leases. Lease payments under an operating lease are recognised as expenses on a straight-line basis over the lease term and included into other operating expenses.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Offsetting of financial instruments

Financial assets and liabilities are offset and the net amount is reported in the [consolidated] statement of financial position when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously. The right of set-off must not be contingent on a future event and must be legally enforceable in all of the following circumstances:

- ▶ The normal course of business;
- ▶ The event of default; and
- ▶ The event of insolvency or bankruptcy of the entity and all of the counterparties.

These conditions are not generally met in master netting agreements, and the related assets and liabilities are presented gross in the consolidated statement of financial position.

Renegotiated loans

Where possible, the Group seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions.

From 1 January 2018, the Group derecognises a financial asset, such as a loan to a customer, when the terms and conditions have been renegotiated to the extent that, substantially, it becomes a new loan, with the difference recognised as a derecognition gain or loss, to the extent that an impairment loss has not already been recorded. The newly recognised loans are classified as Stage 1 for ECL measurement purposes, unless the new loan is deemed to be POCI. Restructuring of impaired loans does not result in derecognition of financial instrument. When assessing whether or not to derecognise a loan to a customer, amongst others, the Group considers the following factors:

- ▶ Change in currency of the loan;
- ▶ Change in counterparty;
- ▶ If the modification is such that the instrument would no longer meet the SPPI criterion.

If the modification does not result in cash flows that are substantially different, the modification does not result in derecognition. Based on the change in cash flows discounted at the original EIR, the Group records a modification gain or loss, presented within interest revenue calculated using EIR in the statement of profit or loss, to the extent that an impairment loss has not already been recorded.

Impairment of financial assets under IAS 39

Before 1 January 2018, the Group assessed at each reporting date whether there was any objective evidence that a financial asset or a group of financial assets was impaired. A financial asset or a group of financial assets was deemed to be impaired if, and only if, there was objective evidence of impairment as a result of one or more events that had occurred after the initial recognition of the asset (an incurred "loss event") and that loss event (or events) had an impact on the estimated future cash flows of the financial asset or the group of financial assets that could be reliably estimated. Evidence of impairment may have included indications that the borrower or a group of borrowers was experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they would enter bankruptcy or other financial reorganisation and where observable data indicated that there was a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlated with defaults.

The Group assessed whether objective evidence of impairment existed individually for financial assets that were individually significant, or collectively for financial assets that were not individually significant.

If there was an objective evidence that an impairment loss had been incurred, the amount of the loss was measured as the difference between the assets' carrying amount and the present value of estimated future cash flows (excluding future expected credit losses that have not yet been incurred), discounted using original effective interest rate, or, for financial assets available-for-sale, as the difference between cost of investment and its fair value. The carrying amount of the asset was reduced and the amount of the loss was recognised in profit or loss. Interest revenue continued to be accrued on the reduced carrying amount based on the original effective interest rate of the asset, or, for financial assets available-for-sale, using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. Assets together with the associated allowance were written off when there is no realistic prospect of future recovery and all collateral had been realised or has been transferred to the Group. If in a subsequent year the amount of the estimated impairment loss decreased because of an event occurring after the impairment had been recognised, the previously recognised impairment loss was reversed in consolidated statement of profit or loss, except for equity investments available-for-sale, for which increase in their fair value after impairment were recognised in other comprehensive income.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Impairment of financial assets under IAS 39 (continued)

For the purpose of a collective evaluation of impairment, financial assets were grouped on the basis of the Group's internal credit grading system that considered credit risk characteristics such as asset type, industry, geographical location, collateral type, past-due status and other relevant factors.

Future cash flows on a group of financial assets that were collectively evaluated for impairment were estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience was adjusted on the basis of current observable data to reflect the effects of current conditions that had not affected the years on which the historical loss experience was based and to remove the effects of conditions in the historical period that did not exist currently. Estimates of changes in future cash flows reflected, and were directionally consistent with, changes in related observable data from year to year (such as changes in unemployment rates, property prices, commodity prices, payment status, or other factors that were indicative of incurred losses in the group or their magnitude). The methodology and assumptions used for estimating future cash flows were reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Derecognition of financial assets and liabilities

Financial assets

A financial asset (or, where applicable a part of a financial asset or part of a group of similar financial assets) is derecognised where:

- ▶ The rights to receive cash flows from the asset have expired;
- ▶ The Group has transferred its rights to receive cash flows from the asset, or retained the right to receive cash flows from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a "pass-through" arrangement; and
- ▶ The Group either (a) has transferred substantially all the risks and rewards of the asset, or (b) has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

Where the Group has transferred its rights to receive cash flows from an asset and has neither transferred nor retained substantially all the risks and rewards of the asset nor transferred control of the asset, the asset is recognised to the extent of the Group's continuing involvement in the asset. Continuing involvement that takes the form of a guarantee over the transferred asset is measured at the lower of the original carrying amount of the asset and the maximum amount of consideration that the Group could be required to repay.

Where continuing involvement takes the form of a written and/or purchased option (including a cash-settled option or similar provision) on the transferred asset, the extent of the Group's continuing involvement is the amount of the transferred asset that the Group may repurchase, except that in the case of a written put option (including a cash-settled option or similar provision) on an asset measured at fair value, the extent of the Group's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price.

Write-off

From 1 January 2018, financial assets are written off either partially or in their entirety only when the Group has stopped pursuing the recovery. If the amount to be written off is greater than the accumulated loss allowance, the difference is first treated as an addition to the allowance that is then applied against the gross carrying amount. Any subsequent recoveries are credited to credit loss expense. A write-off constitutes a derecognition event.

Financial guarantees

Financial liabilities

A financial liability is derecognised when the obligation under the liability is discharged or cancelled or expires.

Where an existing financial liability is replaced by another from the same lender on substantially different terms, or the terms of an existing liability are substantially modified, such an exchange or modification is treated as a derecognition of the original liability and the recognition of a new liability, and the difference in the respective carrying amounts is recognised in profit or loss.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Derecognition of financial assets and liabilities (continued)

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit and guarantees. Financial guarantees are initially recognized in the financial statements at fair value, in 'Other liabilities', being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amortized premium and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee.

Any increase in the liability relating to financial guarantees is taken to current year profit. The premium received is recognized in profit or loss on a straight-line basis over the life of the guarantee.

The interest rate is applied to amount of guarantees without consideration of effective interest rate method.

Taxation

The current income tax expense is calculated in accordance with the regulations of the Republic of Azerbaijan and of the countries in which the Group has offices and branches and where its subsidiaries are located.

Deferred tax assets and liabilities are calculated in respect of temporary differences using the liability method. Deferred income taxes are provided for all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes, except where the deferred income tax arises from the initial recognition of goodwill or of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.

A deferred tax asset is recorded only to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised. Deferred tax assets and liabilities are measured at tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates that have been enacted or substantively enacted at the reporting date.

Azerbaijan also has various operating taxes that are assessed on the Group's activities. These taxes are included as a component of general and administrative expenses.

Current and deferred tax are recognised in profit or loss, except when they relate to items that are recognised in other comprehensive income or directly in equity, in which case, the current and deferred tax are also recognised in other comprehensive income or directly in equity respectively. Where current tax or deferred tax arises from the initial accounting for a business combination, the tax effect is included in the accounting for the business combination.

Property and equipment

Property and equipment are carried at cost, excluding the costs of day-to-day servicing, less accumulated depreciation and any accumulated impairment. Such cost includes the cost of replacing part of property and equipment when that cost is incurred if the recognition criteria are met.

The carrying values of property and equipment are reviewed for impairment when events or changes in circumstances indicate that the carrying value may not be recoverable.

Depreciation of an asset, including construction in progress, begins when it is ready and available for use. Depreciation is calculated on a straight-line basis over the following estimated useful lives:

	<u>Years</u>
Buildings	20
Furniture and fixtures	4
Computers and other equipment	4
Vehicles	4
Other equipment	5
Leasehold improvements	7

The asset's residual values, useful lives and methods are reviewed, and adjusted as appropriate, at each financial year-end.

Costs related to repairs and renewals are charged when incurred and included in general and administrative expenses, unless they qualify for capitalization.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Investment property

Investment property is land or building or a part of building held to earn rental income or for capital appreciation and which is not used by the Group or held for the sale in the ordinary course of business. Property that is being constructed or developed or redeveloped for future use as investment property is also classified as investment property.

Investment property is initially recognized at cost, including transaction costs, and subsequently is stated at cost less accumulated depreciation and any accumulated impairment losses. For disclosure purposes investment property is re-measured at fair value reflecting market conditions at the end of the reporting period. Fair value of the Group's investment property is determined on the base of various sources including reports of independent appraisers, who hold a recognized and relevant professional qualification and who have recent experience in valuation of property of similar location and category.

Earned rental income is recorded in the income statement within income arising from non-banking activities. Gains and losses resulting from changes in the fair value of investment property are recorded in the consolidated statement of profit or loss and presented within income or expense arising from non-banking activities.

Subsequent expenditure is capitalized only when it is probable that future economic benefits associated with it will flow to the Group and the cost can be measured reliably. All other repairs and maintenance costs are expensed when incurred. If an investment property becomes owner-occupied, it is reclassified to premises and equipment, and its carrying amount at the date of reclassification becomes its deemed cost.

Reposessed collateral

In certain circumstances, collateral is reposessed following the foreclosure on loans that are in default. Reposessed collateral is measured at the lower of carrying amount and net realizable value and reported within "Other assets".

Intangible assets

Intangible assets consist of banking license, other licenses and computer software.

Intangible assets acquired separately are measured on initial recognition at cost. The cost of intangible assets acquired in a business combination is fair value as at the date of acquisition. Following initial recognition, intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. The useful lives of intangible assets are assessed to be finite. Intangible assets with finite lives are amortised over the useful economic lives of 10 years and assessed for impairment whenever there is an indication that the intangible asset may be impaired.

Intangible assets with indefinite useful lives are not amortised and assessed for impairment at least at each financial year-end whenever there is an indication that the intangible asset may be impaired.

Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate of the amount of obligation can be made.

Retirement and other employee benefit obligations

The Group does not have any pension arrangements separate from the State pension system of the Republic of Azerbaijan, which requires current contributions by the employer calculated as a percentage of current gross salary payments; such expense is charged in the period the related salaries are earned. In addition, the Group has no post-retirement benefits.

Share capital

Share capital

Ordinary shares are classified as equity. External costs directly attributable to the issue of new shares, other than on a business combination, are shown as a deduction from the proceeds in equity. Any excess of the fair value of consideration received over the par value of shares issued is recognised as additional paid-in capital.

Dividends

Dividends are recognised as a liability and deducted from equity at the reporting date only if they are declared before or on the reporting date. Dividends are disclosed when they are proposed before the reporting date or proposed or declared after the reporting date but before the financial statements are authorised for issue.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Contingencies

Contingent liabilities are not recognised in the consolidated statement of financial position but are disclosed unless the possibility of any outflow in settlement is remote. A contingent asset is not recognised in the consolidated statement of financial position but disclosed when an inflow of economic benefits is probable.

Recognition of income and expenses

Revenue is recognised to the extent that it is probable that the economic benefits will flow to the Group and the revenue can be reliably measured. Expenses are recognized when incurred. The following specific recognition criteria must also be met before revenue and expense is recognised.

Interest and similar income and expense

From 1 January 2018, the Group calculates interest revenue on debt financial assets measured at amortized cost by applying the EIR to the gross carrying amount of financial assets other than credit-impaired assets (before 1 January 2018: by applying EIR to the amortized cost of financial assets). EIR is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset or financial liability. The calculation takes into account all contractual terms of the financial instrument (for example, prepayment options) and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective interest rate, but not future credit losses. The carrying amount of the financial asset or financial liability is adjusted if the Group revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate and the change in carrying amount is recorded as interest revenue or expense.

When a financial asset becomes credit-impaired, the Group calculates interest revenue by applying the effective interest rate to the net amortised cost of the financial asset. If the financial assets cures and is no longer credit-impaired, the Group reverts to calculating interest revenue on a gross basis.

For purchased or originated credit-impaired (POCI) financial assets, the Group calculates interest revenue by calculating the credit-adjusted EIR and applying that rate to the amortised cost of the asset. The credit-adjusted EIR is the interest rate that, at original recognition, discounts the estimated future cash flows (including credit losses) to the amortised cost of the POCI assets.

Interest revenue on all financial assets at FVPL is recognised using the contractual interest rate.

Fee and commission income

The Group earns fee and commission income from several types of services it provides to its customers. Fee income can be divided into the following categories:

Fee income earned from services that are provided over a certain period of time

Fees earned for the provision of services over a period of time are accrued over that period. These fees include commission income on guarantees and letters of credit. Loan commitment fees for loans that are likely to be drawn down and other credit related fees are deferred (together with any incremental costs) and recognised as an adjustment to the effective interest rate on the loan.

Fee income earned at a point in time

Fees arising from settlement and cash operations are recognized upon completion of the underlying transactions. Each cash operation and settlement operation is treated as a separate performance obligation.

Fee income from providing transaction services

Fees arising from negotiating or participating in the negotiation of a transaction for a third party – such as where the Group's performance obligation is the arrangement of the acquisition of shares or other securities – are recognised on completion of the underlying transaction. Fees or components of fees that are linked to certain performance obligations are recognised after fulfilling the corresponding criteria. When the contract provides for a variable consideration, fee and commission income is only recognized to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur until the uncertainty associated with the variable consideration is subsequently resolved. Revenue is recognized when the Group's right to receive the payment is established.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Foreign currency translation

The consolidated financial statements are presented in AZN, which is the Group's functional and presentation currency. Transactions in foreign currencies are initially recorded in the functional currency, converted at the rate of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the reporting date. Gains and losses resulting from the translation of foreign currency transactions are recognised in current year profit as gains less losses from foreign currencies – translation differences. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates as at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

Differences between the contractual exchange rate of a transaction in a foreign currency and the CBAR exchange rate on the date of the transaction are included in gains less losses from dealing in foreign currencies.

The Group used the following official exchange rates at 31 December 2018 and 2017, in the preparation of these financial statements:

	2018	2017
1 US dollar	AZN 1.7000	AZN 1.7001
1 euro	AZN 1.9468	AZN 2.0307
1 Georgian lari	AZN 0.6367	AZN 0.6514
1 Turkish lira	AZN 0.3212	AZN 0.4499

Standards issued but not yet effective

The standards and interpretations that are issued, but not yet effective, up to the date of issuance of the Group's consolidated financial statements are disclosed below. The Group intends to adopt these standards, if applicable, when they become effective.

IFRS 16 Leases

IFRS 16 was issued in January 2016 and it replaces IAS 17 *Leases*, IFRIC 4 *Determining whether an Arrangement Contains a Lease*, SIC-15 *Operating Leases – Incentives* and SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease*. IFRS 16 sets out the principles for the recognition, measurement, presentation and disclosure of leases and requires lessees to account for all leases under a single on-balance sheet model similar to the accounting for finance leases under IAS 17. The standard includes two recognition exemptions for lessees – leases of 'low-value' assets and short-term leases (i.e., leases with a lease term of 12 months or less). At the commencement date of a lease, a lessee will recognise a liability to make lease payments (i.e., the lease liability) and an asset representing the right to use the underlying asset during the lease term (i.e., the right-of-use asset). Lessees will be required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset.

Lessees will be also required to remeasure the lease liability upon the occurrence of certain events (e.g., a change in the lease term, a change in future lease payments resulting from a change in an index or rate used to determine those payments). The lessee will generally recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset.

Lessor accounting under IFRS 16 is substantially unchanged from today's accounting under IAS 17. Lessors will continue to classify all leases using the same classification principle as in IAS 17 and distinguish between two types of leases: operating and finance leases.

IFRS 16, which is effective for annual periods beginning on or after 1 January 2019, requires lessees and lessors to make more extensive disclosures than under IAS 17.

The Group plans to adopt IFRS 16 effective for annual periods beginning on or after 1 January 2019. The Group will elect to apply the standard to contracts that were previously identified as leases applying IAS 17 and IFRIC 4. The Group will therefore not apply the standard to contracts that were not previously identified as containing a lease applying IAS 17 and IFRIC 4.

The Group will elect to use the exemptions proposed by the standard on lease contracts for which the lease terms ends within 12 months as of the date of initial application, and lease contracts for which the underlying asset is of low value. The Group is currently under process of assessing effect of the IFRS 16.

(Figures in tables are in thousands of Azerbaijani manats)

3. Summary of significant accounting policies (continued)

Standards issued but not yet effective (continued)

IFRIC Interpretation 23 Uncertainty over Income Tax Treatment

The Interpretation addresses the accounting for income taxes when tax treatments involve uncertainty that affects the application of IAS 12 and does not apply to taxes or levies outside the scope of IAS 12, nor does it specifically include requirements relating to interest and penalties associated with uncertain tax treatments. The Interpretation specifically addresses the following:

- ▶ Whether an entity considers uncertain tax treatments separately;
- ▶ The assumptions an entity makes about the examination of tax treatments by taxation authorities;
- ▶ How an entity determines taxable profit (tax loss), tax bases, unused tax losses, unused tax credits and tax rates;
- ▶ How an entity considers changes in facts and circumstances.

An entity has to determine whether to consider each uncertain tax treatment separately or together with one or more other uncertain tax treatments. The approach that better predicts the resolution of the uncertainty should be followed. The interpretation is effective for annual reporting periods beginning on or after 1 January 2019, but certain transition reliefs are available. The Group will apply the interpretation from its effective date. Since the Group operates in a complex tax environment, applying the Interpretation may affect its consolidated financial statements. In addition, the Group may need to establish processes and procedures to obtain information that is necessary to apply the Interpretation on a timely basis.

Amendments to IFRS 9 Prepayment Features with Negative Compensation

Under IFRS 9, a debt instrument can be measured at amortised cost or at fair value through other comprehensive income, provided that the contractual cash flows are 'solely payments of principal and interest on the principal amount outstanding' (the SPPI criterion) and the instrument is held within the appropriate business model for that classification. The amendments to IFRS 9 clarify that a financial asset passes the SPPI criterion regardless of the event or circumstance that causes the early termination of the contract and irrespective of which party pays or receives reasonable compensation for the early termination of the contract.

The amendments should be applied retrospectively and are effective from 1 January 2019, with earlier application permitted. These amendments have no impact on the consolidated financial statements of the Group.

Annual improvements 2015-2017 cycle (issued in December 2017)

These improvements include:

IAS 12 Income Taxes

The amendments clarify that the income tax consequences of dividends are linked more directly to past transactions or events that generated distributable profits than to distributions to owners. Therefore, an entity recognises the income tax consequences of dividends in profit or loss, other comprehensive income or equity according to where the entity originally recognised those past transactions or events.

An entity applies those amendments for annual reporting periods beginning on or after 1 January 2019, with early application is permitted. When an entity first applies those amendments, it applies them to the income tax consequences of dividends recognised on or after the beginning of the earliest comparative period. Since the Group's current practice is in line with these amendments, the Group does not expect any effect on its financial statements.

(Figures in tables are in thousands of Azerbaijani manats)

4. Significant accounting judgments and estimates

In the process of applying the Bank's accounting policies, management has used its judgments and made estimates in determining the amounts recognized in the consolidated financial statements. The most significant use of judgments and estimates are as follows:

Impairment losses on financial assets

The measurement of impairment losses both under IFRS 9 and IAS 39 across all categories of financial assets requires judgement, in particular, the estimation of the amount and timing of future cash flows and collateral values when determining impairment losses and the assessment of a significant increase in credit risk. These estimates are driven by a number of factors, changes in which can result in different levels of allowances. The Group's ECL calculations are outputs of complex models with a number of underlying assumptions regarding the choice of variable inputs and their interdependencies. Elements of the ECL models that are considered accounting judgements and estimates include:

- ▶ The Group's internal credit grading model, which assigns PDs to the individual grades;
- ▶ The Group's criteria for assessing if there has been a significant increase in credit risk and so allowances for financial assets should be measured on a LTECL basis and the qualitative assessment;
- ▶ The segmentation of financial assets when their ECL is assessed on a collective basis;
- ▶ Development of ECL models, including the various formulae and the choice of inputs;
- ▶ Determination of associations between macroeconomic scenarios and, economic inputs and the effect on PDs, EADs and LGDs;
- ▶ Selection of forward-looking macroeconomic scenarios and their probability weightings, to derive the economic inputs into the ECL models.

More details are provided in Notes 9 and 26.

Fair value of financial instruments

Where the fair values of financial assets and financial liabilities recorded in the consolidated statement of financial position cannot be derived from active markets, they are determined using a variety of valuation techniques that include the use of mathematical models. The input to these models is taken from observable markets where possible, but where this is not feasible, a degree of judgment is required in establishing fair values. Additional details are provided in Note 27.

Impairment of banking license

The recoverable amount of banking license is measured annually, irrespective of whether there is any indication that it may be impaired. This requires an estimation of the value in use of the cash-generating unit. Estimating the value in use requires the Group to make an estimate of the expected future cash flows from the cash-generating unit and also to choose a suitable discount rate in order to calculate the present value of those cash flows. The Group reviews and validates at the end of each reporting period its decision to classify the useful life of an intangible asset as indefinite. If events and circumstances no longer support an indefinite useful life, the change from indefinite to finite life is accounted for as a change in accounting estimate under IAS 8, which requires such changes to be recognised prospectively. Furthermore, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. The carrying amount of banking license at 31 December 2018 was AZN 19,892 thousand (31 December 2017: AZN 31,587 thousand). More details are provided in Note 12.

5. Cash and cash equivalents

Cash and cash equivalents comprise:

	2018	2017
Cash on hand	135,938	71,250
Current accounts with the CBAR, the NGB and the CBRT	257,234	388,733
Current accounts with other credit institutions	83,499	58,594
Time deposits with credit institutions up to 3 months	1,026,383	947,194
Less: allowance for impairment	(8)	-
Cash and cash equivalents	1,503,046	1,465,771

Current accounts with other credit institutions consist of non-interest bearing correspondent account balances with resident and non-resident banks in the amount of AZN 83 thousand (31 December 2017: AZN 3,199 thousand) and AZN 83,416 thousand (31 December 2017: AZN 55,395 thousand), respectively.

(Figures in tables are in thousands of Azerbaijani manats)

5. Cash and cash equivalents (continued)

As at 31 December 2018, the Group placed AZN 1,026,383 thousand in time deposits with one resident bank and fourteen non-resident banks maturing through March 2019 with interest rates ranging between 1% and 10% p.a. (31 December 2017: AZN 947,194 thousand with one resident bank and eight non – resident banks maturing through February 2018 with interest rates ranging between 0.9% and 14.99% p.a.).

All balances of cash equivalents are allocated to Stage 1.

6. Trading securities

Trading securities comprise:

	<u>2018</u>	<u>2017</u>
Corporate bonds	895	2,224
Trading securities	895	2,224

7. Amounts due from credit institutions

Amounts due from credit institutions comprise:

	<u>2018</u>	<u>2017</u>
Time deposits with credit institutions for more than 3 months	180,121	466,370
Loans to banks	18,583	22,789
Obligatory reserve with the CBAR, the NBG and the CBRT	83,981	72,540
Restricted deposits	52,518	31,201
	<u>335,203</u>	<u>592,900</u>
Less: allowance for impairment	(369)	(871)
Amounts due from credit institutions	334,834	592,029

As at 31 December 2018, time deposits with credit institutions mature between January 2019 and June 2022 (31 December 2017: between January 2018 and December 2018) with interest rates ranging between 1.3% and 11% p.a. (31 December 2017: between 0% and 2.2% p.a.).

As at 31 December 2018, the Group had outstanding amount of AZN 17,415 thousand (31 December 2017: AZN 21,918 thousand) of secured loan issued to one resident commercial bank (31 December 2017: one resident commercial banks) and AZN 1,169 thousand (31 December 2017: AZN 871 thousand) of unsecured loans issued to one resident commercial bank (31 December 2017: one resident commercial banks) with contractual maturity through December 2019 (31 December 2017: December 2018) and with interest rates ranging between 1.9% and 10% p.a. (31 December 2017: 11.5% and 15% p.a.).

Credit institutions in the Republic of Azerbaijan are required to maintain a non-interest earning cash deposit (obligatory reserve with restriction on withdrawal) with the CBAR at the level of 0.5% (2017: 0.5%) and 1.0% (2017: 1.0%) of the previous month average of funds attracted from customers by a credit institution in AZN and foreign currencies, respectively. Credit institutions in the Republic of Georgia are required to maintain a mandatory interest earning cash deposit with the NBG at the level of 5% (2017: 7%) and 25% (2017: 20%) of the average of funds attracted from customers by the credit institution in GEL and foreign currencies, respectively with remaining maturity less than 1 year. For foreign currency liabilities with remaining maturity of 1-2 years the reserve requirement amounts to 10%. Credit institutions in the Republic of Turkey are required to maintain a mandatory interest earning cash deposit with the CBRT at the level of 1.5%-8% for TRY deposits and other liabilities according to their maturities (2017: 4%-10.5%) and 4%-20% for foreign currency deposits and other liabilities according to their maturities (2017: 4%-24%).

(Figures in tables are in thousands of Azerbaijani manats)

7. Amounts due from credit institutions (continued)

An analysis of changes in gross carrying value and corresponding ECL allowance on amounts due from credit institutions during the year ended 31 December 2018 is as follows:

	<u>Stage 1</u>	<u>Stage 2</u>	<u>Stage 3</u>	<u>Total</u>
Gross carrying value as at 1 January 2018	570,111	21,918	871	592,900
New assets originated or purchased	273,385	-	-	273,385
Assets repaid	(516,233)	(4,503)	(871)	(521,607)
Foreign exchange adjustments	(9,475)	-	-	(9,475)
At 31 December 2018	317,788	17,415	-	335,203
	<u>Stage 1</u>	<u>Stage 2</u>	<u>Stage 3</u>	<u>Total</u>
ECL allowance as at 1 January 2018	(21)	-	(850)	(871)
New assets originated or purchased	(423)	-	-	(423)
Assets repaid	198	-	850	1,048
Foreign exchange adjustments	(123)	-	-	(123)
At 31 December 2018	(369)	-	-	(369)

The movements in allowance for impairment of amounts due from credit institutions during the year ended 31 December 2017 were as follows:

	<u>2017</u>
1 January	(907)
Reversal	36
31 December	(871)

8. Investment securities

Investment securities comprise:

	<u>2018</u>	<u>2017</u>
Debt securities at FVOCI (previously classified as investment securities available-for-sale)		
Certificate of deposits	486,919	-
Notes issued by the Central Bank of Azerbaijan Republic	367,229	282,237
US treasury bonds	292,717	4,233
Bonds of the Ministry of Finance of the Republic of Azerbaijan	232,917	103,614
Bonds of financial institutions	21,061	4,015
Corporate bonds	20,850	9,146
AMF bonds	3,001	-
Turkey Government Bonds	1,233	2,285
Debt securities at FVOCI	1,425,927	405,530
	<u>2018</u>	<u>2017</u>
Debt securities at amortized cost		
Corporate bonds	11,821	7,932
Turkey Government Bonds	12,056	-
Bonds of financial institutions	8,650	14,382
Certificates of deposits of financial institutions	-	17,489
Treasury bonds of the Ministry of Finance of Georgia	-	765
	32,527	40,568
Less: allowance for impairment	(308)	(160)
Debt securities at amortized cost	32,219	40,408

All balances of investment securities are allocated to Stage 1.

(Figures in tables are in thousands of Azerbaijani manats)

8. Investment securities (continued)

An analysis of changes in the gross carrying values and associated ECLs in relation to debt securities at FVOCI is as follows:

<i>Debt securities at FVOCI</i>	<i>Stage 1</i>
Gross carrying value as at 1 January 2018	405,530
New assets originated or purchased	1,414,221
Assets repaid	(390,596)
Unwinding of discount (recognised in interest revenue)	600
Fair value increase	721
Foreign exchange adjustments	(4,549)
At 31 December 2018	1,425,927

<i>Debt securities at FVOCI</i>	<i>Stage 1</i>
ECL as at 1 January 2018	-
New assets originated or purchased	(796)
Assets repaid	53
Changes to models and inputs used for ECL calculations	(13)
Foreign exchange adjustments	-
At 31 December 2018	(756)

An analysis of changes in the gross carrying values and associated ECLs in relation to debt securities at amortized cost is as follows:

<i>Debt securities at amortised cost</i>	<i>Stage 1</i>
Gross carrying value as at 1 January 2018	40,568
New assets originated	24,384
Assets repaid	(32,106)
Unwinding of discount (recognised in interest income)	253
Foreign exchange and other movements	(572)
At 31 December 2018	32,527

<i>Debt securities at amortised cost</i>	<i>Stage 1</i>
ECL as at 1 January 2018	(563)
New assets originated	(64)
Assets repaid	266
Foreign exchange and other movements	53
At 31 December 2018	(308)

9. Loans to customers

Loans to customers comprise:

	<i>2018</i>	<i>2017</i>
Legal entities	1,579,798	1,258,722
Individuals	200,984	155,270
Loans to customers (gross)	1,780,782	1,413,992
Less: allowance for impairment	(49,217)	(63,324)
Loans to customers (net)	1,731,565	1,350,668

(Figures in tables are in thousands of Azerbaijani manats)

9. Loans to customers (continued)

Loans are made in the following industry sectors:

	<u>2018</u>	<u>2017</u>
Trade and services	715,534	485,670
Individuals	200,984	155,270
Manufacturing	175,822	141,134
Non-banking credit organizations	161,177	155,257
Agriculture and food processing	125,994	82,943
Transport and telecommunication	124,999	46,346
Construction	110,103	135,712
Mining	53,156	69,175
Energy	40,378	53,627
Leasing	22,516	32,044
Other	50,119	56,814
Total loans (gross)	<u>1,780,782</u>	<u>1,413,992</u>

As at 31 December 2018, loans granted to top 6 customers (2017: 7 customers) which individually exceeded 5% of the Group's equity, amounted to AZN 300,344 thousand (2017: AZN 335,080 thousand).

Finance lease receivables

Included in corporate lending portfolio are finance lease receivables. The analysis of finance lease receivables at 31 December 2018 is as follows:

	<i>Not later than 1 year</i>	<i>Later than 1 year and not later than 5 years</i>	<i>Later than 5 years</i>
Gross investment in finance leases	5,593	4,043	-
Unearned future finance income on finance leases	(1,002)	(621)	-
Net investment in finance leases	<u>4,591</u>	<u>3,422</u>	<u>-</u>

The analysis of finance lease receivables at 31 December 2017 is as follows:

	<i>Not later than 1 year</i>	<i>Later than 1 year and not later than 5 years</i>	<i>Later than 5 years</i>
Gross investment in finance leases	10,984	6,808	-
Unearned future finance income on finance leases	(75)	(2,029)	-
Net investment in finance leases	<u>10,909</u>	<u>4,779</u>	<u>-</u>

An analysis of changes in the gross carrying value and corresponding ECL during the year ended 31 December 2018 is as follows:

	<u>Stage 1</u>	<u>Stage 2</u>	<u>Stage 3</u>	<u>Total</u>
Gross carrying value as at 1 January 2018	1,062,507	146,507	204,978	1,413,992
New assets originated or purchased	1,184,286	-	-	1,184,286
Assets repaid (excluding write-offs)	(598,353)	(92,327)	(47,369)	(738,049)
Transfers to Stage 1	8,712	(8,712)	-	-
Transfers to Stage 2	(298,162)	298,162	-	-
Transfers to Stage 3	(4,522)	(13,581)	18,103	-
Unwinding of discount	10,774	1,490	-	12,264
Changes to contractual cash flows due to modifications not resulting in derecognition	-	(117)	-	(117)
Amounts written off	(1,096)	-	(10,443)	(11,539)
Foreign exchange adjustments	(79,732)	(323)	-	(80,055)
At 31 December 2018	<u>1,284,414</u>	<u>331,099</u>	<u>165,269</u>	<u>1,780,782</u>

(Figures in tables are in thousands of Azerbaijani manats)

9. Loans to customers (continued)

	Stage 1	Stage 2	Stage 3	Total
ECL as at 1 January 2018	(6,079)	(3,648)	(51,421)	(61,148)
New assets originated or purchased	(19,177)	-	-	(19,177)
Assets repaid	4,230	1,330	23,436	28,996
Transfers to Stage 1	(328)	328	-	-
Transfers to Stage 2	8,238	(8,238)	-	-
Transfers to Stage 3	1,087	924	(2,011)	-
Impact on period end ECL of exposures transferred between stages during the period	273	(966)	(11,479)	(12,172)
Unwinding of discount (recognised in interest revenue)	(82)	(111)	(1,810)	(2,003)
Changes to models and inputs used for ECL calculations	(1,952)	909	(963)	(2,006)
Amounts written off	1,156	-	16,633	17,789
Foreign exchange adjustments	555	(51)	-	504
At 31 December 2018	(12,079)	(9,523)	(27,615)	(49,217)

Collateral and other credit enhancements

The amount and type of collateral required depends on an assessment of the credit risk of the counterparty. Guidelines are implemented regarding the acceptability of types of collateral and valuation parameters.

The main types of collateral obtained are as follows:

- ▶ For commercial lending, charges over real estate properties, cash, securities, equipment and trade receivables;
- ▶ For retail lending, mortgages over residential properties;
- ▶ The Group also obtains guarantees from parent company for loans to their customers.

Management monitors the market value of collateral, requests additional collateral in accordance with the underlying agreement, and monitors the market value of collateral obtained during its review of the adequacy of the allowance for loan impairment.

The Group calculates LGD rate of certain corporate and small lending loans in Stage 3 using discounted value of collaterals. As at 31 December 2018, maximum exposure of such individually assessed loans amounted to AZN 160,072 thousand for which ECL of AZN 24,694 thousand was created. If these loans were not collateralized, ECL amount for these loans would be AZN 89,368 based on collective assessment.

10. Investment property

The movements in investment property were as follows:

	2018	2017
Opening balance at 1 January	1,668	1,654
Additions (subsequent expenditure)	97,061	14
Impairment loss	(13,546)	-
Amortisation for the period	(148)	-
Foreign translation difference	(13,316)	-
Closing balance at 31 December	71,719	1,668

In 2011, the Bank acquired land for the amount of AZN 2,000 thousand as investment property which is held for long-term appreciation in value. As at 31 December 2018, the fair value of this investment property amounted to AZN 1,590 thousand (2017: AZN 1,668 thousand).

In June 2018, after the increase of share capital, PASHA Yatirim Bankasi A.S. purchased a real estate classified as investment property amounting to AZN 97,061 thousand as of balance sheet date (2017: none). As at 31 December 2018, the fair value of this investment property amounted to AZN 70,129 thousand.

(Figures in tables are in thousands of Azerbaijani manats)

11. Property and equipment

The movements in property and equipment were as follows:

	<i>Land</i>	<i>Buildings</i>	<i>Furniture and fixtures</i>	<i>Computers and other equipment</i>	<i>Vehicles</i>	<i>Other equipment</i>	<i>Leasehold improvements</i>	<i>Total</i>
Cost								
31 December 2016	415	4,107	10,077	8,659	1,138	643	3,105	28,144
Additions	-	-	3,050	1,377	203	28	89	4,747
Disposals	-	-	(482)	(251)	(47)	(17)	-	(797)
Foreign currency translation difference	-	-	(39)	(109)	(7)	(12)	(33)	(200)
31 December 2017	415	4,107	12,606	9,676	1,287	642	3,161	31,894
Additions	-	751	4,517	3,923	596	84	707	10,578
Disposals	-	-	(3)	(13)	(32)	(2)	-	(50)
Foreign currency translation difference	-	-	(65)	(266)	(35)	(19)	(44)	(429)
31 December 2018	415	4,858	17,055	13,320	1,816	705	3,824	41,993
Accumulated depreciation								
31 December 2016	-	(942)	(6,474)	(4,979)	(750)	(461)	(1,729)	(15,335)
Depreciation charge	-	(205)	(1,836)	(1,917)	(183)	(115)	(432)	(4,688)
Disposals	-	-	482	214	47	14	1	758
Foreign currency translation difference	-	-	31	102	2	10	34	179
31 December 2017	-	(1,147)	(7,797)	(6,580)	(884)	(552)	(2,126)	(19,086)
Depreciation charge	-	(209)	(2,234)	(1,877)	(221)	(48)	(319)	(4,908)
Disposals	-	-	3	13	32	2	-	50
Foreign currency translation difference	-	-	35	99	5	17	31	187
31 December 2018	-	(1,356)	(9,993)	(8,345)	(1,068)	(581)	(2,414)	(23,757)
Net book value								
31 December 2018	415	3,502	7,062	4,975	748	124	1,410	18,236
31 December 2017	415	2,960	4,809	3,096	403	90	1,035	12,808
31 December 2016	415	3,165	3,603	3,680	388	182	1,376	12,809

(Figures in tables are in thousands of Azerbaijani manats)

12. Intangible assets

The movements in intangible assets were as follows:

	<i>Goodwill</i>	<i>Banking license</i>	<i>Licenses</i>	<i>Computer software</i>	<i>Digital products</i>	<i>Total</i>
Cost						
31 December 2016	3,642	42,228	8,842	7,489	-	62,201
Additions	-	-	2,906	4,468	-	7,374
Disposals	-	-	(281)	(1)	-	(282)
Foreign currency translation difference	-	(4,405)	(17)	(126)	-	(4,548)
31 December 2017	3,642	37,823	11,450	11,830	-	64,745
Additions	-	-	3,298	1,542	11,377	16,217
Disposals	-	-	-	(112)	-	(112)
Internal transfer	-	-	(563)	563	-	-
Foreign currency translation difference	-	(9,036)	15	(385)	-	(9,406)
31 December 2018	3,642	28,787	14,200	13,438	11,377	71,444
Accumulated amortization						
31 December 2016	(3,642)	-	(2,382)	(1,110)	-	(7,134)
Amortisation charge	-	-	(1,494)	(1,269)	-	(2,763)
Disposals	-	-	281	1	-	282
Impairment	-	(6,236)	-	-	-	(6,236)
Foreign currency translation difference	-	-	5	55	-	60
31 December 2017	(3,642)	(6,236)	(3,590)	(2,323)	-	(15,791)
Amortisation charge	-	-	(1,934)	(1,613)	-	(3,547)
Disposals	-	-	-	111	-	111
Impairment	-	(2,659)	-	-	-	(2,659)
Internal transfer	-	-	175	(175)	-	-
Foreign currency translation difference	-	-	(5)	201	-	196
31 December 2018	(3,642)	(8,895)	(5,354)	(3,799)	-	(21,690)
Net book value						
31 December 2018	-	19,892	8,846	9,639	11,377	49,754
31 December 2017	-	31,587	7,860	9,507	-	48,954
31 December 2016	-	42,228	6,460	6,379	-	55,067

Digital products mainly represents the Group's banking products under development.

Impairment testing of intangible assets with indefinite lives

Banking license acquired through business combination with indefinite lives has been allocated to one individual cash-generating unit for impairment testing which is PASHA Yatirim Bankasi A.Ş.

The carrying amount of the banking license acquired allocated to the cash-generating units is AZN 19,892 thousand (31 December 2017: AZN 31,587 thousand).

Key assumptions used in fair value calculation

As at 31 December 2018 and 2017, recoverable amount of cash generating unit have been determined based on value in use method. The valuation is based on the information about historical and prospective financials and strategic initiatives of the bank, and other third party information available on the market.

(Figures in tables are in thousands of Azerbaijani manats)

12. Intangible assets (continued)

Key assumptions used in fair value calculation (continued)

The calculation of value in use is most sensitive to the following assumptions:

- ▶ Financial performance (including current and forecasted results);
- ▶ Cost of equity;
- ▶ ROE (including current and forecasted results);
- ▶ Growth rate of loan portfolio;
- ▶ GDP growth rate in Turkey;
- ▶ Leverage ratio;
- ▶ Period of discounted cash flow of 8 years;
- ▶ Long term inflation growth rate of 5% (2017: 3%).

The following rates are used by the Bank for calculation of Cost of Equity:

		2018	2017
Cost of equity calculation			
US Risk-Free Rate	a	2.9%	2.7%
US Market risk premium	b	5.1%	5.1%
Country risk premium	c	3.5%	3.1%
Beta	d	0.82	0.82
Cost of equity USD	e = (a+b*d+c)	10.5%	9.9%
USA inflation rate	f	2.3%	2.3%
Turkey inflation rate	j	7.0%	5.5%
Cost of equity TRY	h=(1+e)*((1+j)/(1+f))-1	15.6%	13.3%

As a result of the valuation, recoverable amount of cash generating unit amounted to 182,341 AZN thousand (2017: AZN 151,359 thousand). Accordingly, the license was partially impaired by amount of AZN 2,659 thousand (2017: AZN 6,236 thousand). The impairment loss was mainly due to decrease in return on equity.

Sensitivity for reasonably possible increase in discount rate by 1% (from 15.6% to 16.6%) (2017: from 13.3% to 14.3%) would result in additional impairment of AZN 18,378 thousand (2017: AZN 24,379 thousand) under the same assumption of the long-term Return on Equity.

13. Other assets and liabilities

Other assets comprise:

	2018	2017
Other financial assets		
Settlements on money transfers	6,065	11,267
Clearance cheque accounts	7,118	1,443
Accrued commission receivable on guarantees and letters of credit	901	466
Other	19	55
	14,103	13,231
Less: allowance for impairment of other financial assets	(492)	-
Total other financial assets	13,611	13,231
Other non-financial assets		
Reposessed collateral	13,929	15,287
Deferred expenses	2,441	2,308
Prepayments for acquisition of property, equipment and intangible assets	2,078	1,771
Other prepayments	3,055	1,299
Taxes, other than income tax	2	-
	21,505	20,665
Other assets	35,116	33,896

(Figures in tables are in thousands of Azerbaijani manats)

13. Other assets and liabilities (continued)

As at 31 December 2017 and 2018, clearance cheque accounts consist of receivables from other banks for which cheques stand as collateral.

As at 31 December 2018 deferred expenses of AZN 1,217 thousand (31 December 2017: AZN 1,297 thousand) related to long term software support.

Other liabilities comprise:

	2018	2017
Other financial liabilities		
Settlements on money transfer	7,432	11,804
Clearance cheque accounts	7,118	1,443
Accrued expenses	3,027	626
Other	2,297	720
	<u>19,874</u>	<u>14,593</u>
Other non-financial liabilities		
Payable to employees	18,944	16,064
Deferred income	1,218	965
Taxes, other than income tax	326	139
Other provision	112	118
Other	825	221
	<u>21,425</u>	<u>17,507</u>
Other liabilities	<u>41,299</u>	<u>32,100</u>

14. Amounts due to banks and government funds

Amounts due to banks and government funds comprise:

	2018	2017
Entrepreneurship Development Fund of the Republic of Azerbaijan	247,985	138,747
Short-term deposits from banks	197,664	107,160
Long-term deposits from banks	25,485	131,540
Correspondent accounts with other banks	25,340	4,118
Azerbaijan Mortgage and Credit Guarantee Fund	20,367	11,201
Amount due to IT Development Fund	4,914	5,251
State Agency on Mandatory Health Insurance	3,220	-
Loans from the CBAR and NBG	-	1,956
Amounts due to banks and government funds	<u>524,975</u>	<u>399,973</u>

As at 31 December 2018, Entrepreneurship Development Fund of the Republic of Azerbaijan had current account amounting to AZN 61,321 thousand (31 December 2017: nil). The Group had loans received from the Entrepreneurship Development Fund of the Republic of Azerbaijan amounting to AZN 186,664 thousand (31 December 2017: AZN 138,747 thousand), maturing through December 2028 (31 December 2017: through December 2027), and bearing interest rate of 1.0% p.a. The loans were acquired for the purposes of assistance in gradually improving entrepreneurship environment in Azerbaijan under the government program. The loans have been granted to local entrepreneurs at interest rate of 5% p.a. (31 December 2017: 6% p.a.).

As at 31 December 2018, the Group received short-term funds both resident and non-resident commercial banks comprising AZN 197,442 thousand (31 December 2017: AZN 107,160 thousand) maturing through December 2019 (31 December 2017: August 2018) and with interest rates ranging between 0.10% and 7.00% p.a. (31 December 2017: ranging between 0.10% and 15.20% p.a.).

As at 31 December 2018, the Group received long-term funds from both resident and non-resident commercial banks comprising AZN 25,485 thousand (31 December 2017: AZN 131,540) maturing through December 2022 with interest rate 3.00% p.a. (31 December 2017: January 2019 with interest rate ranging between 1.00% and 2.50% p.a.).

As at 31 December 2018, the Group had loans refinanced from the Azerbaijan Mortgage and Credit Guarantee Fund amounting to AZN 20,367 thousand (31 December 2017: AZN 11,201 thousand), maturing through December 2048 (31 December 2017: through October 2047) and bearing interest rate of 4.0% p.a.

As at 31 December 2018, the Group had loans refinanced from the IT Development Fund amounting to AZN 4,914 thousand (31 December 2017: AZN 5,251 thousand), maturing through October 2023 (31 December 2017: through December 2021) and bearing interest rate of 1.0% p.a.

(Figures in tables are in thousands of Azerbaijani manats)

15. Amounts due to customers

The amounts due to customers include the following:

	<u>2018</u>	<u>2017</u>
Demand deposits	2,946,841	1,856,582
Time deposits	1,007,111	1,033,379
Amounts due to customers	<u>3,953,952</u>	<u>2,889,961</u>
Held as security against guarantees issued (Note 22)	23,352	38,481

An analysis of customer accounts by economic sector follows:

	<u>2018</u>	<u>2017</u>
Individuals	1,265,829	775,936
Trade and services	739,982	491,191
Investment holding companies	494,449	517,692
Manufacturing	444,912	455,919
Transport and communication	382,365	218,090
Construction	194,889	128,187
Insurance	123,068	87,244
Mining	117,200	75,542
Hotel business	46,220	48,395
Public organizations	24,906	18,758
Non banking credit organizations	20,426	9,218
Agriculture	19,390	26,096
Energy	9,573	8,946
Other	70,743	28,747
Amounts due to customers	<u>3,953,952</u>	<u>2,889,961</u>

As at 31 December 2018, customer deposits included balances with five (31 December 2017: five) largest customers comprised AZN 1,736,416 thousand or 44% of the total customer deposits portfolio (31 December 2017: AZN 1,298,632 thousand or 45% of the total customer deposits portfolio).

16. Other borrowed funds

As at 31 December 2017, other borrowed funds included balances with three foreign banks amounting to AZN 39,105 thousand maturing through April 2021 and bearing interest rates ranging between 1.47% and 3.72% p.a. The borrowings were repaid before maturity in 2018.

17. Debt securities issued

As at 31 December 2018, PASHA Yatirim Bankasi A.S. had issued interest-bearing bonds with carrying amount of AZN 102,300 thousand (31 December 2017: AZN 81,765 thousand) maturing in December 2022 (31 December 2017: matured in December 2022). Bonds issued by the bank as at 31 December 2018, bear annual interest rates ranging from 3% to 30% (31 December 2017: from 5% to 12.1%).

18. Subordinated debt

As of 31 December 2018, subordinated debt represents USD denominated subordinated loan of AZN 18,921 (31 December 2017: nil) borrowed by the Group from its parent maturing on 8 August 2024.

(Figures in tables are in thousands of Azerbaijani manats)

19. Derivative financial instruments

The Group enters into derivative financial instruments for trading purposes. The table below shows the fair values of derivative financial instruments, recorded as assets or liabilities, together with their notional amounts. The notional amount, recorded gross, is the amount of a derivative's underlying asset, reference rate or index and is the basis upon which changes in the value of derivatives are measured. The notional amounts indicate the volume of transactions outstanding at the year end and are not indicative of the credit risk.

	2018			2017		
	Notional amount	Fair values		Notional amount	Fair value	
		Asset	Liability		Asset	Liability
Foreign exchange contracts						
Forwards and swaps – foreign	7,958	–	(15)	59,389	40	(2,058)
Forwards and swaps – domestic	66,429	2,048	(66)	8,501	1,625	–
Options – domestic	16,909	2	–	–	–	–
Total derivative assets/ (liabilities)		2,050	(81)		1,665	(2,058)

Foreign and domestic in the table above stand for counterparties where foreign means non-Azerbaijani entities and domestic means Azerbaijani entities.

As at 31 December 2018 and 2017, the Group has positions in the following types of derivatives:

Forwards

Forwards and futures contracts are contractual agreements to buy or sell a specified financial instrument at a specific price and date in the future. Forwards are customised contracts transacted in the over-the-counter market.

Swaps

Swaps are contractual agreements between two parties to exchange movements in interest and foreign currency rates and equity indices, and (in the case of credit default swaps) to make payments with respect to defined credit events based on specified notional amounts.

Options

Options are contractual agreements that convey the right, but not the obligation, for the purchaser either to buy or sell a specific amount of a financial instrument at a fixed price, either at a fixed future date or at any time within a specified period.

20. Taxation

The corporate income tax expense comprises:

	2018	2017
Current tax charge	(24,854)	(20,219)
Deferred tax credit/(charge) – origination and reversal of temporary differences	3,841	(3,473)
Less: deferred tax recognised in other comprehensive income	82	(6)
Income tax expense	(20,931)	(23,698)

Deferred tax related to items charged or credited to other comprehensive income during the year is as follows:

	2018	2017
Net (gains)/losses on investment securities FVOCI	(82)	6
Income tax (charged)/credited to other comprehensive income	(82)	6

(Figures in tables are in thousands of Azerbaijani manats)

20. Taxation (continued)

The effective income tax rate differs from the statutory income tax rates. A reconciliation of the income tax expense based on statutory rates with actual is as follows:

	2018	2017
Profit before income tax expense	94,984	112,790
Statutory tax rate	20%	20%
Theoretical tax expense at the statutory rate	(18,997)	(22,558)
Tax effect of non-deductible expenses	(2,441)	(951)
Effect from change in tax legislation	154	(271)
Effect of difference in tax rate in foreign country	(102)	151
Tax effect of tax-exempt income	67	89
Utilised tax losses carried forward, not recognized previously	242	-
Other	146	(158)
Income tax expense	(20,931)	(23,698)

Deferred tax assets and liabilities as at 31 December 2018 and 2017 and their movements for the respective years comprise:

	Origination and reversal of temporary differences				2017	Origination and reversal of temporary differences				2018
	2016	In the statement of profit or loss	In other comprehensive income	Translation difference		Effect of adoption of IFRS 9	In the statement of profit or loss	In other comprehensive income	Translation difference	
Tax effect of deductible temporary differences										
Tax losses carried forward	536	(552)	-	16	-	-	130	-	(7)	123
Trading securities	573	(573)	-	-	-	-	-	-	-	-
Amounts due from credit institutions	4,024	(4,024)	-	-	-	-	9	-	(2)	7
Loans to customers	395	(139)	-	(21)	235	-	822	-	(137)	920
Investment securities	15	-	6	-	21	-	-	-	-	21
Investment property	69	(3)	-	-	66	-	2,996	-	-	3,062
Property and equipment	151	(155)	-	4	-	-	169	-	(6)	163
Intangible assets	-	-	-	-	-	-	84	-	-	84
Derivative financial liabilities	333	(18)	-	-	315	-	(315)	-	-	-
Provision for guarantees and letters of credit	318	(318)	-	-	-	-	-	-	-	-
Other liabilities	2,915	458	-	(26)	3,347	-	600	-	(143)	3,804
Deferred tax asset	9,329	(5,324)	6	(27)	3,984	-	4,495	-	(295)	8,184
Amounts due from credit institutions	-	(2,618)	-	-	(2,618)	-	2,026	-	-	(592)
Derivative financial assets	(169)	(156)	-	-	(325)	-	112	-	-	(213)
Investment securities	(9)	8	-	-	(1)	(48)	113	(82)	45	27
Loans to customers	(118)	(2,677)	-	(3)	(2,798)	(160)	(2,015)	-	10	(4,963)
Property and equipment	(237)	132	-	5	(100)	-	(440)	-	176	(364)
Intangible assets	(68)	44	-	(1)	(25)	-	(21)	-	2	(44)
Other assets	(325)	(561)	-	-	(886)	-	(732)	-	106	(1,512)
Amounts due to banks and government funds	(222)	222	-	-	-	-	-	-	-	-
Amounts due to customers	(6,534)	6,534	-	-	-	-	-	-	-	-
Provision for guarantees and letters of credit	-	(330)	-	-	(330)	245	(147)	-	-	(232)
Banking license	(8,446)	1,247	-	882	(6,317)	-	532	-	1,611	(4,174)
Deferred tax liabilities	(16,128)	1,845	-	883	(13,400)	37	(572)	(82)	1,950	(12,067)
Net deferred tax assets/(liabilities)	(6,799)	(3,479)	6	856	(9,416)	37	3,923	(82)	1,655	(3,883)

(Figures in tables are in thousands of Azerbaijani manats)

20. Taxation (continued)

Deferred taxes in the consolidated statement of financial position as at 31 December 2018 and 2017 can be reconciled as follows:

	2018	2017
Deferred tax assets	4,003	640
Deferred tax liabilities	(7,886)	(10,056)
Net deferred tax liabilities	(3,883)	(9,416)

21. Equity

As at 31 December 2018 and 2017, the Bank's authorized, issued and fully paid capital amounted to AZN 333,000 thousand comprising of 10,000 ordinary shares with a par value of AZN 33,300 per ordinary share. Each ordinary share entitles one vote to the shareholder.

On 25 April 2017 Shareholders of the Bank declared dividends totalling AZN 58,636 thousand on ordinary shares (AZN 5,864 per share) which was paid as at 31 December 2017.

On 10 May 2018 Shareholders of the Bank declared dividends totalling AZN 61,414 thousand on ordinary shares (AZN 6,141 per share) which was paid as at 31 December 2018.

Foreign currency translation reserve

Foreign currency translation reserve is used to record exchange difference arising from the translation of the financial statements of foreign subsidiaries.

Unrealised gains/(losses) on investment securities

This reserve records fair value changes on investment securities.

22. Commitments and contingencies

Operating environment

Azerbaijan continues economic reforms and development of its legal, tax and regulatory frameworks. The future stability of the Azerbaijan economy is largely dependent upon these reforms and the effectiveness of economic, financial and monetary measures undertaken by the government as well as crude oil prices and stability of Azerbaijani manat.

The Azerbaijan economy has been negatively impacted by decline of oil prices and devaluation of Azerbaijani manat during 2015. This resulted in reduced access to capital, a higher cost of capital, inflation and uncertainty regarding economic growth.

In response to these challenges, Azerbaijani government announced plans to accelerate reforms and support to financial system. On 6 December 2016 President of the Republic of Azerbaijan approved "Strategic road maps for the national economy and main economic sectors of Azerbaijan". The road maps cover 2016-2020 development strategy, long-term outlook up to 2025 and vision beyond 2025.

Furthermore, during 2018 the government continued tight monetary policy as well as allocated foreign currency resources which stabilized Azerbaijani manat. During 2018, CBAR gradually reduced refinancing rate from 15% to 9.75% with aim of normalising monetary policy.

The Group's management is monitoring economic developments in the current environment and taking precautionary measures it considered necessary in order to support the sustainability and development of the Group's business in the foreseeable future.

Legal

In the ordinary course of business, the Group is subject to legal actions and complaints. Management believes that the ultimate liability, if any, arising from such actions or complaints will not have a material adverse effect on the financial condition or the results of future operations of the Group.

(Figures in tables are in thousands of Azerbaijani manats)

22. Commitments and contingencies (continued)

Taxation

Azerbaijani tax, currency and customs legislation is subject to varying interpretations, and changes, which can occur frequently. Management's interpretation of such legislation as applied to the transactions and activity of the Group may be challenged by the relevant authorities. Recent events within the Azerbaijan suggest that the tax authorities are taking a more assertive position in its interpretation of the legislation and assessments and, as a result, it is possible that transactions and activities that have not been challenged in the past may be challenged. As such, significant additional taxes, penalties and interest may be assessed. Fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review.

Management believes that its interpretation of the relevant legislation as at 31 December 2018 is appropriate and that the Group's tax, currency and customs positions will be sustained.

Insurance

The Group has not currently obtained insurance coverage related to liabilities arising from errors or omissions.

Compliance with the CBAR ratios

CBAR requires banks to maintain certain prudential ratios computed based on statutory financial statements. As at 31 December 2018 and 2017, the Bank was in compliance with these ratios except for the followings:

- a) Ratio of maximum credit exposure of a bank per a single borrower or a group of related borrowers that should not exceed 7 percent of the Bank's Tier 1 capital when the market value of the collateral of credit exposures is less than 100 percent of such credit exposures, or the market value of real estate collateral of loans is below 150% of the loan value. As at 31 December 2018 the Bank's ratio was 38.0% (31 December 2017: 25.27%). As of 31 March 2019, this breach was cured and the Bank became compliant with this prudential norm;
- b) Ratio of maximum credit exposure of a bank per a single borrower or a group of related borrowers that should not exceed 20 percent of the Bank's Tier 1 capital when the market value of the collateral of credit exposures is more than 100 percent of such credit exposures, or the market value of real estate collateral of loans is above 150% of the loan value. As at 31 December 2018 the Bank's ratio was 31.1% (31 December 2017: no breach). As of 31 March 2019, this breach was cured and the Bank became compliant with this prudential norm;
- c) Ratio of the share in one legal entity which should not exceed 10% of total capital. As at 31 December 2018 the Bank's ratio was 35.66% (31 December 2017: 39.41%);
- d) Ratio of the total share in other legal entities which should not exceed 40% of total capital. As at 31 December 2018 the Bank's ratio was 52.46% (31 December 2017: 57.85%).

Throughout the year the Bank submitted information regarding these breaches to the Financial Markets Supervision Authority (the "FMSA") on a monthly basis and no sanctions were imposed on the Bank. Management believes that the Bank will not face any sanctions against the Bank in the future.

Financial commitments and contingencies

The Group provides guarantees and letters of credit to customers with primary purpose of ensuring that funds are available to a customer as required. Guarantees and standby letters of credit represent irrevocable assurances that the Group will make payments in the event that a customer cannot meet its obligations to third parties. Documentary and commercial letters of credit, which are written undertakings by the Group on behalf of a customer authorizing a third party to draw drafts on the Group up to a stipulated amount under specific terms and conditions, are collateralized by the underlying shipments of goods, to which they relate, or cash deposits and, therefore, carry less risk than a direct borrowing.

(Figures in tables are in thousands of Azerbaijani manats)

22. Commitments and contingencies (continued)

Financial commitments and contingencies (continued)

Financial commitments and contingencies comprise:

	2018	2017
Credit-related commitments		
Guarantees issued	549,196	390,089
Unused credit lines	133,479	153,616
Letters of credit	5,146	6,441
	<u>687,821</u>	<u>550,146</u>
Operating lease commitments		
Not later than 1 year	4,911	4,565
Later than 1 year but not later than 5 years	19,176	16,487
Later than 5 years	-	1,377
	<u>24,087</u>	<u>22,429</u>
Less: provision for ECL for credit related commitments	(6,470)	(3,112)
Commitments and contingencies (before deducting collateral)	<u>705,438</u>	<u>569,463</u>
Less: cash held as security against guarantees issued (Note 15)	(23,352)	(38,481)
Commitments and contingencies	<u>682,086</u>	<u>530,982</u>

An analysis of changes in the ECLs during the year ended 31 December 2018 is as follows:

	Stage 1	Stage 2	Stage 3	Total
ECL as at 1 January 2018	(2,025)	(1,952)	(290)	(4,267)
New exposures	(1,685)	(1,191)	-	(2,876)
Exposures derecognised or matured (excluding write-offs)	328	283	288	899
Transfers to Stage 1	(2,231)	2,231	-	-
Transfers to Stage 2	245	(245)	-	-
Transfers to Stage 3	-	(487)	487	-
Impact on period end ECL of exposures transferred between stages during the period	1,780	(506)	(1,364)	(90)
Changes to inputs used for ECL calculations	(319)	8	3	(308)
Foreign exchange adjustments	172	-	-	172
At 31 December 2018	<u>(3,735)</u>	<u>(1,859)</u>	<u>(876)</u>	<u>(6,470)</u>

23. Credit loss expense and other impairment and provisions

The table below shows the ECL charges on financial instruments recorded in the consolidated statement of profit or loss for the year ended 31 December 2018:

	Note	Stage 1	Stage 2	Stage 3	Total
Cash and cash equivalents	5	(8)	-	-	(8)
Due from credit institutions	7	(225)	-	850	625
Investment securities at FVOCI	8	(756)	-	-	(756)
Investment securities at amortised cost	8	202	-	-	202
Loans to customers	9	(7,629)	(5,713)	8,983	(4,359)
Credit loss on financial assets		<u>(8,416)</u>	<u>(5,713)</u>	<u>9,833</u>	<u>(4,296)</u>
Other financial assets		-	-	(492)	(492)
Credit related commitments	22	(1,882)	93	(586)	(2,375)
Total credit loss expense		<u>(10,298)</u>	<u>(5,620)</u>	<u>8,755</u>	<u>(7,163)</u>

Allowance for impairment of other assets is deducted from the carrying amounts of the related assets. Provision for ECL for credit related commitments are recorded in liabilities.

(Figures in tables are in thousands of Azerbaijani manats)

24. Net fee and commission income

Net fee and commission income comprise:

	<u>2018</u>	<u>2017</u>
Servicing plastic card operations	11,674	8,224
Settlements operations	10,216	8,103
Guarantees and letters of credit	8,941	6,313
Cash operations	2,687	1,681
Securities operations	13	225
Other	352	285
Fee and commission income	<u>33,883</u>	<u>24,831</u>
Servicing plastic card operations	(11,212)	(7,828)
Settlements operations	(3,090)	(2,810)
Guarantees and letters of credit	(1,567)	(1,238)
Cash operations	(798)	(1,123)
Securities operations	(41)	(14)
Other	(670)	(627)
Fee and commission expense	<u>(17,378)</u>	<u>(13,640)</u>
Net fee and commission income	<u>16,505</u>	<u>11,191</u>

25. Personnel, general and administrative expenses

Personnel expenses comprise:

	<u>2018</u>	<u>2017</u>
Salaries and bonuses	(40,546)	(33,107)
Social security costs	(7,274)	(6,369)
Other employee related expenses	(3,735)	(4,415)
Total personnel expenses	<u>(51,555)</u>	<u>(43,891)</u>

General and administrative expenses comprise:

	<u>2018</u>	<u>2017</u>
Professional services	(8,329)	(8,502)
Operating leases	(7,563)	(6,987)
Software cost	(3,872)	(3,298)
Impairment of repossessed collateral	(2,347)	(338)
Insurance	(1,971)	(1,330)
Charity and sponsorship	(1,774)	(1,997)
Advertising costs	(1,731)	(2,237)
Membership fees	(1,520)	(910)
Utilities	(1,062)	(780)
Repair and maintenance	(966)	(840)
Security expenses	(844)	(595)
Stationery	(660)	(282)
Transportation and business trip expenses	(659)	(613)
Entertainment	(659)	(611)
Taxes, other than income tax	(576)	(430)
Communications	(561)	(606)
Printing expenses	(43)	(28)
Other expenses	(515)	(543)
Total general and administrative expenses	<u>(35,652)</u>	<u>(30,927)</u>

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management

Introduction

Risk is inherent in the Group's activities but it is managed through a process of ongoing identification, measurement and monitoring, subject to risk limits and other controls. This process of risk management is critical to the Group's continuing profitability and each individual within the Group is accountable for the risk exposures relating to his or her responsibilities. The Group is exposed to credit risk, liquidity risk and market risk, the latter being subdivided into trading and non-trading risks. It is also subject to operating risks.

The independent risk control process does not include business risks such as changes in the environment, technology and industry. They are monitored through the Group's strategic planning process.

Risk management structure

The Supervisory Board is ultimately responsible for identifying and controlling risks; however, there are separate independent bodies responsible for managing and monitoring risks.

Supervisory Board

The Supervisory Board is responsible for the overall risk management approach and for approving the risk strategies and principles.

Audit Committee

The Audit Committee has the overall responsibility for the establishment and development of the audit mission and strategy. It is responsible for the fundamental audit issues and monitoring Internal Audit's activities.

Executive Board

The Executive Board has the responsibility to monitor the overall risk process within the Group.

Risk Committee

The Risk Committee has the overall responsibility for the development of the risk strategy and implementing principles, frameworks, policies and limits. It is responsible for the fundamental risk issues and manages and monitors relevant risk decisions.

Risk Management

The Risk Management Department is responsible for implementing and maintaining risk related procedures to ensure an independent control process.

Bank Treasury

Bank Treasury is responsible for managing the Group's assets and liabilities and the overall financial structure. It is also primarily responsible for the funding and liquidity risks of the Group.

Internal Audit

Risk management processes throughout the Group are audited annually by the internal audit function, which examines both the adequacy of the procedures and the Group's compliance with the procedures. Internal Audit discusses the results of all assessments with management, and reports its findings and recommendations to the Audit Committee.

Risk measurement and reporting systems

The Group's risks are measured using a method which reflects both the expected loss likely to arise in normal circumstances and unexpected losses, which are an estimate of the ultimate actual loss based on statistical models. The models make use of probabilities derived from historical experience, adjusted to reflect the economic environment. The Group also runs worse case scenarios that would arise in the event that extreme events which are unlikely to occur do, in fact, occur.

Monitoring and controlling risks is primarily performed based on limits established by the Group. These limits reflect the business strategy and market environment of the Group as well as the level of risk that the Group is willing to accept, with additional emphasis on selected industries. In addition the Group monitors and measures the overall risk bearing capacity in relation to the aggregate risk exposure across all risks types and activities.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Introduction (continued)

Information compiled from all the businesses is examined and processed in order to analyse, control and identify early risks. This information is presented and explained to the Management Board, the Risk Committee, and the head of each business division. The report includes aggregate credit exposure, hold limit exceptions and liquidity ratios. On a monthly basis detailed reporting of industry, customer and geographic risks takes place. Senior management assesses the appropriateness of the allowance for credit losses on a quarterly basis. The Board of Directors receives a comprehensive risk report once a quarter which is designed to provide all the necessary information to assess and conclude on the risks of the Group.

For all levels throughout the Group, specifically tailored risk reports are prepared and distributed in order to ensure that all business divisions have access to extensive, necessary and up-to-date information.

A daily briefing is given to the Management Board and all other relevant employees of the Group on the utilisation of market limits and liquidity, plus any other risk developments.

Risk mitigation

Bank actively uses collateral to reduce its credit risks.

Excessive risk concentration

Concentrations arise when a number of counterparties are engaged in similar business activities, or activities in the same geographic region, or have similar economic features that would cause their ability to meet contractual obligations to be similarly affected by changes in economic, political or other conditions. Concentrations indicate the relative sensitivity of the Group's performance to developments affecting a particular industry or geographical location.

In order to avoid excessive concentrations of risks, the Group's policies and procedures include specific guidelines to focus on maintaining a diversified portfolio. Identified concentrations of credit and customer's deposit risks are controlled and managed accordingly.

Credit risk

Credit risk is the risk that the Group will incur a loss because its customers, clients or counterparties failed to discharge their contractual obligations. The Group manages and controls credit risk by setting limits on the amount of risk it is willing to accept for individual counterparties and for geographical and industry concentrations, and by monitoring exposures in relation to such limits.

The Group has established a credit quality review process to provide early identification of possible changes in the creditworthiness of counterparties, including regular collateral revisions. Counterparty limits are established by the use of a credit risk classification system. The credit quality review process allows the Group to assess the potential loss as a result of the risks to which it is exposed and take corrective action.

Derivative financial instruments

Credit risk arising from derivative financial instruments is, at any time, limited to those with positive fair values, as recorded in the consolidated statement of financial position.

Credit-related commitments risks

The Group makes available to its customers guarantees which may require that the Group make payments on their behalf. Such payments are collected from customers based on the terms of the letter of credit. They expose the Group to similar risks to loans and these are mitigated by the same control processes and policies.

The maximum exposure to credit risk for the components of the consolidated statement of financial position, including derivatives, before the effect of mitigation through the use of master netting and collateral agreements, is best represented by their carrying amounts.

Where financial instruments are recorded at fair value, the carrying value represents the current credit risk exposure but not the maximum risk exposure that could arise in the future as a result of changes in values.

For more detail on the maximum exposure to credit risk for each class of financial instrument, references shall be made to the specific notes. The effect of collateral and other risk mitigation techniques is shown in Note 8.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Credit risk (continued)

Impairment assessment

From 1 January 2018, the Group calculates ECL based on several probability-weighted scenarios to measure the expected cash shortfalls, discounted at an approximation to the EIR. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. The mechanics of the ECL calculations are outlined below and the key elements are as follows:

PD	The <i>Probability of Default</i> is an estimate of the likelihood of default over a given time horizon. A default may only happen at a certain time over the assessed period, if the facility has not been previously derecognised and is still in the portfolio.
EAD	The <i>Exposure at Default</i> is an estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, whether scheduled by contract or otherwise, expected drawdowns on committed facilities, and accrued interest from missed payments.
LGD	The <i>Loss Given Default</i> is an estimate of the loss arising in the case where a default occurs at a given time. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from the realisation of any collateral. It is usually expressed as a percentage of the EAD.

The ECL allowance is based on the credit losses expected to arise over the life of the asset (the lifetime expected credit loss or LTECL), unless there has been no significant increase in credit risk since origination, in which case, the allowance is based on the 12 months' expected credit loss (12mECL). The 12mECL is the portion of LTECL that represent the ECLs that result from default events on a financial instrument that are possible within the 12 months after the reporting date. Both LTECL and 12mECL are calculated on either an individual basis or a collective basis, depending on the nature of the underlying portfolio of financial instruments.

The Bank has established a policy to perform an assessment, at the end of each reporting period, of whether a financial instrument's credit risk has increased significantly since initial recognition, by considering the change in the risk of default occurring over the remaining life of the financial instrument. Based on the above process, the Group groups its loans into Stage 1, Stage 2, Stage 3 and POCI, as described below:

Stage 1:	When loans are first recognized, the Bank recognizes an allowance based on 12mECL. Stage 1 loans also include facilities where the credit risk has improved and the loan has been reclassified from Stage 2.
Stage 2:	When a loan has shown a significant increase in credit risk since origination, the Bank records an allowance for the LTECL. Stage 2 loans also include facilities, where the credit risk has improved and the loan has been reclassified from Stage 3.
Stage 3:	Loans considered credit-impaired. The Bank records an allowance for the LTECL.
POCI:	Purchased or originated credit impaired (POCI) assets are financial assets that are credit impaired on initial recognition. POCI assets are recorded at fair value at original recognition and interest revenue is subsequently recognised based on a credit-adjusted EIR. ECL are only recognised or released to the extent that there is a subsequent change in the lifetime expected credit losses.

Definition of default and cure

The Bank considers a financial instrument defaulted and therefore Stage 3 (credit-impaired) for ECL calculations in all cases when the borrower becomes 90 days past due on its contractual payments. The Group considers amounts due from banks defaulted and takes immediate action when the required intraday payments are not settled by the close of business as outlined in the individual agreements.

As a part of a qualitative assessment of whether a customer is in default, the Bank also considers a variety of instances that may indicate unlikeliness to pay. When such events occur, the Bank carefully considers whether the event should result in treating the customer as defaulted and therefore assessed as Stage 3 for ECL calculations or whether Stage 2 is appropriate.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Credit risk (continued)

Such events include:

- ▶ Default and Credit-impaired assets:
 - ▶ Loans with principal amount and/or accrued interest and/or any of other payment overdue by more than 90 days from the date specified in the contract;
 - ▶ 2 times within three years restructured loans that have been overdue (in principal amount and/or accrued interest and/or any of other payment) less than 30 days from the date specified in the contract at the moment of each particular restructuring;
 - ▶ "Non-healthy" restructured loans that were PAR 30 at the moment of restructuring; (originally in Stage 3), when NPV loss restructuring is more than 10%;
 - ▶ Any loan considered by management as non-performing (except non-performing loans that meet Stage 2 criteria).
- ▶ Existing of information that borrower will/has enter bankruptcy, insolvency or a similar condition.
- ▶ Default (according to IRB and External Rating).
- ▶ Default on other financial instruments of the same borrower.

It is the Group's policy to consider a financial instrument as 'cured' and therefore re-classified out of Stage 3 when none of the default criteria have been present for at least six consecutive months. The decision whether to classify an asset as Stage 2 or Stage 1 once cured depends on the updated credit grade, at the time of the cure, and whether this indicates there has been a significant increase in credit risk compared to initial recognition.

Internal rating and PD estimation process

The Group's Risk Department operates its internal rating models. The Bank runs separate models for its key portfolios in which its corporate customers are rated based on Moody's model. Small and medium enterprises and consumer loans are scored from 1 to 20 and from 1 to 4 using internal grades, respectively. The models incorporate both qualitative and quantitative information and, in addition to information specific to the borrower, utilise supplemental external information that could affect the borrower's behaviour. Where practical, they also build on information from the national and international external rating agencies. PDs, incorporating forward looking information and the IFRS 9 stage classification of the exposure, are assigned for each grade. This is repeated for each economic scenario as appropriate.

Treasury and interbank relationships

The Bank's treasury and interbank relationships and counterparties comprise financial services institutions, banks, broker-dealers, exchanges and clearing-houses. For these relationships, the Bank analyses publicly available information such as financial information and other external data, e.g., the external ratings, and assigns the internal rating, as shown in the table below.

Corporate and small business lending

For corporate loans, the borrowers are assessed by specialised credit risk employees of the Group. The credit risk assessment is based on a credit scoring model that takes into account various historical, current and forward-looking information such as:

- ▶ Historical financial information together with forecasts and budgets prepared by the client. This financial information includes realised and expected results, solvency ratios, liquidity ratios and any other relevant ratios to measure the client's financial performance.
- ▶ Any publicly available information on the clients from external parties. This includes external rating grades issued by rating agencies.
- ▶ Any macro-economic or geopolitical information, e.g., GDP growth relevant for the specific industry and geographical segments where the client operates.
- ▶ Any other objectively supportable information on the quality and abilities of the client's management relevant for the company's performance.

The complexity and granularity of the rating techniques varies based on the exposure of the Group and the complexity and size of the customer. Some of the less complex small business loans are rated within the Group's models for retail products.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Credit risk (continued)

Consumer lending

Consumer lending comprises unsecured personal loans, credit cards and overdrafts. These products along with residential mortgages and some of the less complex small business lending are rated by an automated scorecard tool primarily driven by debt to income (DTI) and payment to income (PTI) ratios. Other key inputs into the models are GDP growth, changes in personal income/salary levels, personal indebtedness.

The Group's internal credit rating grades are as follows:

<i>Internal rating grade for SME</i>	<i>Moody's based internal/external ratings for Corporate and Financial institutions</i>	<i>Internal rating description</i>
1	Aaa	High grade
2-4	Aa1 to Aa3	
5-7	A1 to A3	
8-10	Baa1 to Baa3	Standard grade
11-13	Ba1 to Ba3	
14-16	B1 to B3	
17-19	Caa1 to Caa3	Sub-standard grade
20	Ca	
Default	C	Impaired

Internal rating for consumer loans is based on overdue days. High grade rating is used for Central Bank and Ministry of Finance of the Republic of Azerbaijan.

Exposure at default

The exposure at default (EAD) represents the gross carrying amount of the financial instruments subject to the impairment calculation, addressing both the client's ability to increase its exposure while approaching default and potential early repayments too. To calculate the EAD for a Stage 1 loan, the Bank assesses the possible default events within 12 months for the calculation of the 12mECL. For Stage 2, Stage 3 financial assets, the exposure at default is considered for events over the lifetime of the instruments.

The Bank determines EADs by modelling the range of possible exposure outcomes at various points in time, corresponding the multiple scenarios. The IFRS 9 PDs are then assigned to each economic scenario based on the outcome of Bank's models.

Loss given default

For corporate lending assets, LGD values are assessed semi-annually.

The credit risk assessment is based on a standardized LGD assessment framework that results in a certain LGD rate. These LGD rates take into account the expected EAD in comparison to the amount expected to be recovered or realised from any collateral held.

Where appropriate, further recent data is used in order to determine the IFRS 9 LGD rate for each group of financial instruments. When assessing forward-looking information, the expectation is based on multiple scenarios. Examples of key inputs involve changes in, collateral values including property prices for mortgages, commodity prices, payment status or other factors that are indicative of losses in the group.

The Group segments its retail lending products into smaller homogeneous portfolios, based on key characteristics that are relevant to the estimation of future cash flows. The applied data is based on historically collected loss data and involves a wider set of transaction characteristics (e.g., product type) as well as borrower characteristics.

LGD rates are estimated for the Stage 1, Stage 2, Stage 3 and POCI segment of each asset class.

Significant increase in credit risk

The Group continuously monitors all assets subject to ECLs. In order to determine whether an instrument or a portfolio of instruments is subject to 12mECL or LTECL, the Bank assesses whether there has been a significant increase in credit risk since initial recognition.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Credit risk (continued)

The Group also applies a secondary qualitative method for triggering a significant increase in credit risk for an asset, such as moving a customer/facility to the watch list, or the account becoming restructured due to credit event. In certain cases, the Group may also consider that events explained in "Definition of default" section above are a significant increase in credit risk as opposed to a default. Regardless of the change in credit grades, if contractual payments are more than 30 days past due, the credit risk is deemed to have increased significantly since initial recognition.

When estimating ECLs on a collective basis for a group of similar assets, the Group applies the same principles for assessing whether there has been a significant increase in credit risk since initial recognition.

Grouping financial assets measured on a collective basis

Dependent on the factors below, the Group calculates ECLs either on a collective or on an individual basis.

Asset classes where the Group calculates ECL on an individual basis include:

- ▶ PD for all corporate and small business lending;
- ▶ LGD for Stage 3 corporate and small business lending which are above predetermined threshold and are collateralized.

Asset classes where the Bank calculates ECL on a collective basis include:

- ▶ PD and LGD for all consumer lending;
- ▶ LGD for all corporate and small business lending which are in Stage 1 and Stage 2;
- ▶ LGD for corporate and small business lending which are in Stage 3, neither are above predetermined threshold nor are collateralized.

Forward-looking information and multiple economic scenarios

In its ECL models, the Bank relies on a broad range of forward looking information as economic inputs, such as:

- ▶ GDP growth rates;
- ▶ Inflation;
- ▶ Monetary policy rate;
- ▶ Dynamics of real and nominal effective exchange rates;
- ▶ Real estate price.

The inputs and models used for calculating ECLs may not always capture all characteristics of the market at the date of the financial statements. To reflect this, qualitative adjustments or overlays are occasionally made as temporary adjustments when such differences are significantly material.

The Group obtains the forward-looking information from third party sources (external rating agencies, governmental bodies e.g. central Groups, and international financial institutions). Experts of the Group's Credit Risk Department determine the weights attributable to the multiple scenarios with the values of the key forward looking economic variables/assumptions used in each of the economic scenarios for the ECL calculations.

Where financial instruments are recorded at fair value, the amounts shown below represent the current credit risk exposure but not the maximum risk exposure that could arise in the future as a result of changes in values.

For more details on the maximum exposure to credit risk for each class of financial instrument, references shall be made to the specific notes. The effect of collateral and other risk specific mitigation technique is shown in Note 10.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Credit risk (continued)

Credit quality per class of financial assets

The credit quality of financial assets is managed by the Group internal credit ratings. The table below shows the credit quality by class of asset for loan-related lines in the consolidated statement of financial position, based on the Group's credit rating system.

	Note		High grade	Standard grade	Sub-standard grade	Impaired	Total
Cash and cash equivalents, except for cash on hand	5	Stage 1	1,248,809	115,093	3,214	-	1,367,116
Amounts due from credit institutions	7	Stage 1	192,579	121,825	3,384	-	317,788
		Stage 2	-	-	17,415	-	17,415
	9	Stage 1	95,833	1,142,713	45,868	-	1,284,414
		Stage 2	64,416	100,837	165,846	-	331,099
Loans to customers		Stage 3	-	-	4,140	161,129	165,269
Investment investments securities	8						
- Measured at FVOCI		Stage 1	1,301,613	123,689	625	-	1,425,927
- Measured at amortised cost	22	Stage 1	-	32,527	-	-	32,527
		Stage 1	-	111,012	3,740	-	114,752
		Stage 2	94	11,080	7,545	-	18,719
Unused credit lines		Stage 3	-	-	8	-	8
Letters of credit		Stage 1	395	4,428	323	-	5,146
		Stage 1	13,904	493,744	4,479	-	512,127
		Stage 2	3,503	20,088	13,399	-	36,990
Guarantees issued		Stage 3	-	-	-	79	79
Other financial assets	13	Stage 1	-	14,103	-	-	14,103
Total			2,921,146	2,291,139	269,986	161,208	5,643,479

The table below shows gross balances under IAS 39 as at 31 December 2017 based on the Group's internal credit rating system:

	Notes	Neither past due nor impaired			Past due but not impaired	Individually impaired	Total
		High grade	Standard grade	Sub-standard grade			
31 December 2017							
Cash and cash equivalents except for cash on hand	5	388,733	1,005,788	-	-	-	1,394,521
Amounts due from credit institutions	7	72,540	519,489	-	-	871	592,900
Investment securities – available-for-sale	8	392,369	13,161	-	-	-	405,530
Loans and receivables	8	40,568	-	-	-	-	40,568
Loans to customers	9						
Corporate lending		-	1,024,510	23,716	111,391	99,105	1,258,722
Individual lending		-	143,037	4,455	4,699	3,079	155,270
Other financial assets	13	-	13,231	-	-	-	13,231
Total		894,210	2,723,105	28,171	116,090	103,055	3,864,631

In the table above cash and cash equivalents, amounts due from credit institution and loan customers of high grade are those having a minimal level of credit risk, normally with a credit rating on or close to sovereign level or very well collateralised. Other borrowers with good financial position and good debt service are included in the standard grade. Sub-standard grade comprises loans below standard grade but not individually impaired. Past due loans to customers include those that are only past due by a few days. An analysis of past due loans as at 31 December 2017, by age, is provided below. The majority of the past due loans are not considered to be impaired.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Credit risk (continued)

Aging analysis of past due but not impaired loans per class of financial assets

31 December 2017	Less than 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to customers					
Corporate lending	10,477	8,499	7,708	84,707	111,391
Individual lending	278	4	-	4,417	4,699
Total	10,755	8,503	7,708	89,124	116,090

See Note 9 for more detailed information with respect to the allowance for impairment of loans to customers.

Financial guarantees, letters of credit and loan commitments are assessed and a provision for expected credit losses is calculated in similar manner as for loans.

The geographical concentration of the Group's monetary assets and liabilities is set out below:

	2018				2017			
	The Republic of Azerbaijan	OECD countries	CIS and other non-OECD countries	Total	The Republic of Azerbaijan	OECD countries	CIS and other non-OECD countries	Total
Financial assets								
Cash and cash equivalents	667,549	763,596	71,901	1,503,046	608,263	714,111	143,397	1,465,771
Trading securities	-	895	-	895	-	2,224	-	2,224
Amounts due from credit institutions	50,597	239,269	44,968	334,834	45,250	491,312	55,467	592,029
Investment securities	603,212	832,649	22,285	1,458,146	389,907	12,344	43,687	445,938
Derivative financial assets	1,064	722	264	2,050	1,625	-	40	1,665
Loans to customers	1,341,437	254,761	135,367	1,731,565	958,190	319,730	72,748	1,350,668
Other financial assets	6,735	6,876	-	13,611	11,788	1,443	-	13,231
	2,670,594	2,098,768	274,785	5,044,147	2,015,023	1,541,164	315,339	3,871,526
Financial liabilities								
Amounts due to banks and government funds	498,758	8,823	17,394	524,975	324,582	48,941	26,450	399,973
Amounts due to customers	3,892,304	8,484	53,164	3,953,952	2,848,654	14,415	26,892	2,889,961
Other borrowed funds	-	-	-	-	-	39,105	-	39,105
Derivative financial liabilities	-	37	44	81	-	2,058	-	2,058
Debt securities issued	84,922	17,378	-	102,300	42,476	39,289	-	81,765
Subordinated debts	18,921	-	-	18,921	-	-	-	-
Other financial liabilities	12,552	7,118	204	19,874	13,052	1,456	85	14,593
	4,507,457	41,840	70,806	4,620,103	3,228,764	145,264	53,427	3,427,455
Net assets/ (liabilities)	(1,836,863)	2,056,928	203,979	424,044	(1,213,741)	1,395,900	261,912	444,071

Liquidity risk and funding management

Liquidity risk is the risk that the Group will be unable to meet its payment obligations when they fall due under normal and stress circumstances. To limit this risk, management has arranged diversified funding sources in addition to its core deposit base, manages assets with liquidity in mind, and monitors future cash flows and liquidity on a daily basis. This incorporates an assessment of expected cash flows and the availability of high grade collateral which could be used to secure additional funding if required.

The Group maintains a portfolio of highly marketable and diverse assets that can be easily liquidated in the event of an unforeseen interruption of cash flow. In addition, the Group maintains obligatory reserves with the CBAR, NBG and CBRT, the amount of which depends on the level of customer funds attracted.

The liquidity position is assessed and managed by the Bank based on certain liquidity ratios established by the CBAR. As at 31 December 2018 and 2017, these ratios were as follows:

	2018, %	2017, %
Instant Liquidity Ratio (30% is the minimum required by the CBAR) (assets receivable or realisable within one day/liabilities repayable on demand)	44	53

As at 31 December 2018, liquidity ratio of PASHA Bank Georgia JSC (average volume of liquid assets / average volume of liabilities) based on requirements established by the NBG was 34% (31 December 2017: 47%). Minimum required level of liquidity by NBG is 30%.

As at 31 December 2017, liquidity ratio of PASHA Yatirim Bankasi A.S. based on requirements established by the CBRT was 865% (31 December 2017: 220%). Minimum required level of liquidity by CBRT is 100%.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Liquidity risk and funding management (continued)

Analysis of financial liabilities by remaining contractual maturities

The table below summarises the maturity profile of the Group's financial liabilities at 31 December based on contractual undiscounted repayment obligations. Repayments which are subject to notice are treated as if notice were to be given immediately. However, the Group expects that many customers will not request repayment on the earliest date the Group could be required to pay and the table does not reflect the expected cash flows indicated by the Group's deposit retention history.

<i>Financial liabilities</i>	<i>Less than 3 months</i>	<i>3 to 12 months</i>	<i>1 to 5 years</i>	<i>Over 5 years</i>	<i>Total 2018</i>
As at 31 December 2018					
Amounts due to banks and government funds	197,228	108,757	151,777	86,531	544,293
Amounts due to customers	3,142,801	446,785	320,478	99,865	4,009,929
Debt securities issued	18,474	2,481	93,172	-	114,127
Subordinated debts	281	281	21,726	-	22,288
Derivative financial liabilities	37	-	-	-	37
Other financial liabilities	19,874	-	-	-	19,874
Total undiscounted financial liabilities	3,378,695	558,304	587,153	186,396	4,710,548

<i>Financial liabilities</i>	<i>Less than 3 months</i>	<i>3 to 12 months</i>	<i>1 to 5 years</i>	<i>Over 5 years</i>	<i>Total 2017</i>
As at 31 December 2017					
Amounts due to banks and government funds	173,361	52,735	124,869	64,654	415,619
Amounts due to customers	1,986,147	569,100	379,726	-	2,934,973
Other borrowed funds	3,370	12,285	24,497	-	40,152
Gross settled financial liabilities					
- Contractual amounts payable	(19,609)	(5,079)	-	-	(24,688)
- Contractual amounts receivable	19,260	5,240	-	-	24,500
Net settled derivative financial liabilities	569	1,489	-	-	2,058
Debt securities issued	39,919	-	52,713	-	92,632
Other financial liabilities	14,593	-	-	-	14,593
Total undiscounted financial liabilities	2,217,610	635,770	581,805	64,654	3,499,839

The table below shows the contractual expiry by maturity of the Group's credit related commitments.

	<i>Less than 3 months</i>	<i>3 to 12 months</i>	<i>1 to 5 years</i>	<i>Over 5 years</i>	<i>Maturity undefined</i>	<i>Total</i>
As at 31 December 2018	238,711	132,336	271,499	6,812	38,463	687,821
As at 31 December 2017	278,494	151,338	70,835	-	49,479	550,146

The Group expects that not all of the contingent liabilities or commitments will be drawn before expiry of the commitments.

The Group's capability to repay its liabilities relies on its ability to realise an equivalent amount of assets within the same period of time. There is a significant concentration of deposits from organizations of related parties in the period of one year. Any significant withdrawal of these funds would have an adverse impact on the operations of the Group. Management believes that this level of funding will remain with the Group for the foreseeable future and that in the event of withdrawal of funds, the Group would be given sufficient notice so as to realise its liquid assets to enable repayment.

The maturity analysis does not reflect the historical stability of current accounts. Their liquidation has historically taken place over a longer period than indicated in the tables above. These balances are included in amounts due in less than three months in the tables above.

Operational risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications, or lead to financial loss. The Group cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Group is able to manage the risks. Controls include effective segregation of duties, access, authorisation and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)

Market risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate due to changes in market variables such as interest rates, foreign exchanges, and equity prices. The Group manages exposures to market risk based of sensitivity analysis. The Group has no significant concentration of market risk.

Interest rate risk

Interest rate risk arises from the possibility that changes in interest rates will affect future cash flows or the fair values of financial instruments.

The sensitivity of current year profit is the effect of the assumed changes in interest rates on the net interest income for one year, based on the floating rate non-trading financial assets and financial liabilities held at 31 December 2018. The Group does not have substantial amount of floating rate non-trading financial instruments as at 31 December 2018 and 2017.

Currency risk

Currency risk is defined as the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates. The Group is exposed to the effects of fluctuations in the prevailing foreign currency exchange rates on its statement of financial position and statement of cash flows.

The Assets and Liabilities Management Committee controls currency risk by management of the open currency position on the estimated basis of AZN devaluation and other macroeconomic indicators, which gives the Group an opportunity to minimize losses from significant currency rates fluctuations toward its national currency. The Treasury Department performs daily monitoring of the Group's open currency position with the aim to match the requirements of the CBAR.

As at 31 December 2018, the Group had the following exposure to foreign currency exchange rate risk:

	AZN	USD	EUR	GEL	TRY	Other	Total 2018
Financial assets							
Cash and cash equivalents	436,106	848,599	166,972	13,742	22,186	15,441	1,503,046
Trading securities	-	494	-	-	401	-	895
Amounts due from credit institutions	21,735	246,842	45,711	3,256	-	17,290	334,834
Investment securities	485,791	840,234	117,414	12,037	2,670	-	1,458,146
Derivative financial assets	1,064	722	-	264	-	-	2,050
Loans to customers	642,311	717,367	213,706	45,147	113,034	-	1,731,565
Other financial assets	2,074	499	3,934	7	7,095	2	13,611
Total financial assets	1,589,081	2,654,757	547,737	74,453	145,386	32,733	5,044,147
The effect of derivatives	34,529	15,380	-	-	557	-	50,466
Financial liabilities							
Amounts due to banks and government funds	276,508	160,773	71,266	4,463	11,221	744	524,975
Amounts due to customers	1,114,474	2,326,046	461,877	12,294	7,204	32,057	3,953,952
Derivative financial liabilities	-	-	-	44	37	-	81
Debt securities issued	-	84,922	-	-	17,378	-	102,300
Subordinated debts	-	18,921	-	-	-	-	18,921
Other financial liabilities	10,902	3,680	1,110	156	4,026	-	19,874
Total financial liabilities	1,401,884	2,594,342	534,253	16,957	39,866	32,801	4,620,103
The effect of derivatives	-	35,181	-	-	15,240	-	50,421
Net position after the effect of derivatives	221,726	40,614	13,484	57,496	90,837	(68)	424,089

(Figures in tables are in thousands of Azerbaijani manats)

26. Risk management (continued)**Currency risk (continued)**

As at 31 December 2017, the Group had the following exposure to foreign currency exchange rate risk:

	AZN	USD	EUR	GEL	TRY	Other	Total 2017
Financial assets							
Cash and cash equivalents	196,085	865,637	379,731	8,305	4,499	11,514	1,465,771
Trading securities	-	-	-	-	2,224	-	2,224
Amounts due from credit institutions	45,244	456,286	66,911	5,237	-	18,351	592,029
Investment securities	385,851	27,582	-	22,919	6,307	3,279	445,938
Derivative financial assets	1,625	-	-	40	-	-	1,665
Loans to customers	458,845	418,444	233,957	38,065	201,328	29	1,350,668
Other financial assets	10,157	559	1,064	3	1,443	5	13,231
Total financial assets	1,097,807	1,768,508	681,663	74,569	215,801	33,178	3,871,526
The effect of derivatives	-	14,424	-	-	10,076	-	24,500
Financial liabilities							
Amounts due to banks and government funds	155,215	162,513	29,681	6,510	46,035	19	399,973
Amounts due to customers	696,416	1,551,068	603,266	5,433	3,874	29,904	2,889,961
Other borrowed funds	-	7,073	32,032	-	-	-	39,105
Derivative financial liabilities	1,576	-	-	-	482	-	2,058
Debt securities issued	-	42,476	-	-	39,289	-	81,765
Other financial liabilities	11,299	629	1,087	80	1,456	42	14,593
Total financial liabilities	864,506	1,763,759	666,066	12,023	91,136	29,965	3,427,455
The effect of derivatives	-	-	9,934	-	14,754	-	24,688
Net position after the effect of derivatives	233,301	19,173	5,663	62,546	119,987	3,213	443,883

Currency risk sensitivity

The following table details the Group's sensitivity to increase and decrease in the USD, EUR, GEL and TRY against the AZN. These are the sensitivity rate used when reporting foreign currency risk internally to key management personnel and represents management's assessment of the possible change in foreign currency exchange rates. The sensitivity analysis includes only outstanding foreign currency denominated monetary items and adjusts their translation at the end of the period for specified changes in foreign currency rates. The sensitivity analysis includes external loans as well as loans to foreign operations within the Group where the denomination of the loan is in a currency other than the currency of the lender or the borrower.

Impact on profit before tax based on assets value as at 31 December 2018 and 2017:

	2018		2017	
	USD/AZN +14%	USD/AZN -3%	USD/AZN +11.3%	USD/AZN -11.3%
Impact on profit before tax	5,686	(1,218)	2,167	(2,167)
	2018		2017	
	EUR/AZN +14%	EUR/AZN -3%	EUR/AZN +13.5%	EUR/AZN -13.5%
Impact on profit before tax	1,888	(405)	765	(765)
	2018		2017	
	GEL/AZN +15%	GEL/AZN -15%	GEL/AZN +15%	GEL/AZN -15%
Impact on profit before tax	8,624	(8,624)	9,382	(9,382)
	2018		2017	
	TRY/AZN +20%	TRY/AZN -25%	TRY/AZN +20%	TRY/AZN -14%
Impact on profit before tax	18,167	(22,709)	23,997	(16,798)

(Figures in tables are in thousands of Azerbaijani manats)

27. Fair values measurement

Fair value hierarchy

The Bank uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

- ▶ Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;
- ▶ Level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly; and
- ▶ Level 3: techniques which use inputs which have a significant effect on the recorded fair value that are not based on observable market data.

For the purpose of fair value disclosures, the Group's has determined classes of assets and liabilities on the basis of the nature, characteristics and risks of the asset or liability and the level of the fair value hierarchy:

	Date of valuation	Fair value measurement using			Total
		Quoted prices in active markets (Level 1)	Significant observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Assets measured at fair value					
Trading securities	31 December 2018	895	-	-	895
Investment securities – at FVOCI	31 December 2018	337,346	1,088,581	-	1,425,927
Derivative financial assets	31 December 2018	-	2,050	-	2,050

Assets for which fair values are disclosed

Cash and cash equivalents	31 December 2018	1,503,046	-	-	1,503,046
Amounts due from credit institutions	31 December 2018	-	334,834	-	334,834
Investment securities measured at amortised cost	31 December 2018	19,585	-	13,487	33,072
Loans to customers	31 December 2018	-	-	1,682,643	1,682,643
Investment property	31 December 2018	-	-	71,719	71,719
Other financial assets	31 December 2018	-	-	13,611	13,611

	Date of valuation	Fair value measurement using			Total
		Quoted prices in active markets (Level 1)	Significant observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Liabilities measured at fair value					
Derivative financial liabilities	31 December 2018	-	81	-	81

Liabilities for which fair values are disclosed

Amounts due to banks and government funds	31 December 2018	-	525,021	-	525,021
Amounts due to customers	31 December 2018	-	-	3,953,178	3,953,178
Debt securities issued	31 December 2018	-	-	103,096	103,096
Subordinated debt	31 December 2018	-	-	18,921	18,921
Other financial liabilities	31 December 2018	-	-	19,874	19,874

(Figures in tables are in thousands of Azerbaijani manats)

27. Fair values measurement (continued)**Fair value hierarchy (continued)**

	Date of valuation	Fair value measurement using			Total
		Quoted prices in active markets (Level 1)	Significant observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Assets measured at fair value					
Trading securities	31 December 2017	2,224	-	-	2,224
Investment securities – available for sale	31 December 2017	16,400	385,851	3,279	405,530
Derivative financial assets	31 December 2017	-	1,665	-	1,665
Assets for which fair values are disclosed					
Cash and cash equivalents	31 December 2017	1,465,771	-	-	1,465,771
Amounts due from credit institutions	31 December 2017	-	-	592,029	592,029
Investment securities – loans and receivables	31 December 2017	-	-	41,084	41,084
Loans to customers	31 December 2017	-	-	1,326,636	1,326,636
Investment property	31 December 2017	-	-	1,668	1,668

	Date of valuation	Fair value measurement using			Total
		Quoted prices in active markets (Level 1)	Significant observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Liabilities measured at fair value					
Derivative financial liabilities	31 December 2017	-	2,058	-	2,058
Liabilities for which fair values are disclosed					
Amounts due to banks and government funds	31 December 2017	-	-	399,973	399,973
Amounts due to customers	31 December 2017	-	-	2,895,186	2,895,186
Other borrowed funds	31 December 2017	-	-	39,105	39,105
Debt securities issued	31 December 2017	-	-	81,701	81,701

Fair value of financial assets and liabilities not carried at fair value

Set out below is a comparison by class of the carrying amounts and fair values of the Group's financial instruments that are not carried at fair value in the consolidated statement of financial position. The table does not include the fair values of non-financial assets and non-financial liabilities.

	Carrying value 2018	Fair value 2018	Unrecognized gain/(loss) 2018	Carrying value 2017	Fair value 2017	Unrecognized gain/(loss) 2017
Financial assets						
Cash and cash equivalents	1,503,046	1,503,046	-	1,465,771	1,465,771	-
Amounts due from credit institutions	334,834	334,834	-	592,029	592,029	-
Investment securities measured at amortised cost	32,219	33,072	853	40,408	41,084	676
Loans to customers	1,731,565	1,682,643	(48,922)	1,350,668	1,326,636	(24,032)
Other financial assets	13,611	13,611	-	13,231	13,231	-
Financial liabilities						
Amounts due to banks and government funds	524,975	525,021	(46)	399,973	399,973	-
Amounts due to customers	3,953,952	3,953,178	774	2,889,961	2,895,186	(5,225)
Other borrowed funds				39,105	39,105	-
Subordinated debts	18,921	18,921	-	-	-	-
Debt securities issued	102,300	103,096	(796)	81,765	81,701	64
Other financial liabilities	19,874	19,874	-	-	-	-
Total unrecognised change in unrealised fair value			(48,137)			(28,517)

(Figures in tables are in thousands of Azerbaijani manats)

27. Fair values measurement (continued)

Valuation techniques and assumptions

The following is a description of the determination of fair value for financial instruments which are recorded at fair value using valuation techniques. These incorporate the Group's estimate of assumptions that a market participant would make when valuing the instruments.

Fixed rate financial instruments

The fair value of fixed rate financial assets and liabilities carried at amortised cost are estimated by comparing market interest rates when they were first recognized with current market rates offered for similar financial instruments. The estimated fair value of fixed interest bearing deposits is based on discounted cash flows using prevailing money-market interest rates for debts with similar credit risk and maturity. For quoted debt issued the fair values are calculated based on quoted market prices. For those notes issued where quoted market prices are not available, a discounted cash flow model is used based on a current interest rate yield curve appropriate for the remaining term to maturity.

Assets for which fair value approximates carrying value

For financial assets and financial liabilities that are liquid or having a short term maturity (less than three months) it is assumed that the carrying amounts approximate to their fair value. This assumption is also applied to demand deposits, without a specific maturity and variable rate financial instruments.

Fixed and variable rate financial instruments

For quoted debt instruments the fair values are determined based on quoted market prices. The fair values of unquoted debt instruments are estimated by discounting future cash flows using rates currently available for debt on similar terms, credit risk and remaining maturities.

Movements in level 3 assets and liabilities at fair value

The following tables show a reconciliation of the opening and closing amount of Level 3 assets and liabilities which are recorded at fair value:

	At 31 December 2017	Transfers at adoption of IFRS 9	At 1 January 2018	Total gain recorded in profit or loss	Total gain recorded in other comprehen- sive income	Purchases	Sales	Exchange difference	At 31 December 2018
Assets									
Investment securities at FVOCI	3 279	-	3 279	(4)	-	-	(3,208)	(67)	-
Total	<u>3,279</u>	<u>-</u>	<u>3,279</u>	<u>(4)</u>	<u>-</u>	<u>-</u>	<u>(3,208)</u>	<u>(67)</u>	<u>-</u>

As at 31 December 2017, securities determined as Level 3 assets which are recorded at fair value were purchased close to reporting period ending 31 December 2016. Level 3 financial assets include corporate bonds with floating rates, which are valued using discounted cash flow techniques based on current rates available for debt instruments with similar terms and credit risk characteristics as at 31 December 2017. There was not any movement except change in fair value and translation difference as at 31 December 2017.

(Figures in tables are in thousands of Azerbaijani manats)

28. Maturity analysis of assets and liabilities

The table below shows an analysis of assets and liabilities according to when they are expected to be recovered or settled. See Note 26 "Risk management" for the Group's contractual undiscounted repayment obligations.

	2018			2017		
	Within one year	More than one year	Total	Within one year	More than one year	Total
Cash and cash equivalents	1,503,046	-	1,503,046	1,465,771	-	1,465,771
Trading securities	895	-	895	2,224	-	2,224
Amounts due from credit institutions	334,834	-	334,834	592,029	-	592,029
Investment securities	1,194,736	263,410	1,458,146	397,343	48,595	445,938
Derivative financial assets	2,050	-	2,050	1,665	-	1,665
Loans to customers	792,469	939,096	1,731,565	662,823	687,845	1,350,668
Investment property	-	71,719	71,719	-	1,668	1,668
Property and equipment	-	18,236	18,236	-	12,808	12,808
Intangible assets	-	49,754	49,754	-	48,954	48,954
Current income tax assets	-	-	-	2,154	-	2,154
Deferred income tax assets	-	4,003	4,003	-	640	640
Other assets	34,457	659	35,116	32,907	989	33,896
Total assets	3,862,487	1,346,877	5,209,364	3,156,916	801,499	3,958,415
Amounts due to banks and government funds	306,430	218,545	524,975	223,731	176,242	399,973
Amounts due to customers	3,569,598	384,354	3,953,952	2,530,743	359,218	2,889,961
Other borrowed funds	-	-	-	15,153	23,952	39,105
Debt securities issued	20,610	81,690	102,300	39,289	42,476	81,765
Derivative financial liabilities	37	44	81	2,058	-	2,058
Current income tax liability	5,516	-	5,516	1,136	-	1,136
Deferred income tax liabilities	-	7,886	7,886	-	10,056	10,056
Subordinated Debt	-	18,921	18,921	-	-	-
Provision for credit related guarantees and other assets	6,425	-	6,425	3,112	-	3,112
Other liabilities	41,299	-	41,299	30,266	1,834	32,100
Total liabilities	3,949,915	711,440	4,661,355	2,845,488	613,778	3,459,266
Net assets	(87,428)	635,437	548,009	311,428	187,721	499,149

Negative gap is due to significant concentration of amounts due to customers represented by related parties in the period of one year. Management believes that this level of funding will remain with the Group for the foreseeable future and that in the event of withdrawal of funds, the Group would be given sufficient notice so as to realise its liquid assets to enable repayment.

29. Related party disclosures

In accordance with IAS 24 *Related Party Disclosures*, parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions. In considering each possible related party relationship, attention is directed to the substance of the relationship, not merely the legal form.

Related parties may enter into transactions which unrelated parties might not, and transactions between related parties may not be effected on the same terms, conditions and amounts as transactions between unrelated parties.

(Figures in tables are in thousands of Azerbaijani manats)

29. Related party disclosures (continued)

The volumes of related party transactions, outstanding balances at the year end, and related expense and income for the year are as follows:

	2018					2017				
	Parent	Entities under common control	Key management personnel	Other	Total	Parent	Entities under common control	Key management personnel	Other	Total
Cash and cash equivalents	-	60	-	-	60	-	2,225	-	-	2,225
Loans outstanding at 1 January, gross	-	110,974	3,380	24,285	138,639	-	100,381	3,293	24,345	128,019
Loans issued during the year	-	179,381	5,412	36,462	221,255	-	134,117	2,219	6	136,342
Loan repayments during the year	-	(155,271)	(3,354)	(26,835)	(185,460)	-	(122,899)	(2,120)	(80)	(125,099)
Interest accrual	-	-	186	126	312	-	1,853	32	13	1,898
Foreign currency translation difference	-	(4,986)	(1,340)	(141)	(6,467)	-	(2,478)	(44)	1	(2,521)
Loans outstanding at 31 December, gross	-	130,098	4,284	33,897	168,279	-	110,974	3,380	24,285	138,639
Less: allowance for impairment at 31 December	-	(1,172)	(114)	(191)	(1,477)	-	(977)	(2)	-	(979)
Loans outstanding at 31 December, net	-	128,926	4,170	33,706	166,802	-	109,997	3,378	24,285	137,660
Interest income on loans	-	7,761	368	1,918	10,047	-	7,876	463	22	8,361
	2018					2017				
	Parent	Entities under common control	Key management personnel	Other	Total	Parent	Entities under common control	Key management personnel	Other	Total
Deposit at 1 January	-	436,436	4,978	94,685	536,099	-	454,434	5,800	58,806	519,040
Deposits received during the year	-	1,039,466	11,729	55,784	1,106,979	-	404,684	563	56,043	461,290
Deposits repaid during the year	-	(1,190,743)	(11,546)	(54,139)	(1,256,428)	-	(442,625)	(1,344)	(20,918)	(464,887)
Interest accrual	-	683	117	-	800	-	167	3	59	229
Foreign currency translation difference	-	(16,042)	80	(2,568)	(18,530)	-	19,776	(44)	695	20,427
Deposits at 31 December	-	269,800	5,358	93,762	368,920	-	436,436	4,978	94,685	536,099
Amounts due to banks and government funds	-	50,005	-	-	50,005	-	52,557	-	-	52,557
Current accounts	45,059	511,255	2,767	829,788	1,388,849	43,374	280,136	321,681	75,609	720,800
Subordinated debts	18,921	-	-	-	18,921	-	-	-	-	-
Debt securities issued	42,464	40,675	-	-	83,139	-	40,692	-	-	40,692
Other Assets	-	334	14	3	351	-	-	-	-	-
Other liabilities	36	2,912	-	219	3,167	-	-	-	-	-
Interest expense on deposits	(1,428)	(17,435)	(262)	(3,081)	(22,206)	(117)	(15,762)	(549)	(617)	(17,045)
Guarantees issued	-	6,766	-	6,173	12,939	-	21,917	-	-	21,917
Letters of credit issued	-	-	-	573	573	-	387	-	-	387
Unused credit lines	182	13,639	1,789	6,061	21,671	187	39,839	1,148	285	41,459
Fee and commission income	48	4,177	26	1,539	5,790	56	4,049	20	3	4,128
Fee and commission expense	(400)	(112)	-	(35)	(547)	-	-	-	-	-
Net gains/(losses) from foreign currencies: dealing	1,237	3,106	38	2,225	6,606	307	4,062	1,447	2,168	7,984
Other operating expenses	(59)	(2,713)	(5)	-	(2,777)	-	(1,725)	-	-	(1,725)
Other income	-	34	-	-	34	-	-	-	-	-

As at 31 December 2018, the Group has guarantee from its parent received as a collateral in respect of loans issued to borrowers in the amount of AZN 89,001 thousand (2017: AZN 122,401 thousand).

(Figures in tables are in thousands of Azerbaijani manats)

29. Related party disclosures (continued)

Compensation to members of key management personnel was comprised of the following:

	<u>2018</u>	<u>2017</u>
Salaries and other benefits	(11,902)	(12,147)
Social security costs	(2,056)	(2,087)
Total key management compensation	<u>(13,958)</u>	<u>(14,234)</u>

30. Changes in liabilities arising from financing activities

	<i>Note</i>	<i>Debt securities issued</i>	<i>Subordinated debt</i>	<i>Total liabilities from financing activities</i>
Carrying amount at 31 December 2016		18,705	-	18,705
Proceeds from issue		165,216	-	165,216
Redemption		(101,321)	-	(101,321)
Foreign currency translation		(1,747)	-	(1,747)
Other		912	-	912
Carrying amount at 31 December 2017	17	<u>81,765</u>	-	<u>81,765</u>
Proceeds from issue		146,132	18,700	164,832
Redemption		(110,453)	-	(110,453)
Foreign currency translation		(15,085)	-	(15,085)
Other		(59)	221	162
Carrying amount at 31 December 2018	17, 18	<u>102,300</u>	<u>18,921</u>	<u>121,221</u>

31. Capital adequacy

The Bank maintains an actively managed capital base to cover risks inherent in the business. The adequacy of the Bank's capital is monitored using, among other measures, the ratios established by the CBAR.

During the past year, the Bank had complied in full with all its externally imposed capital requirements.

The primary objectives of the Bank's capital management are to ensure that the Bank complies with externally imposed capital requirements and that the Bank maintains strong credit ratings and healthy capital ratios in order to support its business and to maximise shareholders' value.

The Bank manages its capital structure and makes adjustments to it in the light of changes in economic conditions and the risk characteristics of its activities. In order to maintain or adjust the capital structure, the Bank may adjust the amount of dividend payment to shareholders, return capital to shareholders or issue capital securities. No changes were made in the objectives, policies and processes from the previous years.

CBAR capital adequacy ratio

The CBAR requires banks to maintain a minimum capital adequacy ratio of 10% (2017: 10%) of risk-weighted assets for regulatory capital. As at 31 December 2018 and 2017 the Bank's capital adequacy ratio on this basis was as follows:

	<u>2018</u>	<u>2017</u>
Tier 1 capital	313,559	328,238
Tier 2 capital	121,482	78,294
Less: deductions from capital	(149,301)	(148,987)
Total regulatory capital	<u>285,740</u>	<u>257,545</u>
Risk-weighted assets	<u>2,099,493</u>	<u>1,553,166</u>
Capital adequacy ratio	12%	15%

(Figures in tables are in thousands of Azerbaijani manats)

31. Capital adequacy (continued)

NBG capital adequacy ratio

The NBG requires banks to maintain a minimum total capital adequacy ratio of 9.6% (2017: 9.6%) of risk-weighted assets for regulatory capital. As at 31 December 2018, capital adequacy ratio of PASHA Bank Georgia was 24.8% (31 December 2017: 39%).

The BRSA requires banks to maintain a minimum total capital adequacy ratio of 8% (2017: 8%) of risk-weighted assets for regulatory capital. Capital Adequacy Standard Ratio of PASHA Yatirim is calculated in accordance with BRSA. As at 31 December 2018 the bank's capital adequacy ratio was 38% (31 December 2017: 32%).

32. Events after the reporting period

In December 2018, Executive Board of the Bank approved issuance of debt securities in the total amount of USD 25,000 thousand (or AZN 42,500 thousand) with the maturity of 3 years through private placement. In January 2019, the Bank placed debt securities in the total amount of USD 11,434 thousand (AZN 19,438 thousand) which was bought back by the Bank in April 2019.

In January 2019, PASHA Yatirim Bankasi A.Ş. issued new debt securities in the total amount of USD 25,000 thousand with the maturity of more than 3 years. In addition, during January and February 2019, PASHA Yatirim Bankasi A.Ş. issued short-term debt securities in the total amount of TRY 50,000 thousand.

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