ADB

Technical Assistance Consultant's Report

Project Number: 46536-001
September 2015

Republic of Azerbaijan: Electronic Payments and Financial Inclusion (under Microfinance Sector Development Project)

(Cofinanced by the Financial Sector Development Partnership Fund)

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For Central Bank of Azerbaijan
Asian Development Bank

Asian Development Bank

Landscape Assessment of Electronic Payments and Financial Inclusion in the Republic of Azerbaijan

September 2015

Asian Development Bank

Commissioned to:

Digital Disruptions

TA-8621 AZE: Microfinance Sector Development

September 2015

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Digital Disruptions (www.digital-disruptions.com) is a boutique consulting firm in banking and payments, with an emphasis on digital financial services. It provides advisory services to financial institutions, mobile operators, payment networks, international organizations, technology vendors, governments, and start-ups involved in the intersection of telecommunications and financial services.

This report is a product of the ADB technical assistance project (TA 8621), Microfinance Sector Development, which is managed by team leader Inmaculada Martinez, private sector development specialist at the Central and West Asia Regional Department, ADB.

Asian Development Bank

Currency and Abbreviations

$1 USD = 1.05 Azeri manat

1 Azeri manat = $0.95 USD

(Note: currency rate fixed as of February 22, 2015. Previous rates were 1 Azeri manat = $1.27)

ADB	Asian Development Bank
AMFA	Azerbaijan Microfinance Association
AZN	Azerbaijan Manat
CBAR	Central Bank of Azerbaijan Republic
EBRD	European Bank for Reconstruction and Development
EUR	Euro
GDP	Gross Domestic Product
IMF	International Monetary Fund
MF	Microfinance
MFI	Microfinance Institution
MNO	Mobile Network Operator
MSME	Micro Small and Medium Enterprise
NBCI	Non-Bank Credit Institutions
NGO	Non-Government Organization
SME	Small and Medium Enterprise
USD	United States Dollar

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Executive Summary

Overview of Technical Assistance

In October 2014, the Asian Development Bank (ADB) initiated a technical assistance (TA) project with the Government of Azerbaijan, and specifically the Central Bank of Azerbaijan, to enhance its understanding of inclusive financial services in the country. The overall technical assistance aims to support the development of a National Financial Inclusion Strategy which will be comprised of four elements: credit and savings, microinsurance, non-bank regulation, and retail payments. Each of these elements is being analyzed by a specialist consultant.

The purpose of the payments TA is to better understand the comprehensive landscape of retail payments in Azerbaijan, such as products, customers, providers, and channels, with a particular emphasis on its current regulatory environment vis-à-vis payments and financial inclusion. Additional activities include showcasing international best practices on regulatory models for alternative channels and digital financial services for underserved segments.

Report Summary

Azerbaijan has witnessed incredible economic growth since regaining its independence nearly twenty-five years ago, to the point that it is now considered an upper middle-income country. Yet the country lags on most indications of financial inclusion such as, percentage of adults with bank accounts, savings propensity, debit card usage, etc. – compared to its peer countries. This is especially relevant given how young the average Azeri is: just 30 years of age.

Electronic payments, such as debit cards, mobile payments, and alternative channels such as Automatic Teller Machines and Point-of-Sale merchants, are increasingly seen as a critical tool to provide needed services to the underserved, and to spur additional financial inclusion of traditional banking products such as savings, loans, and insurance.

Generally speaking, the large banks in Azerbaijan have eschewed this segment, preferring instead to address the needs of the middle and upper-income segment, most of who reside in Baku. Small, private banks have made some inroads, though they are overwhelmingly focused on credit. The country has a strong cadre of microfinance institutions who reach nearly 600,000 low-income individuals, but regulation prohibits them from offering non-credit services. Azerpost, the government owned postal bank, has extensive reach to rural areas, but chiefly dominates in money transfers. Meanwhile, mobile network operators, among other players, are eager to address the payment service needs of their existing customers – many of whom constitute the 'unbanked' and 'underbanked' – with a range of innovative financial products via the mobile channel, pending the passage of the Draft Law on Payment Services Law.

While there has been growth of Automatic Teller Machines and (notably) Point-of-Sale merchants over the last five years, the growth has principally been in Baku. Credit cards are almost exclusively geared towards the upper class in the capital; debit cards, meanwhile, are prevalent, but usage is low, and the one scheme oriented towards the underserved – a government pension scheme – has its cardholders principally using the debit card as an ATM card: withdrawing their benefits, in full, every month. To-date there are no electronic payment products with any meaningful usage among the underserved.

If there is a bright spot, it is that customers by and large seem open to experimenting. Self-service kiosks are an innovate feature of the Azeri landscape, within a few years customers have begun to trust the machines with bill payments and loan repayments alike, which suggests that even low-income customers can quickly warm to technology-enabled channels, if well designed. A young population tends to be more technologically savvy, particularly with mobile phones. In focus groups that the ADB conducted as part of this analysis, participants of all income and age ranges expressed interest in trying out alternative channels such as mobile payments and banking agents, where financial services are distributed through retail outlets.

The Central Bank of Azerbaijan has been hard at work pushing financial inclusion on two fronts: the first is after years of planning and development, it recently unveiled a user-friendly financial literacy program, which will help consumers better understand not only what type of financial products exist, but also how to use them. Secondly, a Payment Service Law, currently under review by the President's Cabinet, aims to create more competition by allowing non-bank providers to apply for and issue 'electronic money'. While there are other aspects of the regulatory framework that may pose some hindrance, most notably restrictions on account opening (by agents) and deposit taking (by Microfinance Institutions), it will no doubt foster a substantial innovation in the payments space, to the benefit of banked and unbanked Azeris alike.

A. Country Overview

The Republic of Azerbaijan, located in the South Caucasus with a population of 9.8 million, has witnessed impressive economic growth over the last twenty-five years since it regained its sovereignty from the Soviet Union in 1991. While the initial five years of independence were marked by political and military unrest[1], since 1996 the country embarked on land-mark reforms, principally by state-sponsored, multi-year programs (e.g., the "State Assistance Programme to Small and Medium Businesses in Azerbaijan", which took place from 1997-2000, and the "State Programme of Poverty Reduction and Economic Development in the Republic of Azerbaijan", which took place from 2003-2005). As a result of these initiatives, in the period of 2004-2011, for example, the real GDP trebled, including single-year GDP growth of 34.5% in 2006 and 25% in 2007.

Owing to oil deposits located in the Caspian Sea, it should be noted that the country's economy is heavily reliant on hydrocarbon exports, which contributes roughly 95% to its $30B worth of exports (and 70% of the government's revenues). With the substantial drop of oil prices in 2014-2015, the World Bank estimates just 1.5% growth in 2015 for Azerbaijan (from a high of 5.8% GDP growth in 2013), followed by a slight rebound to 2.7% in 2016 and 2017, roughly in line with its developing country peers in Europe and Central Asia (see Figure 1).

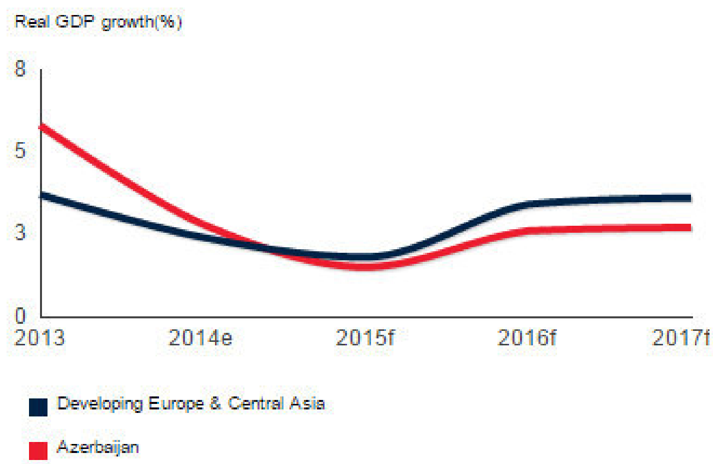


Figure 1. Real GDP Growth (%), World Bank

This dependence on oil exports had a significant effect on the local currency. According to the Azerbaijan State Statistical Committee (AzSTAT) , the country's Current Account Balance (CAB) surplus halved from Q3 2010 to Q3 2014, from just over 32% to 16% of GDP, chiefly due to a decrease in oil exports. To maintain the original currency peg of 1 manat, the local currency, to $1.27 USD, the Central Bank of Azerbaijan spent 27% of its reserves between November 2014 and February 2015. Ultimately, the pressure on the local currency was too great, and the Central Bank was forced to devalue the manat 34% overnight on February 21st, 2015, to the current rate of 1 manat = $0.95 USD. (The implications of the sudden devaluation to financial inclusion are addressed later in the report.) In many ways this move was expected: other regional currencies, such as the Russian ruble, the Kazakh tenge, and the Georgian Lari that had dropped sharply against the dollar in the same timeframe.

[1] Heydar Aliyev Foundation. http://www.azerbaijan.az/portal/Economy/Reforms/reforms_e.html

Inflation, meanwhile, has risen, from a consistent rate of 1.5% over the course of 2014, to 2% in February 2015 and 3.5% in June 2015, chiefly caused by the aforementioned local currency devaluation and higher import prices (particularly the costs for food, which in one month grew 6.6%). While the governor of the Central Bank of Azerbaijan is targeting an inflation rate of between 5% and 7%, the International Monetary Fund (IMF), following a June 2015 mission to the country, estimates a 'likely' inflation rate of 8.5% for 2015[2]. That rate would be on the high end over the last few years, though still well below the historical rates of inflation of first half of the last decade, as Figure 2 illustrates.

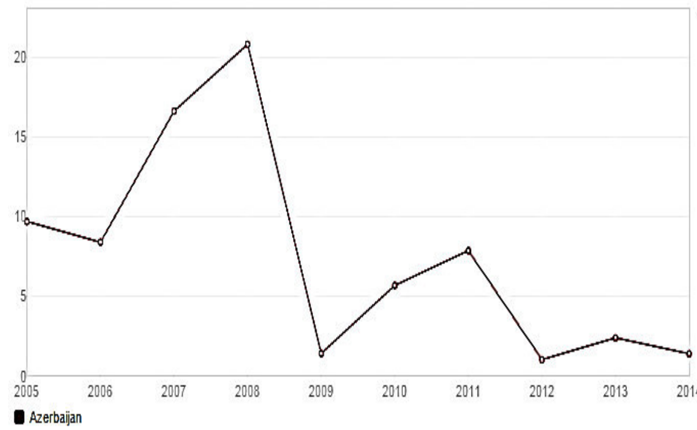


Figure 2. Inflation in Azerbaijan (%), World Bank (2015)

B. State of Financial Inclusion

The remarkable economic growth of Azerbaijan over the past 15 years has, fortunately, translated in real income gains at the base of the pyramid. Using national poverty lines, the World Bank estimates that poverty rates plummeted from 50% in the early 2000s to 5% in 2013, while extreme poverty declined from 20% to just under 3% during the same timeframe. Poverty incidence is only slightly higher in the rural areas than urban areas of the country, while the income inequality, measured by a Gini coefficient of 33.9 in 2008[3], is relatively low compared to developing countries, and in line with developed countries such as Ireland (34) and Canada (32).

Against this backdrop of positive developments for the poor, the country's financial inclusion metrics lag behind its peer countries. Financial inclusion here is defined as "*quality and affordable access to a full range of formal financial services, such as loans, savings, insurance, and money transfers*", which are usually oriented to those 'underserved' customers that have traditionally been marginalized (e.g., rural, low-income, illiterate, etc.) by the current financial services system[4].

To measure Azerbaijan's state of financial inclusion, the World Bank's Global Findex is instructive; it contains the most comprehensive data set to measure financial inclusion from over 140 economics around the world, and its most recent report, released April 2015, uses data from over 150,000 customer surveys conducted in 2014. For ease of comparison, data for a specific country is presented

[2] International Monetary Fund. https://www.imf.org/external/np/sec/pr/2015/pr15265.htm
[3] CIA Factbook. https://www.cia.gov/library/publications/the-world-factbook/rankorder/2172rank.html#aj
[4] The Center for Financial Inclusion at ACCION has a more comprehensive definition of the term. See www.centerforfinancialinclusion.org/index2.php?option=com_content&view=article&id=579&Itemid=161

alongside data from other countries in the region, as well as that from all peer countries with similar income levels (in Azerbaijan's case, the region is 'Europe and Central Asia' and the income level cohort is 'Upper middle income').

Account Access

As can be seen in the highlighted rows in Table 1 below, the percentage of bank accounts for individuals over 15 years of age in Azerbaijan (denoted by the "Country data" column) is 29.2%, far below those in the cohort of European and Central Asian countries (51.4%) and Upper middle income countries (70.5%). Only 10% of the 'Young Adults' segment in Azerbaijan claim to have a bank account, nearly six times less than that of upper middle income countries. This is particularly concerning as Azerbaijan has a relatively young population, with an average age of just under 30.

	Country data	Europe & Central Asia	Upper middle income
Account (% age 15+)			
All adults	29.2	51.4	70.5
Women	25.9	47.4	67.3
Adults belonging to the poorest 40%	26.9	44.2	62.7
Young adults (% ages 15–24)	10.0	35.6	58.1
Adults living in rural areas	30.1	45.7	68.8

Table 1. Account holders (% of overall population) in Azerbaijan compared to cohort countries (World Bank, 2015).

Debit Cards and ATMs

From an electronic payments perspective, just 15.7% report possessing a debit card[5] - again well below upper middle countries, where just under half do. This indicates that roughly half of all account holders (29.2% in Table 1) are using traditional savings passbooks and associated branch networks to conduct banking transactions, rather than electronic means. Actual usage of the debit card to make payments is even less, at 6.3% of the population, significantly below Europe and Central Asian cohort at 23%. It should be noted, however, that the ratio of payment usage to ownership – in other words, the percentage of the cardholders who actually *use* their cards (6.3%:15.7%, or 40% of cardholders) is roughly in line with that of upper middle income countries.

Interestingly, in 2014 there was been a sharp decline in use of Automatic Teller Machines (ATMs) to withdraw money compared to 2011 data, from 88.2% to 57.1%. While it is possible that this may be due to customer reluctance or fear of using electronic channels, there were no major events (e.g., massive card fraud) during this period to suggest this; in fact, individuals typically become more comfortable

[5] There is some discrepancy between the survey data obtained by the World Bank in terms of number of debit card holders, and the number of debit cards issued according to the Central Bank of Azerbaijan. This is likely due to survey methodology, particularly the fact that many cardholders may not *use* their debit card with any consistent frequency, and thus do not report owing one.

with electronic payments over time, not less. The more likely explanation is therefore an increased branch growth and accessibility among the main banks (see Section F on Channels) has steer people away from ATMs and into branches. Section E of this report provides more details on debit card and other electronic payment products in the country.

	Country data	Europe & Central Asia	Upper middle income
Access to Financial Institution Account (% age 15+)			
Has debit card	15.7	36.9	45.9
Has debit card, 2011	10.0	36.4	38.5
ATM is the main mode of withdrawal (% with an account)	57.1	66.7	55.7
ATM is the main mode of withdrawal (% with an account), 2011	88.2	72.5	42.8
Other Digital Payments in the Past Year (% age 15+)			
Used a debit card to make payments	6.3	22.9	19.9
Used a credit card to make payments	8.1	14.9	14.4
Used the Internet to pay bills or make purchases	4.2	11.9	15.3

Table 2. Debit card holders and usage (% of overall population) compared to cohort countries (World Bank, 2015).

Savings

As Table 3 indicates below, roughly 40% of Azerbaijanis save any sort of money, which is in line with Europe and Central Asia, though about a third less of those from Upper Middle Income countries. The proportion of adults who save at a financial institution, however, is just above 5%, over six times less than the Upper Middle Income group (though an increase from a meager 1.6% measured in 2011). The majority of the remaining 35% are presumably saving in informal means, which represents an untapped opportunity for the banking sector. That being said, as mentioned in Section A, the overnight devaluation of the local currency would likely have adverse effects i on customers' trust and desire to save at banks, even though customers would stand to benefit from the security and the interest rate offered on customer deposits.

	Country data	Europe & Central Asia	Upper middle income
Savings in the Past Year (% age 15+)			
Saved at a financial institution	5.3	8.4	32.2
Saved at a financial institution, 2011	1.6	4.9	25.1
Saved using a savings club or person outside the family	1.6	6.6	4.9
Saved any money	39.5	38.5	62.7
Saved for old age	11.1	11.8	30.6
Saved for a farm or business	8.9	5.1	17.6
Saved for education or school fees	7.7	12.1	25.4

Table 3. Savings behavior (% of overall population) compared to cohort countries (World Bank, 2015).

Credit and Domestic Remittances

Despite the figures above, the financial inclusion picture in Azerbaijan does have some bright spots. There is strong access to credit (46% of population), 18% of which is offered by the banking sector – well above those from the Europe and Central Asia, and Upper Middle Income cohorts. Owing to the urban-rural divide in the country, domestic remittances are also widespread, where 1 in 5 Azerbaijanis having sent or received a money transfer. As discussed in Section D, the extensive retail network of Azerpost, the national postal network which recently was permitted to offer basic financial services to the population, has no doubt contributed to this. (The full Global Findex 2014 data on Azerbaijan, including Credit and Domestic Remittances data, is available in Appendix A.)

C. The Role of Electronic Payments in Financial Inclusion

In its simplest form, a payment is effectively an exchange of value between two parties. In many cases, this involves Party A providing some form of currency in exchange for goods and services provided by Party B. These "parties" can include individuals ("people"), merchants, businesses, financial institutions, and governments, and thus various forms of payments are often abbreviated by the two parties in question: e.g., P2M is Person-to-Merchant, B2B is Business-to-Business, and G2P is Government-to-Person.

Using the above definition, electronic payment products are therefore considered a key part of financial inclusion strategy, where a key focus is enabling a safer, faster, cheaper, and more convenient way to make and accept payments. Among these characteristics, compared to more traditional forms such as cash and check, electronic payments can offer a superior option for both consumer and merchant. This takes the form of quickly transferring funds to a far-away family member by text message, enabling a small store to pay its multiple suppliers using a prepaid card, or receiving government-funded social benefit transfers directly in a recipient's bank account. For this reason, these three cases in particular – merchant payments, domestic transfers, and government payments – are covered in more detail in Section E.

Moreover, electronic payments are increasingly being viewed as an "entry point" to traditional banking services for those that do not have access to financial services. Often, this so-called "unbanked" segment may not have any interaction with a formal financial institution, and thus the banking sector, in turn, has limited information on how best to reach them and design financial products for them. If, for example, a government benefits program is disbursed into a bank account instead of cash or check, the individual slowly ends up developing an ongoing relationship (and hopefully trust) with the bank, and the bank in turn not only has a better understanding of the customer, but also actual data (in this case, monthly payments) by which to design and offer subsequent products, such as a loan or insurance product.

In some models, certain products (e.g., a debit card tied to a savings account) can itself blur the lines between traditional banking product and a payment product. The former refers to the provision of a full suite of core financial products – chiefly savings, loans, and insurance – to individuals. While many Azerbaijani banks also provides some payment services (e.g., debit card issuance, online money transfer), as discussed in the next section, these are complementary offerings and are usually a distinct unit from the retail arm of the bank.

Lastly, it is worth noting that promoting 'financial inclusion' need not be limited to the purview of microfinance institutions (MFIs). While the aim of MFIs are indeed to provide financial services (typically beyond credit, though as Section D details in Azerbaijan they are limited from doing so), various stakeholders – large and small banks, payment processors, mobile network operators, postal networks, technology vendors, distribution channels – all have a major role to play.

D. Providers

Large Banks

From a high of nearly 250 independent banks in the 1990s, Azerbaijan now has 44 regulated commercial banks. This is still considered a relatively high number for a country of fewer than 10 million people, and the majority of banks have between 1% and 3% of total assets. In 2014, the Central Bank increased the minimum capital requirements from 10 million AZN to 50 million AZN (approximately $9.5M USD to $47.5M USD in current exchange rate), in part to spur further consolidation, but the number of banks has remained steady. Most of these banks primarily serve corporate interests, and thus only a third are engaged with retail operations; currently there are just over 800 branches across the country, about half of which are in the capital, Baku.

The country is dominated by 5 main banks, 3 of which play in the consumer (retail) space. The largest by far is the International Bank of Azerbaijan (IBA), which was founded shortly after the county regained its independence, and is 51% owned by the government of Azerbaijan. The IBA manages roughly $10 billion USD in assets, which represents nearly of half of the assets of the total bank sector. Pasha Holding, a large conglomerate in Azerbaijan comprising insurance, banking, property, development, construction, and tourism, owns both Pasha Bank and Kapital Bank, formerly a Soviet Bank and now the country's second-largest bank. Apart from Yapi Credi Bank, which is Turkish owned, and a number of corporate offices of large international banks, there is an absence of foreign retail banks in the country.

Large Banks' Role in Financial Inclusion

Generally speaking, the IBA and Kapital Bank do not have explicit activities dedicated to financial inclusion. That being said, there are two relevant initiatives that are worth highlighting:

1. Both the IBA and Kapital Bank manage the government disbursement scheme to pensioners. This program details are discussed further in Section E.

2. IBA is 100% owner of the main card processor in the country, AzeriCard, which, in 1997, was the first in the country to issue debit cards. Kapital Bank, meanwhile, operates its own

processing center under the same name. The role of processors in financial inclusion is discussed later in this section.

Small Banks

The main small banks of relevance to financial inclusion are Access Bank, Demir Bank, and Bank of Baku (all of whom were interviewed for this report). Access Bank (previously called the Microfinance Bank of Azerbaijan before being renamed in 2008) and Demir Bank are majority foreign owned by entities such as the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC), the private sector arm of the World Bank. Bank of Baku is a private domestic bank that has in the past few years has expanded outside of the capital.

It should be noted that these small banks do not target the underserved consumer segment, per se – their interest is chiefly in providing a single product (i.e., loans) to small and medium enterprises. Generally speaking, banks in Azerbaijan which target consumers overwhelmingly concentrate on issuance of consumer credit, and mainly to the upper and middle-class of the country; they rarely offer savings accounts, and almost never any payment products such as debit cards, to the lower-income segment. According to one small bank, credit made up nearly 90% of its revenues, and there has been a reluctance to focus on non-credit products as a result. This is partly due to the wide interest rate spread in the country (close to 10%), which, while below its neighboring countries in Central Asia, is far higher than Eastern European markets (see Figure 3). According to a May 2014 report issued by the International Monetary Fund (IMF), the "high operating costs, lack of competition, and diseconomies of scale for small banks remain key impediments that prevent interest spreads from declining in Azerbaijan."[6]

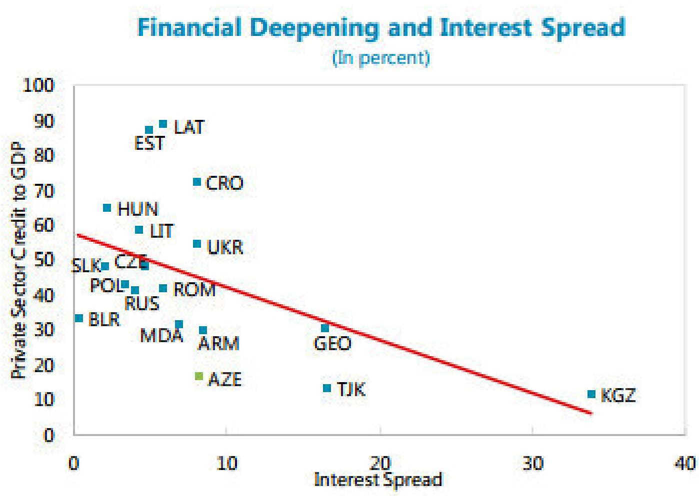


Figure 3. Interest Rate Spreads (%), IMF (2014)

Interestingly, the recent currency devaluation may have a silver lining vis-à-vis banks' product diversification efforts: customers' dissatisfaction at higher loan repayment amounts[7], coupled with banks' reluctance to issue new loans (there is concern in the banking community that a second round of

[6] International Monetary Fund, *Determinants of Banks Spreads in Azerbaijan*, May 2014. http://www.imf.org/external/pubs/ft/scr/2014/cr14160.pdf

[7] Many low-income customers (roughly 50%, according to one small bank) had loans issued in USD, and thus saw their effective repayment amounts increase after the local currency devalued in February 2015.

devaluation may occur) may mean that banks put additional focus on offering products beyond credit. This was mentioned by a handful of banks, and to-date it is too early if such anecdotal evidence leads to concerted product and market development efforts – but it remains nonetheless a promising aspect to watch for in the coming months.

Microfinance Institutions

There are approximately 17 Microfinance institutions (MFIs) in Azerbaijan, and these are denoted as Non-Bank Credit Institutions (NBCIs) in Azerbaijan, owing to a regulatory limitation whereby they are legally limited to only providing credit, and supervised by the Central Bank. As microfinance institutions can only issue credit – unlike other countries, there is no designation that allows them to capture deposits without being a fully licensed bank – this means that low-income (and chiefly rural) customers often do not have access to a broad range of financial services and payment products.

The largest MFI is FINCA Azerbaijan: they boast 67 offices in every region in the country (46 of which are full-service), which it claims gives it the largest geographic coverage of any financial institution except IBA, and provide mainly individual loans of around $2,000 USD to 150,000 customers, the bulk of whom live in rural areas[8]. AzeCcredit, initially a project by the NGO World Vision in 1996 is the second-largest, with approximately 80,000 customers and 46 branches across the country.

In its most recent annual report, the Azerbaijan Microfinance Association (AMFA), an umbrella group of 34 members, among which there are 17 MFIs and 4 credit unions, reports over 600,000 microcredit borrowers and strong overall loan portfolio quality[9].

		Total Equity	Total Staff	Cumulative Loans Disbursed (for Micro credits)	Microcredit Portfolio Outstanding	Active Borrowers	Female Clients, %	PAR> 30%	PAR> 30-180 days %	Write Off
Total	5,562,423,031	963,608,086	11,056	6,100,074,929	1,384,800,754	613,555	24.9%	2.7%	1.9%	1,905,129

Table 4. Microcredit Portfolio Report ($USD) as of December 31, 2014, AMFA Annual Report (loans up to $20,000 USD)

As card issuance is limited to licensed banks (international brands such as MasterCard and Visa provide a financial institution with a Bank Identification Number (BIN) when one becomes a member), the role of MFIs in *directly* providing electronic payments is severely curtailed. The one exception is their use of Self-Service Kiosks, a form of electronic repayment, which is covered in Section F under Channels. That being said, their branch networks, sales force (e.g., loan officers), extensive outreach to, and knowledge of, low-income customers, and perhaps most importantly, deep trust engendered that these customers have towards them, makes MFIs a viable stakeholder with whom other providers (e.g., banks, Azerpost, or, pending legislation, mobile network operators) could partner to reach the underserved segments. Moreover, in separate interviews with FINCA Azerbaijan, AzerCredit, and KredAgro (another leading

[8] Author interview with FINCA Azerbaijan, May 2014.
[9] AMFA Annual Report, 2014. http://www.amfa.az/admin/uploads/annual/annual-report-2014-pages-cover.compressed.pdf

MFI), all mentioned their interest, if it were to be legally permitted, in proving payment services such as domestic transfers and debit cards payments, or proving services to banks by acting as banking agents.

Azerpost

After legislation permitting it to do so in 2002, the national, state-owned postal network, Azerpost, began offering financial services in 2008, primarily due to its over 1500 branches located all across the country, most notably in rural areas. It offers a number of financial products, such as foreign exchange, international remittances (they have a partnership with Western Union) and MasterCard and Visa-branded salary debit cards, and accepts utility payments (gas, electricity, water) by cash or electronic payments, which they claim represents 95% of all utility payments in the country. They are prohibited from issuing credit and capturing deposits from the public, however. Its main financial product is domestic money transfers, which is detailed further in Section E.

Azerpost has the largest network of any financial entity in the country: over 1500 post office branches across the country, including 74 administrative offices. For this reason, it is the organization with the greatest direct relationship to the unbanked population (as mentioned below, mobile operators do have a strong outreach, though this is less ‘face-to-face’ than the postal network), and the Central Bank views Azerpost as a key asset it its efforts to promote financial inclusion, particularly in the rural areas.

To provide the reader with a sense of the Azerpost postal network and its financial services outlet, the following photos were taken by the author of a branch of the town of Sheki (population 63,700), a semi-urban area in the country’s north-west region.

Mobile Network Operators (MNOs)

Although at time of writing, Mobile Network Operators (MNOs) are not permitted to directly offer payment services to consumers (though, as detailed in Section H on Regulation, the current E-Payment Law seeks to change this), like MFIs, they may serve as an important partner for those stakeholders that can, and thus it is worthwhile to briefly describe the MNO landscape in the country. As indicated by the figures below, this is especially the case given their wide outreach to the population; many of the low-income individuals that are “underserved” by banks are, in fact, currently “well-served” customers of the mobile operators.

There are approximately 11 million subscriptions in Azerbaijan, owing to the use of multiple “SIM”s (Subscriber Identity Modules) among consumers, a common practice in emerging markets. Estimates for individual penetration ranges from roughly 70-80% of the adult population, but in either case, the vast majority of Azerbaijanis have a mobile subscription. In addition, most of the country’s geography is covered by a wireless signal, and operators claim that close to 99% of the population is covered.

Three are three MNOs in the country: Azercell, Bakcell, and Azerfon (which goes by the brand name NAR). All are modern telecommunication service providers that provide 2G, 3G, and 4G services. As of June 2014, Azercell had 5.2 million subscribers’, Bakcell had 3.3 million subscribers, and Azerfon had 2.5 million subscribers. Approximately one-third of all current mobile devices are smartphones, and while this figure had been growing steadily year-on-year, the recent devaluation has forced customers to temporarily cut back on the (now) higher cost of smartphone purchases. Still, the eventual growth of smartphones is expected to rise, and this has implications with respects to financial inclusion in terms of services (financial or otherwise, such as marketing) that could be provided through those devices.

As can be surmised from the strong penetration among the population, there is intense competition in the mobile telecommunications market in Azerbaijan, particularly in Baku, and thus there is an increased focus in providing Value Added Services (VAS) to retain customers (and, if possible, derive top-line revenue). This is particularly important as the vast majority of subscriptions are “pre-paid” -- in other words, customers are not locked in to lengthy “post-paid” contracts that are common in Europe and North America, and thus the costs to switch to a rival mobile operator is quite low for the customer. In separate interview with MNOs, they indicated significant interest in playing an active role in “mobile financial services: the provision of various forms of financial services (including electronic payments) over the mobile channel. In many countries in Africa, Asia, and Latin America, mobile financial services have, in fact, been led primarily by the mobile operator, in some cases with great success (the case of M-Pesa, offered by Safaricom in Kenya, is the most widely cited, but several others exist, including in Tanzania, Zimbabwe, Bangladesh, Pakistan, and the Philippines). That being said, the MNOs indicated they are interested in forming partnerships with banks and, if needed, playing a more passive role, such as permitting banks to use their voice, data, or retail agent network.

Payment Processors and Payment Infrastructure

It is also worth briefly mentioning the role of payment processors in financial inclusion, as well as noting the national payment infrastructure in place. There are currently nine card processing centers: Azericard (100% owned by IBA) and MilliKart are the two main ones; followed by Bank of Baku, Kapital Bank, and the much smaller Yapi Credi, and four smaller ones. AzeriCard has membership with 18 banks and carries roughly 2 million bank cards; MilliKart with 12 banks and 900,000 bank cards. If the transaction is processed exclusively on their network, these entities clear the payment transactions and send them to the Central Bank's Real-Time Gross Settlement System (RTGS) for settlement. This is depicted in Figure 5 below.

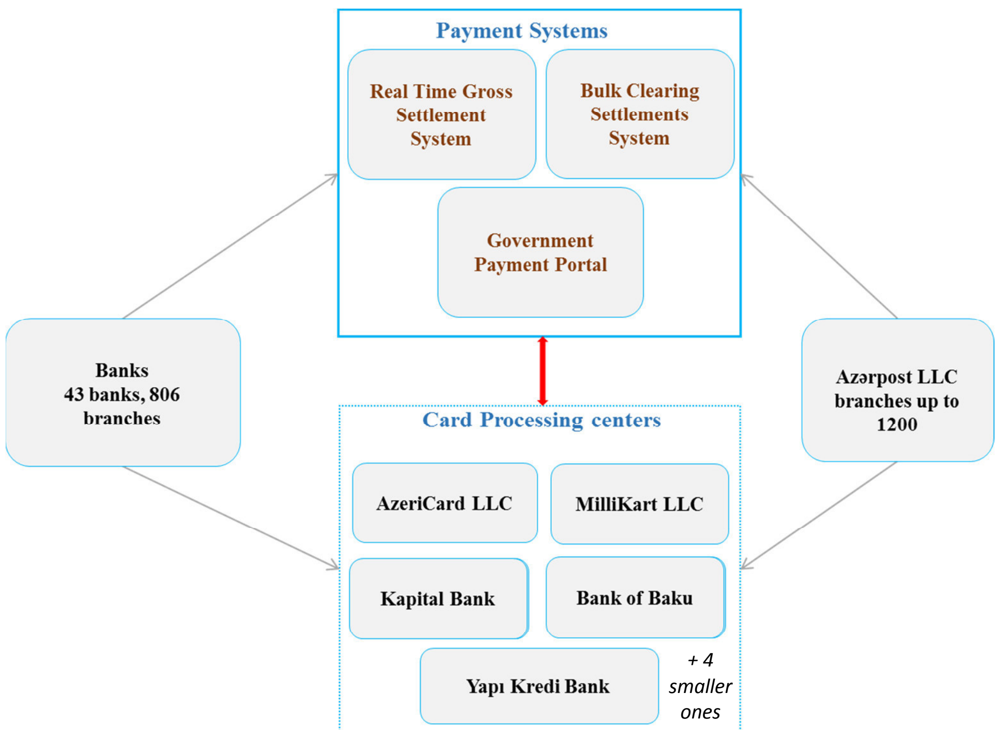


Figure 4. National Payment Structure, Central Bank of Azerbaijan (2015)

One focus on financial inclusion is enabling greater electronic payment acceptance from merchants, which would allow customers to pay electronically rather than through cash (while also creating more transparency for both parties as the transaction created a digital "paper trail"). For this to happen, it will be the responsibility of the above processors to "acquire" additional merchants, particularly in underserved areas. Lastly, the Central Bank of Azerbaijan has begun the development of a national switch to process domestic card transactions; currently, card transactions that are handled by two separate processors (e.g., AzeriCard and MilliKart) are routed out-of-country to Visa and MasterCard processing centers before being switched to the correct party locally.

E. Electronic Payment Products

Retail Payments

From an electronic payments perspective, the Bulk Clearing and Settlement System (BCSS), created in 2002 for small-value dominates; the most recent figures in March 2014 show over 2 million transactions taking place that month, with an average value of 550 manat. The BCSS was created with recurring payments in mind, and thus salaries, utility payments, and government tax payments are the common types of transactions using this platform.

Azerbaijan has seen strong growth in plastic cards since these were first launched in the late 1990s ; to-date there are no options for mobile money or agent banks (due to regulatory limits). As of the March 2014, the country had issued 5.9 million bank cards, over 1 million being credit and the rest being debit, with a growth rate 13.4% or nearly 700,000 additional cards issued over the prior year.

The Central Bank estimates that there are 5.2 million unique cardholders; in discussion with banks, it appears that a small urban, middle-class population tends to carry multiple cards, especially to "aggregate" a cardholder's total available credit. A popular installment loan scheme – where customers have the option to pay merchants over 3, 6, or 12 months – first launched by Bank of Baku, has been replicated by other banks.

According to statistics published by the Central Bank, in the month of March 2014, there were nearly 6.8 million bank card transactions conducted, worth just over an estimated 1 billion manat. However, nearly 4.8 million of those transactions (70%) were conducted to withdraw roughly 830 million of manat in cash at ATMs, which suggests either a poor merchant acceptance network or a customer need for immediate liquidity. Average transaction amount at Point-of-Sale (POS) terminals was just under 40 manat.

It is well known that most debit cards are, in fact, used primarily to withdraw cash, with the Central Bank estimating that a mere 7% - almost half of the figure for neighboring Kazakhstan and Kyrgyzstan – of all non-cash transactions are done through payment cards. Moreover, as in most developing countries, actual card usage is lower than the number of issuing cards would suggest. While the Central Bank does not collect data on card activity rates, more than one bank estimated that nearly 50% of cards were more than 30-day inactive. (This may explain part of the discrepancy data between "cards issued" by the Central Bank and "cards used" by the Global Findex survey to customers.)

Online payments are still rudimentary, with online mobile payments, such as those offered by payment portals GoldenPay and e-Manat, being at a very early stage; primarily the use-cases are limited to utility bill payments and mobile network operator airtime top-ups. These work primarily with smartphone and data service (from the mobile operator or Wifi), and thus are clearly oriented towards the middle and upper class.

Bill payments are mainly done at correspondent agents, such as Azerpost, as well as through self-service kiosks, which accept cash. This channel appears to be more prevalent in Central Asian countries and is discussed in further detail in Section F.

Money Transfers

The domestic money transfer business is dominated by Azerpost, being its key financial product. It offers a real-time transfer service, either cash-to-cash or cash-to-account, at relatively affordable prices, particularly for higher value amounts: 1.5 manat for values up to 50 manat, and 2.5 manat for any transfer value over 100 manat (recall 1 Azeri manat = $0.95 USD). Azerpost further calculates that the average value of each transaction is between 100 and 200 Azeri manat ($95 to $190 USD), and estimates that it conducts nearly 500,000 transactions per quarter (recall that roughly 20% of Azerbaijanis have sent or received a domestic remittance in the previous year).

It should be noted that while banks do offer intra-bank (i.e., account-to-account electronic funds transfers), the service is not as common as other channels such as Azerpost. This is because the main domestic money transfer corridors are between Baku and the (low population density) regions of Azerbaijan, owing to the rural-urban migration patterns of the country; those residents who live in Baku are more likely to transfer money in cash, even for larger amounts. Because the rural recipients rarely have bank accounts, and because banks have few branches in rural areas, Azerpost ends up being the main option for formal domestic transfers in Azerbaijan – in fact it claims that is effectively has 'no competition' in the urban to rural money transfer corridor.

Government Pension Scheme

Since the early 2000s, the Government of Azerbaijan introduced a pension scheme whereby pensioners would receive benefits directly into a bank account and an associated debit card. In interviews with the Central Bank, it is estimated that there are approximately 1.2 million users of the scheme, receiving an average of 170 manat ($162 USD) per month. (The average age of the recipient is 63 for females and 65 for males.) This means that the government disburses roughly $2.3 billion of pension benefits every year.

IBA and Kapital Bank are the primary issuers for these debit cards, which are personalized and MasterCard or Visa branded. While there is no specific data collected on activity rates, it is assumed that they are used almost exclusively to withdraw cash at nearby ATMs once a month; payment usage for the government benefit cards at POS-enabled merchants is virtually non-existent.

Moreover, the Central Bank assumes that nearly the full benefit amount is withdrawn every month (the bank accounts are not interest-bearing). With this in mind, it is arguable whether the government has achieved any significant increase in financial inclusion with the debit card program (there are other objectives the government may have had in launching it, such as lower cost of delivery and less "leakage" (value that is pocketed between intermediaries from issuance to disbursement), as the savings accounts are merely used as "temporary repositories" to receive benefits, and debit cards exclusively used to withdraw in cash once a month. There may well be an opportunity, such as through a combination of better product design (more features and benefits of the savings products), merchant acceptance (more locations to use the card for payments), and financial literacy (explaining the advantages of saving products and debit cards), to enhance the existing program to deepen financial inclusion among this segment of the population, which (presumably) is largely underbanked.

F. Channels

Point-of-Sale (POS) Merchants and Automatic Teller Machines (ATMs)

Azerbaijan has seen impressive growth card-accepting merchants over the last five years, from nearly 8,857 in March 2011, to 20,994 in March 2012, to 38,772 in March 2014. This puts POS merchants a greater per capita density that neighboring ex-Soviet states such as Kazakhstan, Kyrgyzstan, Moldova, and even Russia. The number of transactions has also skyrocketed, from 7 million in March 2011 to 33 million in March 2014.

It should be noted, however, that there is wide disparity between Baku and the regions: March 2014 data indicates 30,675 POS terminals in Baku, compared to just 8,097 for the rest of the country (just under 4 times more), and one card processor estimated that, on a per capita basis, Baku has currently nearly 7 times as many POS terminals per capita. Because payments are a two-sided market, this is to be expected: as the vast majority of cardholders live in Baku, merchant acquirers have little incentive to install costly wireless POS machines in rural areas. Moreover, average ticket sizes tend to be significantly higher in urban areas than rural, in part due to the type of merchants (e.g., middle-end apparel store vs small convenience shop) found in the corresponding markets.

It should be noted that a key assumption is that the "merchant discount rates" – the commission, usually a percentage of the transaction size, that merchant pay to accept payment cards – in Azerbaijan, currently from 1.2% to 2.5% for both debit and credit cards, is not a barrier to expanded merchant acceptance, particularly for small businesses in the rural areas. Rather, it appears that a) a lack of customers (issuing side) in the regions and most significantly, and b) a desire for merchants to either remain "informal" or not reveal true sales volume (to decrease tax burden) by accepting electronic payments, are the main obstacles preventing more merchants from accepting card payments. This is relevant because of a current Central Bank effort to implement a national payment switch and have local banks set their own (lower) interchange rates (currently, domestic interchange rates are set by MasterCard and Visa), which it assumes will spur greater merchant acceptance.

ATMs have seen a similar increase over the years, although the growth has not been as pronounced. In March 2011 there were 1,929 ATMs in the country; three years late there was a modest increase to 2,443 plus and an additional 2,000 self- service kiosks which disburse cash and are discussed below. On a more positive note, the regional disparity is not as pronounced, with Baku making up just over half

(56%) of all ATMs. In some ways this is not surprising; if merchant acceptance is low outside of Baku, but there is a strong issuance of cards (in part due to government schemes, for example), than banks have no choice but to expand ATM acceptance in those regions so customers can withdraw cash. In the most recent data available from the Central Bank, a typical ATM would see an average withdrawal of 176 manat (in the month of March 2014, there was 348,805 manat withdrawn for 1979 transactions), which is quite high for ATM withdrawals, but perhaps less surprising given the propensity for individuals (chief among them pensioners, as described earlier), to withdraw most of their deposits on a frequent basis.

Self-Service Kiosks

As mentioned in an earlier section on bill-payments, one alternative channel to reach the underserved that is noteworthy is self-service kiosks, which are effectively cash-in machines that allow the depositor to pay bills and loans using a highly interactive touch-screen. There are a number of third-party vendors that provide this service, such as Million, shown in the below photos taken by the author.

e-Manat is another provider, and has nearly 2000 of such kiosks in the country, 1300 of which are in Baku. Nearly 40 merchants are available, including 13 banks and microfinance institutions, and its CEO estimates nearly 800,000 customers use it monthly, each performing an average of 5-6 merchant payment transactions. In some cases, microfinance institutions have bought their own self-service kiosks for repayments – FINCA Azerbaijan, for example, estimates that, since they placed them nearly two years ago, nearly 30% of all repayments transactions are done through self-service kiosks installed in their branches, rather than at branches of bank correspondents. This indicates that even low-income customers, in a relatively short amount of time, show comfort with technology and financial services -- in particular cash deposits, which are typically the most “risky” transaction from a customer perspective.

Brief Notes on Mobile Banking and Agent Banking

To-date, mobile banking, whereby a bank provides both information-based and transaction-based banking services through a customers' mobile phone (usually, but not limited to, a smartphone), is rudimentary in Azerbaijan. Roughly a third of banks offer mobile banking, and even then the available functionality is relatively narrow, and furthermore it is not marketed extensively. Discussions with both large and small banks uncovered that actual customer usage of the mobile banking service is low.

Agent banking is when a non-bank entity, such as pharmacies, lottery houses, supermarkets, convenience stores – and sometimes MFIs – conducts transactions, either financial or operational, on behalf of a bank. This has been a winning model to expand outreach to rural areas in Latin America, starting with Brazil in 2001, which has used it successfully to reach the underserved.[10] In Africa, most models of mobile money utilize agents (in most cases, managed by a mobile operator, rather than a bank) to perform critical 'cash-in' and 'cash-out' functionality – in other words, to exchange cash for electronic money and vice-versa.

The current regulatory framework in Azerbaijan does not permit agent banking, though Microfinance Institutions replied that they would be eager to use their branch and/or sales force network as an extension of the banking value chain, especially in light of restrictions to offer products beyond loans. If the Draft Law on Payment Services Bill is passed, a more conservative form of agent banking would be permissible. Section H provides more details on the Draft Law.

G. Customers

Despite being classified as an upper middle-income nation (with a GNI per capita of $7,350), financial inclusion is relatively low, as indicated earlier by the Global Findex 2014 results. . (Some caution should be applied as income is not distributed equally throughout the country). Azerbaijan's population was 9.7 million as of July 2014, with roughly 7.5 million above the age of 15 years, and a median age of just over 30 years old.

This "youth bulge", depicted in the population pyramid at right, has two major implications for financial inclusion: the first is that timing is crucial to reach the underserved population; the second is that young people tend to be more open to trying new financial products through

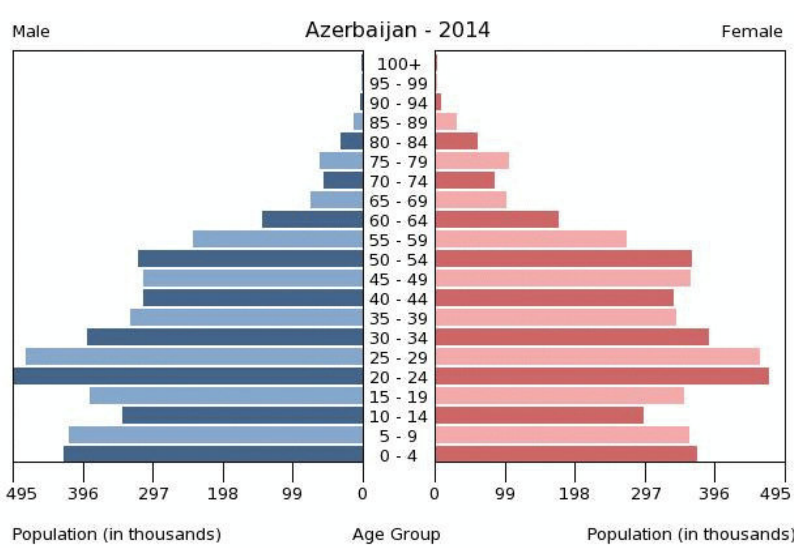


Figure 6. Population Pyramid, Azerbaijan (2014)

[10] *Agent Banking in Latin America*, Allianc
global.org/sites/default/files/discussion_

alternative channels, and furthermore, more adept at using those that involve technology. That bodes well for innovations in electronic payments such as bank cards, self-service kiosks and mobile phones.

In July 2015, small focus groups[11] were conducted with current clients of a leading microfinance institution to gauge their current behavior with respects to electronic payments and financial inclusion. It is worth highlighting the severe impact on customer perception towards banks that the recent devaluation has had: low-income customers who took out loans dominated in USD (in Azerbaijan, about half of the loan volume is issued in USD, based on customer preference, but repayments are in local currency), saw their effective repayments increase by 34%. While many banks and microfinance institutions have offered to refinance the loans with longer payment terms, they have not absorbed any of the increase, and have instead recalculated the new principal and interest repayments with the new exchange rate. The result is that customers' trust in financial institutions has plummeted; there are even efforts among some customer groups to lobby the government to force banks to maintain repayment amounts with previous exchange rates. New innovations, either in financial products or alternative channels, to the low-income segment are likely to be met with more suspicion and skepticism than before.

When asked about certain payment products, their response was balanced. A number of customers held pensioner debit cards, and as expected they claimed it was primarily used at the ATM every month to withdraw the full amount, because they had immediate expenses to address (such as education, food, and bills). Moreover, they claimed that POS machines were not close to where they were, and were thus considered "inconvenient". Azerpost received high marks for being close to them, but some participants complained that the service was "very slow", presumably due to long lines. All the clients had phones, and roughly half hand smartphones; they indicated that some microfinance institutions had used text messages to send them reminder and notifications, which they had welcomed.

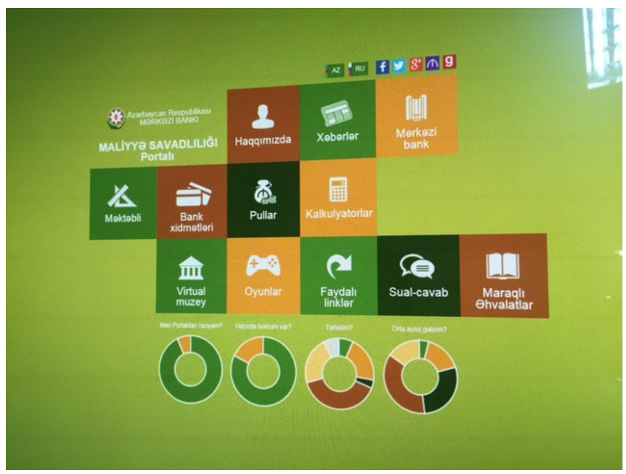
Participants were asked about two potential products: mobile money and banking agents. They indicated interest in sending money transfers via the mobile phone channel, as well as repaying microfinance loans, as currently they only method is through cash, either at a bank correspondent, the MFI's tellers (for those MFIs that handle cash; some, such as FINCA, do not) or at the self-service kiosk mentioned earlier in this report). Interestingly, customers preferred to receive their pension benefits directly in a bank account, where it could be swiftly withdrawn through an ATM. Participants seemed enthusiastic about the prospects of banking agents, indicating the proximity would results in less time and be more convenient. Unlike in other countries where similar questions are asked, they did not indicate that they would feel discomfort or lack of trust in dealing with a non-bank representative (e.g., a shop owner) for their financial services.

[11] It should be noted that only a handful of focus groups in Baku and its outskirts were conducted with a 8-10 participants in each focus group (including a mix of gender, age, card usage, etc.), and thus responses to questions, particularly about hypothetical products (such as mobile money or banking agents) should be treated with caution. More compressive focus groups and/or ethnographic research is suggested to gauge customer willingness to try and adopt new products and channels.

Financial Literacy

Though the country has high levels of basic literacy, a lack of *financial* literacy was the most often cited barrier among the stakeholder interviewees for low financial inclusion. Many organizations cited low levels of basic understanding of financial services among the poor as the main reason of the low uptake[12].

In light of this, the Research and Development Division of the Central Bank has put significant efforts and resources into enabling financial inclusion since 2010. At time of writing, it was just about to launch an online portal whereby customers could receive a host of information – everything from savings account calculators, to inflation, to how to use debit cards, in a simple, user-friendly way. The Central Bank also plans to invest in stand-alone kiosks, complete with touchscreens, which will be placed inside a handful of commercial bank branches (they are expensive and thus the initial roll-out will be limited to the main branches of banks).



[12] The author's hypothesis, however, is that financial literacy is a necessary but not a sufficient condition for financial access – in other words, banks and microfinance institutions (and other stakeholders that may play key roles in the future, e.g., mobile network operators) also have opportunities to offer greater, better designed, and more affordable financial services to the underserved segment.

H. Regulation

Overview of Central Bank of Azerbaijan and Role in Financial Inclusion

Following an act of government shortly after the country regained independence, the Central Bank of Azerbaijan was created in 1992. According to its 2011-2014 Strategic Plan[13], its mission is three-fold: maintain price stability, preserve financial stability, and support economic growth of the country.

It has four main pillars: Banking Supervision, Monetary Policy, Treasury, and Payments. A core focus of the latter is the stability and ongoing development of the country's payment systems, and as such has a legal responsibility to oversee the national settlement systems. It maintains ten core principles[14] to uphold, including legal issues, financial risk management, and participation in payment systems.

While the Central Bank does note in its Strategic Plan that "Technology Development" is a concrete opportunity to provide financial services to the rest of the country, it does not have an explicit department dedicated to financial inclusion. Much of the leadership to promote financial inclusion has thus been implicitly led by the respective Directors of the Non-Banking Supervision, Payments, and Research and Development units (names can be found in the interviewee list in Appendix A).

Motivation of Draft Payment Service Law

After a lengthy consultative process with participants in the local payment ecosystem, the Central Bank of Azerbaijan put together a "Draft Law on Payment Services"", which is currently making its way through parliament. The Central Bank hopes that it will take effect towards the end of this year or beginning of 2016.

[13] *2011-2014 Strategic Plan*, Central Bank of Azerbaijan. http://en.cbar.az/assets/1898/Strategic_Plan_english_version_130911_FINAL.pdf

[14] See *Oversight Concept on Payment Systems*, Central Bank of Azerbaijan, at http://en.cbar.az/assets/1913/Oversight_Conception_on_Payment_Systems..pdf

The Draft Law on Payment Services primarily describes requirements regarding the issuance and use of e-money, and was modeled after the European Payment Service Directive (PSD), which provided the legal basis to create an EU-wide single market for payments.

The purpose, broadly speaking, of the Draft Law is to encourage more competition and innovation in the electronic payments sector, as well as the development of the sector vis-à-vis broadening the type, and efficiency of, these payment services. Any entity, both non-banks and banks, can apply to be an e-money issuer; such "e-money institutions", regulated by the Central Bank, need to satisfy basic prudential requirements, have funds equivalent to the value of its operations (i.e., cannot "create" virtual money), and have initial capital requirements (amount to be determined). They are also permitted to set up its own branches and representatives (such as payment agents), and contract third-parties to sell and redeem electronic money.

In the following sub-sections, an assessment is provided not only on the Draft Law, but also other regulatory elements that are considered critical to promote an 'enabling environment' for financial inclusion. Each sub-section begins with a motivation for its importance broadly speaking, a description of the current or envisioned state in the Azerbaijani context, followed by an evaluation.

Electronic Money

Importance: E-money, simply defined, is monetary value which is stored on an electronic device, and which can be accepted as a means of payment other than to the issuer. E-money issuance is at the core of supporting a "cashless economy", and even more so if issuers beyond financial institutions are permitted to do so.

Azeri context: The Draft Law would permit any entity, both non-banks and banks, would be able to apply to be an e-money issuer; such "e-money institutions", regulated by the Central Bank, need to satisfy basic prudential requirements, have funds equivalent to the value of its operations (i.e., cannot "create" virtual money), and have initial capital requirements (amount to be determined). As envisioned under the Draft Law on Payment Services, e-money issuers would also be permitted to set up their own branches and representatives (such as payment agents – see next sub-section), and contract third-parties to sell and redeem e-money.

Assessment: Allowing a range of providers – not just banks – to issue e-money is a key enabler for financial inclusion using payments. The Central Bank has taken a prudent approach to allow other innovators to offer financial services (directly or through intermediaries), while putting in appropriate "risk-based" (vs rules-based) policies to safeguard the financial system.

Payment Agents

Importance: Allowing providers – financial institutions, MFIs, mobile network operators, and other third parties – to leverage the physical infrastructure of retail agents, such as pharmacies, lottery houses, supermarkets, or small convenient stores, and conduct financial transactions provides a major boost to reaching marginalized (and especially rural) communities where bank branches seldom exist.

Azeri context: At these agents, the Draft Law on Payment Services would allow customers to 'deposit' cash into an e-money account, pay bills or make loan repayments, and transfer funds to another e-money account. But while the eligibility of "payment agents" is broad – it can be any retail storefront – the agents would not be allowed to open any bank accounts (see next sub-section on Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) protocols), although would be permitted to realize the redemption of electronic money.

Assessment: It is worth emphasizing that these are "payment agents" and not "banking agents" as is typically covered in other emerging markets such as Latin America, sub-Saharan Africa, and certain parts of Asia. At these agents, the Draft Law would allow customers to 'deposit' cash into an e-money account, pay bills or make loan repayments, and transfer funds to another e-money account. But while the eligibility of "payment agents" is broad – it can be any retail storefront – the agents would not be allowed to open any bank accounts (and thus do not perform any Know Your Customer (KYC) checks or follow any Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) protocols), and would not be permitted to disburse any funds (i.e., customers could not withdraw cash from either a bank account or e-money account). This policy means that the standard model for banking agents and mobile money (which has shown success in reaching the underserved in Latin America and Africa), whereby "agents" perform cash-in as well as cash-out services (and in some cases, account opening), would not be replicable in Azerbaijan. In further discussion with the Central Bank, it clarified that a mobile network operator, if it were a licensed e-money provider, would be permitted to use its 'branches' (retail outlets managed by the MNO itself) to open e-money accounts.

Additionally, the Draft Law stipulates that the total cost of payment services rendered to payment service users must not increase. This forbids providers from charging an additional fee to the customer to transact at payment agents – a point that may make it harder for financial institutions to justify their payments business model.

Know-Your-Customer (KYC) Requirements

Importance: Almost all countries must adhere to Customer Due Diligence (sometimes called Know Your Customer – KYC) guidelines to open accounts and to conduct transactions over a certain limit (usually

$10,000 USD), with the intent to support Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT).

Azeri context: Customer Due Diligence for bank account opening is relatively straightforward in Azerbaijan, consisting of verifying (in person) a single national ID card and a signed (paper) application form. The Payment Service Law does not envision paperless account opening.

Per the Draft Law, payment agents will not be permitted to perform KYC or open accounts on behalf of banks. Transactions over $10,000 are reported to the Central Bank, per Financial Action Task Force guidelines. Moreover, Azerbaijan does not have different "tiered" level of accounts, with different levels of customer requirements (presumably because it is already not onerous to open a basic bank account).

Assessment: Account-opening is the "entry" point to full range of financial services. It is a positive factor that the requirements to open an account are minimal (a national ID that every citizen carries). The downside is the channel: only banks (at a bank branch, moreover) can open accounts, and as of now neither paperless or non-branch models exist to open an account. (That being said, the Central Bank has indicated interest in learning more about if a paperless or banking agents could be replicated in the country.)

Consumer Protection

Importance: Electronic payments mean higher likelihood of fraud, identity theft, and loss of payment instruments. Consumer protection policies seek to provide recourse for customers and mechanisms for providers to prevent them.

Azeri context: To date there are no explicit rules regarding consumer protection for electronic payments – such as customer liability for unauthorized transactions, dispute resolution mechanisms between provider and customer, and requirement to provide a paper vs digital receipt. Moreover, there is no specific consumer protection agency in the country which monitors protection issues and which explicitly serves as a channel for consumers.

That being, the Central Bank recognizes the important of consumer protection generally, and has developed 'methodological guidelines' to handle consumer appeals, working closely with multilateral organization such as the World Bank. In fact, the Draft Law on Payment Services encompasses rules regarding consumer protection, such as customer liability for unauthorized transactions, dispute resolution mechanisms between provider and customer, and requirements to provide a paper vs digital receipt.

Assessment: It is recommended to provide basic consumer protection guidelines, particularly as e-money policies are developed. In the future, the Central Bank may consider an ombudsman or independent agency to dedicate efforts specifically on these topics as it pertains to payments, or consumer financial services more broadly.

Interoperability

Importance: Certain governments and central banks have policies to "mandate" interoperable financial systems, i.e., connecting mobile money to the banking system and insisting that e-money issuers interconnect their platforms. Other countries have explicitly avoided this policy.

Azeri context: While the Central Bank operates a Real-Time Gross Settlement System (RTGS) whereby most transactions flow through, it does not, by design, mandate interoperability of e-money products. This means, for example, that e-money issuers would not necessarily have to collaborate with like-minded competitors from the onset and interconnect their respective systems.

Assessment: It is generally recommended to let the market, rather than the government, dictate the nature and pace of interoperability of payment systems. In this regard, Azerbaijan does not have any restrictive policies towards forcing providers to interoperate – overall a positive factor.

Taxation

Importance: In certain (rare) cases, government will tax certain transactions – such as in Colombia ("4 por 1000" – 0.4% tax on withdrawals) or pending legislation in Uganda to tax mobile money transactions differently.

Azeri context: As of now there is no taxation on deposits, withdrawals, or electronic payments. (This is generally the case in most countries).

Assessment: No prohibitive regulation on taxing transactions is viewed as a positive factor to enable financial inclusion (no "eating away" at deposits or withdrawals).

Deposit-Taking via Non-Bank Actors

Importance: To-date, non-bank actors (such as MFIs but also retail agents, per above) are prohibited from undertaking a range of activities, such as account-opening and capturing deposits.

Azeri context: Only regulated financial institutions can capture deposits from the public. Non-bank financial institutions (i.e., MFIs) are not permitted to take deposits or open accounts for customers. The

Payment Service Law, however, does envision that “agents” will be able to accept customer deposits into an e-money account.

Assessment: MFIs not being able to capture deposits naturally limits their ability to provide financial services to their (loan) customers – even when presumably this would benefit both customers and the MFIs (intermediation). Allowing agents to accept deposits is a major boost for financial inclusion, though as noted previously, not permitting the reverse transaction (withdrawals) is a downside.

Telecom Regulation

Importance: In certain countries (e.g., Peru), telecoms are mandated to open up bearer channels such as USSD for “essential services” such as banking, particularly as low-income segments often have basic phones.

Azeri context: Telecommunications in the country is regulated by the Ministry of Communication and Information Technologies of Azerbaijan. There is no regulation that mandates mobile operators to open any bearer channels – nor for that matter which prohibits them from offering financial services.

On a related note, to-date there has not been any significant interaction or joint efforts between the Ministry of Communication and the Central Bank vis-à-vis promoting (or regulating) mobile financial services.

Assessment: This is a non-issue so far. If and when mobile network operators become interested and involved in financial services (which is likely, based on interviews), it may be worthwhile for the Central Bank to engage more closely with the Ministry and define joint strategies and actions, as has been done in several countries (most notably Pakistan).

Comparison of Azeri Regulatory Framework with International Best Practices

It is instructive to compare the local context of these key regulations with best practices from countries that are considered to have a supportive regulatory environment to enable financial inclusion using electronic payments. Specifically, we look at the case of Kenya, with its success of the M-Pesa mobile money model; Philippines, whose Central Bank has, since 2001, taken a highly collaborative approach with both banks and mobile operators to test innovations such as mobile money; and Colombia, which in 2006 permitted banking agents and has seen concrete success it account opening and transaction usage through these agents.

The matrix comparison is below:

	Azerbaijan	Kenya	Philippines	Colombia
E-Money	Yes – anyone can issue	Yes – anyone can issue	Yes – anyone can issue	Yes – anyone can issue
Retail Agents	Yes – but partial range of operations	Yes – full range of operations	Yes – full range of operations	Yes – full range of operations
AML/CFT	Nothing unique for digital or fin inclusion	>1 piece of ID needed	Basic account requirements	Paperless account opening
Consumer Protection	General only	General and specific to digital financial services	General and specific to digital financial services	General only
Interoperability	Not mandated	Not mandated	Not mandated	Not mandated
Taxation	None	None – but some want to tax mobile money tx	None	40 bps on withdrawals from savings account
Deposit-Taking	Only banks	Banks, MFIs, and non-FI	Banks, MFIs, and non-FI	Banks, MFIs, and non-FI
Telecom Regulation	None (vis fin ser)	None (vis fin ser)	None (vis fin ser)	MNOs must allow USSD access to banks

Figure 7. Regulatory Framework Comparison Matrix between select countries, Author's analysis

Generally speaking, compared to other emerging markets, Azerbaijan has developed many best-in-class practices. That being said, the highlights in red font indicate areas that may limit providers' ability in using payments to reach the underserved.

The first is the limitation of account-opening from retail agents, which as discussed makes using the standard banking agent and mobile models that have seen success in Latin America and Africa, respectively, difficult to replicate. The author does not believe that leveraging the postal network of Azerpost, while an asset, would provide sufficient functionality for the underserved.

The second is the limitation of non-banks to capture deposits. Naturally the Central Bank is fully aware of the limitation of product range, as well as the implications for deepening financial inclusion, and has intentionally decided to take a more cautious approach to the market. With that in mind, other markets have successfully introduced a 'middle-ground' between NBCIs and full-fledged banks, which allow certain MFIs, based on select criteria, to operate savings accounts and capture deposits from the public.

Implications of timelines for Passage of Draft Law on Payment Services

It should be noted that because the Draft Law has not yet been approved, there is considerable ambiguity among participants as to what is feasible with regards to e-money issuance and alternative channels, and most, if not all, prefer to take a "wait-and-see" approach before investing in any projects that touch on these themes. It will be worthwhile to consider what, if any, payment financial inclusion projects may be initiated, either in research or implementation phase, while the law is being considered by parliament, as it may take longer than expected to get passed and fully defined.

Appendix A: List of Interviewees

Organization	Type	People
Finca Azerbaijan	Microfinance Institution	Muhammad Mobeen, Finance Specialist
Azercredit	Microfinance Institution	Mehriban Yusifova, Head of Marketing and Product
KredAgro	Microfinance Institution	Majid Asadov, Chairman,
Azerbaijan Microfinance Association	Microfinance Institution	Jale Hajiyeva, Exec Director
AzerPost	Delivery Channel	Yashar Ahmadov, Head of Financial Services Marketing Farid Husynov, Head of Operations
GoldenPay	Delivery Channel	Farid Ismayilzada, CEO
Modenis / e-Manat	Delivery Channel	Ruslan Tahbov, CEO
Central Bank – Payments	Regulatory Agency	Kamala Gurbanova, Director Tamerlan Rustamov, Senior Specialist
Central Bank – Non-Bank Supervision	Regulatory Agency	Khayyam Ismayilov, Director
Central Bank – Research and Development	Research and Development	Vugar Ahmadov, Director
NAR (Azerfon)	Mobile Operator	Turan Naghiyeva, Mobile Financial Services Manager Elvin Aliyev, Product Development Manager
Bakcell	Mobile Operator	Shola Ismiyaeva, Treasury sub-unit Head
MilliKart	Payment Processor	Jalal Orujov, Exec Director
AzerCard	Payment Processor	Anar Sultanov, Exec Director
Demir Bank	Bank	Shamsi Afandizada, Head of Non-Credit Department Shirinli Orkhan, Deputy head of Product Development
Access Bank	Bank	Rahman Aliyev, Head of Retail Services Sabina Gurbanova, Head of Bank Services Sevinj Aliyeva, Head of Plastic Cards
Bank of Baku (e-Pul)	Bank	Anar Abbasov, Director, e-Pul
ADB	International Organization	Nail Valiyev, Economics Officer
IFC/World Bank	International Organization	Teymur Heybatov, Operations Officer, Finance & Markets
EBRD	International Organization	Ayten Rustamova, Senior Banker

Appendix B: Global Findex 2014 for Azerbaijan

Azerbaijan

Europe & Central Asia			Upper middle income
Population, age 15+ (millions)	7.3	GNI per capita ($)	7,350

	Country data	Europe & Central Asia	Upper middle income
Account (% age 15+)			
All adults	29.2	51.4	70.5
Women	25.9	47.4	67.3
Adults belonging to the poorest 40%	26.9	44.2	62.7
Young adults (% ages 15–24)	10.0	35.6	58.1
Adults living in rural areas	30.1	45.7	68.8
Financial Institution Account (% age 15+)			
All adults	29.2	51.4	70.4
All adults, 2011	14.9	43.3	57.4
Mobile Account (% age 15+)			
All adults	..	0.3	0.7
Access to Financial Institution Account (% age 15+)			
Has debit card	15.7	36.9	45.9
Has debit card, 2011	10.0	36.4	38.5
ATM is the main mode of withdrawal (% with an account)	57.1	66.7	55.7
ATM is the main mode of withdrawal (% with an account), 2011	88.2	72.5	42.8
Use of Account in the Past Year (% age 15+)			
Used an account to receive wages	13.9	22.5	18.1
Used an account to receive government transfers	4.3	7.3	9.6
Used a financial institution account to pay utility bills	1.6	12.5	12.3
Other Digital Payments in the Past Year (% age 15+)			
Used a debit card to make payments	6.3	22.9	19.9
Used a credit card to make payments	8.1	14.9	14.4
Used the Internet to pay bills or make purchases	4.2	11.9	15.3

Appendix B: Global Findex 2014 for Azerbaijan (continued)

Azerbaijan

Europe & Central Asia			Upper middle income
Population, age 15+ (millions)	7.3	GNI per capita ($)	7,350

	Country data	Europe & Central Asia	Upper middle income
Domestic Remittances in the Past Year (% age 15+)			
Sent remittances	19.4	12.9	15.4
Sent remittances via a financial institution (% senders)	4.7	31.5	37.2
Sent remittances via a mobile phone (% senders)	0.0	2.5	8.8
Sent remittances via a money transfer operator (% senders)	15.2	11.8	19.7
Received remittances	19.9	15.5	17.8
Received remittances via a financial institution (% recipients)	3.1	22.1	29.8
Received remittances via a mobile phone (% recipients)	0.0	1.0	5.6
Received remittances via a money transfer operator (% recipients)	8.5	15.6	17.9
Savings in the Past Year (% age 15+)			
Saved at a financial institution	5.3	8.4	32.2
Saved at a financial institution, 2011	1.6	4.9	25.1
Saved using a savings club or person outside the family	1.6	6.6	4.9
Saved any money	39.5	38.5	62.7
Saved for old age	11.1	11.8	30.6
Saved for a farm or business	8.9	5.1	17.6
Saved for education or school fees	7.7	12.1	25.4
Credit in the Past Year (% age 15+)			
Borrowed from a financial institution	18.9	12.4	10.4
Borrowed from a financial institution, 2011	17.7	7.8	7.9
Borrowed from family or friends	33.3	23.6	24.0
Borrowed from a private informal lender	6.1	2.1	2.6
Borrowed any money	46.4	39.5	37.7
Borrowed for a farm or business	7.1	2.8	6.6
Borrowed for education or school fees	4.4	6.2	6.1
Outstanding mortgage at a financial institution	7.0	10.2	9.1