

**“Yapi Kredi Bank Azerbaijan” CJSC
Consolidated Financial Statements**

Year ended 31 December 2010

Together with Independent Auditors' Report

Contents

Independent auditors' report

Consolidated statement of financial position.....	1
Consolidated statement of comprehensive income	2
Consolidated statement of changes in equity	3
Consolidated statement of cash flows.....	4

Notes to consolidated financial statements

1. Principal activities	5
2. Basis of preparation	5
3. Summary of accounting policies	7
4. Significant accounting judgments and estimates	16
5. Segment information.....	17
6. Cash and cash equivalents.....	18
7. Amounts due from credit institutions.....	18
8. Loans to customers	19
9. Investment securities available-for-sale	21
10. Property and equipment.....	22
11. Intangible assets.....	22
12. Taxation.....	23
13. Other assets and liabilities	24
14. Amounts due to credit institutions	25
15. Amounts due to customers	25
16. Equity.....	26
17. Commitments and contingencies.....	26
18. Fee and commission income and expense.....	27
19. Personnel expenses	28
20. General and administrative expenses.....	28
21. Risk management.....	29
22. Fair values of financial instruments.....	35
23. Maturity analysis of assets and liabilities	36
24. Related party disclosures.....	36
25. Capital adequacy	37

Independent auditors' report

To the Shareholders and Board of Directors of Yapi Kredi Bank CJSC -

We have audited the accompanying consolidated financial statements of Yapi Kredi Bank CJSC and its subsidiary, which comprise the consolidated statement of financial position as at 31 December 2010, and the consolidated statements of comprehensive income, of changes in equity and of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, 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.

Auditors' responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements 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 entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Yapi Kredi Bank CJSC and its subsidiary as at 31 December 2010, and their financial performance and their cash flows for the year then ended in accordance with International Financial Reporting Standards.

Ernst & Young Holdings (CIS) B.V.

9 March 2011

Consolidated statement of financial position**As at 31 December 2010***(Thousands of Azerbaijani Manats)*

	Notes	2010	2009 (Note 2)	2008 (Note 2)
Assets				
Cash and cash equivalents	6	101,131	83,014	26,251
Amounts due from credit institutions	7	18,786	8,410	7,833
Loans to customers	8	67,990	28,439	9,567
Investment securities available-for-sale	9	11,861	28,238	57,269
Property and equipment	10	4,136	4,208	2,996
Intangible assets	11	429	61	67
Other assets	13	902	438	344
Total assets		205,235	152,808	104,327
Liabilities				
Amounts due to credit institutions	14	79,077	42,601	6,282
Amounts due to customers	15	74,422	66,587	58,636
Current income tax liability	12	-	-	411
Deferred income tax liability	12	-	13	7
Other liabilities	13	1,240	1,081	1,004
Subordinated loan		-	-	161
Advances from shareholders for increase in share capital	16	-	-	12,713
Total liabilities		154,739	110,282	79,214
Equity				
Share capital	16	31,610	27,209	14,496
Retained earnings		18,886	15,317	10,617
Total equity		50,496	42,526	25,113
Total liabilities and equity		205,235	152,808	104,327

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

Coskun M. Bulak



Chairman & Chief Executive Officer

Khalida Hasanova



Chief of Accounting Control Department

9 March 2011



Consolidated statement of comprehensive income**For the year ended 31 December 2010***(Thousands of Azerbaijani Manats)*

	<i>Notes</i>	2010	2009
Interest income			
Loans to customers		7,059	2,825
Cash and cash equivalents		2,187	2,100
Amounts due from credit institutions		1,143	957
Investment securities		<u>1,012</u>	<u>2,683</u>
		<u>11,401</u>	<u>8,565</u>
Interest expense			
Amounts due to credit institutions		(2,009)	(1,627)
Amounts due to customers		(512)	(375)
		<u>(2,521)</u>	<u>(2,002)</u>
Net interest income		8,880	6,563
Impairment charge on interest bearing assets	7, 8	<u>(1,184)</u>	<u>(786)</u>
Net interest income after impairment charge on interest bearing assets		<u>7,696</u>	<u>5,777</u>
Fee and commission income	18	6,061	3,592
Fee and commission expense	18	(674)	(726)
Net gains from dealing operations		2,344	1,989
Net losses from foreign currency translation differences		(142)	(242)
Dividend income		-	18
Non-interest income		<u>7,589</u>	<u>4,631</u>
Personnel expenses	19	(3,978)	(2,902)
General and administrative expenses	20	(2,220)	(2,021)
Depreciation and amortization	10, 11	(910)	(630)
Non-interest expense		<u>(7,108)</u>	<u>(5,553)</u>
Profit before income tax expense		8,177	4,855
Income tax expense	12	(207)	(155)
Profit for the year		<u><u>7,970</u></u>	<u><u>4,700</u></u>
Other comprehensive income for the year		-	-
Total comprehensive income for the year		<u><u>7,970</u></u>	<u><u>4,700</u></u>

The accompanying notes on pages 5 to 38 are an integral part of these consolidated financial statements.

Consolidated statement of changes in equity**For the year ended 31 December 2010***(Thousands of Azerbaijani Manats)*

	<i>Attributable to shareholders of the Bank</i>		
	<i>Share capital</i>	<i>Retained earnings</i>	<i>Total</i>
31 December 2008	14,496	10,617	25,113
Issue of share capital (Note 16)	12,713	-	12,713
Total comprehensive income for the year	-	4,700	4,700
31 December 2009	27,209	15,317	42,526
Total comprehensive income for the year	-	7,970	7,970
Capitalization of 2009 profit (Notes 12 and 16)	4,401	(4,401)	-
31 December 2010	31,610	18,886	50,496

Consolidated statement of cash flows**For the year ended 31 December 2010***(Thousands of Azerbaijani Manats)*

	<i>Notes</i>	<i>2010</i>	<i>2009</i>
Cash flows from operating activities			
Interest received		10,169	8,062
Interest paid		(2,561)	(1,989)
Fees and commissions received		5,833	3,643
Fees and commissions paid		(674)	(726)
Realized gains less losses from dealing in foreign currencies		2,344	1,989
Other income received		-	60
Personnel expenses paid		(3,686)	(2,888)
Other operating expenses paid		(3,667)	(2,208)
Cash flows from operating activities before changes in operating assets and liabilities		7,758	5,943
<i>Net (increase)/decrease in operating assets</i>			
Amounts due from credit institutions		(9,422)	(580)
Loans to customers		(40,452)	(19,476)
Other assets		(518)	(154)
<i>Net increase /(decrease) in operating liabilities</i>			
Amounts due to credit institutions		36,531	36,267
Amounts due to customers		7,821	7,990
Other liabilities		1,373	38
Net cash flows from operating activities before income tax		3,091	30,028
Income tax paid		-	(560)
Net cash from operating activities		3,091	29,468
Cash flows from investing activities			
Purchase of investment securities available-for-sale		(15,750)	(150,093)
Proceeds from redemption of investment securities available-for-sale		32,127	179,448
Purchase of property and equipment	10	(831)	(1,852)
Acquisition of intangible assets	11	(378)	(12)
Dividends received		-	18
Net cash from investing activities		15,168	27,509
Cash flows from financing activities			
Repayment of subordinated loan		-	(161)
Net cash used in financing activities		-	(161)
Effect of exchange rates changes on cash and cash equivalents		(142)	(53)
Net increase in cash and cash equivalents		18,117	56,763
Cash and cash equivalents, beginning	6	83,014	26,251
Cash and cash equivalents, ending	6	101,131	83,014

The accompanying notes on pages 5 to 38 are an integral part of these consolidated financial statements.

(Thousands of Azerbaijani Manats)

1. Principal activities

Yapi Kredi Bank Azerbaijan (the "Bank") was incorporated and is domiciled in the Republic of Azerbaijan. Yapi Kredi Bank Azerbaijan is a closed joint-stock company limited by shares and was set up in accordance with Azerbaijani regulations.

The Bank's principal business activity is commercial and retail banking operations within the Republic of Azerbaijan. The Bank has operated under a full banking licence issued by the Central Bank of the Republic of Azerbaijan (the "CBA") since 11 January 2000 under registration number 243. The Bank participates in the state deposit insurance scheme, which was introduced by the Azeri Law, "Deposits of individuals insurance in Azerbaijan Republic" dated 29 December 2006. The State Deposit Insurance Fund guarantees full repayment of deposits of individuals in the amount up to AZN 30 thousands. The Bank's registered address is 32/12 Jafar Jabbarli street Baku, AZ1065, The Republic of Azerbaijan.

On 31 July 2007, Yapi Kredi Bank Azerbaijan registered its wholly-owned brokerage subsidiary, Yapi Kredi Invest LLC (the "Subsidiary") with the Ministry of Justice of the Republic of Azerbaijan. The Subsidiary commenced its operations in February 2008 and is involved in dealing and brokerage operations. The official address of the Subsidiary is: J Jafar Jabbarli street 32/12, Baku, AZ1065, The Republic of Azerbaijan.

The consolidated financial statements include the financial statements of Yapi Kredi Bank Azerbaijan and its subsidiary (collectively referred to as the "Bank").

The Bank has 6 branches (2009: 5 branches) within the Republic of Azerbaijan. The Bank had 149 employees at 31 December 2010 (2009: 128).

Shareholder	2010	2009
	%	%
Yapı ve Kredi Bankası A.Ş.	99.8	99.8
YK Yatırım Menkul Değerler A.Ş.	0.1	0.1
YK Lease A.Ş.	0.1	0.1
Total	100.0	100.0

Yapı ve Kredi Bankası A.Ş. ("YKB") is the ultimate parent of the Bank. YKB's shares have been traded on the Istanbul Stock Exchange ("ISE") since 1987. As at 31 December 2010, 18.20% of the shares of YKB are publicly traded (31 December 2009 – 18.20%). The remaining 81.80% is owned by Koç Finansal Hizmetler A.Ş. ("KFS"). The ultimate shareholders of KFS are UniCredito Italiano SPA and Koç Holding, with 50% ownership each.

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 reporting and functional currency of the 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. These consolidated financial statements are presented in thousands of Azerbaijani Manats ("AZN"), except per share amounts and unless otherwise indicated.

The consolidated financial statements have been prepared under the historical cost convention except as disclosed in the accounting policies below. For example, available-for-sale securities have been measured at fair value.

*(Thousands of Azerbaijani Manats)***2. Basis of preparation (continued)****Reclassifications**

The following reclassifications have been made to the 2009 balances to conform to the 2010 presentation:

- Reclassification of Mandatory cash balances with the CBA and Due from other banks to Amounts due from credit institutions;
- Reclassification of Other financial assets to Other assets;
- Reclassification of Due to other banks to Amounts due to credit institutions;
- Reclassification of Other financial liabilities to Other liabilities;
- Reclassification of Capital contribution to Retained earnings;
- Reclassification of Provision for impairment of amounts due from other banks and Provision for impairment of loans to customers to Impairment charges on interest bearing assets;
- Reclassification of Personnel expenses and Depreciation and amortization expenses from Administrative and other operating expenses into respective categories;
- Reclassification of Administrative and other operating expenses to General and administrative expenses.

The effect of the reclassifications on the consolidated statement of financial position as at 31 December 2009 and consolidated statement of comprehensive income for the year then ended is presented in the table below:

	<i>As previously reported</i>	<i>Effect of reclassifications</i>	<i>As reclassified</i>
Statement of Financial Position			
Mandatory cash balances with the CBA	290	(290)	-
Due from other banks	8,120	(8,120)	-
Amounts due from credit institutions	-	8,410	8,410
Other financial assets	16	(16)	-
Other assets	422	16	438
Due to other banks	42,601	(42,601)	-
Amounts due to credit institutions	-	42,601	42,601
Other financial liabilities	125	(125)	-
Other liabilities	956	125	1,081
Capital contribution	515	(515)	-
Retained earnings	14,802	515	15,317
Statement of comprehensive income			
Provision for impairment of amounts due from other banks	(42)	42	-
Provision for impairment of loans to customers	(744)	744	-
Impairment charges on interest bearing assets	-	(786)	(786)
Administrative and other operating expenses	(5,553)	5,553	-
Personnel expenses	-	(2,902)	(2,902)
Depreciation and amortization	-	(630)	(630)
General and administrative expenses	-	(2,021)	(2,021)

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies

In accordance with IAS 1 "Presentation of financial statements", the Bank has presented a comparative consolidated statement of financial position as at 31 December 2008 which is the earliest comparative period, as it has retrospectively reclassified items in the consolidated financial statements.

Additional paid in capital as at 31 December 2008 has been presented as Advances from shareholders for increase in share capital.

The effect of the reclassifications on the consolidated statement of financial position as at 31 December 2008 is presented in the table below:

	<i>As previously reported</i>	<i>Effect of reclassifications</i>	<i>As reclassified</i>
Statement of Financial Position			
Mandatory cash balances with the CBA	3,725	(3,725)	-
Due from other banks	4,108	(4,108)	-
Amounts due from credit institutions	-	7,833	7,833
Other financial assets	24	(24)	-
Other assets	320	24	344
Due to other banks	6,282	(6,282)	-
Amounts due to credit institutions	-	6,282	6,282
Other financial liabilities	84	(84)	-
Other liabilities	920	84	1,004
Capital contribution	515	(515)	-
Retained earnings	10,102	515	10,617

Changes in accounting policies

The Bank has adopted the following amended IFRS and new International Financial Reporting Interpretations Committee ("IFRIC") Interpretations during the year. The principal effects of these changes are as follows:

IAS 24 "Related party disclosures" (Revised)

The revised IAS 24, issued in November 2009, simplifies the disclosure requirements for government-related entities and clarifies the definition of a related party. Previously, an entity controlled or significantly influenced by a government was required to disclose information about all transactions with other entities controlled or significantly influenced by the same government. The revised standard requires disclosure about these transactions only if they are individually or collectively significant. The revised IAS 24 is effective for annual periods beginning on or after 1 January 2011, with earlier application permitted. The Bank has decided to early adopt the revised IAS 24 from 1 January 2010. These amendments did not have any impact on the Bank's consolidated financial statements.

Amendment to IAS 39 "Financial Instruments: recognition and measurement" - Eligible Hedged Items

The amendment to IAS 39 was issued in August 2008, and became effective for annual periods beginning on or after 1 July 2009. The amendment addresses the designation of a one-sided risk in a hedged item, and designation of inflation as a hedged risk or portion in particular situations. It clarifies that an entity is permitted to designate a portion of the fair value changes or cash flow variability of a financial instrument as hedged item. The amendment did not affect the Bank's consolidated financial statements as the Bank has not entered into any such hedges.

IFRS 3 "Business Combinations" (revised in January 2008) and IAS 27 "Consolidated and Separate Financial Statements" (revised in January 2008)

The revised standards were issued in January 2008 and became effective for financial years beginning on or after 1 July 2009. Revised IFRS 3 introduces a number of changes in the accounting for business combinations that impact the amount of goodwill recognised, the reported results in the period that an acquisition occurs, and future reported results. Revised IAS 27 requires that a change in the ownership interest of a subsidiary is accounted for as an equity transaction. Therefore, such a change has no impact on goodwill, nor it gives rise to a gain or loss. Furthermore, the revised standard changes the accounting for losses incurred by the subsidiary as well as the loss of control of a subsidiary. The changes introduced by the revised Standards did not affect the Bank's consolidated financial statements.

IFRS 2 Share-based Payment: Group Cash-settled Share-based Payment Transactions

The amendment to IFRS 2 was issued in June 2009 and became effective for financial years beginning on or after 1 January 2010. The amendment clarifies the scope and the accounting for group cash-settled share-based payment transactions. This amendment also supersedes IFRIC 8 and IFRIC 11. This amendment had no impact on the Bank's consolidated financial statements.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Changes in accounting policies (continued)

IFRIC 17 "Distribution of Non-Cash Assets to Owners"

IFRIC Interpretation 17 was issued on 27 November 2008 and is effective for annual periods beginning on or after 1 July 2009. IFRIC 17 applies to pro rata distributions of non-cash assets except for common control transactions and requires that a dividend payable should be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity; an entity should measure the dividend payable at the fair value of the net assets to be distributed; an entity should recognise the difference between the dividend paid and the carrying amount of the net assets distributed in profit or loss. The Interpretation also requires an entity to provide additional disclosures if the net assets being held for distribution to owners meet the definition of a discontinued operation. This interpretation had no impact on the Bank's consolidated financial statements.

Improvements to IFRSs

In April 2009 the IASB issued the second omnibus of amendments to its standards, primarily with a view to removing inconsistencies and clarifying wording. Most of the amendments are effective for annual periods beginning on or after 1 January 2010. There are separate transitional provisions for each standard. Amendments included in April 2009 "Improvements to IFRS" had no impact on the accounting policies, financial position or performance of the Bank, except the following amendments resulting in changes to accounting policies, as described below.

- IFRS 8 Operating Segment Information: clarifies that segment assets and liabilities need only be reported when those assets and liabilities are included in measures that are used by the chief operating decision maker. As the Bank's chief operating decision maker does not review segment assets and liabilities, the Bank does not disclose this information.
- IAS 7 Statement of Cash Flows: Explicitly states that only expenditure that results in recognising an asset can be classified as a cash flow from investing activities.

Basis of consolidation

Basis of consolidation from 1 January 2010

Subsidiaries, which are those entities in which the Bank has an interest of more than one half of the voting rights, or otherwise has power to exercise control over their operations, are consolidated. 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 unrealized gains on transactions between group companies are eliminated in full; unrealized 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 Bank.

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 derecognizes the assets (including goodwill) and liabilities of the subsidiary, the carrying amount of any non-controlling interests, the cumulative translation differences, recorded in equity; recognizes 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 recognized in other comprehensive income to profit or loss.

Basis of consolidation prior to 1 January 2010

In comparison to the above mentioned requirements which were applied on a prospective basis, the following differences applied:

- Losses incurred by the Bank were attributed to the non-controlling interests until the balance was reduced to nil. Any further excess losses were attributable to the parent, unless the non-controlling interests had a binding obligation to cover these.
- Upon loss of control, the Bank accounted for the investment retained at its proportionate share of net asset value at the date control was lost.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Financial assets

Initial recognition

Financial assets in the scope of IAS 39 are classified as either financial assets at fair value through profit or loss, loans and receivables, held-to-maturity investments, or available-for-sale financial assets, as appropriate. When financial assets are recognized initially, they are measured at fair value, plus, in the case of investments not at fair value through profit or loss, directly attributable transaction costs. The Bank determines the classification of its financial assets upon initial recognition, and subsequently can reclassify financial assets in certain cases as described below.

Date of recognition

All regular way purchases and sales of financial assets are recognised on the trade date i.e. the date that the Bank 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 marketplace.

'Day 1' profit

Where the transaction price in a non-active market is different to the fair value from other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets, the Bank immediately recognises the difference between the transaction price and fair value (a 'Day 1' profit) in the consolidated statement of comprehensive income. In cases where use is made of data which is not observable, the difference between the transaction price and model value is only recognised in the consolidated statement of comprehensive income when the inputs become observable, or when the instrument is derecognised.

Loans and receivables

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

Available-for-sale financial assets

Available-for-sale financial assets are those non-derivative financial assets that are designated as available-for-sale or are not classified as loans and receivables. After initial recognition available-for-sale financial assets are measured at fair value with gains or losses being recognised in other comprehensive income until the investment is derecognised or until the investment is determined to be impaired at which time the cumulative gain or loss previously reported in other comprehensive income is reclassified as part of current profit and loss. However, interest calculated using the effective interest method is recognised as current profit and loss.

Determination of fair value

The fair value for financial instruments traded in active market at the reporting date is based on their quoted market price or dealer price quotations (bid price for long positions and ask price for short positions), without any deduction for transaction costs.

For all other financial instruments not listed in an active market, the fair value is determined by using appropriate valuation techniques. Valuation techniques include net present value techniques, comparison to similar instruments for which market observable prices exist, options pricing models and other relevant valuation models.

Offsetting

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 recognized amounts and there is an intention to settle on a net basis, or to realize the asset and settle the liability simultaneously. This is not generally the case with master netting agreements, and the related assets and liabilities are presented gross in the consolidated statement of financial position.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Financial assets (continued)

Reclassification of financial assets

If a non-derivative financial asset classified as held for trading is no longer held for the purpose of selling in the near term, it may be reclassified out of the fair value through profit or loss category in one of the following cases:

- a financial asset that would have met the definition of loans and receivables above may be reclassified to loans and receivables category if the Bank has the intention and ability to hold it for the foreseeable future or until maturity;
- other financial assets may be reclassified to available for sale or held to maturity categories only in rare circumstances.

A financial asset classified as available for sale that would have met the definition of loans and receivables may be reclassified to loans and receivables category of the Bank has the intention and ability to hold it for the foreseeable future or until maturity.

Financial assets are reclassified at their fair value on the date of reclassification. Any gain or loss already recognized in profit or loss is not reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortized cost, as applicable.

Cash and cash equivalents

Cash and cash equivalents consist of cash on hand, amounts due from the CBA, excluding obligatory reserves, and amounts due from credit institutions that mature within ninety days of the date of origination and are free from contractual encumbrances.

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 General and administrative expenses.

Borrowings

Issued financial instruments or their components are classified as liabilities, where the substance of the contractual arrangement results in the Bank 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 credit institutions 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 the consolidated statement of comprehensive income when the borrowings are derecognised as well as through the amortisation process.

Impairment of financial assets

The Bank assesses at each reporting date whether there is any objective evidence that a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment as a result of one or more events that has occurred after the initial recognition of the asset (an incurred 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or the group of financial assets that can be reliably estimated. Evidence of impairment may include indications that the borrower or a group of borrowers is experiencing significant financial difficulty, default or delinquency in interest or principal payments, the probability that they will enter bankruptcy or other financial reorganization and where observable data indicate that there is a measurable decrease in the estimated future cash flows, such as changes in arrears or economic conditions that correlate with defaults.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Impairment of financial assets (continued)

Amounts due from credit institutions and loans to customers

For amounts due from credit institutions and loans to customers carried at amortized cost, the Bank first assesses individually whether objective evidence of impairment exists individually for financial assets that are individually significant, or collectively for financial assets that are not individually significant. If the Bank determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risks characteristics and collectively assesses them for impairment. Assets that are individually assessed for impairment and for which an impairment loss is, or continues to be, recognized are not included in a collective assessment of impairment.

If there is an objective evidence that an impairment loss has been incurred, the amount of the loss is 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). The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognized in the consolidated statement of comprehensive income. Interest income continues to be accrued on the reduced carrying amount based on the original effective interest rate of the asset. Loans together with the associated allowance are written off when there is no realistic prospect of future recovery and all collateral has been realized or has been transferred to the Bank. If, in a subsequent year, the amount of the estimated impairment loss increases or decreases because of an event occurring after the impairment was recognized, the previously recognized impairment loss is increased or reduced by adjusting the allowance account. If a future write-off is later recovered, the recovery is credited to the consolidated statement of comprehensive income.

The present value of the estimated future cash flows is discounted at the financial asset's original effective interest rate. If a loan has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

For the purpose of a collective evaluation of impairment, financial assets are grouped on the basis of the Bank's internal credit grading system that considers 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 are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the years on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect, and are 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 are indicative of incurred losses in the group or their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Available-for-sale financial investments

For available-for-sale financial investments, the Bank assesses at each reporting date whether there is objective evidence that an investment or a group of investments is impaired.

In the case of equity investments classified as available-for-sale, objective evidence would include a significant or prolonged decline in the fair value of the investment below its cost. Where there is evidence of impairment, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that investment previously recognized in the consolidated statement of comprehensive income – is reclassified from other comprehensive income as current profit and loss. Impairment losses on equity investments are not reversed through current profit and loss; increases in their fair value after impairment are recognised in other comprehensive income.

In the case of debt instruments classified as available-for-sale, impairment is assessed based on the same criteria as financial assets carried at amortised cost. Future interest income is based on the reduced carrying amount and is accrued using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss. The interest income is recorded in the consolidated statement of comprehensive income. If, in a subsequent year, the fair value of a debt instrument increases and the increase can be objectively related to an event occurring after the impairment loss was recognized in the consolidated statement of comprehensive income, the impairment loss is reversed through the consolidated statement of comprehensive income.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Impairment of financial assets (continued)

Renegotiated loans

Where possible, the Bank 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.

The accounting treatment of such restructuring is as follows:

- If the currency of the loan has been changed the old loan is derecognized and the new loan is recognized.
- If the loan restructuring is not caused by the financial difficulties of the borrower the Bank uses the same approach as for financial liabilities described below.
- If the loan restructuring is due to the financial difficulties of the borrower and the loan is impaired after restructuring, the Bank recognizes the difference between the present value of the new cash flows discounted using the original effective interest rate and the carrying amount before restructuring in the provision charges for the period. In case loan is not impaired after restructuring the Bank recalculates the effective interest rate.

Once the terms have been renegotiated, the loan is no longer considered past due. Management continuously reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment, calculated using the loan's original or current effective interest rate.

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 derecognized where:

- the rights to receive cash flows from the asset have expired;
- the Bank 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 Bank 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 Bank 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 Bank'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 Bank 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 Bank's continuing involvement is the amount of the transferred asset that the Bank 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 Bank's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price.

Financial liabilities

A financial liability is derecognized 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 the consolidated statement of comprehensive income.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Financial guarantees

In the ordinary course of business, the Bank gives financial guarantees, consisting of letters of credit and guarantees. Financial guarantees are initially recognized in the consolidated financial statements at fair value, in 'Other liabilities', being the premium received. Subsequent to initial recognition, the Bank's liability under each guarantee is measured at the higher of the amortised 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 the consolidated statement of comprehensive income. The premium received is recognized in the consolidated statement of comprehensive income on a straight-line basis over the life of the guarantee.

Taxation

Income taxes have been provided for in the consolidated financial statements in accordance with Azerbaijan legislation enacted or substantively enacted by the end of the reporting period.

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.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries, associates and joint ventures, except where the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

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 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 begins when it is available for use. Depreciation is calculated on a straight-line basis over the following estimated useful lives:

	<u>Years</u>
Leasehold improvements	10
Furniture and fixtures	5
Computers and office equipment	5
Motor vehicles	5

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 other operating expenses, unless they qualify for capitalization.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Intangible assets

Intangible assets include computer software and licenses.

Intangible assets acquired separately are measured on initial recognition at cost. 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 either finite or indefinite. Intangible assets with finite lives are amortised over the useful economic lives of 5 to 10 years and assessed for impairment whenever there is an indication that the intangible asset may be impaired. Amortisation periods and methods for intangible assets with indefinite useful lives are reviewed at least at each financial year-end.

Provisions

Provisions are recognised when the Bank 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.

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 consolidated financial statements are authorised for issue.

Segment reporting

The Bank's segmental reporting is based on the following operating segments: Retail banking and Corporate banking.

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 Bank and the revenue can be reliably measured. The following specific recognition criteria must also be met before revenue is recognised:

Interest and similar income and expense

For all financial instruments measured at amortised cost and interest bearing securities classified as trading or available-for-sale, interest income or expense is recorded at the effective interest rate, which 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 Bank 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 income or expense.

Once the recorded value of a financial asset or a group of similar financial assets has been reduced due to an impairment loss, interest income continues to be recognised using the original effective interest rate applied to the new carrying amount.

Fee and commission income

The Bank earns fee and commission income from a diverse range of services it provides to its customers. Fee income can be divided into the following two categories:

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Recognition of income and expenses (continued)

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 and other advisory fees. 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 from providing transaction services

Fees arising from negotiating or participating in the negotiation of a transaction for a third party are recognised on completion of the underlying transaction. Fees or components of fees that are linked to a certain performance are recognised after fulfilling the corresponding criteria.

Dividend income

Revenue is recognised when the Bank's right to receive the payment is established.

Foreign currency translation

Transactions in foreign currencies are initially recorded in the functional currency converted at the rate of exchange ruling at the date of 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 the statement of comprehensive income as net gains (losses) from foreign currency 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.

Re-translation difference of share capital arising from previous period change in presentation currency is taken to retained earnings.

At 31 December 2010, the principal rate of exchange used for translating foreign currency balances was USD 1 = AZN 0.7979 (2009: USD 1 = AZN 0.8031).

Future changes in accounting policies

Standards and interpretations issued but not yet effective

Amendments to IAS 32 "Financial Instruments: Presentation": Classification of Rights Issues"

In October 2009, the IASB issued amendment to IAS 32. Entities shall apply that amendment for annual periods beginning on or after 1 February 2010. Earlier application is permitted. The amendment alters the definition of a financial liability in IAS 32 to classify rights issues and certain options or warrants as equity instruments. This is applicable if the rights are given pro rata to all of the existing owners of the same class of an entity's non-derivative equity instruments, in order to acquire a fixed number of the entity's own equity instruments for a fixed amount in any currency. The Bank expects that this amendment will have no impact on the Bank's consolidated financial statements.

IFRS 9 "Financial Instruments"

In November 2009 the IASB issued the first phase of IFRS 9 Financial Instruments. This Standard will eventually replace IAS 39 Financial Instrument: Recognition and Measurement. IFRS 9 becomes effective for financial years beginning on or after 1 January 2013. Entities may adopt the first phase for reporting periods ending on or after 31 December 2009. The first phase of IFRS 9 introduces new requirements on classification and measurement of financial assets. In particular, for subsequent measurement all financial assets are to be classified at amortised cost or at fair value through profit or loss with the irrevocable option for equity instruments not held for trading to be measured at fair value through other comprehensive income. The Bank is not early adopting this standard.

IFRIC 19 "Extinguishing Financial Liabilities with Equity Instruments"

IFRIC Interpretation 19 was issued in November 2009 and is effective for annual periods beginning on or after 1 July 2010. The interpretation clarifies the accounting when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor to extinguish all or part of the financial liability. IFRIC 19 is not expected to have any material impact on the Bank's consolidated financial statements.

(Thousands of Azerbaijani Manats)

3. Summary of accounting policies (continued)

Future changes in accounting policies (continued)

Improvements to IFRSs

In May 2010 the IASB issued the third omnibus of amendments to its standards, primarily with a view to removing inconsistencies and clarifying wording. Most of the amendments are effective for annual periods beginning on or after 1 January 2011. There are separate transitional provisions for each standard. Amendments included in May 2010 "Improvements to IFRS" will have impact on the accounting policies, financial position or performance of the Bank, as described below.

- IFRS 3 Business combinations: limits the scope of the measurement choices that only the components of NCI that are present ownership interests that entitle their holders to a proportionate share of the entity's net assets, in the event of liquidation, shall be measured either at fair value or at the present ownership instruments' proportionate share of the acquiree's identifiable net assets. As the amendment should be applied from the date the Bank applies IFRS 3 Revised, it may be required to restate for effects incurred under IFRS 3 Revised, but before the adoption of this amendment. The Bank expects that other amendments to IFRS 3 will have no impact on the consolidated financial statements of the Bank.
- IFRS 7 Financial instruments: Disclosures; introduces the amendments to quantitative and credit risk disclosures. The additional requirements are expected to have minor impact as information is expected to be readily available.
- IAS 34 Interim Financial Reporting: adds disclosure requirements about the circumstances affecting fair values and classification of financial instruments, about transfers of financial instruments between levels of the fair value hierarchy, changes in classification of financial assets and changes in contingent liabilities and assets. Additional disclosures required will be introduced in interim financial statements of the Bank.
- Amendments to IFRS 1, IAS 1, IAS 27 and IFRIC 13 will have no impact on the accounting policies, financial position or performance of the Bank.

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:

Fair value of financial instruments

Where the fair values of financial assets and financial liabilities recorded in the 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.

Taxation

The Bank's uncertain tax positions are reassessed by management at the end of each reporting period. Liabilities are recorded for income tax positions that are determined by management as more likely than not to result in additional taxes being levied if the positions were to be challenged by the tax authorities. The assessment is based on the interpretation of tax laws that have been enacted or substantively enacted by the end of the reporting period and any known court or other rulings on such issues. Liabilities for penalties, interest and taxes other than on income are recognised based on management's best estimate of the expenditure required to settle the obligations at the end of the reporting period.

The Bank uses its judgment in its understanding of the new amendments to the Tax Code which allow financial institutions to be exempted from payment of profit tax starting 1 January 2009 (for three consecutive years), if the current year's profit is capitalized.

Allowance for loan impairment

The Bank regularly reviews its loans and receivables to assess impairment. The Bank uses its judgment to estimate the amount of any impairment loss in cases where a borrower is in financial difficulties and there are few available sources of historical data relating to similar borrowers. Similarly, the Bank estimates changes in future cash flows based on the observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the group of loans and receivables. The Bank uses its judgment to adjust observable data for a group of loans or receivables to reflect current circumstances.

(Thousands of Azerbaijani Manats)

4. Significant accounting judgments and estimates (continued)

Initial recognition of related party transactions

In the normal course of business the Bank enters into transactions with its related parties. IAS 39 requires initial recognition of financial instruments based on their fair values. Judgement is applied in determining if transactions are priced at market or non-market interest rates, where there is no active market for such transactions. The basis for judgement is pricing for similar types of transactions with unrelated parties and effective interest rate analysis.

5. Segment information

For management purposes, the Bank is organized into two operating segments based on products and services as follows:

Retail banking	Principally handling individual customers' deposits, and providing consumer loans, overdrafts, credit cards facilities and funds transfer facilities.
Corporate banking	Principally handling loans and other credit facilities and deposit and current accounts for corporate and institutional customers.

Management monitors the operating results of its business units separately for the purpose of making decisions about resource allocation and performance assessment. Segment performance, as explained in the table below, is measured differently from profit or loss in the consolidated financial statements. Income taxes are managed on a Bank's basis and are not allocated to operating segments.

Transfer prices between operating segments are on an arm's length basis in a manner similar to transactions with third parties.

No revenue from transactions with a single external customer or counterparty amounted to 10% or more of the Bank's total revenue in 2010 or 2009.

The following tables present revenue, expenses and profit information regarding the Bank's operating segments.

2010	<i>Retail banking</i>	<i>Corporate banking</i>	<i>Unallocated</i>	<i>Total</i>
Revenue				
Interest income	1,327	10,074	-	11,401
Fee and commission income	706	5,355	-	6,061
Non-interest income	256	1,946	-	2,202
Total revenue	2,289	17,375	-	19,664
Interest expense	(43)	(2,478)	-	(2,521)
Fee and commission expense	(11)	(663)	-	(674)
Impairment charge on interest bearing assets	(139)	(1,045)	-	(1,184)
Non-interest expense	(827)	(6,281)	-	(7,108)
Segment results	1,269	6,908	-	8,177
Income tax expense	-	-	(207)	(207)
Profit for the year	1,269	6,908	(207)	7,970
Other segment information				
Capital expenditure	141	1,068	-	1,209

(Thousands of Azerbaijani Manats)

5. Segment information (continued)

2009	<i>Retail banking</i>	<i>Corporate banking</i>	<i>Unallocated</i>	<i>Total</i>
Revenue				
Interest income	898	7,667	-	8,565
Fee and commission income	376	3,216	-	3,592
Non-interest income	183	1,582	-	1,765
Total revenue	1,457	12,465	-	13,922
Interest expense	(65)	(1,937)	-	(2,002)
Fee and commission expense	(24)	(702)	-	(726)
Impairment charge on interest bearing assets	(80)	(706)	-	(786)
Non-interest expense	(582)	(4,971)	-	(5,553)
Segment results	706	4,149	-	4,855
Income tax expense	-	-	(155)	(155)
Profit for the year	706	4,149	(155)	4,700
Other segment information				
Capital expenditure	192	1,644	-	1,836

Geographic information

The Bank's revenues from third party customers for the years ended 31 December 2010 and 2009 are generated in the Republic of Azerbaijan.

6. Cash and cash equivalents

Cash and cash equivalents comprise:

	<i>2010</i>	<i>2009</i>	<i>2008</i>
Cash on hand	7,037	8,861	4,133
Current accounts with the Central Bank of the Republic of Azerbaijan	28,768	13,162	11,150
Current accounts with other credit institutions	60,140	60,991	10,968
Time deposits with credit institutions up to 90 days	5,186	-	-
Cash and cash equivalents	101,131	83,014	26,251

Non-cash transaction performed by the Bank during 2010 is represented by the capitalization of its 2009 profit and issuance of share capital for AZN 4,401 thousands.

As at 31 December 2010, time deposits with credit institutions up to 90 days were placed with parent company, YKB with an effective annual interest rate of 5.5% maturing in January 2011 (2009: nil; 2008: nil).

7. Amounts due from credit institutions

Amounts due from credit institutions comprise:

	<i>2010</i>	<i>2009</i>	<i>2008</i>
Obligatory reserve with the Central Bank of the Republic of Azerbaijan	412	290	3,725
Short term loans to credit institutions	5,420	8,178	4,124
Time deposits for more than 90 days	12,922	-	-
Blocked accounts	32	24	24
	18,786	8,492	7,873
Less – Allowance for impairment	-	(82)	(40)
Amounts due from credit institutions	18,786	8,410	7,833

(Thousands of Azerbaijani Manats)

7. Amounts due from credit institutions (continued)

Credit institutions are required to maintain a non-interest earning cash deposit (obligatory reserve) with the CBA, the amount of which depends on the level of funds attracted by the credit institution. The Bank's ability to withdraw such deposit is significantly restricted by the statutory legislation.

As at 31 December 2010 included in the balances of short term loans to credit institutions are loans issued to two (2009: three; 2008: four) resident banks of total AZN 5,400 thousands (2009: AZN 8,077 thousands; 2008: AZN 4,148 thousands) with an average effective interest rate of 4.1% (2009: 7.5%; 2008: 9.2%).

As at 31 December 2010, inter-bank time deposits include AZN 11,969 thousands (2009: nil; 2008: nil) placed with one resident bank with an average effective interest rate of 9.6%.

Blocked accounts represent security deposits placed to secure settlement operations through Master Card.

The movements in allowance for impairment of amounts due from credit institutions were as follows:

	<u>2010</u>	<u>2009</u>
1 January	82	40
(Reversal) charge	(82)	42
31 December	<u>-</u>	<u>82</u>

8. Loans to customers

Loans to customers comprise:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Corporate lending	60,498	24,039	6,793
Consumer lending	4,907	1,112	461
Small business lending	4,522	2,171	666
Residential mortgages	348	452	1,159
Other	-	1,684	763
Gross loans to customers	70,275	29,458	9,842
Less – Allowance for impairment	(2,285)	(1,019)	(275)
Loans to customers	67,990	28,439	9,567

Allowance for impairment of loans to customers

A reconciliation of the allowance for impairment of loans to customers by class is as follows:

	<u>Corporate lending 2010</u>	<u>Small business lending 2010</u>	<u>Consumer lending 2010</u>	<u>Residential mortgages 2010</u>	<u>Other 2010</u>	<u>Total 2010</u>
At 1 January 2009	801	52	96	9	61	1,019
Impairment charge/(reversal)	1,127	93	109	(2)	(61)	1,266
At 31 December 2010	1,928	145	205	7	-	2,285
Individual impairment	638	38	78	-	-	754
Collective impairment	1,290	107	127	7	-	1,531
	<u>1,928</u>	<u>145</u>	<u>205</u>	<u>7</u>	<u>-</u>	<u>2,285</u>
Gross amount of loans, individually determined to be impaired, before deducting any individually assessed impairment allowance	<u>638</u>	<u>38</u>	<u>78</u>	<u>-</u>	<u>-</u>	<u>754</u>

(Thousands of Azerbaijani Manats)

8. Loans to customers (continued)**Allowance for impairment of loans to customers (continued)**

	<i>Corporate lending 2009</i>	<i>Small business lending 2009</i>	<i>Consumer lending 2009</i>	<i>Residential mortgages 2009</i>	<i>Other 2009</i>	<i>Total 2009</i>
At 1 January 2009	137	13	10	24	91	275
Impairment charge/(reversal)	664	39	86	(15)	(30)	744
At 31 December 2009	801	52	96	9	61	1,019
Individual impairment	257	-	37	-	17	311
Collective impairment	544	52	59	9	44	708
	801	52	96	9	61	1,019
Gross amount of loans, individually determined to be impaired, before deducting any individually assessed impairment allowance	303	-	43	-	20	366

Individually impaired loans

Interest income accrued on loans, for which individual impairment allowances have been recognized, for the year ended 31 December 2010, comprised AZN 534 thousands (2009: AZN 84 thousands).

The fair value of collateral that the Bank holds relating to loans individually determined to be impaired at 31 December 2010 amounts to AZN 1,491 thousands (2009: AZN 800 thousands). In accordance with the CBA requirements, loans may only be written off with the approval of the Supervisory Board and, in certain cases, with the respective decision of the Court.

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 corporate lending, charges over real estate and trade receivables, third party guarantees;
- For consumer lending, cash, charges over credited consumer appliances, third party guarantees and mortgages over residential properties;
- For auto lending, cash, liens over vehicles and third party guarantees.

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.

Concentration of loans to customers

At 31 December 2010, the Bank has thirteen borrowers (2009: thirteen borrowers; 2008: eleven borrowers) with aggregated loan amounts above AZN 2,000 thousands (2009: AZN 400 thousands; 2008: AZN 200 thousands). The aggregate amount of these loans was AZN 43,287 thousands (2009: AZN 19,557 thousands; 2008: AZN 7,954 thousands) or 61.6% of the gross loan portfolio (2009: 66.4%; 2008: 84.95%)

Loans have been extended to the following types of customers:

	<i>2010</i>	<i>2009</i>	<i>2008</i>
Private companies	53,746	20,974	6,793
Individuals	9,777	5,419	3,049
State companies	6,752	3,065	-
Total gross loans to customers	70,275	29,458	9,842

(Thousands of Azerbaijani Manats)

8. Loans to customers (continued)**Concentration of loans to customers (continued)**

Loans are made within Azerbaijan in the following industry sectors:

	2010	2009	2008
Real estate construction	29,986	8,680	90
Trading enterprises	23,672	13,453	4,075
Individuals	9,777	5,419	3,049
Manufacturing	6,840	1,906	2,628
Total gross loans to customers	70,275	29,458	9,842

9. Investment securities available-for-sale

Investment securities available-for-sale comprise:

	2010	2009	2008
Notes issued by the CBA	6,001	-	20,539
Bonds issued by the Mortgage Fund of the Republic of Azerbaijan	3,162	-	-
Treasury bills of the Ministry of Finance of the Republic of Azerbaijan	2,037	26,945	36,670
Corporate bonds	601	1,233	-
Total debt securities	11,801	28,178	57,209
Corporate unquoted shares	60	60	60
Total available-for-sale securities	11,861	28,238	57,269

Nominal interest rates and maturities of debt securities are as follows:

	2010		2009		2008	
	<i>Annual interest rate</i>	<i>Maturity</i>	<i>Annual interest rate</i>	<i>Maturity</i>	<i>Annual interest rate</i>	<i>Maturity</i>
Notes issued by the CBA	1.0%	1 month	-	-	3.98% - 5.3%	1 month
Bonds issued by the Mortgage Fund of the Republic of Azerbaijan	3.25%	9 years	-	-	-	-
Treasury bills of the Ministry of Finance of the Republic of Azerbaijan	3.75% - 9.5%	12 months	1.35% - 9.5%	1-15 months	8.71% - 11.04%	1-18 months
Corporate bonds	14.0%	12 months	14%	19 months		

At 31 December 2010, the equity investment securities available-for-sale are:

Name	Nature of business	Country of registration	Share of ownership	Fair value		
				2010	2009	2008
Baku Stock Exchange	Stock exchange	Republic of Azerbaijan	5.56%	60	60	60
Total				60	60	60

The Bank's management believes that the fair value of these investments does not differ materially from its carrying value.

(Thousands of Azerbaijani Manats)

10. Property and equipment

The movements in property and equipment were as follows:

	<i>Leasehold improvements</i>	<i>Furniture and fixtures</i>	<i>Computers and office equipment</i>	<i>Motor vehicles</i>	<i>Total</i>
Cost					
31 December 2009	3,091	454	1,642	156	5,343
Additions	498	86	247	-	831
Disposals	-	-	-	(24)	(24)
31 December 2010	3,589	540	1,889	132	6,150
Accumulated depreciation					
31 December 2009	(353)	(121)	(587)	(74)	(1,135)
Depreciation charge	(391)	(219)	(264)	(26)	(900)
Disposals	-	-	-	21	21
31 December 2010	(744)	(340)	(851)	(79)	(2,014)
Net book value:					
31 December 2009	2,738	333	1,055	82	4,208
31 December 2010	2,845	200	1,038	53	4,136
	<i>Leasehold improvements</i>	<i>Furniture and fixtures</i>	<i>Computers and office equipment</i>	<i>Motor vehicles</i>	<i>Total</i>
Cost					
31 December 2008	1,881	334	1,420	147	3,782
Additions	1,210	144	461	9	1,824
Disposals	-	(24)	(239)	-	(263)
31 December 2009	3,091	454	1,642	156	5,343
Accumulated depreciation					
31 December 2008	(92)	(81)	(566)	(47)	(786)
Depreciation charge	(261)	(64)	(260)	(27)	(612)
Disposals	-	24	239	-	263
31 December 2009	(353)	(121)	(587)	(74)	(1,135)
Net book value:					
31 December 2008	1,789	253	854	100	2,996
31 December 2009	2,738	333	1,055	82	4,208

11. Intangible assets

The movements in intangible assets were as follows:

	<i>Licenses</i>	<i>Computer software</i>	<i>Total</i>
Cost			
31 December 2009	26	115	141
Additions	1	377	378
31 December 2010	27	492	519
Accumulated amortization			
31 December 2009	(7)	(73)	(80)
Amortisation charge	-	(10)	(10)
31 December 2010	(7)	(83)	(90)
Net book value:			
31 December 2009	19	42	61
31 December 2010	20	409	429

(Thousands of Azerbaijani Manats)

11. Intangible assets (continued)

	<i>Licenses</i>	<i>Computer software</i>	<i>Total</i>
Cost			
31 December 2008	22	107	129
Additions	4	8	12
31 December 2009	<u>26</u>	<u>115</u>	<u>141</u>
Accumulated amortization			
31 December 2008	-	(62)	(62)
Amortisation charge	(7)	(11)	(18)
31 December 2009	<u>(7)</u>	<u>(73)</u>	<u>(80)</u>
Net book value:			
31 December 2008	<u>22</u>	<u>45</u>	<u>67</u>
31 December 2009	<u>19</u>	<u>42</u>	<u>61</u>

12. Taxation

The corporate income tax expense comprises:

	<i>2010</i>	<i>2009</i>
Current tax charge	(220)	(149)
Deferred tax credit /(charge) – origination and reversal of temporary differences	13	(6)
Income tax expense	<u>(207)</u>	<u>(155)</u>

On 19 June 2009 an amendment to the Tax Code was enacted to reduce the corporate income tax rate from 22% to 20% effective from 1 January 2010.

In accordance with the Law of the Republic of Azerbaijan on enhancement of the activities of banks, insurance and reinsurance companies (N710-IIIQ and dated 28 October 2008), financial institutions are exempt from payment of profit tax with effect from 1 January 2009 for a period of three consecutive years, if the current year's profit is capitalized. As a result, based on the shareholders' meeting held on 19 March 2010, the Bank decided to utilise the tax exemption in accordance with the law for the years 2009 – 2011.

In April 2010 the Bank has finalized the capitalization of its 2009 year profit and increased its share capital by AZN 4,401 thousands, representing 220,072,754 shares at AZN 0.02 per share.

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:

	<i>2010</i>	<i>2009</i>
Profit before income tax expense	<u>8,177</u>	<u>4,855</u>
Statutory tax rate	20%	22%
Theoretical income tax expense/(benefit) at the statutory rate	<u>(1,635)</u>	<u>(1,068)</u>
Tax effect of items which are not deductible or assessable for taxation		
Non-deductible expenses	(158)	(58)
Current income tax liability not accrued due to the three-year tax exemption	1,586	968
Impact of change in tax rate to 20% effective from 1 January 2010	-	3
Income tax expense	<u>(207)</u>	<u>(155)</u>

(Thousands of Azerbaijani Manats)

12. Taxation (continued)

Current income tax liability as at 31 December 2010 amounted to nil (2009 – nil; 2008: AZN 411 thousands).

At 31 December 2010 and 2009 the tax effects were calculated only for deductible/taxable temporary differences during the tax exemption period as disclosed earlier. Deferred tax assets and liabilities as at 31 December and their movements for the respective years comprise:

	31 December 2008	Recognised in comprehensive income	31 December 2009	Recognised in comprehensive income	31 December 2010
Tax effect of taxable temporary differences					
Property and equipment	(7)	(6)	(13)	13	-
Net deferred tax liability	(7)	(6)	(13)	13	-

13. Other assets and liabilities

Other assets comprise:

	2010	2009	2008
Amounts in the course of settlement	42	16	24
Total other financial assets	42	16	24
Prepaid taxes other than income tax	491	104	164
Prepayments	360	256	124
Other non-financial assets	9	62	32
Total other non-financial assets	860	422	320
Total other assets	902	438	344

Prepayments made to the Ministry of Taxes of the Republic of Azerbaijan represent withholding tax on interest received from placements with related party. This amount represents tax receivable from the Ministry of Taxes of Azerbaijan under the Double Tax Treaty between the Republic of Azerbaijan and Republic of Turkey.

Other liabilities comprise:

	2010	2009	2008
Trade payables	311	94	31
Other financial liabilities	-	31	53
Total other financial liabilities	311	125	84
Accrued employee costs	625	333	319
Deferred income	290	548	497
Other non-financial liabilities	14	75	104
Total other non-financial liabilities	929	956	920
Total other liabilities	1,240	1,081	1,004

Accrued employee costs includes bonuses for employees based on the financial performance of the Bank of AZN 340 thousands (2009: AZN 217 thousands; 2008: nil) and an accrual for unused vacations of AZN 202 thousands (2009: AZN 116 thousands; 2008: AZN 53 thousands).

At 31 December 2010, deferred income included deferred revenue of AZN 289 thousands (2009: AZN 517 thousands; 2008: AZN 497 thousands) which was primarily comprised of unearned portion of fee and commission income received as an arrangement fee.

(Thousands of Azerbaijani Manats)

14. Amounts due to credit institutions

Amounts due to credit institutions comprise:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Demand deposits	79,077	38,531	4,953
Time deposits	-	4,070	-
Blocked accounts of resident banks	-	-	1,329
Amounts due to credit institutions	<u>79,077</u>	<u>42,601</u>	<u>6,282</u>

The Bank pays interest on correspondent account balances at the rates ranging from 3% p.a. to 4.8% p.a. for USD and from 0.2% p.a. to 1.75% p.a. for Euro (2009: from 1.35% p.a. to 5.00% p.a.; 2008: from 1.35% to 5.00% p.a.).

15. Amounts due to customers

The amounts due to customers include the following:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Current accounts	59,316	48,253	48,119
Time deposits	15,106	18,334	10,517
Amounts due to customers	<u>74,422</u>	<u>66,587</u>	<u>58,636</u>
Held as security against guarantees	192	77	28

At 31 December 2010, amounts due to customers of AZN 29,352 thousands or 39.4% of total amounts due to customers were due to the ten largest customers (2009: AZN 39,139 thousands or 58.8% of total amounts due to customers; 2008: AZN 24,466 thousands or 41.7% of total amounts due to customers).

The average annual interest rate on term deposits of individual customers outstanding at 31 December 2010 comprised 2.87% (2009: 2.8%; 2008: 2.9%), while the average annual interest rate on term deposits of legal entities outstanding at 31 December 2010 was 2.94% (2009: 3.0%; 2008: 3.9%). In addition, in the course of 2010 the Bank paid annual interest of 3% (2009: 1%; 2008: 1%) on current account balances of legal entities with average annual balances in excess of AZN 50 thousands and USD 57 thousands (2009: AZN 50 thousands and USD 57 thousands; 2008: AZN 50 thousands and USD 57 thousands).

At 31 December 2010, the Bank had fourteen customers (2009: eleven; 2008: fourteen) with balances above AZN 1,000 thousands. The aggregate balance of these customers was AZN 34,556 thousands at 31 December 2010 (2009: AZN 40,917 thousands; 2008: AZN 27,176 thousands), which represented 46.4% (2009: 61%; 2008: 46%) of total customer accounts and 22% (2009: 27%; 2008: 25%) of total liabilities.

Amounts due to customers include accounts with the following types of customers:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Private enterprises	62,593	50,448	43,385
Individuals	11,431	16,077	13,437
State and budgetary organizations	398	62	1,814
Amounts due to customers	<u>74,422</u>	<u>66,587</u>	<u>58,636</u>

An analysis of customer accounts by economic sector follows:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Trade	49,804	41,848	29,153
Individuals	11,431	16,077	13,437
Transport and communication	6,706	6,711	4,965
Real estate constructions	5,042	1,017	6,186
Insurance	1,041	872	3,081
Public organizations	398	62	1,814
Amounts due to customers	<u>74,422</u>	<u>66,587</u>	<u>58,636</u>

(Thousands of Azerbaijani Manats)

16. Equity

On 30 January 2009, the issue of 635,670 thousand additional ordinary shares was officially registered as completed by the State Committee for Securities of the Republic of Azerbaijan, and accordingly, the advances from shareholders for increase in share capital of AZN 12,713 thousands in 2008 was recognized as share capital in 2009.

All ordinary shares have a nominal value of AZN 0.02 per share and rank equally. Each share carries one vote.

As discussed in Note 12, on 30 April 2010, the Bank completed the capitalization of AZN 4,401 thousands from its 2009 profit by charging retained earnings and issuance of 220,072,754 additional ordinary shares.

Movements in shares outstanding, issued and fully paid were as follows:

	<i>Number of shares</i>	<i>Nominal amount (in full amount)</i>	<i>Total</i>
<i>Ordinary shares</i>			
31 December 2008	724,800,000	0.02	14,496
Increase in share capital	635,670,000	0.02	12,713
31 December 2009	1,360,470,000	0.02	27,209
Increase in share capital	220,072,754	0.02	4,401
31 December 2010	1,580,542,754	0.02	31,610

17. 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 developments and the effectiveness of economic, financial and monetary measures undertaken by the government.

The Azerbaijani economy is vulnerable to market downturns and economic slowdowns elsewhere in the world. The global financial crisis has resulted in a decline in the gross domestic product, deterioration of liquidity in the banking sector, and tighter credit conditions within Azerbaijan. While the Government of Azerbaijan has introduced a range of stabilization measures aimed at providing liquidity to Azerbaijan banks and companies, there continues to be uncertainty regarding the access to capital and cost of capital for the Bank's counterparties and borrowers in particular, which could affect the Bank's financial position, results of operations and business prospects. In addition, changes in economic conditions have resulted in deterioration in the value of collateral held against loans and other obligations. To the extent that information is available, the Bank has reflected revised estimates of expected future cash flows in its impairment assessment.

While management believes it is taking appropriate measures to support the sustainability of the Bank's business in the current circumstances, unexpected further deterioration in the areas described above could negatively affect the Bank's results and financial position in a manner not currently determinable.

Legal

In the ordinary course of business, the Bank 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 Bank.

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 Bank may be challenged by the relevant regional and federal authorities. Recent events within the Republic of 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. The last tax audit of the Bank was completed in July 2009 and covered the period from January 2006 to March 2009.

(Thousands of Azerbaijani Manats)

17. Commitments and contingencies (continued)

Taxation (continued)

As at 31 December 2010, management believes that its interpretation of the relevant legislation is appropriate and that the Bank's tax, currency and customs positions will be sustained.

Commitments and contingencies

As at 31 December the Bank's commitments and contingencies comprised the following:

	<u>2010</u>	<u>2009</u>
Credit related commitments		
Undrawn loan commitments	15,026	10,934
Guarantees issued	15,399	6,439
Letters of credit	1,697	1,581
	<u>32,122</u>	<u>18,954</u>
Operating lease commitments		
Not later than 1 year	134	149
Later than 1 year but not later than 5 years	60	-
	<u>194</u>	<u>149</u>
Commitments and contingencies (before deducting collateral)	32,316	19,103
Less – Cash held as security against letters of credit and guarantees (Note 15)	(192)	(77)
Commitments and contingencies	<u>32,124</u>	<u>19,026</u>

Most of the outstanding guarantee letters as at 31 December 2010 and 2009 represent guarantees issued to clients for the latter's performance on delivering goods and services, and tender guarantees issued to clients as a pledge of their intent to participate in a bidding tender, announced by various institutions.

18. Fee and commission income and expense

Fee and commission income comprises:

	<u>2010</u>	<u>2009</u>
Consulting	2,326	-
Settlements operations	1,834	1,093
Cash collection	1,055	1,049
Guarantees and letters of credit	369	244
Currency conversion operations	202	750
Plastic card operation	267	190
Other	8	266
Fee and commission income	<u>6,061</u>	<u>3,592</u>

In 2010 the Bank provided consulting services to its customers in relation to finding re-financing sources from the parent company.

*(Thousands of Azerbaijani Manats)***18. Fee and commission income and expense (continued)**

Fee and commission expense comprises:

	<u>2010</u>	<u>2009</u>
Settlements operations	(218)	(205)
Plastic cards operations	(182)	(190)
Securities operations	(122)	(200)
Cash operations	(67)	(66)
Other	(85)	(65)
Fee and commission expense	<u>(674)</u>	<u>(726)</u>
Net fee and commission income	<u>5,387</u>	<u>2,866</u>

19. Personnel expenses

Personnel expenses comprise:

	<u>2010</u>	<u>2009</u>
Salaries and bonuses	(3,170)	(2,299)
Social security costs	(418)	(251)
Other employment expenses	(390)	(352)
Total personnel expenses	<u>(3,978)</u>	<u>(2,902)</u>

20. General and administrative expenses

General and administrative expenses comprise:

	<u>2010</u>	<u>2009</u>
Occupancy and rent	(849)	(812)
Security	(430)	(340)
Communications	(300)	(243)
Repair and maintenance	(216)	(136)
Legal and consultancy	(167)	(110)
Office supplies	(60)	(15)
Utilities	(56)	(37)
Insurance	(30)	(34)
Marketing and advertising	(10)	(73)
Operating taxes other than income tax	(15)	(25)
Other	(87)	(196)
General and administrative expenses	<u>(2,220)</u>	<u>(2,021)</u>

(Thousands of Azerbaijani Manats)

21. Risk management

Introduction

Risk is inherent in the Bank's activities and 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 Bank's sustainability and profitability and each individual within the Bank is accountable for the risk exposures relating to his or her responsibilities. The Bank is exposed to credit risk, liquidity risk, market risk and 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 Bank's strategic planning process.

Risk management structure

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

Board of Directors

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

Management Board

The Management Board has the responsibility to monitor the overall risk process within the Bank.

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 Unit

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

Risk Controlling Unit

The Risk Controlling Unit is responsible for monitoring compliance with risk principles, policies and limits, across the Bank. Each business group has a decentralized unit which is responsible for the independent control of risks, including monitoring the risk of exposures against limits and the assessment of risks of new products and structured transactions. This unit also ensures the complete capture of the risks in risk measurement and reporting systems.

Bank Treasury

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

Internal Audit

Risk management processes throughout the Bank are audited annually by the internal audit function that examines both the adequacy of the procedures and the Bank'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 Bank'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 Bank also runs worst case scenarios that would arise in the event that extreme events which are unlikely to occur do, in fact, occur.

(Thousands of Azerbaijani Manats)

21. Risk management (continued)

Introduction (continued)

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

Information compiled from all the businesses is examined and processed in order to analyse, control and identify early risks. On a regular basis detailed reporting of industry and customer risks takes place.

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 Bank's performance to developments affecting a particular industry.

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

Credit risk

Credit risk is the risk that the Bank will incur a loss because its customers, clients or counterparties failed to discharge their contractual obligations. The Bank 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 Bank 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, which assigns each counterparty a risk rating. Risk ratings are subject to regular revision. The credit quality review process allows the Bank to assess the potential loss as a result of the risks to which it is exposed and take corrective action.

Credit-related commitments risks

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

The table below shows the maximum exposure to credit risk for the components of the consolidated statement of financial position. The maximum exposure is shown gross, before the effect of mitigation through the use of master netting and collateral agreements and after deducting any allowance for impairment.

	<i>Notes</i>	<i>Maximum exposure 2010</i>	<i>Maximum exposure 2009</i>
Cash and cash equivalents (excluding cash on hand)	6	94,094	74,153
Amounts due from credit institutions	7	18,786	8,410
Loans to customers	8	67,990	28,439
Investment securities	9	11,861	28,238
Other assets	13	402	272
		<u>193,133</u>	<u>139,512</u>
Financial commitments and contingencies	17	31,930	18,877
Total credit risk exposure		<u>225,063</u>	<u>158,389</u>

Where financial instruments are recorded at fair value, the amounts shown above 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 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.

(Thousands of Azerbaijani Manats)

21. Risk management (continued)**Credit risk (continued)***Credit quality per class of financial assets*

The credit quality of financial assets is managed by the Bank 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 Bank's credit rating system.

In the table below loans to banks and 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 collateralized. 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.

	Notes	<i>Neither past due nor impaired</i>			<i>Past due but not impaired 2010</i>	<i>Individually impaired 2010</i>	<i>Total 2010</i>
		<i>High grade 2010</i>	<i>Standard grade 2010</i>	<i>Sub-standard grade 2010</i>			
Amounts due from credit institutions	7	412	18,374	-	-	-	18,786
Loans to customers	8						
Corporate lending		2,898	45,519	10,899	544	638	60,498
Small business lending		-	4,457	-	27	38	4,522
Consumer lending		-	1,445	3,163	221	78	4,907
Residential mortgages		-	348	-	-	-	348
Total gross loans to customers		2,898	51,769	14,062	792	754	70,275
Debt investment securities Available-for-sale	9	11,200	-	601	-	-	11,801
Total		14,510	70,143	14,663	792	754	100,862

	Notes	<i>Neither past due nor impaired</i>			<i>Past due but not impaired 2009</i>	<i>Individually impaired 2009</i>	<i>Total 2009</i>
		<i>High grade 2009</i>	<i>Standard grade 2009</i>	<i>Sub-standard grade 2009</i>			
Amounts due from credit institutions	7	8,202	208	-	-	-	8,410
Loans to customers	8						
Corporate lending		17,265	1,431	4,249	791	303	24,039
Small business lending		1,969	185	2	15	-	2,171
Consumer lending		275	20	613	161	43	1,112
Residential mortgages		452	-	-	-	-	452
Other		207	1,185	212	60	20	1,684
Total gross loans to customers		20,168	2,821	5,076	1,027	366	29,458
Debt investment securities Available-for-sale	9	28,178	-	-	-	-	28,178
Total		56,548	3,029	5,076	1,027	366	66,046

It is the Bank's policy to maintain accurate and consistent risk ratings across the credit portfolio. This facilitates focused management of the applicable risks and the comparison of credit exposures across all lines of business and products. The rating system is supported by a variety of financial analytics, combined with processed market information to provide the main inputs for the measurement of counterparty risk. All internal risk ratings are tailored to the various categories and are derived in accordance with the Bank's rating policy. The attributable risk ratings are assessed and updated regularly.

(Thousands of Azerbaijani Manats)

21. Risk management (continued)**Credit risk (continued)***Aging analysis of past due but not impaired loans per class of financial assets*

	<i>Less than 30 days 2010</i>	<i>31 to 60 days 2010</i>	<i>61 to 90 days 2010</i>	<i>More than 90 days 2010</i>	<i>Total 2010</i>
Loans to customers					
Corporate lending	74	-	-	470	544
Small business lending	9	-	-	18	27
Consumer lending	39	-	-	182	221
Total	122	-	-	670	792
	<i>Less than 30 days 2009</i>	<i>31 to 60 days 2009</i>	<i>61 to 90 days 2009</i>	<i>More than 90 days 2009</i>	<i>Total 2009</i>
Loans to customers					
Corporate lending	-	-	786	5	791
Small business lending	-	-	-	15	15
Consumer lending	-	106	40	15	161
Other	-	-	57	3	60
Total	-	106	883	38	1,027

See Note 8 for more detailed information with respect to the allowance for impairment of loans to customers.

Impairment assessment

The main considerations for the loan impairment assessment are based on the information provided by the roll-rate model, which measures the movement of the past due amounts balances in various time brackets. The Bank addresses impairment assessment in two areas: individually assessed allowances and collectively assessed allowances.

Individually assessed allowances

The Bank determines the allowances appropriate for each individually significant loan on an individual basis. Items considered when determining allowance amounts include the sustainability of the counterparty's business plan, its ability to improve performance once a financial difficulty has arisen, projected receipts and the expected dividend payout should bankruptcy ensue, the availability of other financial support and the realizable value of collateral, and the timing of the expected cash flows. The impairment losses are evaluated at each reporting date, unless unforeseen circumstances require more careful attention.

Collectively assessed allowances

Allowances are assessed collectively for losses on loans to customers that are not individually significant (including credit cards, residential mortgages and unsecured consumer lending) and for individually significant loans where there is not yet objective evidence of individual impairment. Allowances are evaluated on each reporting date with each portfolio receiving a separate review.

The collective assessment takes account of impairment that is likely to be present in the portfolio even though there is no yet objective evidence of the impairment in an individual assessment. Impairment losses are estimated by taking into consideration the roll-rate model assessment. The impairment allowance is then reviewed by credit management to ensure alignment with the Bank's overall policy.

Financial guarantees and letters of credit are assessed and provision made in a similar manner as for loans.

(Thousands of Azerbaijani Manats)

21. Risk management (continued)

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

	2010				2009			
	Azerbaijan	OECD	CIS and other foreign banks	Total	Azerbaijan	OECD	CIS and other foreign banks	Total
Assets:								
Cash and cash equivalents	36,043	65,088	23	101,131	22,448	60,541	25	83,014
Amounts due from credit institutions	18,786	-	-	18,786	8,410	-	-	8,410
Loans to customers	67,990	-	-	67,990	28,439	-	-	28,439
Investment securities:								
- available-for-sale	11,861	-	-	11,861	28,238	-	-	28,238
Other financial assets	42	-	-	42	16	-	-	16
	<u>134,722</u>	<u>65,088</u>	<u>23</u>	<u>199,810</u>	<u>87,551</u>	<u>60,541</u>	<u>25</u>	<u>148,117</u>
Liabilities:								
Amounts due to credit institutions	79,077	-	-	79,077	42,601	-	-	42,601
Amounts due to customers	74,422	-	-	74,422	66,587	-	-	66,587
Other financial liabilities	311	-	-	311	125	-	-	125
	<u>153,810</u>	<u>-</u>	<u>-</u>	<u>153,810</u>	<u>109,313</u>	<u>-</u>	<u>-</u>	<u>109,313</u>
Net assets / (liabilities)	<u>(19,088)</u>	<u>65,088</u>	<u>23</u>	<u>46,000</u>	<u>(21,762)</u>	<u>60,541</u>	<u>25</u>	<u>38,804</u>

Liquidity risk

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due under normal and stress circumstances. To limit this risk, management has developed a sophisticated system for comprehensive assessment of expected cash flows. The methodology of the liquidity management tools and reports is approved by the Supervisory Board of the bank, prepared by the Assets and Liabilities Management department and reviewed on the monthly basis by Asset Liabilities Committee.

The Bank maintains a portfolio of highly liquid and secure marketable assets that are primarily composed of the Central Bank of the Republic of Azerbaijan notes that can be easily liquidated in the event of an unforeseen interruption of cash flow. Additionally, the Bank utilizes a highly effective cash management system across all its branches, ATMs and balances of the correspondent accounts.

The liquidity position is assessed and managed by the Bank primarily on a standalone basis, based on minimum liquidity ratio of 30% established by the CBA. As at 31 December, these ratios were as follows:

	2010, %	2009, %
Instant Liquidity Ratio	79.55	132.7

Analysis of financial liabilities by remaining contractual maturities

The tables below summarize the maturity profile of the Bank'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 Bank expects that many customers will not request repayment on the earliest date the Bank could be required to pay and the table does not reflect the expected cash flows indicated by the Bank's deposit retention history.

Financial liabilities	As at 31 December 2010				Total
	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	
Amounts due to credit institutions	79,546	-	-	-	79,546
Amounts due to customers	75,284	761	77	-	76,122
Other financial liabilities	311	-	-	-	311
Total undiscounted financial liabilities	<u>155,141</u>	<u>761</u>	<u>77</u>	<u>-</u>	<u>155,979</u>
Financial liabilities	As at 31 December 2009				Total
	Less than 3 months	3 to 12 months	1 to 5 years	Over 5 years	
Amounts due to credit institutions	38,524	4,158	-	-	42,682
Amounts due to customers	66,092	4,286	173	-	70,551
Other financial liabilities	122	3	-	-	125
Total undiscounted financial liabilities	<u>104,738</u>	<u>8,447</u>	<u>173</u>	<u>-</u>	<u>113,358</u>

(Thousands of Azerbaijani Manats)

21. Risk management (continued)

Liquidity risk (continued)

The table below shows the contractual expiry by maturity of the Bank's financial commitments and contingencies. Each undrawn loan commitment is included in the time band containing the earliest date it can be drawn down. For issued financial guarantee contracts, the maximum amount of the guarantee is allocated to the earliest period in which the guarantee could be called.

	<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</i>
2010	1,781	14,982	10,666	4,693	32,122
2009	9	17,220	1,725	-	18,954

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

The Bank does not receive any significant funds from any one organization or private individual. The maturity analysis does not exhibit any significant negative gaps in any given period.

Included in due to customers are term deposits of individuals. In accordance with the Azerbaijan legislation, the Bank is obliged to repay such deposits upon demand of a depositor. Refer to Note 15.

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 and foreign exchanges. The Bank does not have any significant equity, corporate fixed income or derivatives holdings.

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 following table demonstrates the sensitivity to a reasonable possible change in interest rates, with all other variables held constant, of the Bank's current year profit.

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 2010. The sensitivity of equity is calculated by revaluing fixed rate available-for-sale financial assets at 31 December 2010 for the effects of the assumed changes in interest rates based on the assumption that there are parallel shifts in the yield curve. However, as interest rate of available-for-sale securities in the local market is based on the carried accrued discount or premiums on these securities at the time of purchase or sale (as included in actual price of purchased or sold securities), thus, any change in the rates to be applied to the fixed-rate available-for-sale financial assets does not have any impact or effect on equity.

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 Bank is exposed to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and 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 Bank an opportunity to minimize losses from significant currency rates fluctuations toward its national currency. The Treasury Department performs daily monitoring of the Bank's open currency position with the aim to match the requirements of CBA.

<i>Currency</i>	<i>Increase in currency rate in % 2010</i>	<i>Effect on profit before tax 2010</i>	<i>Increase in currency rate in % 2009</i>	<i>Effect on profit before tax 2009</i>
USD	8.35	109	5.0	648
EUR	14.7	(401)	10.0	(29)

<i>Currency</i>	<i>Decrease in currency rate in % 2010</i>	<i>Effect on profit before tax 2010</i>	<i>Decrease in currency rate in % 2009</i>	<i>Effect on profit before tax 2009</i>
USD	(8.35)	(109)	(5)	648
EUR	(14.7)	401	(10)	29

(Thousands of Azerbaijani Manats)

21. Risk management (continued)**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 Bank cannot expect to eliminate all operational risks, but a control framework and monitoring and responding to potential risks could be effective tools to manage the risks. Controls should include effective segregation of duties, access, authorization and reconciliation procedures, staff education and assessment processes, including the use of internal audit.

22. Fair values of financial instruments

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: 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.

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

At 31 December 2010	Level 1	Level 2	Level 3	Total
Financial assets				
Investment securities – available-for-sale	11,200	601	60	11,861
At 31 December 2009				
Financial assets				
Investment securities – available-for-sale	26,945	1,233	60	28,238

Investment securities available-for-sale

Investment securities available-for-sale valued using a valuation technique or pricing models primarily consist of unquoted equity and debt securities. These securities are valued using models which sometimes only incorporate data observable in the market and at other times use both observable and non-observable data. The non-observable inputs to the models include assumptions regarding the future financial performance of the investee, its risk profile, and economic assumptions regarding the industry and geographical jurisdiction in which the investee operates.

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 Bank'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 2010	Fair value 2010	Carrying value 2009	Fair value 2009	Carrying value 2008	Fair value 2008
Financial assets						
Cash and cash equivalents	101,131	101,131	83,014	83,014	26,251	26,251
Amounts due from credit institutions	18,786	18,786	8,410	8,410	7,883	7,883
Loans to customers	67,990	67,990	28,439	28,439	9,567	9,567
Other financial assets	42	42	16	16	24	24
Financial liabilities						
Amounts due to credit institutions	79,077	79,077	42,601	42,601	6,282	6,282
Amounts due to customers	74,422	74,422	66,587	66,587	58,636	58,636
Other financial liabilities	311	311	125	125	84	84

(Thousands of Azerbaijani Manats)

22. Fair values of financial instruments (continued)

The following describes the methodologies and assumptions used to determine fair values for those financial instruments which are not already recorded at fair value in the financial statements.

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 and savings accounts without a specific maturity.

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.

23. 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 21 "Risk management" for the Bank's contractual undiscounted repayment obligations.

	2010			2009		
	Within one year	More than one year	Total	Within one year	More than one year	Total
Cash and cash equivalents	101,131	-	101,131	83,014	-	83,014
Amounts due from credit institutions	18,786	-	18,786	8,410	-	8,410
Loans to customers	14,418	53,572	67,990	15,890	12,549	28,439
Investment securities available-for-sale	8,639	3,222	11,861	28,178	60	28,238
Property and equipment	-	4,136	4,136	-	4,208	4,208
Intangible assets	-	429	429	-	61	61
Other assets	902	-	902	438	-	438
Total	143,876	61,359	205,235	135,930	16,878	152,808
Amounts due to credit institutions	79,077	-	79,077	42,601	-	42,601
Amounts due to customers	73,867	555	74,422	66,506	81	66,587
Deferred income tax liability	-	-	-	-	13	13
Other liabilities	1,240	-	1,240	1,081	-	1,081
Total	154,184	555	154,739	110,188	94	110,282
Net	(10,308)	60,804	50,496	25,742	16,784	42,526

24. 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.

*(Thousands of Azerbaijani Manats)***24. Related party disclosures (continued)**

At 31 December 2010 the outstanding balances with related parties were as follows:

	2010		2009	
	Parent	Entities under common control	Parent	Entities under common control
Cash and cash equivalents	56,889	-	50,231	-
Amounts due from other credit institutions (contractual interest rate: 4%)	5,188	-	-	-
Customer current/settlement accounts (contractual interest rate: 0-4%)	-	12	-	88

The income and expense arising from related party transactions are as follows:

	2010		2009	
	Parent	Entities under common control	Parent	Entities under common control
Interest income	2,188	-	2,096	-
Interest expense	-	-	(8)	(14)
Fee and commission income	-	-	-	13
Fee and commission expense	(19)	(71)	(16)	-
General and administrative expenses	(36)	(72)	(25)	(56)

Compensation of key management personnel was comprised of the following:

	2010	2009
Salaries and short term benefits	574	172
Unused vacations	71	16
Total key management personnel compensation	645	188

25. Capital adequacy

The objectives of management when managing the Bank's capital are (i) to comply with the capital requirements set by CBA, (ii) to safeguard the Bank's ability to continue as a going concern and (iii) to maintain strong credit ratings and healthy capital ratios in order to support its business and to maximize shareholders' value. Compliance with capital adequacy ratios set by CBA is monitored monthly with reports outlining their calculation reviewed and signed by the Bank's Chief Executive Officer and Chief Accountant. The other objectives of capital management are evaluated annually.

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 or return capital to shareholders. No changes were made in the objectives, policies and processes from the previous years.

The CBA requires each bank or banking group to: (a) hold the minimum level of share capital AZN 10,000 thousands (2009: AZN 10,000 thousands); (b) maintain a ratio of total regulatory capital to the risk-weighted assets (the 'total capital ratio') at or above the prescribed minimum of 12% (2009: 12%) and (c) maintain a ratio of tier 1 capital to the risk-weighted assets (the 'Tier 1 capital ratio') at or above the prescribed minimum of 6% (2009: 6%).

Management believes that the Bank was in compliance with the statutory capital adequacy ratio throughout 2010 and 2009.

*(Thousands of Azerbaijani Manats)***25. Capital adequacy (continued)**

As at 31 December 2010 the Bank's capital adequacy ratio based on the CBA requirements was as follows:

	2010	2009
Tier 1 capital	42,526	37,735
Tier 2 capital	9,346	5,346
Less: deductions from capital	(429)	(54)
Total regulatory capital	51,443	43,027
Risk-weighted assets	140,171	75,611
Tier 1 capital adequacy ratio	30.3%	49.9%
Total capital adequacy ratio	36.7%	56.9%