MOODY'S
INVESTORS SERVICE

CREDIT OPINION
21 June 2017

Update

Rate this Research

RATINGS

OJSC Bank of Baku

Domicile	Baku, Azerbaijan
Long Term Debt	Not Assigned
Type	Not Assigned
Outlook	Not Assigned
Long Term Deposit	Caa1
Type	LT Bank Deposits - Fgn Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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OJSC Bank of Baku

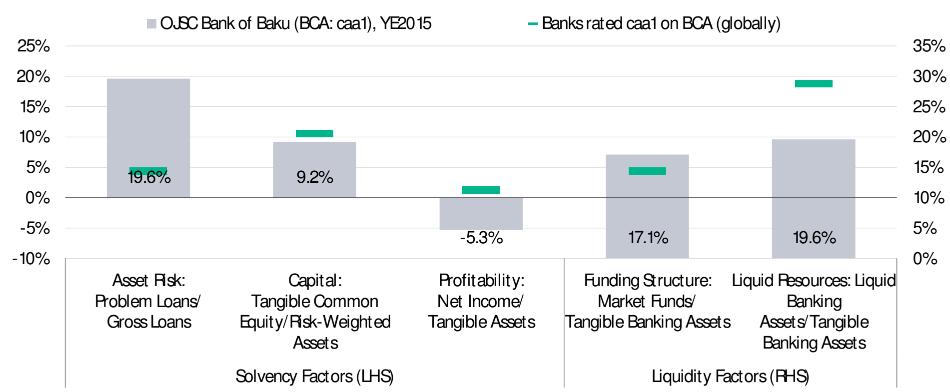
Update Following Rating Action

Summary Rating Rationale

We assign long-term global local-currency and foreign-currency deposit ratings of Caa1 to OJSC Bank of Baku (Bank of Baku), which are at the same level as the bank's baseline credit assessment (BCA) of caa1. Bank of Baku's Caa1/Not Prime long- and short-term global local currency (GLC) ratings do not factor in any probability of government support in the event of a stress situation.

The ratings reflect the bank's (1) robust liquidity profile, and (2) low reliance on market funding. At the same time, the ratings remain constrained by the ongoing pressure on the bank's capitalization, asset quality and profitability following the decline in individuals' real disposable income, and the deteriorated debt service of foreign-currency loans.

Exhibit 1
Rating Scorecard - Key Financial Ratios



Source: Moody's Financial Metrics

Credit Strengths

» Robust liquidity cushion amid steady loan book amortization;

» Relatively low dependence on market funding

Credit Challenges

» Material capital erosion as a result of heavy net losses since 2015;

» Asset quality pressure owing to exposure to unsecured retail lending and unhedged foreign-currency loans; and

» Persisting pressure on profitability amid elevated credit costs and lower net interest income.

Rating Outlook

The bank's Caa1 long-term local and foreign-currency deposit ratings carry a negative outlook, which reflects our expectation that the bank's loss absorption capacity will remain under pressure in the next 12 to 18 months.

Factors that Could Lead to an Upgrade

» Given the negative outlook on the bank's ratings, a ratings upgrade in the next 12-18 months is unlikely;

» The outlook could be changed to stable if the bank improves its recurring revenues and net financial result while maintaining adequate level of capitalization;

» The reversal of the current negative trends in asset quality along with improvements in the Azerbaijani operating environment could enable a positive rating action.

Factors that Could Lead to a Downgrade

» The ratings could be lowered if capitalization or profitability erode beyond Moody's current expectations.

Key Indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

	12-15[2]	12-14[2]	12-13[2]	12-12[2]	12-11[2]	CAGR/Avg.[3]
Total Assets (AZN million)	701	728	643	486	307	22.9[4]
Total Assets (USD million)	448	930	821	620	391	3.5[4]
Tangible Common Equity (AZN million)	49	120	114	84	52	-1.7[4]
Tangible Common Equity (USD million)	31	153	145	107	67	-17.2[4]
Problem Loans / Gross Loans (%)	19.6	6.0	3.2	3.1	3.3	7.0[5]
Tangible Common Equity / Risk Weighted Assets (%)	9.2	18.8	19.0	19.2	18.5	17.0[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	61.1	23.5	13.6	13.7	14.6	25.3[5]
Net Interest Margin (%)	16.1	18.4	17.1	16.2	14.5	16.4[5]
PPI / Average RWA (%)	11.6	14.6	12.9	12.7	9.5	12.3[6]
Net Income / Tangible Assets (%)	-5.3	5.6	7.2	6.7	8.5	4.5[5]
Cost / Income Ratio (%)	35.5	33.8	36.8	37.0	41.5	36.9[5]
Market Funds / Tangible Banking Assets (%)	17.1	13.7	8.0	17.0	12.4	13.7[5]
Liquid Banking Assets / Tangible Banking Assets (%)	19.6	11.9	11.0	12.3	12.1	13.4[5]
Gross Loans / Due to Customers (%)	119.8	139.2	124.8	139.4	128.9	130.4[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel I; IFRS [3] May include rounding differences due to scale of reported amounts [4] Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime [5] Simple average of periods presented for the latest accounting regime. [6] Simple average of Basel I periods presented

Source: Moody's Financial Metrics

Detailed Rating Considerations

ASSET QUALITY IS UNDER MATERIAL PRESSURE OWING TO EXPOSURE TO UNSECURED RETAIL LENDING AND UNHEDGED FOREIGN-CURRENCY LOANS

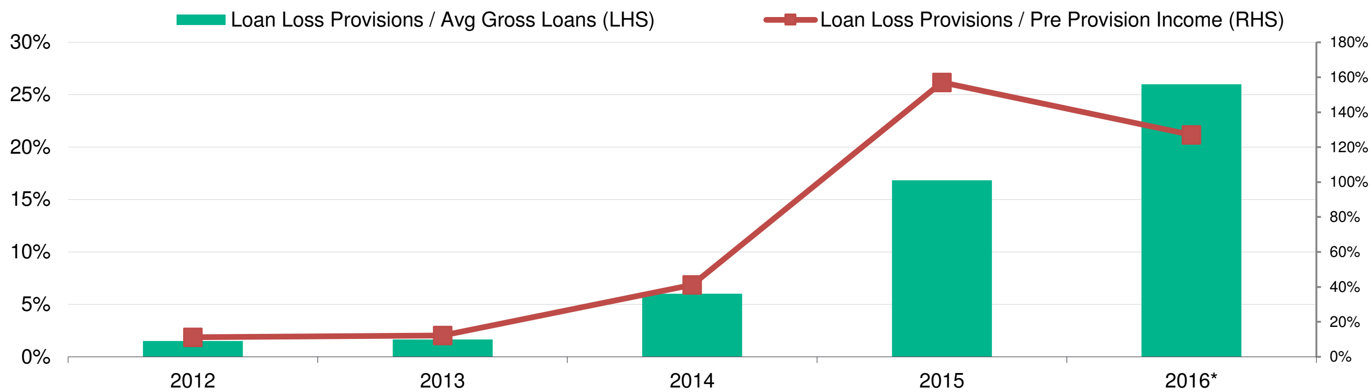
Bank of Baku is a medium-sized bank among about 30 commercial banks operating in Azerbaijan. Headquartered in the City of Baku, the capital city of Azerbaijan, the bank is the country's leading provider of consumer loans, with one of the largest retail loan portfolio among privately owned financial institutions. Around 75% of the bank's gross loan book was provided to individuals as of Q3 2016. Concurrently, unsecured consumer lending amounted to 72% of the bank's loan portfolio.

Bank of Baku's asset quality weakened dramatically throughout 2015-16, following two waves of manat depreciation. This led to an increase in the bank's credit costs to 16.8% of average gross loans in 2015 (the latest available IFRS data), up from 6.0% in 2014. Based on local GAAP reports, the cost of risk in 2016 amounted to 26.0% amid elevated provisioning charges and contracted loan portfolio.

The drastic depreciation of the manat in February and December 2015 adversely affected asset quality, as most of the bank's foreign-currency loans (representing 34% of the total portfolio as of 1 January 2017) were held by unhedged borrowers. As of year-end 2016 non-performing loans overdue by more than 60 days accounted for 27.4% of gross lending and were more than 100% covered by loan loss provisions.

Exhibit 3

Credit Costs Have Surged Since 2015



* - local GAAP data

Source: Moody's Financial Metrics, local GAAP reports

We expect that pressure on the bank's loan portfolio will persist throughout 2017, because accelerated consumer price inflation, along with an increase in unemployment has affected individuals' real disposable income and, as a result, their capacity to service debt. The bank's problem loan ratio will likely deteriorate further, as the bank's gross loan book is steadily declining and has already contracted by 36% in 2016 and by 13% over the first four months of 2017.

We believe, the bank's business model focused on high-risk unsecured consumer lending, is not sustainable in the current environment due to weakened debt servicing capacity of the households. We assign caa2 score to asset quality given the negative trends along with sufficient provisioning coverage.

LOSS-MAKING PERFORMANCE OWING TO ELEVATED CREDIT COSTS AND DECLINED PRE-PROVISION INCOME

The bank's focus on high-margin consumer-lending business provided it with robust core profitability in previous years. However, this trend has reversed since the middle of 2015, driven by increased credit costs and incurred foreign-currency revaluation losses following the manat depreciation. Bank of Baku posted net losses of AZN37.3 million, AZN15.3 million and AZN16.8 million over 2015, 2016 and the first four months of 2017, respectively. These negative financial results were largely driven by heavy provisioning charges amid declined pre-provision income as a result of steady loan book amortization.

We expect that credit costs will remain elevated in the next 12-18 months owing to individuals' deteriorated ability to service debts, while the recovery of unsecured loans will be difficult in the challenging operating environment in Azerbaijan. Concurrently, we expect a further contraction of the bank's pre-provision income owing to ongoing loan book amortization.

To mitigate the negative trends, the bank has focused on cost efficiency since the middle of 2015. The bank has also tightened its underwriting standards in order to contain credit risk. In spite of these steps, it is likely that the pressure from credit costs and weaker recurring revenues will cause the bank to be loss-making in the next 12-18 months. The assigned score to profitability is caa3 in line with macro adjusted historical one.

THE CAPITAL BUFFER IS JUST OVER THE REGULATORY THRESHOLD; URGENT CAPITAL INJECTION IS REQUIRED

This heavy net losses the bank experienced since 2015 have resulted in total capital falling to AZN53.7 million as of 1 May 2017, just above the minimal regulatory threshold of AZN50 million. We believe that Bank of Baku needs an urgent equity injection to meet the regulatory requirements owing to expected net losses at least in the short term. Reportedly, the upcoming annual shareholders' meeting later this month will consider this issue. However, the outcome, amount (if any) and timing of potential support from the shareholders remain uncertain.

In relative terms, the bank's capital adequacy remains acceptable with regulatory Total capital adequacy ratio (CAR) of 15.4% and a Tier 1 ratio of 9.0% reported as of 1 May 2017. We consider its provisions of 32.0% of gross loans or over 100% of non-performing loans as of 1 January 2017 as adequate to absorb expected credit losses. We assign caa3 to capitalization given ongoing negative trends.

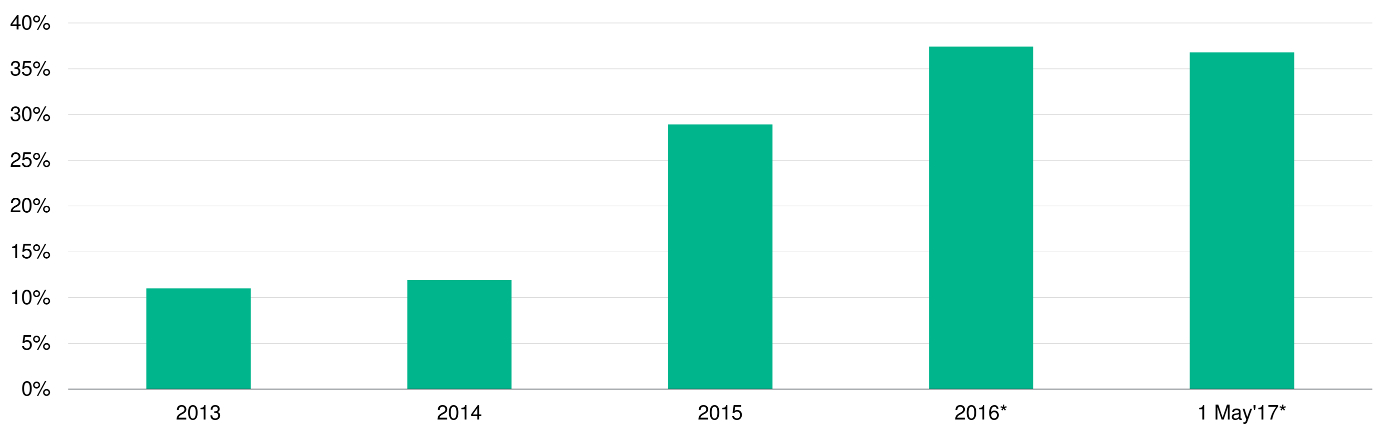
The bank has a relatively diversified shareholder structure, with no single party owning a controlling stake in the equity. The largest shareholder is NAB Holding (35% equity stake), a Turkey-based company that also has interests in a variety of businesses in Azerbaijan, including car dealerships, consumer electronics and tourism. The remainder is dispersed between local businessmen. In Q1 2016, the shareholders provided a seven-year subordinated loan of USD14.3 million, which bolstered the bank's total capital adequacy.

ROBUST LIQUIDITY CUSHION AMID LOAN BOOK AMORTIZATION; LIMITED REFINANCING RISKS

Over the recent years, Bank of Baku has relied on customer deposits as the key source of funding which formed ca. 65% of its liabilities. The bank's wholesale funding amounted to 30% of total non-equity funding, represented either by secured deposits from the Central Bank (in essence swap transactions) or long-term state financing of projects related to small and medium-sized enterprise and mortgage lending. In our view the bank's wholesale funding bears limited refinancing risks.

Bank of Baku's liquidity cushion remain broadly flat and amounted to 36.8% of total assets as of 1 May 2017 compared with 37.4% as of year-end 2016. Liquid assets are mostly held in foreign-currency placed either with the Central Bank of Azerbaijan or local banks.

Exhibit 4
Robust Liquidity Cushion
Liquid Assets / Total Assets, %



* - local GAAP data
Source: Moody's Financial Metrics, local GAAP reports

We expect that Bank of Baku's liquidity cushion will remain robust over the next 12-18 months, amid the ongoing deleveraging of the bank's loan portfolio along with cautious liquidity management. We assign b2 to combined liquidity score in line with expected trends.

Notching Considerations

Global Local-Currency Deposit Rating (Joint Default Analysis)

Bank of Baku's Caa1/Not Prime long- and short-term GLC ratings do not factor in any probability of government support in the event of a stress situation.

Foreign-Currency Deposit Rating

We assign Caa1/Not Prime foreign-currency deposit ratings to Bank of Baku, at the same level as the bank's local currency deposit ratings.

CR Assessment

We have assigned a Counterparty Risk Assessment (CR Assessment) of B3(cr)/ Not-Prime(cr) to Bank of Baku.

CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather expected loss; and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

In most cases, the starting point for the CR Assessment, which is an assessment of the ability to avoid defaulting on its operating obligations, is one notch above the bank's adjusted BCA, which represents our view of the probability of a bank failing on its obligations without considering government support. We then add the same support assumptions as applied to deposit ratings. As a result, the CR Assessment of Bank of Baku is one notch higher than its deposit ratings.

NOTE ON DATA

Unless noted otherwise, data in this report is sourced from company reports and our Banking Financial Metrics. All figures are based on our own chart of account, and are adjusted for analytical purposes. Please refer to the document entitled "Financial Statement Adjustments in the Analysis of Financial Institutions" published on 12 February 2016.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Methodology and Scorecard Factors

Exhibit 5

OJSC Bank of Baku

Macro Factors							
Weighted Macro Profile	**Very Weak +**	**100%**					
Factor		**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency							
Asset Risk							
Problem Loans / Gross Loans		19.6%	caa2	↓↓	caa2	Expected trend	Collateral and provisioning coverage
Capital							
TCE / RWA		9.2%	caa1	↓↓	caa3	Expected trend	

Profitability					
Net Income / Tangible Assets	-5.3%	caa3	←→	caa3	Return on assets
Combined Solvency Score		caa2		caa3	
Liquidity					
Funding Structure					
Market Funds / Tangible Banking Assets	17.1%	b3	↑	b2	Expected trend
Liquid Resources					
Liquid Banking Assets / Tangible Banking Assets	19.6%	caa1	↑↑	b2	Expected trend
Combined Liquidity Score		b3		b2	
Financial Profile				caa2	
Business Diversification				0	
Opacity and Complexity				0	
Corporate Behavior				0	
Total Qualitative Adjustments				0	
Sovereign or Affiliate constraint:				Ba1	
Scorecard Calculated BCA range				caa1-caa3	
Assigned BCA				caa1	
Affiliate Support notching				0	
Adjusted BCA				caa1	

Instrument class	Loss Given Failure notching	Additional Notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Assessment	1	0	b3 (cr)	0	B3 (cr)	--
Deposits	0	0	caa1	0	Caa1	Caa1

Source: Moody's Financial Metrics

Ratings

Exhibit 6

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Negative
Bank Deposits	Caa1/NP
Baseline Credit Assessment	caa1
Adjusted Baseline Credit Assessment	caa1
Counterparty Risk Assessment	B3(cr)/NP(cr)

Source: Moody's Investors Service

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