MOODY'S INVESTORS SERVICE

CREDIT OPINION
22 December 2017

Update

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RATINGS

OJSC Bank of Baku

Domicile	Baku, Azerbaijan
Long Term Debt	Not Assigned
Long Term Deposit	Caa3
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

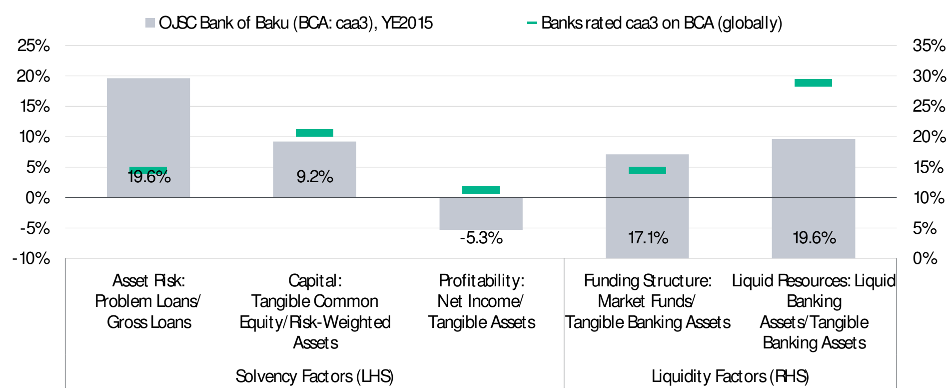
Summary

On 19 December 2017, we downgraded to Caa3 from Caa1 OJSC Bank of Baku's (BoB) long-term foreign- and local-currency deposit ratings. The bank's baseline credit assessment (BCA) and adjusted BCA were also downgraded to caa3 from caa1. The outlook on long-term ratings remained negative. The rating action reflected Moody's concerns over depletion of BoB's capital as a result of ongoing net losses, as well as uncertainty regarding the bank's future financial standing.

Bank of BoB's long-term bank deposit ratings of Caa3 remain at the same level as the bank's BCA and do not factor in any probability of government support in the event of a stress situation.

The ratings reflect the bank's (1) negative tangible common equity (TCE) and need for capital injection, (2) weak earnings generation capacity, and (3) large stock of problem loans. At the same time, BoB's ratings are supported by its relatively low dependence on market funding and satisfactory liquidity profile supported by on-going loan book deleveraging.

Exhibit 1
Rating Scorecard - Key Financial Ratios



Source: Moody's Financial Metrics

Credit strengths

» Good liquidity cushion amid steady loan book amortization

» Relatively low dependence on market funding

Credit challenges

- Material capital erosion
- Heavy net losses since 2015 amid elevated credit costs and weaker net interest income
- Weak asset quality owing to exposure to unsecured retail lending and unhedged foreign-currency loans

Rating outlook

BoB's ratings carry negative outlook, which is driven by downside risks for the bank's financial standing stemming from ongoing net losses and weak pre-provision income.

Factors that could lead to an upgrade

- The ratings could be upgraded and the outlook could be changed to stable if the shareholders replenish the bank's equity, or the bank improves its recurring revenues and net financial result, while maintaining adequate level of capitalization to meet the regulatory requirements.

Factors that could lead to a downgrade

- The ratings could be lowered if there are indications of the bank's failure such as liquidity support beyond that normally associated with the particular class of institution, forbearance in order to delay loss recognition or resolution proceedings, or merger that is effectively mandated by the government on terms unlikely to be available commercially.

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)	449	930	821	620	391	3.5[4]
Tangible Common Equity (AZN million)	49	120	114	84	53	-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 (%)	16.6	18.4	17.1	16.2	14.5	16.5[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 (%)	10.3	11.9	11.0	12.3	12.1	11.5[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

Profile

BoB 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. As of year-end 2016, 90% of the bank's gross loan book was made of loans to individuals. These, is turn, were dominated by unsecured consumer loans (52%), credit card loans (25%).

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.

Detailed rating considerations

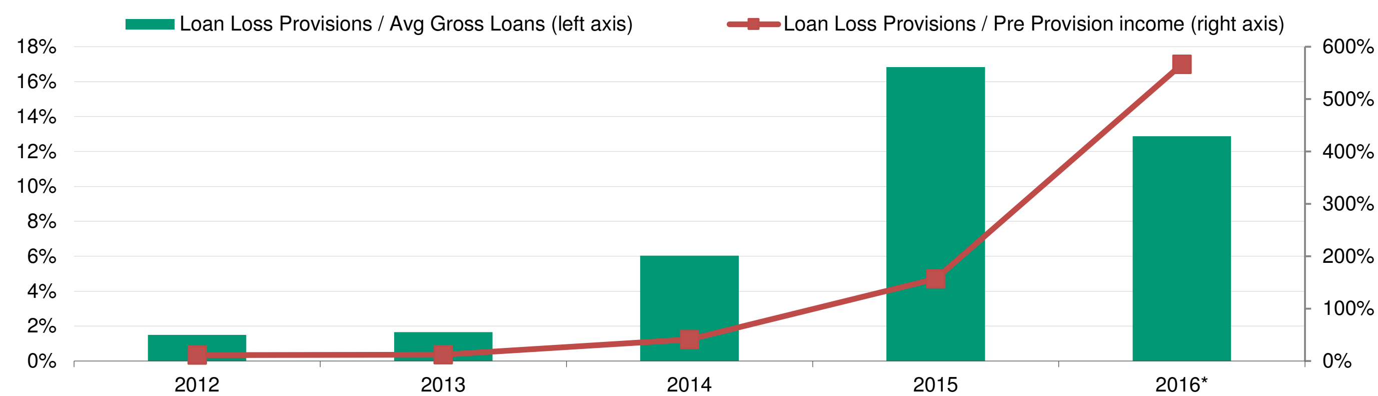
Large stock of problem loans, although fully covered by loan loss reserves

The drastic depreciation of the local currency in 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, problem loans (defined as a sum of doubtful and loss loans as per local quality grading) climbed to 32.5% of gross loans. Through 2017, the bank experienced additional weakening in asset quality metrics. The volume of problem loans increased by 20% in absolute terms, while problem loan ratio reached 42.9% as of 1 October 2017.

Loan portfolio contracted by 38% in 2016 and another 8% during the first eleven months of 2017, adding negative pressure to the bank's problem loan ratio. On the other hand, poor asset quality is balanced against BoB prudent provisioning policy, as demonstrated by its coverage of problem loans of around 100% since year-end 2016.

Exhibit 3

Credit Costs Have Surged Since 2015



* - unaudited IFRS data

Source: Moody's Financial Metrics

We expect that very high problem loan ratio will persist in the next 12-18 months, and assign Asset Quality score of caa2, which is one notch higher than Macro-Adjusted score. The upward adjustment is driven by provisioning coverage of about 100% of problem lending.

Loss-making performance owing to large credit costs and reduction of net interest income

The bank's focus on high-yield consumer-lending business provided it with robust core profitability in the past. However, this trend has reversed since the middle of 2015, driven by increased provisioning charges and foreign-currency revaluation losses following the manat depreciation. Bank of Baku posted net losses of AZN37.3 million and AZN54.5 million in 2015 and 2016, respectively. Over the first eleven months of 2017 the bank recognized a net loss of AZN35.2 million, owing to elevated provisioning charges along with weakened pre-provision income.

On the back of steady loan book amortization BoB's net interest income (NII) fell more than four-fold in 2016 compared to 2015 (IFRS, unaudited) and continued to contract in 2017. Rapid asset quality deterioration also translated into an increase in the bank's credit costs to 16.8% of average gross loans in 2015 and 12.9% in 2016. Over the first eleven months of 2017 the annualized cost of risk amounted to 12.9%.

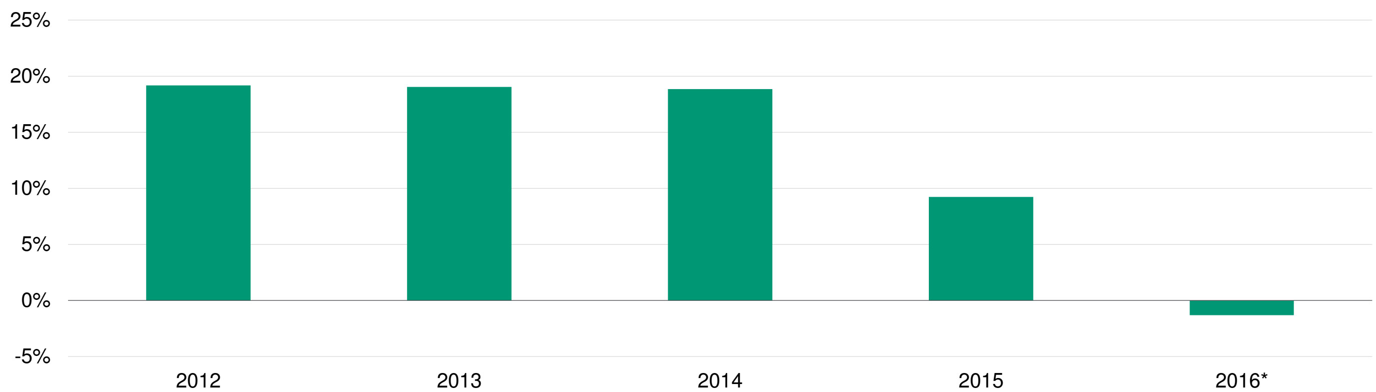
To mitigate the negative trends, the bank has focused on cost efficiency since the middle of 2015. The bank has also tightened its underwriting standards in order to contain credit risk. In spite of these steps, it is likely that the pressure from credit costs and weaker recurring revenues will cause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

Negative tangible common equity and scarce regulatory capital

The caa3 capital score reflects the bank's current weak capitalization as demonstrated by its shareholders' equity-to-total assets ratio of 0.7%, as of year-end 2016 . As of the same date, the bank's tangible common equity (TCE) to risk weighted assets ratio (Moody's key capital metrics) was negative at -1.3%.

Exhibit 4

TCE has eroded owing to heavy losses in 2015-16



* - unaudited IFRS data

Source: Moody's Financial Metrics

Starting from June 2017, BoB has failed to comply with the statutory requirements. As of 1 December 2017, BoB's regulatory total capital amounted to AZN24.8 million, half of AZN50 million minimal threshold. As of the same date the bank reported total capital adequacy ratio (CAR) and Tier 1 ratio of 7.3% and 3.8%, respectively, below the regulatory requirements of 10% and 5%, respectively.

Sufficient liquidity cushion amid loan book amortization and limited refinancing risk

As a part of deleveraging process, BoB's customer deposits shank by 42% in 2016 and accounted for 58% of the bank's liabilities at year-end 2016. In 2017, deposit outflow continued, although at a slower pace. Over the first eleven months of 2017, the bank lost 9% of its customer funding.

Concurrently, the wholesale funding halved in nominal terms and reduced to less than 20% of total liabilities. As of 1 December 2017, more than 50% of BoB's wholesale funding was represented by long-term state financing of projects related to small and medium-sized enterprise and mortgage lending, and the rest was almost equally split between short-term central bank and interbank funding.

Assigned Funding Structure score is caa1, which is one notch below Macro Adjusted score. Apart from the ongoing customer funding outflow, this downward adjustment reflects the dominance of foreign currency deposits (64% of the total), which leaves the bank exposed to FX risk.

The BoB's liquidity cushion amounted to 25% of total assets, as of 1 December 2017, down from 35% on average reported during the first half of the year. Liquid assets are mostly held in form of cash, Nostro at Central Bank and FX Nostro accounts at banks.

We expect that BoB's liquidity may come under pressure over the next 12-18 months, giving the lack of capital and poor financial performance. These considerations justify one notch downward adjustment of BoB's Liquidity score to caa1.

Support and structural considerations

Counterparty risk assessment

We have assigned a Counterparty Risk Assessment (CR Assessment) of Caa2(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.

Source of facts and figures cited in this report

Unless noted otherwise, we have sourced data relating to system-wide trends and market shares from the central bank. Bank-specific figures originate from banks' reports and Moody's Banking Financial Metrics. All figures are based on our own chart of account and may be adjusted for analytical purposes. Please refer to the document Financial Statement Adjustments in the Analysis of Financial Institutions, published on 13 June 2017.

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	Expected trend	
Combined Solvency Score		caa2		caa3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	17.1%	b3	←→	caa1	Expected trend	Deposit quality
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	10.3%	caa1	↑↑	caa1	Expected trend	Quality of liquid assets
Combined Liquidity Score		b3		caa1		
Financial Profile				caa2		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint:				Ba2		
Scorecard Calculated BCA range				caa1-caa3		
Assigned BCA				caa3		
Affiliate Support notching				0		
Adjusted BCA				caa3		

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	caa2 (cr)	0	Caa2 (cr)	--
Deposits	0	0	caa3	0	Caa3	Caa3

Source: Moody's Financial Metrics

Ratings

Exhibit 6

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Negative
Bank Deposits	Caa3/NP
Baseline Credit Assessment	caa3
Adjusted Baseline Credit Assessment	caa3
Counterparty Risk Assessment	Caa2(cr)/NP(cr)

Source: Moody's Investors Service

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