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CREDIT OPINION
17 December 2018

Update

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RATINGS

OJSC Bank of Baku

Domicile	Baku, Azerbaijan
Long Term CRR	Caa2
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
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

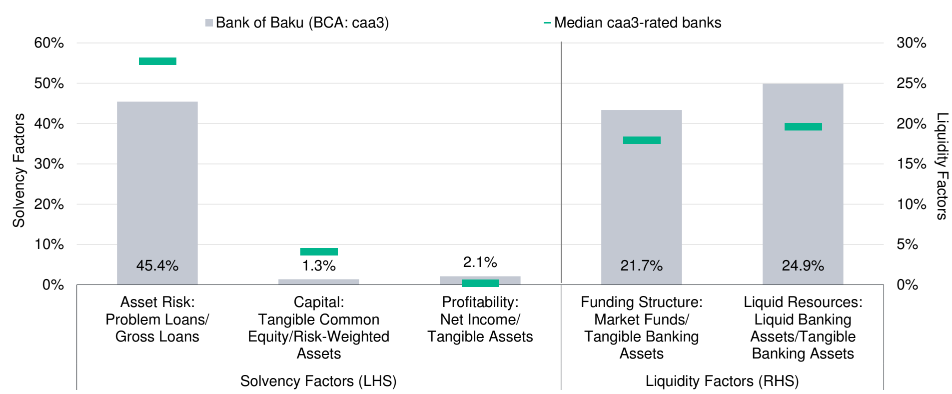
Update to credit analysis

Summary

OJSC Bank of Baku's (BoB) long-term local- and foreign-currency deposit ratings of Caa3 are solely based on the bank's Baseline Credit Assessment (BCA) of caa3 and do not factor in any probability of external support in case of need.

The bank's ratings reflect its (1) weak capital, both as measured by the IFRS-based ratio of tangible common equity (TCE) to risk-weighted assets (RWAs), which stood at 1.3%, as of 31 December 2017, and statutory capital adequacy ratio, that remains below the regulatory requirement in absolute and relative terms; (2) large stock of problem loans, exceeding 40% of gross loans; and (3) improved, although still-weak, profitability, which is unlikely to recover before visible progress is achieved in the workout of the problematic loan portfolio. BoB's ratings also reflect the bank's vulnerable liquidity profile, which might come under pressure if the currently observed deposit outflow starts outpacing the loan book amortization.

Exhibit 1
Key financial ratios



Source: Moody's Financial Metrics

Credit strengths

» Adequate liquidity profile amid loan book amortization

Credit challenges

» Very weak capital, eroded by heavy losses

» Improved, although still-weak, profitability not sufficient to restore capital

» Weak asset quality, resulting from concentrated exposure to unsecured retail lending and unhedged foreign-currency loans

Outlook

BoB's ratings carry a negative outlook, which is driven by downside risks for the bank's financial standing and long-term viability, stemming from the breach of statutory capital requirements and delays in capital injection by shareholders.

Factors that could lead to an upgrade

» The ratings could be upgraded and/or the outlook could be changed to stable if the shareholders replenish BoB's capital to meet the regulatory requirements and the bank achieves progress in reducing its stock of problematic assets.

Factors that could lead to a downgrade

» The ratings could be lowered if the bank (1) requires extraordinary liquidity support, i.e. above and beyond what is normally associated with a going-concern business model, (2) undergoes resolution proceedings, or (3) is mandated by the government to enter into a commercially nonviable merger.

Key indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

	12-17[2]	12-16[2]	12-15[2]	12-14[2]	12-13[2]	CAGR/Avg.[3]
Total Assets (AZN million)	400	509	701	728	643	-11.2[4]
Total Assets (USD million)	235	283	449	930	821	-26.8[4]
Tangible Common Equity (AZN million)	4.0	-4.9	49	120	114	-56.7[4]
Tangible Common Equity (USD million)	2.4	-2.7	31	153	145	-64.3[4]
Problem Loans / Gross Loans (%)	45.4	33.1	19.6	6.0	3.2	21.4[5]
Tangible Common Equity / Risk Weighted Assets (%)	1.3	-1.3	9.2	18.8	19.0	9.4[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	115.2	91.3	61.1	23.5	13.6	60.9[5]
Net Interest Margin (%)	7.1	4.8	16.1	18.4	17.1	12.7[5]
PPI / Average RWA (%)	0.6	3.0	11.6	14.6	12.9	8.5[6]
Net Income / Tangible Assets (%)	2.1	-10.7	-5.3	5.6	7.2	-0.2[5]
Cost / Income Ratio (%)	93.0	68.5	35.5	33.8	36.8	53.5[5]
Market Funds / Tangible Banking Assets (%)	21.7	24.2	17.1	13.7	8.0	17.0[5]
Liquid Banking Assets / Tangible Banking Assets (%)	24.9	24.8	19.6	11.9	11.0	18.4[5]
Gross Loans / Due to Customers (%)	135.7	110.2	119.8	139.2	124.8	126.0[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 small bank among 30 commercial banks operating in Azerbaijan. As of 30 September 2018, it held a market share of 1.0% based on standalone assets of AZN302 million, as reported under local GAAP.

The bank is headquartered in Baku, the capital city of Azerbaijan, and operates through a network of 17 branches. BoB has historically been focused on providing consumer loans. As of year-end 2017, loans to individuals accounted for around 80% of the bank's gross loan book and were in turn dominated by unsecured consumer loans (60%), followed by credit card loans (15%).

BoB was severely hit by the recent 2015-16 financial crisis in Azerbaijan, which resulted in heavy losses, erosion of capital and balance-sheet deleveraging. Starting from mid-2017, the bank's nominal capital remained below the regulatory minimum. As a consequence, BoB is banned from attracting new individual deposits and certain other transactions, which eventually limits its activity and financial recovery prospects.

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 among local businessmen.

Detailed credit considerations

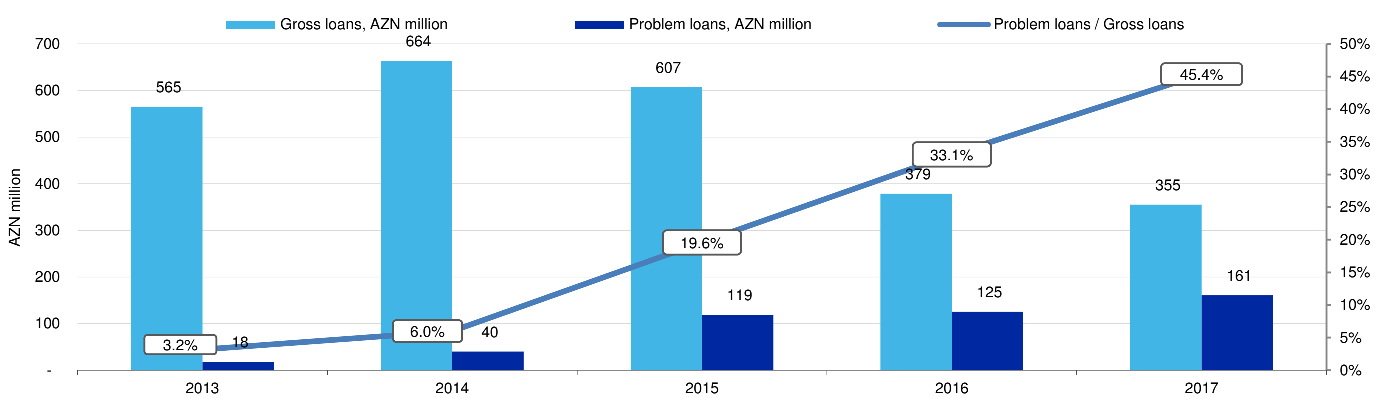
Weak asset quality, resulting from concentrated exposure to unsecured retail lending and unhedged foreign-currency loans

BoB's weak asset-quality metrics is one of the two key factors that underscore its caa3 BCA. The primary causes of the bank's poor asset quality are (1) historically weak underwriting standards, and (2) large share of foreign-currency loans issued to unhedged borrowers, which were severely hit by the sharp devaluation of the Azeri manat in 2015.

As of 31 December 2017 (the latest available IFRS data), problem loans (defined as a sum of all individually impaired corporate loans and retail loans overdue by more than 90 days) accounted for 45% of the bank's gross loans, up from 33% a year earlier. The deterioration was mainly a result of an increase in problem loans in absolute terms (+29% from a year earlier). This increase took place despite the fact that during 2017 BoB wrote off 20% of its gross loans outstanding as of 31 December 2016. The new loan vintages disbursed starting from 2017 seem to show healthier performance compared to the ones issued before 2015-16, however, we still do not expect any notable improvement in the bank's asset-quality metrics in the medium term, because the newly issued loans are yet insufficient to substitute the legacy problematic portfolio. Indeed, according to up-to-date local GAAP data, nonperforming loans stood at 44% of BoB's gross loans as of 30 September 2018, an inch up from 42% reported as of year-end 2017.

BoB's provisioning coverage for IFRS problem loans reduced to 84% as of year-end 2017, down from 113% a year earlier, indicating that the bank might need to set aside additional provisions under IFRS going forward. Large share of foreign currency loans (25% as of 1 November 2018, according to local GAAP data) is another factor of vulnerability for BoB, further aggravated by the bank's focus on retail borrowers, i.e. local currency earners.

Exhibit 3
Asset quality is weak, with no signs of stabilisation



Source: Moody's Financial Metrics

We expect the very high problem loan ratio to persist in the next 12-18 months and assign an Asset Quality score of caa3, which is at the same level as the Macro-Adjusted score.

Improved, although still-weak, profitability not sufficient to restore capital

In 2017, BoB reported net income of AZN8.4 million under IFRS, which translated into return on average assets of 1.8%. For comparison, net losses incurred over 2015-16 in aggregate amounted to AZN92 million (equivalent to 72% of the bank's shareholders' equity as of year-end 2014).

BoB's net interest margin (NIM) widened to 7.1% in 2017 from 4.8% in 2016, and we estimate it to remain relatively stable in 2018 year-to-date. However, the current NIM is still 2.5x lower than that recorded in the pre-crisis period, and we do not expect it to return to the historical highs. Negative pressure on the bank's NIM stems from multiple factors such as shrinking business volume and a high proportion of nonperforming assets on the bank's balance sheet, as well as the systemwide trend for narrowing interest rate spreads.

Cost-cutting measures implemented by BoB in 2015-17 resulted in the reduction of the bank's operating expense, as measured in nominal terms, however, this was insufficient to counterbalance the significant decrease in net revenue. The bank's cost-to-income ratio increased to above 90% in 2017, up from 68% in 2016 and ca. 35% on average in previous years, and we estimate the cost-efficiency to remain weak over 2019.

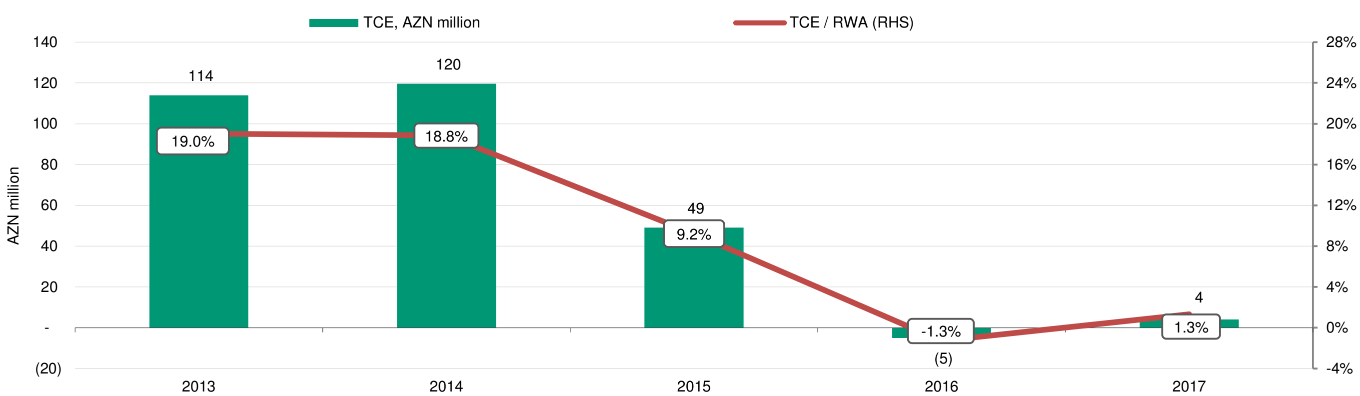
After heavy provisioning charges in 2015-16 (amounting to 15% of the bank's average gross loans, in annualised terms) and a reversal of loan loss provisions in 2017 (1.7% of average gross loans), we expect some normalisation and moderation of credit costs over 2018-19. However, the bottom-line result is still prone to volatility in the next 12-18 months because of the bank's (1) high share of problematic exposures and potential need for additional provision should the bank seek to rebuild its problem loan coverage to 100%; and (2) high open position and elevated exposure to foreign-currency risk. In the long term, the bank's ability to sustain profitable performance will mainly be a function of new business volume generation and tight control over the quality of new loan vintages, as well as strict cost control. The assigned Profitability score of caa1, which is two notches above the Macro-Adjusted historical one of caa3, incorporates our expectations of future trends in BoB's profitability.

Very weak capital, eroded by heavy losses

The caa3 Capital score reflects BoB's weak capitalization as demonstrated by its IFRS-based shareholders' equity-to-total assets ratio of 3.0% as of year-end 2017. As of the same date, the bank's tangible common equity-to-risk-weighted assets ratio (our key capital metric based on IFRS data) stood at 1.3%.

Although BoB returned to profitability in 2017 and might also report some profits for 2018, we do not expect the bank's capital buffer to enhance significantly over the next 12-18 months. BoB's internal capital generation capacity remains well below the bank's capital needs and, therefore, we expect only a slow improvement in its capital metrics.

Exhibit 4
Weak capital, depleted by heavy losses in 2015-16



TCE = tangible common equity
Source: Moody's Financial Metrics

As per the local GAAP, BoB continued to breach statutory requirements, in both absolute and relative terms. As of 1 November 2018, its regulatory total capital amounted to AZN31 million, well below the AZN50 million minimum threshold. As of the same date, the bank reported Tier 1 ratio of 4.7% compared with 5.0% minimum set by the regulator. According to the bank's management, the shareholders recently contributed AZN15 million in the form of cash collateral against problem loans, which should allow BoB to release loan-loss reserves for the same amount by the end of 2018 and thus post net income sufficient to build up statutory capital and meet regulatory requirements. We consider the above measure as helpful from the point of view of formally bringing BoB closer to complying with the regulatory requirements, however, we question the bank's actual ability to quickly foreclose on the built-up collateral and thus reinstate its capital adequacy, because it will need to enter certain legal steps and execute a sequence of formal procedures. Hence, the measure might be insufficient to fully eliminate future credit losses on the subject problem loans.

Adequate liquidity profile amid loan book amortization

As a part of the deleveraging process, BoB's customer deposits almost halved during 2016-17. The deposit outflow continued in 2018 and over the first nine months the bank lost another 35% of its customer funding. The share of core deposits decreased to 67% of total liabilities as of year-end 2017, compared to 80% in pre-crisis period, and is expected to further reduce to below 60% by year-end 2018. Wholesale funding somewhat lagged behind customer deposits, but demonstrated a similar trend. In absolute terms, its volume halved as of 30 September 2018 from year-end 2016, mainly at the expense of short-term interbank funding and the National Bank of Azerbaijan (NBA) swap facility.

The assigned Funding Structure score of caa1 is one notch below the Macro-Adjusted score. Apart from the ongoing customer funding outflow, this downward adjustment reflects the dominance of foreign-currency deposits (55% of the total as of 1 November 2018) and sizable currency mismatch on the bank's balance sheet, which leaves it exposed to FX risk.

BoB's liquidity buffer amounted to 22% of total assets as of 1 November 2018, according to local GAAP, down from 30% on average reported in 2015-17. Liquid assets are mostly held in the form of cash, Nostro accounts at NBA and foreign-currency accounts at commercial banks. We expect BoB's liquidity to come under pressure over the next 12-18 months, in particular if the outflow of deposits is not substituted by other funding sources, and if the amortization and repayment of the healthy portion of the bank's loan book lags significantly behind that outflow. These considerations stand behind our one-notch downward adjustment of BoB's Liquidity score to caa1.

Support and structural considerations

Counterparty Risk (CR) Assessment

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 than both the likelihood of default and the expected financial loss suffered in the event of default, 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 (for example, swaps), letters of credit, guarantees and liquidity facilities.

BoB's CR Assessment is positioned at Caa2(cr)/Not Prime

The CR Assessment is positioned one notch above the Adjusted BCA of caa3 and, therefore, above deposit ratings, reflecting our view that its probability of default is lower than that of senior unsecured debt and deposits. We believe senior obligations represented by the CR Assessment will be more likely preserved in order to limit contagion, minimize losses and avoid disruption of critical functions.

Counterparty Risk Ratings (CRRs)

CRRs are opinions of the ability of entities to honor the uncollateralized portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honored. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralized portion of payables arising from derivatives transactions and the uncollateralized portion of liabilities under sale and repurchase agreements. CRRs are not applicable to funding commitments or other obligations associated with covered bonds, letters of credit, guarantees, servicer and trustee obligations, and other similar obligations that arise from a bank performing its essential operating functions.

BoB's CRRs are positioned at Caa2/Not Prime

We consider Azerbaijan a jurisdiction with a non-operational resolution regime. For non-operational resolution regime countries, the starting point for the CRR is one notch above the bank's Adjusted BCA, to which we then typically add the same notches of government support uplift as applied to the CR Assessment, if any.

Source of facts and figures cited in this report

Unless noted otherwise, we have sourced data relating to systemwide 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 9 August 2018.

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**	**Initial Score**	**Expected Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency							
Asset Risk							
Problem Loans / Gross Loans		45.4%	caa3	←→	caa3		
Capital							
TCE / RWA		1.3%	caa3	←→	caa3		
Profitability							
Net Income / Tangible Assets		-4.7%	caa3	↑	caa1	Expected trend	
Combined Solvency Score			caa3		caa3		
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets		21.7%	b3	↓	caa1	Deposit quality	
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets		24.9%	b3	↓	caa1	Expected trend	
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 Rating	1	0	caa2	0	Caa2	Caa2
Counterparty Risk Assessment	1	0	caa2 (cr)	0	Caa2 (cr)	--
Deposits	0	0	caa3	0	Caa3	Caa3

[1] Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.
Source: Moody's Financial Metrics

Ratings

Exhibit 6

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Negative
Counterparty Risk Rating	Caa2/NP
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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