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INVESTORS SERVICE

CREDIT OPINION
16 April 2019

Update

Rate this Research

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	Stable

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

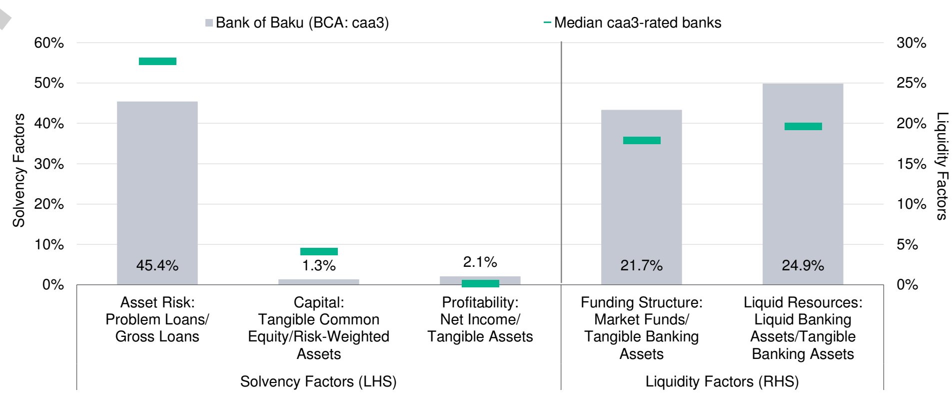
Summary

On 16 April 2019, we affirmed the Caa3 long-term local- and foreign-currency deposit ratings of OJSC Bank of Baku and changed the outlook on these ratings to stable from negative. Concurrently, we affirmed Bank of Baku's Baseline Credit Assessment (BCA) and adjusted BCA of caa3. The rating action reflects the expected improvements in the bank's solvency metrics following the upcoming implementation by the government of its recently announced measures for support of a certain group of qualifying individual borrowers.

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

The bank's BCA reflects its (1) very weak capital, as reflected in both the low IFRS-based ratio of tangible common equity (TCE) to risk-weighted assets (RWAs) and the statutory capital adequacy ratio remaining below the regulatory requirements in absolute and relative terms; (2) large stock of problem loans, exceeding 40% of gross loans; and (3) the still-weak - albeit gradually recovering - profitability. The BCA is supported by our expectation of notable improvements in the bank's solvency metrics (asset quality, profitability and capital) thanks to the measures designed by the authorities to support individual borrowers. BoB's ratings also reflect the bank's vulnerable funding and liquidity profiles, although those might also benefit somewhat from the measures announced by the authorities.

Exhibit 1
Bank of Baku - Key financial ratios



Bank of Baku's ratios are as of year-end 2017, as per the latest available disclosed financial statements prepared under IFRS.
Source: Moody's Financial Metrics

Credit strengths

» Asset quality and profitability will benefit from the government measures supporting individual borrowers

Credit challenges

» Very weak capital at the moment, by both international and local standards

» The still weak asset quality, not expected to be fully restored through the implementation of the government measures

» Vulnerable liquidity profile amid funding outflow

Outlook

BoB's long-term deposit ratings carry a stable outlook, which is driven by our assessment that the potential improvements of BoB's solvency metrics may be counterbalanced by the gradual tightening of the bank's liquidity position.

Factors that could lead to an upgrade

» BoB's ratings could be upgraded if the upcoming measures prove sufficient to materially reduce the bank's stock of problematic assets, improve its profits generation and replenish the bank's capital to meet the regulatory requirements.

Factors that could lead to a downgrade

» BoB's ratings outlook might be revised to negative from stable in case the positive effect on the bank's solvency metrics from the government's upcoming measures supporting individual borrowers proves to be smaller than that currently expected by us.

» BoB's ratings could be lowered if the bank (1) requires extraordinary capital or 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 28 February 2019, it held a market share of less than 1.0% based on standalone assets of AZN264 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 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 dispersed shareholder structure, with no single party owning a controlling stake. 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

Asset quality and profitability will benefit from the government measures supporting individual borrowers

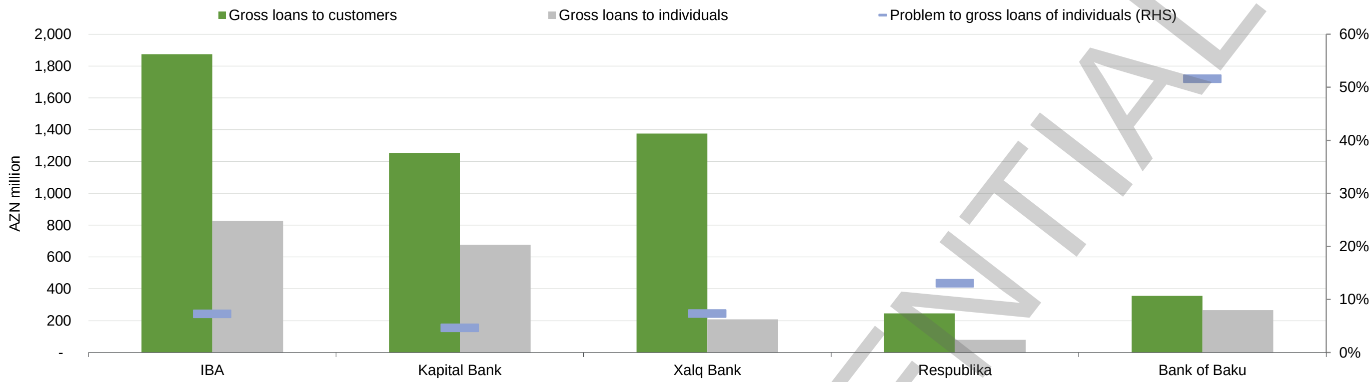
On 28 February, Azerbaijan President Ilham Aliyev signed a decree authorising a number of financial measures to resolve problem loans held by individuals and to ease the debt burden of the general population.

The first set of measures focuses on individual borrowers who took out foreign-currency denominated loans of less than $10,000 before the Azerbaijani manat fell sharply against the US dollar in February 2015 and December 2015. The Ministry of Finance will pay off a portion of such individuals' debts in the amount of either 0.15 cents per dollar or 0.35 cents per dollar, depending on the origination date of the loan. Total compensation is limited to $5,000 per borrower and will be primarily channelled to banks to pay down the individuals' accumulated debts, with the remainder distributed to individuals directly.

The second set of measures applies to personal loans, denominated in either the local or foreign currencies, of up to $10,000 or AZN17,000 that are overdue by more than 360 days and were taken after 1 January 2012. Banks have been advised to restructure such nonperforming loans on preferential terms at the unprecedentedly low interest rate of 1% for five years and with a grace period of one year. Concurrently, accumulated interest payments and fines will be written off. To finance this initiative, the Central Bank of Azerbaijan (CBA) will allocate AZN682 million of five-year loans to banks at an interest rate of 0.1% per year.

BoB is among those local banks benefitting the most from the announced measures, because it has accumulated a large stock of distressed retail loans (see Exhibit). According to BoB's management data, the first set of measures alone should result in a repayment of individuals' overdue loans totaling approximately AZN40 million, which exceeds 10% of the bank's total assets and equals approximately one quarter of its total accumulated problem loans. The government measure, if implemented as expected, will result in a release by BoB of a substantial part of provisions, thus supporting profitability and - ultimately - its capital.

Exhibit 3
Rated Azeri banks' exposure to impaired loans to households
As of the end of 2017

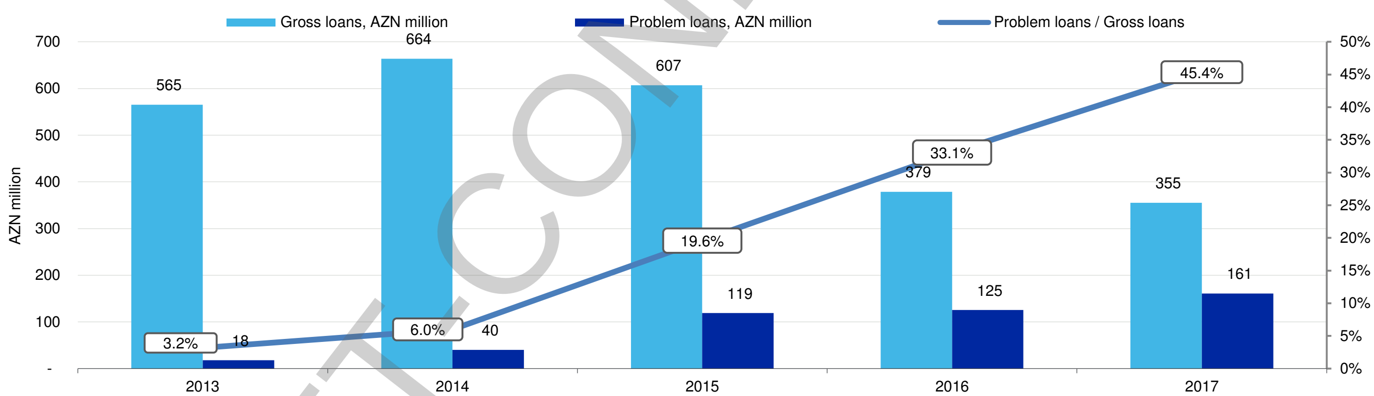


Source: Banks' IFRS reports, Moody's estimates

The still weak asset quality, not expected to be fully restored through the implementation of the government measures

BoB's historically weak asset quality derives from the bank's weak underwriting standards applied before 2015, and in particular the large share of foreign-currency loans issued to unhedged individual borrowers, which were severely hit by the sharp devaluation of the Azeri manat in 2015.

Exhibit 4
Asset quality is weak



Source: Moody's Financial Metrics

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. Even if approximately quarter of problem loans is repaid as part of the government support programme, we do not expect BoB's problem loan ratio to fall significantly below 35% of total gross loans in the aftermath of its full implementation.

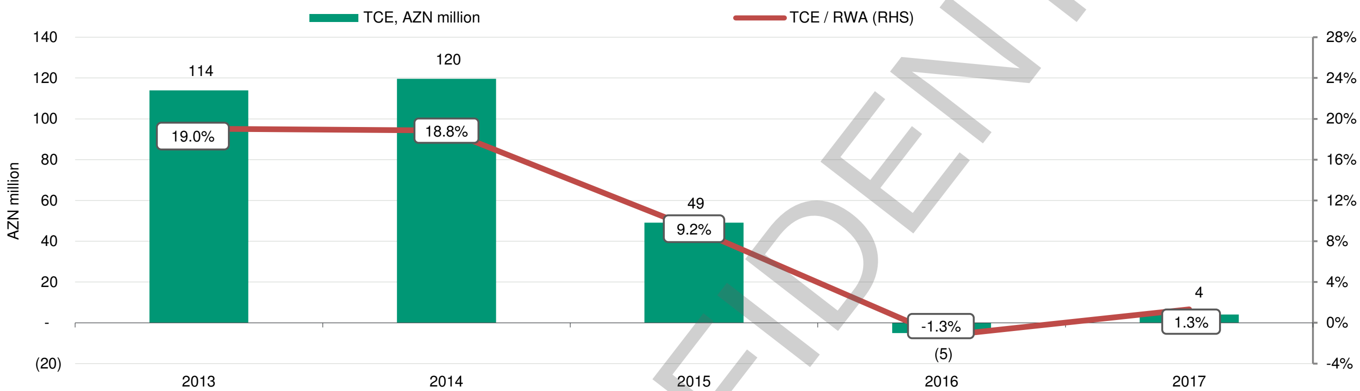
This is (1) because the bank's loan book is still in a shrinkage mode, and also (2) because of the large remaining share of foreign currency loans (23% as of 28 February 2019, according to local GAAP data), which remains the major challenge to BoB's asset quality given the bank's focus on retail borrowers, predominantly local currency earners. Although many of the remaining retail loans will undergo restructuring under the framework of the second set of measures designed by the state authorities, the borrowers' ability to serve these loans even under the eased terms remains questionable. There is also an uncertainty as to the upcoming level of coverage of remaining problem loans by loan loss reserves, because the provisioning policy will rely more than ever on the bank management assumptions and estimates, given the absence of proven pattern of individuals' loan servicing behaviour under the new restructuring terms.

We expect the high problem loan ratio to persist in the next 12-18 months and maintain an Asset Risk score of caa3, which is at the same level as the macro-adjusted score.

Very weak capital at the moment, by both international and local standards

BoB's reported capital levels are weak, 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 (TCE ratio, our key capital metric based on IFRS data) stood at 1.3%.

Exhibit 5
Weak reported capital, depleted by heavy losses in 2015-16



Source: Moody's Financial Metrics

BoB continues to breach statutory capital adequacy requirements, in both absolute and relative terms. As of 28 February 2019, its regulatory total capital amounted to AZN31 million, well below the AZN50 million minimum threshold. On the same date, the bank reported Tier 1 and total capital adequacy ratios of 2.7% and 5.7%, respectively, compared with 5.0% and 10.0% minimum regulatory requirements.

We expect that the government programme for support of individual borrowers will produce, upon its implementation over 2019, a significant one-off boost to BoB's profitability metrics and hence - to its capital. We expect that this one-off positive effect will lead to the bank's statutory capital climbing to the levels commensurate with the local regulatory requirements, whilst its TCE ratio may come close to 8%-10%. The above scenario expectation drives our upward adjustment of the bank's Capital score to caa2 from caa3.

However, absent the government programme for support of individual borrowers, BoB's internal capital generation remains weak and insufficient to replenish and preserve sustainable capital buffer. In 2018, BoB reported net loss of AZN8.5 million under local GAAP, which translated into negative return on equity (ROE) of 3%. For comparison, 2017 was marked by small net IFRS profits of AZN8.4 million. BoB's net interest margin (NIM) is relatively good at 6%-7%, but it still remains 2.5x lower than that recorded in the pre-crisis period, now suppressed by shrinking business volumes and a high proportion of nonperforming assets on the bank's balance sheet. The weakened earnings generation also weighs on BoB's cost efficiency, with the bank's cost-to-income ratio having surged to above 90% in 2017, as reported under IFRS.

In the long term, the improved capital position will give rise to more active new lending at BoB, which will, in turn, spur profits generation, however, this will likely be a very slow positive development. To reflect the expected improving trend, we adjust the bank's Profitability score to b3 from the caa3 score generated based on the very weak historic results.

Vulnerable liquidity profile amid funding outflows

As a part of the deleveraging process and the regulator's ban on the bank's attracting new individual deposits, BoB's customer funding nearly halved during 2016-18. The share of core deposits decreased to 69% of total liabilities as of 28 February 2019 (according to local GAAP), compared to 80% in pre-crisis period. Wholesale funding has also demonstrated a similar declining trend. The assigned Funding Structure score of caa1 is one notch below the macro-adjusted score of b3. Apart from the ongoing customer funding outflow, this downward adjustment reflects the high proportion of foreign-currency deposits (47% of the total, as of 28 February 2019).

In a longer term, BoB's funding structure may benefit from the government's programme of support for individual borrowers, whereby, as part of the second set of the support measures, the restructuring of qualifying retail loans would be backed by the 5-year-long CBA funding. However, this measure is unlikely to improve notably the overall asset-and-liabilities term structure of Azeri banks (including that of BoB), because the tenors of underlying loans would also be rolled-over through the restructuring.

As of 28 February 2019, according to local GAAP, BoB's liquidity buffer equaled approximately 15% of the bank's total assets, down from the 30% reported on average in 2015-17. We expect BoB's liquidity to remain under pressure over the next 12-18 months. BoB's Liquidity scores 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 at Caa2(cr)/Not Prime

The CR Assessment is 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 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 6

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	↑↑	caa2	Expected trend	
Profitability						
Net Income / Tangible Assets	-4.7%	caa3	↑↑	b3	Expected trend	
Combined Solvency Score		caa3		caa2		
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	Stock 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 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 7

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Stable
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

REPORT NUMBER 1169209

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