

CREDIT OPINION

13 December 2019

Update

✓ Rate this Research

RATINGS

OJSC Bank of Baku

Domicile	Baku, Azerbaijan
Long Term CRR	B3
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
Long Term Deposit	Caa1
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 following ratings upgrade

Summary

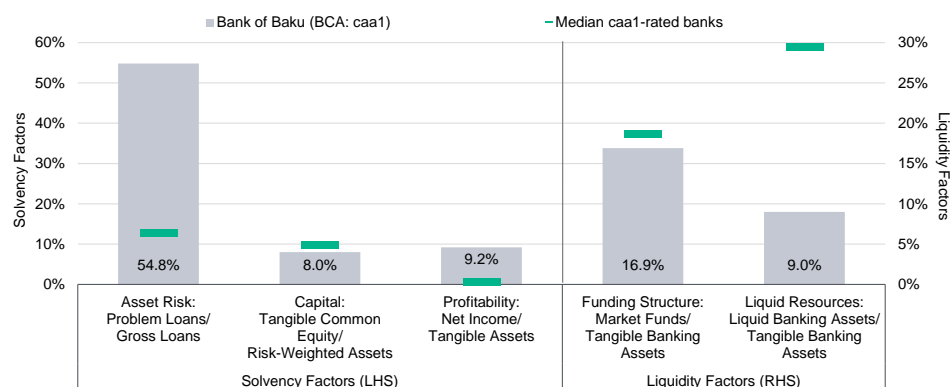
On 27 November 2019, we [upgraded OJSC Bank of Baku's](#) (BoB) long-term local- and foreign-currency deposit ratings to Caa1, and its Baseline Credit Assessment (BCA) and Adjusted BCA to caa1. The outlook on BoB's long-term deposit ratings remained stable.

The rating action reflected the recovery in the bank's capital and improvement in its liquidity, following the implementation by the [Government of Azerbaijan](#) (Ba2 stable) of a set of measures aimed at resolving the problem loans of individual borrowers. Concurrently, BoB's BCA continues to be constrained by the bank's large but reducing stock of problem loans and its still-weak recurring profitability.

BoB's long-term local- and foreign-currency deposit ratings of Caa1 are based solely on the bank's caa1 BCA and do not factor in any probability of external support.

Exhibit 1

Rating Scorecard - Key financial ratios as of end-2018



Source: Moody's estimates based on BoB's unaudited 2018 IFRS financial statements

Credit strengths

- » Strengthened capitalization, boosted by release of loan-loss reserves
- » Improved liquidity and customer deposit-based funding

Credit challenges

- » Very weak asset quality, which is unlikely to be fully restored through the implementation of government measures
- » Weak pre-provision profitability, strained by a large share of nonperforming loans and high operating expenses
- » High dollarization of customer deposits and large, although decreasing, short foreign-currency position

Outlook

The stable outlook on BoB's long-term deposit ratings reflects our view that the expected improvement in the bank's financial fundamentals over the outlook period is already captured in its current ratings.

Factors that could lead to an upgrade

An upgrade of BoB's BCA and long-term deposit ratings could occur if the bank (1) demonstrates an organic improvement in asset quality as a result of a continuing workout of its legacy problem loans and prudent new credit underwriting, and (2) enhances its earnings generation.

Factors that could lead to a downgrade

BoB's BCA and long-term ratings could be downgraded in case of a deterioration in the bank's asset quality and profitability metrics and erosion of its capital. A weakening in the bank's liquidity and funding might also result in a rating downgrade.

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)	399.7	511.7	700.6	728.0	642.9	(11.2) ⁴
Total Assets (USD Million)	235.1	284.0	448.5	929.6	820.7	(26.8) ⁴
Tangible Common Equity (AZN Million)	4.7	(2.3)	49.0	119.6	113.9	(54.9) ⁴
Tangible Common Equity (USD Million)	2.8	(1.3)	31.4	152.7	145.4	(62.9) ⁴
Problem Loans / Gross Loans (%)	45.9	46.4	19.6	6.0	3.2	24.2 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	1.6	-0.6	9.2	18.8	19.0	9.6 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	113.0	122.8	61.1	23.5	13.6	66.8 ⁵
Net Interest Margin (%)	4.7	6.1	16.1	18.4	17.1	12.5 ⁵
PPI / Average RWA (%)	-1.3	5.1	11.6	14.6	12.9	8.6 ⁶
Net Income / Tangible Assets (%)	1.7	-10.2	-5.3	5.6	7.2	-0.2 ⁵
Cost / Income Ratio (%)	118.6	56.9	35.5	33.8	36.8	56.3 ⁵
Market Funds / Tangible Banking Assets (%)	19.6	24.1	17.1	13.7	8.0	16.5 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	25.0	25.0	19.6	11.9	11.0	18.5 ⁵
Gross Loans / Due to Customers (%)	134.0	112.8	119.8	139.2	124.8	126.1 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 Investors Service; Company Filings

Profile

OJSC Bank of Baku (BoB) is a small bank among 30 commercial banks operating in Azerbaijan. As of 30 September 2019, it held a countrywide market share of 1.0%, based on standalone assets of AZN289 million (\$170 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 2018, loans to individuals accounted for around 90% of the bank's gross loan book and were, in turn, dominated by unsecured consumer loans (65%), followed by microloans (18%) and credit card loans (15%).

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

BoB was severely affected by the 2015-16 financial crisis in Azerbaijan, which resulted in heavy losses, capital erosion and balance-sheet deleveraging. Concurrently, the bank became the primary beneficiary of the government measures aimed at resolving the problem loans of individual borrowers, which helped restore its capital and the full scope of its customer operations.

The bank has a dispersed shareholder structure, with no single party owning a controlling stake. The largest shareholder is NAB Holding (with a 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

BoB was among the primary beneficiaries of the government measures aimed at supporting individual borrowers

On 28 February 2019, Azerbaijan President Ilham Aliyev [signed a decree](#) (the Decree) authorizing a number of financial measures to resolve problem loans accumulated by individuals and to ease the debt burden of the general population.

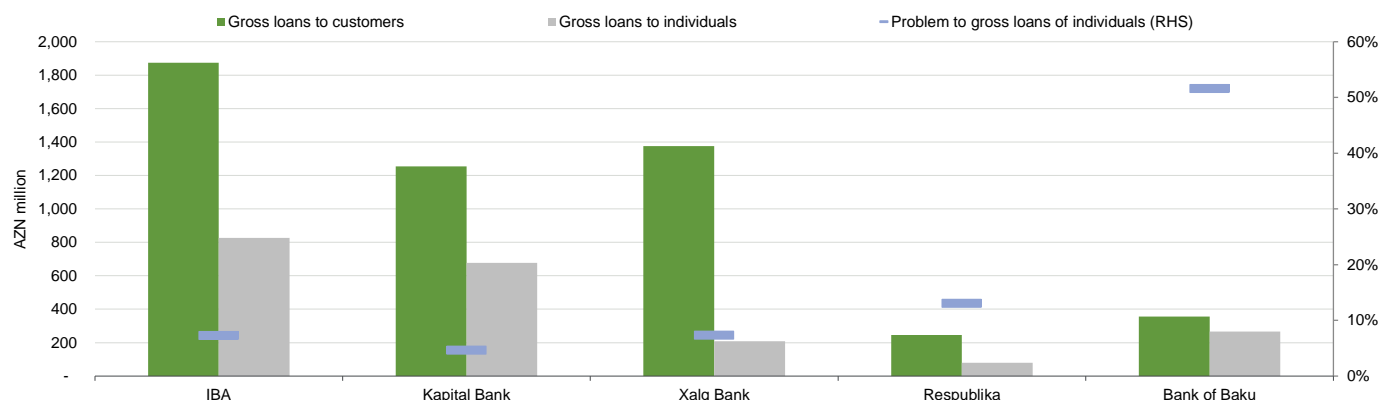
The first set of measures was focused on individuals that borrowed in foreign currency and suffered from the devaluation of the national currency (manat) in 2015. The government made payments in cash to compensate for the increase in loan balances that resulted from the devaluation. The total compensation was limited to \$5,000 per borrower and paid to either banks on loans outstanding or to individuals directly on loans that have already been redeemed.

The second set of measures applied to personal loans, denominated in either local or foreign currency, with an exposure of up to \$10,000 or AZN17,000, overdue more than 360 days. Banks were advised to restructure these loans on concessional terms and write off accrued interest payments and fines. To finance this initiative, the Central Bank of Azerbaijan (CBAR) should provide banks with a five-year funding at an interest rate of 0.1% per year.

BoB, which had focused on consumer lending and accumulated a large stock of distressed retail loans, became one of the main beneficiaries of the announced measures (see Exhibit 3). Payments made under the first set of measures have already allowed BoB to release loan-loss reserves related to the resolved loans, restore its capital and improve its asset quality. The second set of measures is still underway. It will be completed by year-end 2019, resulting in the bank's stronger liquidity profile and a further improvement in its asset-quality metrics.

Exhibit 3

Rated Azeri banks' exposure to impaired loans to households As of the beginning of 2018



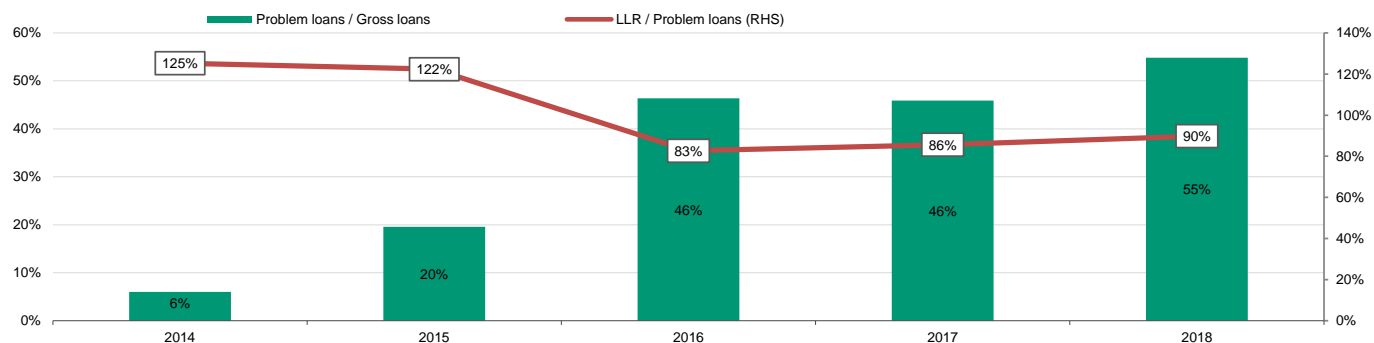
Source: Banks' IFRS reports

Weak asset quality, which is unlikely to be fully restored through the implementation of the Decree

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

As of 31 December 2018 (the latest available unaudited IFRS data), problem loans (defined as Stage 3 loans) amounted to AZN219 million and accounted for 55% of the bank's gross loan portfolio. As of the same date, these loans were 90% covered by loan-loss reserves (LLR).

Exhibit 4

Asset quality is weak

Source: BoB's IFRS reports

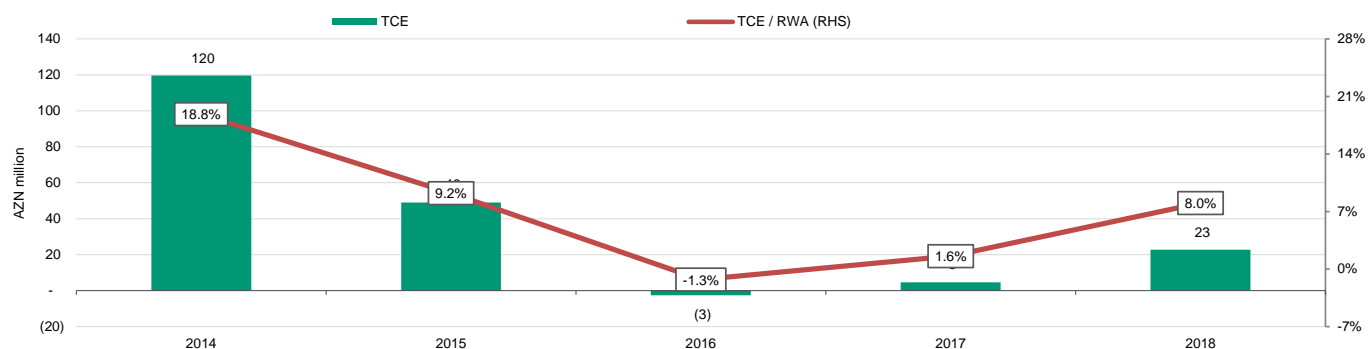
Under the first set of government measures, BoB received AZN53 million of compensation payments on foreign currency-denominated loans to individuals. If we (1) exclude AZN17 million of loans that had been already written off earlier and which, therefore, had no effect on balance-sheet aggregates; and (2) assume that the remaining AZN36 million of foreign-exchange loans, for which the bank received a compensation from the government, were all problematic, the bank's problem loans/gross loans ratio is estimated to decrease to about 40% as of year-end 2019, a still-high level posing downside risks to the bank's solvency metrics. Under the second set of measures, as of mid-November 2019, the bank reported that it had restructured AZN69 million of loans overdue more than 360 days out of the AZN116 million eligible for restructuring. These loans could be reclassified into performing after six consecutive months of timely interest payments. Hence, the effect of the restructuring will be visible only in 2020.

Given that the bank's high problem loan ratio is expected to persist in the next 12-18 months, we maintain an Asset Risk score of caa3, which is at the same level as the Macro-Adjusted score.

Strengthened capitalization, boosted by release of loan-loss reserves

As of year-end 2018 (the latest available IFRS data), BoB's tangible common equity (TCE) increased to 8.0% of risk-weighted assets (RWA). The improvement from 1.6% reported as of year-end 2017 was largely attributed to retained earnings and, to a lesser extent, to a decrease in RWAs. We expect TCE/RWA ratio to grow further and exceed 20% as of year-end 2019, as a result of the implementation of the Decree.

Exhibit 5

TCE recovered in 2018, helped by release of loan loss reserves

Source: BoB's IFRS reports

The effect of the latter has already translated into improved statutory capital metrics. These are reported more frequently and demonstrated strong recovery in the second quarter of 2019, helped by AZN53 million of compensation payments directed to the bank

from the first set of government initiatives. As of 30 September 2019, BoB reported total statutory capital of AZN56 million and a total statutory capital adequacy ratio of 24.2%, in compliance with the regulatory requirements set at AZN50 million and 10%, respectively.

Following the repayment of a portion of foreign-currency loans, their share in total gross loans reduced to 12% as of 30 September 2019 from 24% as of year-end 2018. That said, on the liabilities side, dollarization remained high, resulting in a short foreign-currency position of \$22 million, equivalent to 51% of the bank's total shareholders' equity.

The assigned Capital score of b1 reflects both recent developments and our expectation that the bank will retain its healthy capital buffer in the next 12-18 months. Concurrently, we reduce our positive adjustments to reflect (i) the fact that the bank's strong capital metrics are the result of government measures but not the bank's own capital generation, and (ii) BoB's susceptibility to foreign-exchange risk.

Weak pre-provision profitability, strained by a large share of nonperforming loans and high operating expenses

In 2018, BoB reported a net income of AZN26.5 million under IFRS (2017: AZN6.7 million), translating into a return on average assets of 7.7%. Such an impressive bottom line was achieved largely because of (1) the release of AZN15.0 million of loan-loss reserves (attributed not to the implementation of the Decree, but repayment of a portion of legacy problematic loans), and (2) income tax benefit of AZN10.4 million, net of which the bank would have been break-even.

BoB's large stock of nonperforming loans constrains its net interest margin, which reduced to around 5% in 2016-18 from above 15% in pre-crisis years. The bank's weak pre-provision profitability is also a result of its high operating expense. Compared with that as of year-end 2015, BoB's balance sheet shrank 59% in 2018. Over the same period, its operating expense decreased only by 29%. As a result, the bank's operating expense/total assets increased to 7.7% in 2018 from the already-high 5% in 2015-16.

According to local GAAP, BoB reported a net income of AZN32.3 million for the first nine months of 2019. Quarterly reports are fairly condensed and provide neither detailed breakdowns nor supplementary notes. Yet, we understand that the bank's high profit in 2019 was largely a result of a one-off gain associated with the implementation of the Decree.

In the next 12-18 months, we expect BoB's pre-provision profitability to remain modest, strained by a large share of nonperforming loans and high operating expenses. In the longer term, however, an accelerated loan book growth, if combined with prudent credit underwriting, will spur profit generation. To reflect the expected improving trend, we adjust the bank's Profitability score to caa1 from the caa3 score assigned based on its very weak historical results.

Improved liquidity and customer deposit-based funding

As a result of the deleveraging process and the regulator's ban on the bank attracting new individual deposits, BoB's customer funding halved during 2017-18. The outflow continued in H1 2019, but reversed once the bank restored its capital base and the regulator lifted the restriction on attracting customer deposits. In Q3 2019, customer deposits demonstrated strong growth, having increased by AZN30 million compared to the level reported as of year-end 2018.

As of 30 September 2019, customer deposits accounted for 72% of the bank's total liabilities. The increase of this proportion from 64% reported as of year-end 2018 was attributed to the reduced share of other liabilities since about AZN40 million of the CBAR funding and accounts payable to the government were replaced by the compensation payment channeled to retained earnings and capital.

By year-end 2019, BoB will receive low interest rate funding from the CBAR as part of the second set of measures advising banks to restructure loans to individuals overdue more than 360 days on concessional terms. Although this will likely result in a higher share of wholesale funding in the bank's liabilities, we consider this funding source as a stable one and thus we do not make any negative adjustment and assign a b3 score for Funding, in line with the current Macro-Adjusted score.

According to local GAAP, BoB's liquidity buffer equaled 25% of the bank's total assets as of 30 September 2019. Liquid assets comprised cash and cash equivalents (43% of the total), securities (35%) and bank deposits (22%). We expect BoB's liquidity to remain good over the next 12-18 months and maintain a Liquidity score of b3.

Environmental, social and governance considerations

In line with our general view on the banking sector, BoB has a low exposure to environmental risks and moderate exposure to social risks (see our [Environmental risk heat map](#) and [Social risk heat map](#) for further information).

Governance is highly relevant for BoB, as it is to all participants in the banking industry. Corporate governance weaknesses can lead to a deterioration in a bank's credit quality, while governance strengths can benefit its credit profile. For banks in CIS, we have identified key-person and related-party risks as key governance risks. These risks are manifested in, but are not limited to, heavy related-party loan concentrations and banks' heavy dependence on single individuals for business, which often give rise to weak corporate governance and lax underwriting standards. Fraud and weak risk management have recently caused multiple bank closures and restructurings in CIS.

Governance risks are largely internal rather than externally driven, and for BoB, we do not have any particular governance concern, and neither do we apply any corporate behavior adjustment to the bank. BoB has not shown any material governance shortfall in recent years, and its risk management framework is commensurate with its risk appetite. Nonetheless, corporate governance remains a key credit consideration and requires ongoing monitoring.

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 B3(cr)/Not Prime

The CR Assessment, before government support, is one notch above BoB's Adjusted BCA of caa1, to which we then typically add the same notches for government support uplift, as applied to deposit and senior unsecured debt ratings. Such assignments reflect our view that senior obligations represented by the CR Assessment will more likely be preserved to limit contagion, minimize losses and avoid the 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 B3/Not Prime

We consider Azerbaijan a jurisdiction with a nonoperational resolution regime. For nonoperational 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.

Methodology and scorecard

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	45.9%	caa3	↔	caa3	Expected trend		
Capital							
Tangible Common Equity / Risk Weighted Assets (Basel I)	1.6%	caa3	↑↑	b1	Expected trend	Stress capital resilience	
Profitability							
Net Income / Tangible Assets	-4.6%	caa3	↑↑	caa3	Expected trend		
Combined Solvency Score		caa3		caa1			
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets	19.6%	b3	↔	b3	Deposit quality		
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets	25.0%	b3	↓	b3	Stock of liquid assets		
Combined Liquidity Score		b3		b3			
Financial Profile				caa1			
Qualitative Adjustments				Adjustment			
Business Diversification				0			
Opacity and Complexity				0			
Corporate Behavior				0			
Total Qualitative Adjustments				0			
Sovereign or Affiliate constraint				Ba2			
BCA Scorecard-indicated Outcome - Range				b3 - caa2			
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 Rating	1	0	b3	0	B3	B3
Counterparty Risk Assessment	1	0	b3 (cr)	0	B3(cr)	
Deposits	0	0	caa1	0	Caa1	Caa1

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Stable
Counterparty Risk Rating	B3/NP
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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