MOODY'S
INVESTORS SERVICE

CREDIT OPINION

7 December 2020

Update

Rate this Research

OJSC Bank of Baku

Update following rating upgrade to B3

Summary

On 8 December 2020, we upgraded OJSC Bank of Baku's (BoB) long-term local- and foreign-currency deposit ratings to B3 from Caa1, and its Baseline Credit Assessment (BCA) and Adjusted BCA to b3 from caa1. The outlook on BoB's long-term deposit ratings remains stable.

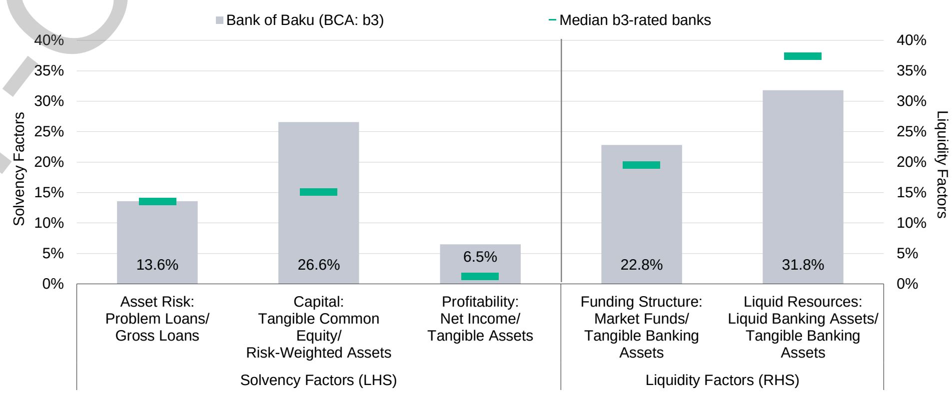
The rating action reflects the substantial improvement in the bank's asset quality, following the implementation of a set of measures by the Government of Azerbaijan (Ba2 stable) aimed at resolving the problem loans of individual borrowers. BoB's BCA is also supported by the bank's strong capital position. At the same time, the bank's standalone assessment continues to be constrained by its still-large stock of problem loans and focus on consumer and micro lending, segments sensitive to the pandemic-induced economic downturn, and modest recurring profitability, which is eaten away by high operating and credit costs.

BoB's long-term local- and foreign-currency deposit ratings of B3 are based solely on the bank's b3 BCA and do not factor in any probability of external support.

Exhibit 1

Rating Scorecard - Key financial ratios

As of 31 December 2019



Source: Moody's Financial Metrics

RATINGS

OJSC Bank of Baku

Domicile	Baku, Azerbaijan
Long Term CRR	B2
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
Long Term Deposit	B3
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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» Contacts continued on last page

Credit strengths

» Robust capitalization

» Stable funding structure and good liquidity

Credit challenges

» Intrinsically high asset risks stemming from the bank's focus on risky consumer lending

» Modest recurring profitability, which is eaten away by high operating and credit costs

» Difficult operating environment, as captured by Azerbaijan's Very Weak + Macro Profile

Outlook

The stable outlook on BoB's long-term deposit ratings balances the bank's robust capital buffers and good funding and liquidity, against asset-quality pressures and modest profitability.

Factors that could lead to an upgrade

» An upgrade of Bank of Baku's BCA and long-term deposit ratings could occur if the bank demonstrates further material and sustainable improvement in recovery of its solvency metrics as a result of a continuing workout of legacy problem loans and prudent new credit underwriting.

» However, the upward pressure might only develop on the backdrop of improved operating conditions in Azerbaijan.

Factors that could lead to a downgrade

» Bank of Baku'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 beyond Moody's current expectations.

» A weakening of the bank's liquidity and funding profiles might also result in the ratings downgrade.

Key indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

	12-19[2]	12-18[2]	12-17[2]	12-16[2]	12-15[2]	CAGR/Avg.[3]
Total Assets (AZN Million)	373.9	289.4	399.7	511.7	700.6	(14.5)[4]
Total Assets (USD Million)	220.4	170.6	235.1	284.0	448.5	(16.3)[4]
Tangible Common Equity (AZN Million)	68.5	22.7	4.7	(2.3)	49.0	8.7[4]
Tangible Common Equity (USD Million)	40.4	13.4	2.8	(1.3)	31.4	6.5[4]
Problem Loans / Gross Loans (%)	13.6	54.8	45.9	46.4	19.6	36.1[5]
Tangible Common Equity / Risk Weighted Assets (%)	26.6	8.0	1.6	-0.6	9.2	9.0[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	31.9	99.8	113.0	122.8	61.1	85.7[5]
Net Interest Margin (%)	7.6	5.6	4.7	6.1	16.1	8.0[5]
PPI / Average RWA (%)	2.3	0.5	-1.3	5.1	11.6	3.6[6]
Net Income / Tangible Assets (%)	6.5	9.2	1.7	-10.2	-5.3	0.4[5]
Cost / Income Ratio (%)	81.5	95.1	118.6	56.9	35.5	77.5[5]
Market Funds / Tangible Banking Assets (%)	22.8	16.9	19.6	24.1	17.1	20.1[5]
Liquid Banking Assets / Tangible Banking Assets (%)	31.8	8.9	25.0	25.0	19.6	22.1[5]

Gross Loans / Due to Customers (%)	143.9	237.2	134.0	112.8	119.8	149.5[5]

[1] All figures and ratios are adjusted using Moody's standard adjustments. [2] Basel I; IFRS. [3] May include rounding differences because of the scale of reported amounts. [4] Compound annual growth rate (%) based on the periods for the latest accounting regime. [5] Simple average of periods for the latest accounting regime. [6] Simple average of Basel I periods.
Sources: Moody's Investors Service and company filings

Profile

OJSC Bank of Baku (BoB) is a small bank among 30 commercial banks operating in Azerbaijan. As of 30 September 2020, it held a countrywide market share of 1.0%, based on standalone assets of AZN394 million ($232 million), as reported under the 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 31 October 2020, 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%).

BoB was severely affected by the 2015-16 financial crisis in Azerbaijan, which resulted in heavy losses, capital erosion and balance-sheet deleveraging. In 2019, 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.

Recent developments

The rapid and widening spread of the coronavirus pandemic, the deteriorating global operating environment, lower oil prices and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. In Azerbaijan, as elsewhere in the world, we expect the pandemic and social distancing measures to first and foremost hit small and medium-sized enterprises (SMEs) operating in the above-mentioned segments. This shock was exacerbated by the oil price collapse in March 2020, given the importance of the oil and gas sector to the country's economy. The escalation of the long-standing conflict with Armenia (Ba3 stable) in September-October 2020 exerted additional pressure on the domestic economy and the banking sector. We estimate that Azerbaijan's GDP will decline by 3.0% in 2020, followed by a recovery in 2021. On 13 April 2020, we changed our outlook on the banking system of Azerbaijan to negative from positive.

Detailed credit considerations

BoB BCA is constrained by Azerbaijan's weak operating environment

As bank operating in its home market, BoB is heavily influenced by the country's operating environment.

Azerbaijan's "Very Weak +" Macro Profile reflects its (1) high growth volatility and limited economic diversification with high reliance on oil and gas sectors; (2) low institutions and governance strength, reflecting weaknesses in respect of control of corruption and rule of law, as well as limited though gradually strengthening policy credibility and effectiveness; (3) moderate susceptibility to event risk; and (4) very high level of deposit dollarisation in the banking sector.

The coronavirus pandemic is causing an unprecedented shock to the global economy. In Azerbaijan, as elsewhere in the world, we expect the pandemic and social distancing measures to first and foremost hit small and medium-sized enterprises (SMEs) operating in the segments of global passenger airlines and shipping, lodging and leisure (including cruise lines and restaurants), automotives. In Azerbaijan this shock was exacerbated by the oil price collapse in March 2020, given the importance of the oil and gas sector to the country's economy. The escalation of the long-standing conflict with Armenia (Ba3 stable) in September-October 2020 exerted additional pressure on the domestic economy and the banking sector.

We estimate that the country's GDP will decline by 3.0% in 2020, followed by a recovery in 2021. However, the potential for downside outcomes is increasing with the second wave of coronavirus infections.

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

On 28 February 2019, Azerbaijan's 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) provided banks with a five-year funding at an interest rate of 0.1% per year.

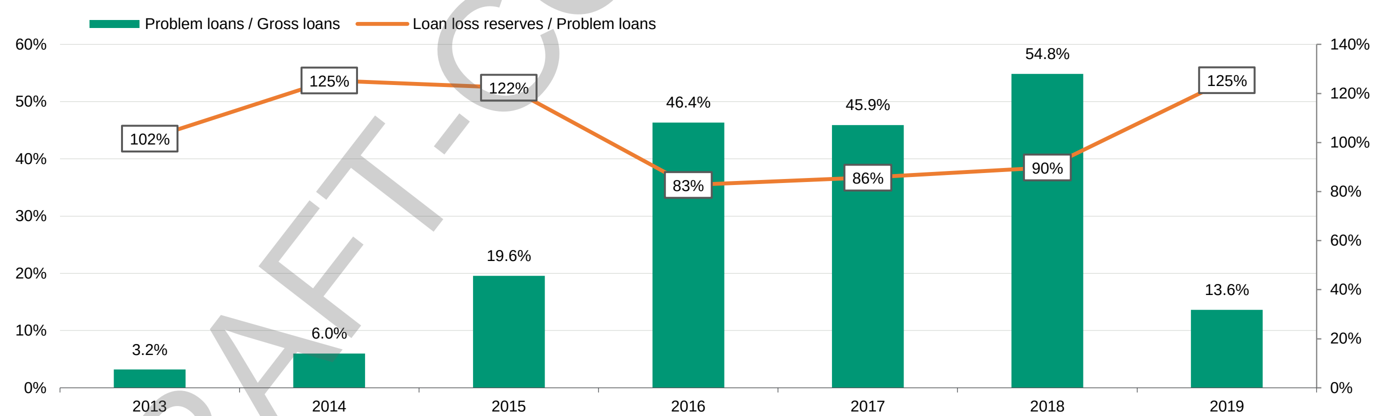
BoB, which had historically focused on consumer lending and accumulated a large stock of distressed retail loans, became one of the main beneficiaries of the announced measures. In accordance with the Decree, the bank received from the Ministry of Finance funds in the amount of AZN103 million in 2019. Of this, AZN53 million was directed to a compensation for losses on retail loans that were fully impaired, which allowed BoB to release loan-loss reserves related to the resolved loans, restore its capital and improve its asset quality. The other AZN50 million was disbursed to customers as compensation from the government and had no effect on the income statement. Additionally, the bank restructured overdue loans in the amount of AZN85 million for five years at 1% and with a one-year grace period for the payment of principal. Before restructuring, these loans were either written off or presented in Stage 3. Accrued interest on these loans, as well as accumulated fines and penalties, were written off. In return, BoB received a loan from the CBAR under favorable conditions in the same amount of AZN85 million with an annual interest rate of 0.1% for five years under the state guarantee. As a result, the bank cleaned its loan book of problematic legacy exposures and reported a net fair value gain on the initial recognition of the CBAR loan, which again boosted its capital.

Intrinsically high asset risks stemming from the bank's focus on risky consumer lending

As a result of the implementation of the Decree, BoB's problem loans (defined as Stage 3 loans) declined to 13.6% of gross loans as of year-end 2019, from 54.8% as of year-end 2018. Concurrently, the coverage of problem loans by loan-loss reserves increased to 125% from 90%.

Exhibit 3

Asset-quality metrics have improved



Source: BoB's IFRS reports

All in all, in 2019, the bank wrote off AZN194 million of loans (including interest accrued, fines and penalties), which was equivalent to 48% of gross loans as of year-end 2018. Restructured loans in the amount of AZN85 million were derecognized and recorded as new loans. These loans are 100% provisioned and will continue to remain so until their full repayment. In the loan book, they are measured at a fair value close to zero. The current loan portfolio (AZN270 million) is free of legacy problematic exposures and is made of fresh loans issued in 2019-20.

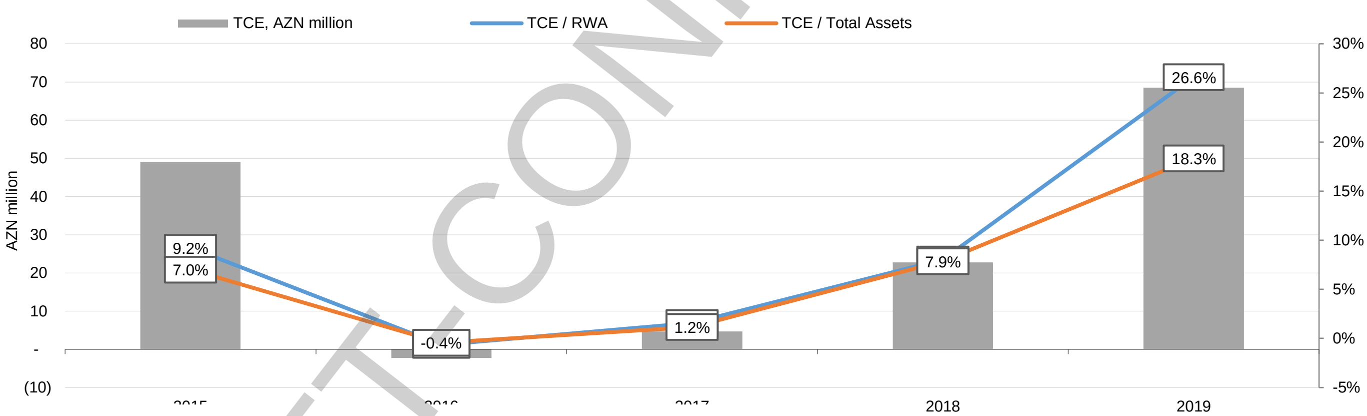
The bank retains its focus on consumer lending, an inherently risky segment with high credit costs. As an unsecured consumer lender, BoB targets primarily low-to-middle income households, inter alia, in the informal economy, which are particularly vulnerable to the decline in domestic business activity and are subject to limited public support during the pandemic. At the same time, over the last two years, BoB has built up its risk management team and tightened its underwriting standards. In particular, the bank shifted its focus to lower-risk borrowers, including public-sector employees such as school teachers and medical personnel, that is, people with middle-size but stable income, which underpins good quality of the newly built portfolio. Furthermore, the share of foreign-currency-denominated loans declined to below 4% as of September 2020 from 27% in 2015, before the devaluation. The bank was also proactive in managing its loan book growth. Loan portfolio expanded by 6% in the first quarter of 2020, but sharply decelerated in subsequent quarters because the bank tightened its lending criteria amid the pandemic and military conflict with Armenia.

The assigned Asset Risk score of caa2 takes into consideration the sharp decrease in the stock and share of problem loans in 2019. At the same time, it reflects the bank's concentration in unsecured consumer lending, as well as our expectation of renewed asset-quality deterioration because of the weakened economic environment, which however will be manageable, given the improvements in consumer loan origination and collection processes.

Robust capitalization

The bank's capital is strong and compares favorably with that of its similarly rated global peers. As of year-end 2019, BoB's tangible common equity (TCE) increased to 26.6% of RWA. The bank's TCE/total assets was also high at 18.3%, showing moderate nominal leverage. The improvement from 8.0% and 7.9%, respectively, reported as of year-end 2018 was mainly a result of the implementation of the Decree. Payment by the government of compensation for the devaluation of the national currency back in 2015 allowed BoB to release loan-loss reserves in the amount of AZN24 million. Concurrently, the restructuring of overdue loans entitled BoB to receive funding of AZN85 million from the CBAR and report AZN16 million of net fair value gain on the initial recognition of this loan.

Exhibit 4
TCE recovered in 2018-19, helped by the release of loan-loss reserves and government support



Source: BoB's IFRS reports

The bank's statutory capital metrics are also strong. As of 30 September 2020, BoB reported total capital of AZN83 million and a total capital adequacy ratio of 27.6%, 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 gross loans declined to 4% as of 30 September 2020 from 24% as of year-end 2018. However, on the liability side, dollarization remained high, because around 40% of customer deposits were denominated in US dollars. However, these deposits are now fully covered by liquid foreign-currency assets in the form of cash placements with the CBAR, banks' nostro accounts and foreign-currency-denominated securities. As of 30 September 2020, BoB maintained a long foreign-currency position equivalent to 8% of the bank's capital, which is within the regulatory limit set at 10%.

The assigned Capital score of ba2 reflects BoB's strong capital metrics and our expectation that the bank will retain its healthy capital buffers in the next 12-18 months, supported by prudent business expansion strategy.

Modest recurring profitability, which is eaten away by high operating and credit costs

In 2019, BoB reported a net income of AZN37.1 million under IFRS, equivalent to a return on average assets of 11.2%. The bank's high profit in 2019 was mainly a result of one-off gains associated with the implementation of the Decree. In particular, the bank (1) released AZN24.0 million of loan-loss reserves on repayment by the government of compensation for the local-currency devaluation, and (2) booked a net fair value gain of AZN16 million on initial recognition of the CBAR loan obtained as a result of the restructuring of overdue retail loans. Net of these one-offs, the bank would have been break-even.

At the same time, government measures allowed BoB to clean its loan book of problematic legacy exposures and restore the full scope of its banking operations. According to the local GAAP, BoB reported a net income of AZN8.6 million for the first nine months of 2020. Quarterly reports indicate steady growth in net interest income (NII), supported by new lending. In January-September 2020, NII increased 38% year on year and accounted for 81% of net revenue. That said, BoB's operating efficiency remained modest, as indicated by ratio of operating expense/average assets at 9.3%. High operating costs mainly relate to labor-intensive loan granting and collecting processes.

Good bottom-line profitability in 2020 is supported by currently low credit costs and positive trend in loan collection in recent months. However, we do not view this situation as sustainable in the longer term and expect the bank's impairment charges to normalise at ca. 3.0% of average gross loans. At the same time, we expect BoB to remain profitable, because accelerated loan book growth, if combined with prudent credit underwriting, will spur profit generation. The assigned Profitability score of caa2 reflects the above-mentioned considerations.

Stable funding structure and good liquidity

BoB maintains a deposit-based funding structure. As of 30 September 2020, customer deposits accounted for 56% of total liabilities, under the local GAAP. The deposits are granular, and 90% are made of retail deposits. In the first nine months of 2020, customer deposits remained virtually flat, notwithstanding the economic disruption and reduced household income. For comparison, systemwide customer deposits decreased by 9% over the same period.

As of 30 September 2020, the share of market funding was 34%. Market funding included the AZN85 million loan from the CBAR received by the bank for five years at 0.1% interest rate as a result of the restructuring of the same amount of overdue retail loans under the Decree. Another AZN23 million was received from the national funds for entrepreneurship and mortgage support. We consider these funding sources stable and subject to low refinancing risk, and, therefore, adjust the Funding Structure score upward to b1.

According to the local GAAP, BoB's liquidity buffer equaled 25% of the bank's total assets as of 30 September 2030. Liquid assets were comprised of cash and cash equivalents (51% of the total), securities (23%), and bank accounts and deposits (26%). 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 of the banking sector, BoB has low exposure to environmental risks (see our Environmental risk heat map for further information).

For social risks, we also place BoB in line with our general view of the banking sector, which indicates moderate exposure. The most relevant social risks for banks arise from the way they interact with their customers. Social risks are particularly high in the area of data security and customer privacy, which are partly mitigated by sizable technology investments and banks' long track record of handling sensitive client data. Fines and reputational damage because of product mis-selling or other types of misconduct are further social risks. Social trends are also relevant in a number of areas, such as shifting customer preferences toward digital banking services, increasing information technology costs, aging population concerns in several countries affecting the demand for financial services or socially driven policy agendas that may translate into regulations that affect banks' revenue base. We also view the pandemic as a social risk under our environmental, social and governance (ESG) framework, given the substantial implications for public health and safety, and the fact that the bank's asset quality and profitability will be hurt by the weakening economic growth following the pandemic. For further information, see our Social risk heat map.

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 the Commonwealth of

Independent States (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. Nonetheless, corporate governance remains a key credit consideration and requires ongoing monitoring.

Support and structural considerations

Government support considerations

Given BoB's small size and lack of systemic importance, we assume a low probability of government support, which does not provide any uplift to the bank's ratings.

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 B2(cr)/Not Prime

The CR Assessment, before government support, is one notch above BoB's Adjusted BCA of b3, to which we then typically add the same notches of 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 B2/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 related 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.

UPDATE SCORECARD and RATINGS before the publication

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	38.1%	caa3	↑↑	caa2	Collateral and provisioning coverage	
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel I)	26.6%	ba1	↔	ba2	Expected trend	
Profitability						
Net Income / Tangible Assets	5.8%	ba1	↓↓	caa2	Expected trend	
Combined Solvency Score		b1		b3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	22.8%	b3	↑↑	b1	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	31.8%	b2	↓	b3	Stock of liquid assets	
Combined Liquidity Score		b3		b2		
Financial Profile				b3		
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				b2 - caa1		
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 6

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Stable
Counterparty Risk Rating	B2/NP
Bank Deposits	B3/NP
Baseline Credit Assessment	b3
Adjusted Baseline Credit Assessment	b3

Counterparty Risk Assessment	B2(cr)/NP(cr)

Source: Moody's Investors Service

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