

CREDIT OPINION

9 July 2021

Update

✓ Rate this Research

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	Positive

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 issuance of 2020 IFRS financials

Summary

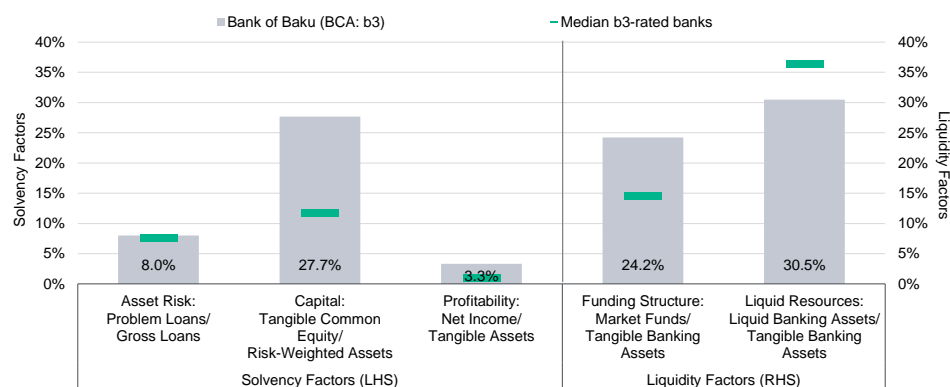
OJSC Bank of Baku's (Bank of Baku) long-term local- and foreign-currency deposit ratings of B3 are based solely on the bank's b3 Baseline Credit Assessment (BCA) and do not factor in any probability of external support.

Bank of Baku's b3 BCA is supported by a substantial improvement in the bank's asset quality over the past two years and its strong capital position. At the same time, the BCA is constrained by the still-large stock of problem loans and the bank's focus on high-risk consumer and microlending segments, as well as its modest recurring profitability, which is being eroded by high operating costs.

Exhibit 1

Rating Scorecard - Key financial ratios

As of 31 December 2020



Source: Moody's Financial Metrics

Credit strengths

- » Robust capital adequacy
- » Stable funding structure and sound liquidity

Credit challenges

- » Intrinsically high asset risk, stemming from the bank's focus on risky consumer lending
- » Modest profitability, suppressed by high operating expenses and potentially increasing provisions

Outlook

The outlook on Bank of Baku's B3 long-term local- and foreign-currency deposit ratings is positive, reflecting our expectation that an improvement in the operating environment in Azerbaijan will gradually translate into an improvement in the bank's standalone financial fundamentals, particularly its asset quality and 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 a further significant and sustainable improvement in its solvency metrics while maintaining solid capital and liquidity buffers.

Factors that could lead to a downgrade

- » A downgrade of Bank of Baku's BCA and deposit ratings is unlikely over the next 12-18 months, given the current positive rating outlook and the improving operating environment for banks in Azerbaijan.
- » Nevertheless, 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 an erosion of its capital beyond our current expectations.

Key indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

	12-20 ²	12-19 ²	12-18 ²	12-17 ²	12-16 ²	CAGR/Avg. ³
Total Assets (AZN Million)	419.4	373.9	289.4	399.7	511.7	(4.9) ⁴
Total Assets (USD Million)	246.8	220.4	170.6	235.1	284.0	(3.4) ⁴
Tangible Common Equity (AZN Million)	84.9	68.5	22.7	4.7	(2.3)	--
Tangible Common Equity (USD Million)	50.0	40.4	13.4	2.8	(1.3)	--
Problem Loans / Gross Loans (%)	8.0	13.6	54.8	45.9	46.4	33.7 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	27.7	26.6	8.0	1.6	-0.6	12.7 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	19.9	31.9	99.8	113.0	122.8	77.5 ⁵
Net Interest Margin (%)	9.2	7.6	5.6	4.7	6.1	6.6 ⁵
PPI / Average RWA (%)	3.3	2.3	0.5	-1.3	5.1	2.0 ⁶
Net Income / Tangible Assets (%)	3.3	6.5	9.2	1.7	-10.2	2.1 ⁵
Cost / Income Ratio (%)	75.5	81.5	95.1	118.6	56.9	85.5 ⁵
Market Funds / Tangible Banking Assets (%)	24.2	22.8	16.9	19.6	24.1	21.5 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	30.5	31.8	8.9	25.0	25.0	24.3 ⁵
Gross Loans / Due to Customers (%)	138.9	143.9	237.2	134.0	112.8	153.4 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 (Bank of Baku) is a small bank among the 26 commercial banks operating in Azerbaijan. As of 31 December 2020, it held a countrywide market share of 1.3%, based on standalone assets of AZN410 million (\$241 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. Bank of Baku has historically been focused on providing consumer loans. As of 31 December 2020, loans to individuals accounted for around 70% of the bank's gross loan book and were, in turn, dominated by unsecured consumer loans (65% of the total).

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.moody's.com for the most updated credit rating action information and rating history.

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 owned by Mr Hikmat Ismayilov (31.11%), "Azpetrol Neft Shirketi" LLC (28.89%) and Mr Elchin Isayev (5%).

On 28 February 2019, the president of [Azerbaijan](#) (Ba2 positive) Ilham Aliyev [signed a decree](#) authorising a number of financial measures to resolve problem loans accumulated by individuals and to ease the debt burden of the general population. Bank of Baku, which had historically focused on consumer lending and had accumulated, by that time, a large stock of distressed retail loans, became one of the main beneficiaries of the announced measures.

Detailed credit considerations

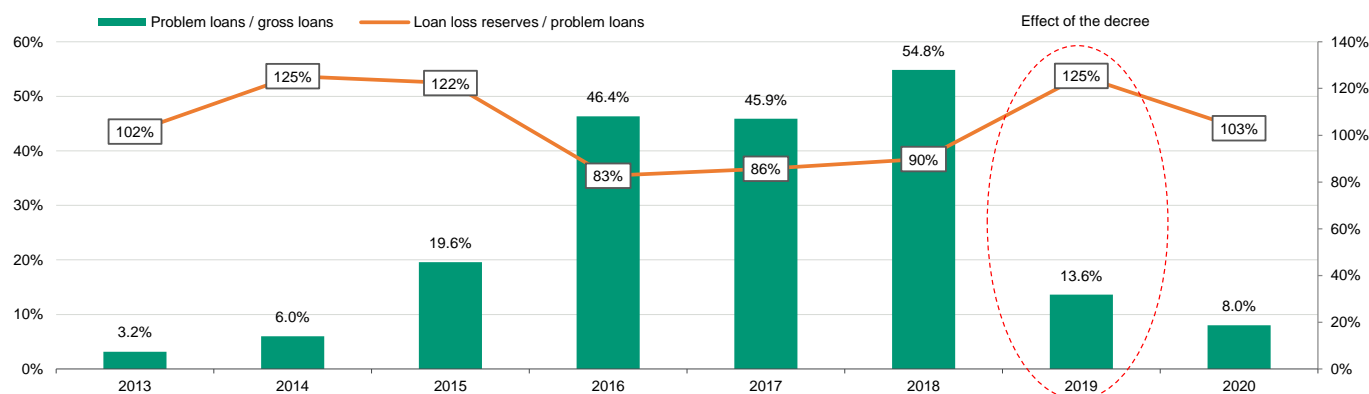
Intrinsically high asset risk, stemming from the bank's focus on risky consumer lending

The assigned Asset Risk score of caa1 reflects the bank's concentration in unsecured consumer lending, which makes its asset quality vulnerable to the pandemic-induced risks, and its large share of restructured loans, a portion of which will likely migrate to the problematic category. However, we expect the bank's problem loan ratio to keep below 10% over the next 12-18 months.

As of 31 December 2020, Bank of Baku's problem loans accounted for 8.0% of gross loans, compared with 13.6% at the beginning of the year. On top of this, as of 1 May 2021, approximately 23% of all loans comprised loans restructured as a result of implementation of the president's 2019 decree (these loans are accounted as purchased and originated credit impaired loans net of loan loss reserves). The bank's management expects it to collect at least one quarter of these restructured loans in the course of 2021. The amount of loans restructured because of the pandemic is not significant.

Exhibit 3

Asset-quality metrics improved in 2019, helped by the decree



Source: Bank of Baku's IFRS reports

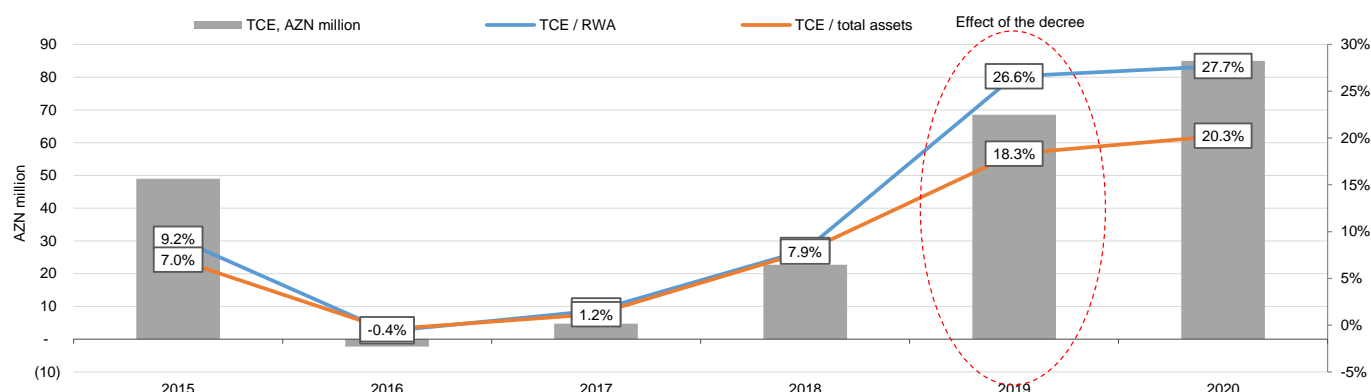
The bank's moderate asset quality is a result of its focus on unsecured consumer lending, an inherently risky segment with high credit costs. Bank of Baku targets primarily low- to middle-income households in the informal economy among others, which are particularly vulnerable to the decline in domestic business activity and are subject to limited public support. More positively, the share of foreign-currency-denominated loans declined to below 3% as of December 2020 from 27% in 2015.

Over the past two years, Bank of Baku has significantly strengthened its risk management and tightened underwriting standards, which translated into reduced credit risk. Still, the credit growth in the region of 20% contemplated in 2021 (after the conservative flat dynamics in 2020) will give rise to some asset quality deterioration as the rapidly augmented loan books starts seasoning.

Robust capital adequacy

We view Bank of Baku's capital adequacy as one of its strengths and assign a Capital score of ba1. This reflects our expectation that the bank will retain its good capital buffers over the next 12-18 months, with its tangible common equity (TCE)/risk-weighted assets (RWA) above 20%, even as loan growth accelerates. The latest available Moody's-calculated ratio of TCA/RWA was 27.7% as of year-end 2020, supported by strong retained earnings and a decrease in RWA over the past two years.

Exhibit 4

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

Source: Bank of Baku's IFRS reports

Modest bottom-line profitability, suppressed by high operating expenses and potentially increasing provisions

In 2020, Bank of Baku reported a net income of AZN15.2 million under IFRS, equivalent to a return on average assets of 3.5%. Good bottom-line profitability was supported by an increase in recurring revenue following the balance-sheet cleanup and the replacement of the legacy problematic portfolio with new loans that are of better quality and generate stable net interest income (NII). In 2020, the bank's NII amounted to AZN37 million, which was 20% higher than the level in 2019, and accounted for more than 90% of net revenue.

Additionally, the bank continued to release loan loss reserves, although the released amount significantly reduced to AZN9.5 million in 2020 from AZN24.1 million in 2019.

Bank of Baku's operating expense increased 5% in 2020 despite the cost-cutting measures implemented amid the pandemic and the economic downturn. As a result, operating efficiency, although improved, remained modest as indicated by a cost-to-income ratio of 76% and operating expense/total assets of 6.8% (2019: 81% and 7.3%, respectively). High operating costs are mainly attributable to labour-intensive loan issuing and problem loan collection processes.

We expect Bank of Baku to remain profitable over the next 12-18 months because the completed cleaning up of the loan book will spur profit generation. At the same time, in 2021-22, the bank will have to resume charging provisions. Thus, we expect net income/total assets to hover around 0.5% in the next 12 to 18 months, which is consistent with the assigned Profitability score of caa1.

Stable funding structure and sound liquidity

As of 31 December 2020, customer deposits accounted for 60% of Bank of Baku's total liabilities, according to IFRS. The deposit portfolio is granular, and 92% is made of retail deposits. In 2020, Bank of Baku's customer deposits increased 6%, notwithstanding the economic disruption and reduced household income. For comparison, systemwide customer deposits fell by 6% in the same period.

Dollarisation of deposits remained high, with 34% of customer deposits being denominated in foreign currency, predominantly in US dollars. This share is below the system average of 55%. Also, these deposits are fully covered by liquid foreign-currency assets in the form of cash placements with the Central Bank of the Republic of Azerbaijan (CBAR), dues from banks and foreign-currency-denominated securities. As of 31 December 2020, Bank of Baku had a long foreign-currency position equivalent to 6% of the bank's capital, which is within the regulatory limit set at 10%.

As of 31 December 2020, Bank of Baku's share of market funding was 36% of total liabilities. Market funding included the AZN72 million loan from the CBAR received by the bank for five years at a 0.1% interest rate against an equivalent amount of overdue retail loans restructured under the decree. Another AZN27 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, make an upward adjustment to the Funding Structure score to b1.

According to the IFRS, Bank of Baku's liquidity buffer was 31% of the bank's total assets as of 31 December 2020. Its liquid assets comprised cash and cash equivalents (79% of the total), securities (19%), and bank accounts and deposits (2%). We expect Bank of Baku's liquidity to remain good over the next 12-18 months and maintain its Liquidity score of b2.

ESG considerations

In line with our general view of the banking sector, Bank of Baku has a low exposure to environmental risks (see our [environmental risk heat map](#) for further information).

Banks in the Commonwealth of Independent States (CIS) face social risks from four key factors, three of which stem from demographic and societal trends that pose greater risks for CIS banks than the global average. First, a potential escalation of domestic and regional conflicts can trigger economic disruptions and a deterioration in asset quality and funding. Second, shrinking and ageing populations in some CIS countries (Russia, Ukraine and Belarus) are a long-term threat to banks' revenue generation and profitability. Third, state-owned banks actively involved in social policies play an important role in several CIS banking systems, and their policy-driven lending decisions often increase asset risks. The fourth key factor is customer relations, which pose very high risks for CIS banks as they do for their peers globally. See [Banks – Commonwealth of Independent States: Civil unrest and demographic changes pose substantial social risks](#) for further information. We also regard the pandemic as a social risk under our environmental, social and governance (ESG) framework, given the substantial implications for public health and safety.

Governance is highly relevant for Bank of Baku, as it is to all entities 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 CIS, we have identified key-person and related-party risks as the key governance risks. These risks, which are manifested in, but are not limited to, heavy related-party loan concentrations and banks' heavy dependence on single individuals for business, often give rise to weak corporate governance and lax underwriting standards.

Governance risks are largely internal rather than externally driven, and, for Bank of Baku, we do not have any particular governance concern, nor do we apply any Corporate Behaviour adjustment to the bank. Bank of Baku has not shown any significant 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

Government support considerations

Given Bank of Baku'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 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 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.

Bank of Baku's CR Assessment is positioned at B2(cr)/Not Prime

The CR Assessment, before government support, is one notch above Bank of Baku'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, minimise losses and avoid the disruption of critical functions.

Counterparty Risk Ratings (CRRs)

CRRs are opinions of the ability of entities to honour the uncollateralised portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRR liabilities typically relate to transactions with unrelated parties. Examples of CRR liabilities include the uncollateralised portion of payables arising from derivatives transactions and the uncollateralised 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.

Bank of Baku'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 judgement. When read in conjunction with our research, a fulsome presentation of our judgement 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		Weak -	100%				
Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2	
Solvency							
Asset Risk							
Problem Loans / Gross Loans	25.5%	caa3	↑↑	caa1	Expected trend	Collateral and provisioning coverage	
Capital							
Tangible Common Equity / Risk Weighted Assets (Basel I)	27.7%	baa3	↓	ba1	Expected trend		
Profitability							
Net Income / Tangible Assets	3.3%	baa3	↓↓	caa1	Expected trend		
Combined Solvency Score		ba3		b2			
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets	24.2%	b2	↑↑	b1	Market funding quality		
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets	30.5%	b1	↓	b2	Expected trend		
Combined Liquidity Score		b2		b1			
Financial Profile				b2			
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				b1 - b3			
Assigned BCA				b3			
Affiliate Support notching				0			
Adjusted BCA				b3			
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	b2	0	B2	B2	
Counterparty Risk Assessment	1	0	b2 (cr)	0	B2(cr)		
Deposits	0	0	b3	0	B3	B3	

[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	Positive
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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