

CREDIT OPINION

10 August 2022

Update



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RATINGS

OJSC Bank of Baku

| | |
|-------------------|--|
| Domicile | Baku, Azerbaijan |
| Long Term CRR | B1 |
| Type | LT Counterparty Risk Rating - Fgn Curr |
| Outlook | Not Assigned |
| Long Term Debt | Not Assigned |
| Long Term Deposit | B2 |
| 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 following ratings upgrade

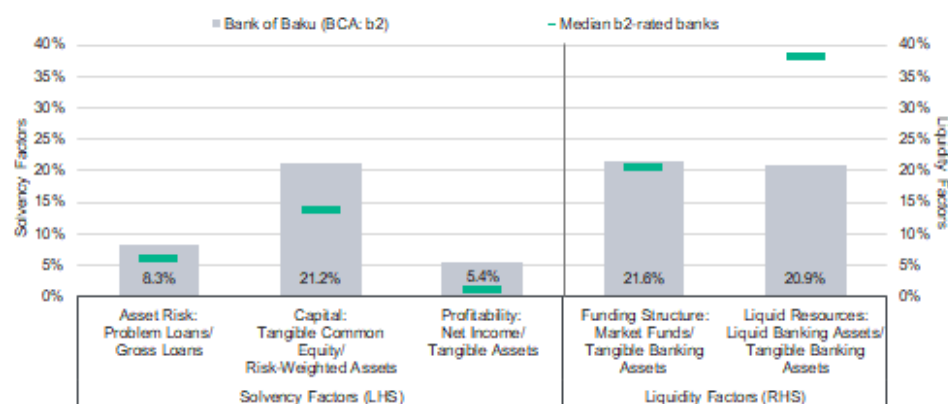
Summary

OJSC Bank of Baku's (Bank of Baku) long-term local- and foreign-currency deposit ratings of B2 are on par with the bank's b2 Baseline Credit Assessment (BCA) and do not benefit from any probability of external support.

Bank of Baku's b2 BCA reflects the substantial improvement in the bank's asset quality over the past two years and its strong capital position and profitability which all boost the bank's solvency profile. At the same time, the BCA is constrained by the bank's focus on high-risk consumer and microlending segments, as well as its relatively weaker funding profile, a result of its high loan-to-deposit ratio, although its deposits have historically been stable.

Exhibit 1

Rating Scorecard - Key financial ratios As of 31 December 2021



Source: Moody's Financial Metrics

Credit strengths

- » Still solid capital buffers
- » Strong profitability, supported by its ability to generate high pre-provision profitability

Credit challenges

- » Intrinsically high asset risk, stemming from the bank's focus on risky consumer lending
- » High loan-to-deposit ratio

Outlook

The stable outlooks of the long-term ratings reflect Moody's expectations that the financial performance of the affected banks will remain resilient

Factors that could lead to an upgrade

- » Further significant and sustainable improvement in its solvency metrics and funding while maintaining sound liquidity buffers could put upward pressure on the bank's ratings.

Factors that could lead to a downgrade

- » A deterioration in the bank's asset quality and capital metrics and an erosion of its liquidity buffers could put downward pressure on the bank's ratings .

Key indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

| | 12-21 ² | 12-20 ² | 12-19 ² | 12-18 ² | 12-17 ² | CAGR/Avg. ³ |
|--|--------------------|--------------------|--------------------|--------------------|--------------------|------------------------|
| Total Assets (AZN Million) | 519.5 | 419.4 | 373.9 | 289.4 | 399.7 | 6.8 ⁴ |
| Total Assets (USD Million) | 305.7 | 246.8 | 220.4 | 170.6 | 235.1 | 6.8 ⁴ |
| Tangible Common Equity (AZN Million) | 112.7 | 84.9 | 68.5 | 22.7 | 4.7 | 121.3 ⁴ |
| Tangible Common Equity (USD Million) | 66.3 | 50.0 | 40.4 | 13.4 | 2.8 | 121.4 ⁴ |
| Problem Loans / Gross Loans (%) | 3.2 | 8.0 | 13.6 | 54.8 | 45.9 | 25.1 ⁵ |
| Tangible Common Equity / Risk Weighted Assets (%) | 21.2 | 27.7 | 26.6 | 8.0 | 1.6 | 17.0 ⁶ |
| Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%) | 9.8 | 19.9 | 31.9 | 99.8 | 113.0 | 54.9 ⁵ |
| Net Interest Margin (%) | 9.5 | 9.2 | 7.6 | 5.6 | 4.7 | 7.3 ⁵ |
| PPI / Average RWA (%) | 3.7 | 3.3 | 2.3 | 0.5 | -1.3 | 1.7 ⁶ |
| Net Income / Tangible Assets (%) | 6.4 | 3.3 | 6.5 | 9.2 | 1.7 | 5.4 ⁵ |
| Cost / Income Ratio (%) | 67.4 | 75.5 | 81.5 | 95.1 | 118.6 | 87.6 ⁵ |
| Market Funds / Tangible Banking Assets (%) | 21.6 | 24.2 | 22.8 | 16.9 | 19.6 | 21.0 ⁵ |
| Liquid Banking Assets / Tangible Banking Assets (%) | 20.9 | 30.5 | 31.8 | 8.9 | 25.0 | 23.4 ⁵ |
| Gross Loans / Due to Customers (%) | 155.6 | 138.9 | 143.9 | 237.2 | 134.0 | 161.9 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 2021, it held a countrywide market share of 1.4%, based on consolidated total assets of AZN519 million (\$306 million).

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on <https://ratings.moody.com> for the most updated credit rating action information and rating history.

The bank is headquartered in Baku, the capital city of Azerbaijan, and operates through a network of 18 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).

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%).

Detailed credit considerations

High asset risk stems from the bank's focus on riskier consumer lending

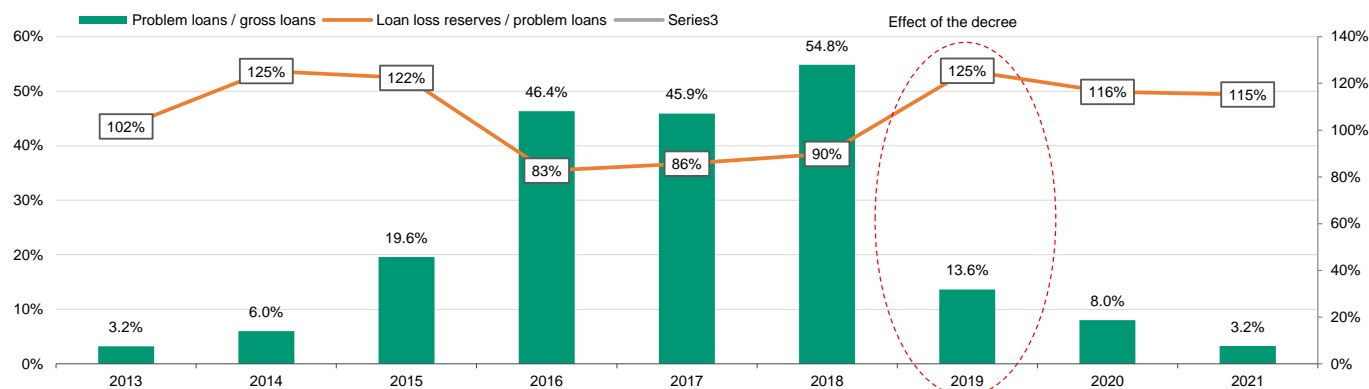
The assigned Asset Risk score of caa1 reflects the bank's concentration in unsecured consumer lending, which makes its asset quality vulnerable to any economic shock, and its large share of restructured loans, a portion of which will migrate to the problematic category. However, Bank of Baku's problem loans ratio improved substantially in 2021 to 3.3% from 8.0% in 2020 but strong loan growth will likely increase formation of new problem loans in the next 12-18 months.

On top of this, in the first half of 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). We expect at least a quarter of these restructured loans to have been resolved and collected in 2021, per management guidance.

Bank of Baku's large consumer loan book, with about 88% of the loans granted to individuals as of December 2021, will continue to strain the bank's asset risk score. The bank targets the 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. In addition, the majority of the loans are unsecured, which hinders recovery rates. That said, Bank of Baku's problem loans coverage ratio was 115% as of end of 2021, which we believe will provide a good buffer to absorb expected losses. In addition, the bank's exposure to foreign currency loans is limited, at only about 4% of its loans book in 2021.

Exhibit 3

Asset risk remain high despite the bank's low NPL ratio and good coverage ratio



Source: Bank of Baku's IFRS reports

Over the past two years, Bank of Baku has significantly strengthened its risk management and tightened underwriting standards. Still, loans increased by 40% in 2021 and will expose the bank to some asset quality deterioration as the loan book starts seasoning.

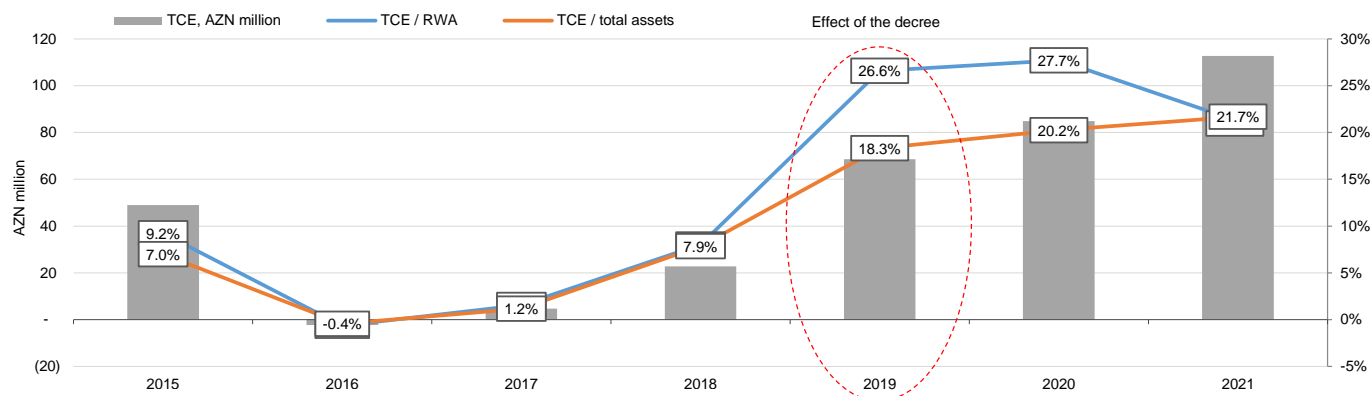
Capital will remain robust

We view Bank of Baku's capital adequacy as one of its credit 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. As of end of 2021, Bank of Baku's tangible common equity (TCE)/risk-weighted assets (RWA) was 21%, despite the strong loan growth.

Bank of Bank's solvency also benefits from its low leverage. The bank's shareholders' equity to total assets ratio was 23%. As a proportion of total assets, Bank of Bank has the highest volume of risk weighted assets at 96% compared to an average of 63% for its rated domestic peers. The bank's robust capital adequacy is supported by its strong retained earnings.

Exhibit 4

TCE ratio continued to improve in 2021 but we expect it to stabilise



Source: Bank of Baku's IFRS reports

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

In 2021, Bank of Baku reported a net income of AZN33 million under IFRS, equivalent to a return on average assets of 7.1%. 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 2021, the bank's NII amounted to AZN44 million, which was 18% higher than the level in 2020, and accounted for more than 90% of net revenue.

Additionally, the bank continued to release loan loss reserves, with the amount increasing significantly to AZN27.3 million in 2021 from AZN9.5 million in 2020.

Bank of Baku's operating expense increased 12% in 2021 despite the cost-cutting measures implemented amid the pandemic and the economic downturn. However, operating efficiency improved as the bank achieved a cost-to-income ratio of 67%, down from 76% in 2020; and the ratio of operating expense to total assets of 6.1% from 6.8% over same period. 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 its rapid loan growth in 2021 will bring in strong revenue, amid a stronger economic background in Azerbaijan. We expect revenue growth to outpace cost growth, supporting profitability, notwithstanding our view that credit costs will rise. In 2021, the bank's bottom line also benefited from net recoveries. The bank's net income to tangible banking asset ratio was strong at 6.4% in 2021 and we expect it to remain stable but assigns a ba3 score to reflect our view of the high risk nature of the bank's client base.

Bank Baku's funding structure is moderated by its high loan-to-deposit ratio

As of 31 December 2021, customer deposits accounted for 61% of Bank of Baku's total liabilities, according to IFRS financial statements. The deposit portfolio is granular, and 93% is made of retail deposits. In 2021, Bank of Baku's customer deposits increased 25%, with secured deposits from Azerbaijan Deposit Insurance Fund increasing by 60%. Bank of Baku's deposit growth far outpaced that of the system which increased deposits by 12% in the same period.

Dollarisation of deposits remained high, with 33% of customer deposits being denominated in foreign currency, predominantly in US dollars. This share, however, is below the system average of 49%. 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. We expect Bank of Baku's net foreign currency position, which was 6% as of 31 December 2020, and therefore within the regulatory limit set at 10%, to remain within the 10%.

As of 31 December 2021, Bank of Baku's ratio of market funding to total liabilities was 28%. Market funding included the AZN56 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 AZN37 million was received from the national funds for entrepreneurship and mortgage support. We consider these funding sources stable and subject to low refinancing risk. However, despite the stability of these funds, we note that Bank of Baku's loan-to-deposit ratio is extremely high at 156%, compared to an average of 67% for its domestic peers. We assign a Funding Structure score of b3, a notch down from the initial score, to reflect this risk.

According to the IFRS, Bank of Baku's liquidity buffer was 24% of the bank's total assets as of 31 December 2021. Its liquid assets comprised cash and cash equivalents (66% of the total), securities (32%), 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 B1(cr)/Not Prime

The CR Assessment, before government support, is one notch above Bank of Baku's Adjusted BCA of b2, 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 B1/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 | 8.3% | caa1 | ↑↑ | caa1 | Unseasoned risk | Collateral and provisioning coverage | |
| Capital | | | | | | | |
| Tangible Common Equity / Risk Weighted Assets (Basel I) | 21.2% | baa3 | ↓ | ba1 | Expected trend | | |
| Profitability | | | | | | | |
| Net Income / Tangible Assets | 5.4% | baa3 | ↔ | ba3 | Loan loss charge coverage | | |
| Combined Solvency Score | | ba3 | | b1 | | | |
| Liquidity | | | | | | | |
| Funding Structure | | | | | | | |
| Market Funds / Tangible Banking Assets | 21.6% | b2 | ↓ | b3 | Market funding quality | | |
| Liquid Resources | | | | | | | |
| Liquid Banking Assets / Tangible Banking Assets | 20.9% | b2 | ↔ | b2 | Expected trend | | |
| Combined Liquidity Score | | b2 | | b3 | | | |
| Financial Profile | | | | b2 | | | |
| Qualitative Adjustments | | | | Adjustment | | | |
| Business Diversification | | | | 0 | | | |
| Opacity and Complexity | | | | 0 | | | |
| Corporate Behavior | | | | 0 | | | |
| Total Qualitative Adjustments | | | | 0 | | | |
| Sovereign or Affiliate constraint | | | | Ba1 | | | |
| BCA Scorecard-indicated Outcome - Range | | | | b1 - b3 | | | |
| Assigned BCA | | | | b2 | | | |
| Affiliate Support notching | | | | 0 | | | |
| Adjusted BCA | | | | b2 | | | |
| 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 | b1 | - | B1 | B1 | |
| Counterparty Risk Assessment | 1 | 0 | b1 (cr) | - | B1(cr) | | |
| Deposits | 0 | 0 | b2 | - | B2 | B2 | |

[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 | B1/NP |
| Bank Deposits | B2/NP |
| Baseline Credit Assessment | b2 |
| Adjusted Baseline Credit Assessment | b2 |
| Counterparty Risk Assessment | B1(cr)/NP(cr) |

Source: Moody's Investors Service

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