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CREDIT OPINION

26 July 2016

Update

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RATINGS

OJSC Bank of Baku

Domicile	Baku, Azerbaijan
Long Term Debt	Not Available
Type	Not Available
Outlook	Not Available
Long Term Deposit	B3
Type	LT Bank Deposits - Fgn Curr
Outlook	Negative

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.

Analyst Contacts

Petr Paklin 7-495-228-6051
AVP-Analyst
petr.paklin@moodys.com

Maria Malyukova 7-495-228-6106
AVP-Analyst
maria.malyukova@moodys.com

Yaroslav Sovgyra 7-495-228-6076
Associate Managing Director
yaroslav.sovgyra@moodys.com

OJSC Bank of Baku

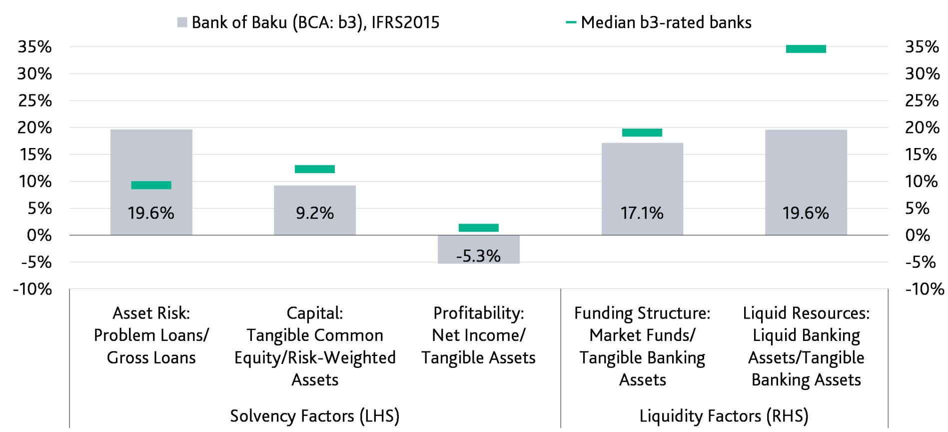
Semi-annual update

Summary Rating Rationale

We assign long-term global local-currency and foreign-currency deposit ratings of B3 to OJSC Bank of Baku (Bank of Baku), which are at the same level as the bank's baseline credit assessment (BCA) of b3. Bank of Baku's B3/Not Prime long- and short-term global local currency (GLC) ratings do not factor in any probability of government support in the event of a stress situation.

The ratings reflect the bank's (1) moderate capital adequacy and adequate provisioning levels; (2) good pre-provision income generation capacity; and (3) robust liquidity profile. At the same time, the ratings remain constrained by the ongoing pressure on the bank's asset quality and profitability following the decline in individuals' real disposable income, and the deteriorating debt service of foreign-currency loans.

Exhibit 1
Rating Scorecard - Key Financial Ratios



Source: Moody's Financial Metrics

Credit Strengths

» Adequate capital buffer bolstered by recent injection from shareholders

» Robust liquidity cushion amid steady loan book amortisation

Credit Challenges

» Asset quality pressure owing to exposure to unsecured retail lending and unhedged foreign-currency loans

» Persisting pressure on profitability amid elevated credit costs and foreign-exchange revaluation losses

» Individual borrowers' weakened creditworthiness in the context of the economic contraction

Rating Outlook

The bank's B3 long-term GLC and foreign-currency deposit ratings carry a negative outlook, which reflects our expectation that the bank's financial result and capitalisation will remain under pressure in the next 12 to 18 months.

Factors that Could Lead to an Upgrade

» Given the negative outlook on the bank's ratings, a ratings upgrade in the next 12-18 months is unlikely

» The outlook could be changed to stable if the bank proves to be resilient against asset quality erosion and maintains adequate levels of profitability and capitalisation

Factors that Could Lead to a Downgrade

» Material increase in credit costs, beyond the level we currently anticipate

» Material decline in the bank's pre-provision income

» Significant weakening of its loss-absorption capacity as measured by its Tier 1 capital adequacy ratio or its problem loan coverage ratio

Key Indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

	12-15[2]	12-14[2]	12-13[2]	12-12[2]	12-11[2]	Avg.
Total Assets (AZN million)	700.6	728.0	642.9	486.2	307.3	22.9[3]
Total Assets (USD million)	448.5	929.6	820.7	620.1	391.1	3.5[3]
Tangible Common Equity (AZN million)	49.0	119.5	113.9	83.8	52.5	-1.7[3]
Tangible Common Equity (USD million)	31.4	152.7	145.4	106.8	66.8	-17.2[3]
Problem Loans / Gross Loans (%)	19.6	6.0	3.2	3.1	3.3	7.0[4]
Tangible Common Equity / Risk Weighted Assets (%)	9.2	18.8	19.0	19.2	18.5	17.0[5]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	61.1	23.5	13.6	13.7	14.6	25.3[4]
Net Interest Margin (%)	16.1	18.4	17.1	16.2	14.5	16.4[4]
PPI / Average RWA (%)	11.6	14.6	12.9	12.7	9.5	12.3[5]
Net Income / Tangible Assets (%)	-5.3	5.6	7.2	6.7	8.5	4.5[4]
Cost / Income Ratio (%)	35.5	33.8	36.8	37.0	41.5	36.9[4]
Market Funds / Tangible Banking Assets (%)	17.1	13.7	8.0	17.0	12.4	13.7[4]
Liquid Banking Assets / Tangible Banking Assets (%)	19.6	11.9	11.0	12.3	12.1	13.4[4]
Gross loans / Due to customers (%)	119.8	139.2	124.8	139.4	128.9	130.4[4]

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel I; IFRS [3] Compound Annual Growth Rate based on IFRS reporting periods [4] IFRS reporting periods have been used for average calculation [5] Basel I & IFRS reporting periods have been used for average calculation

Source: Moody's Financial Metrics

Detailed Rating Considerations

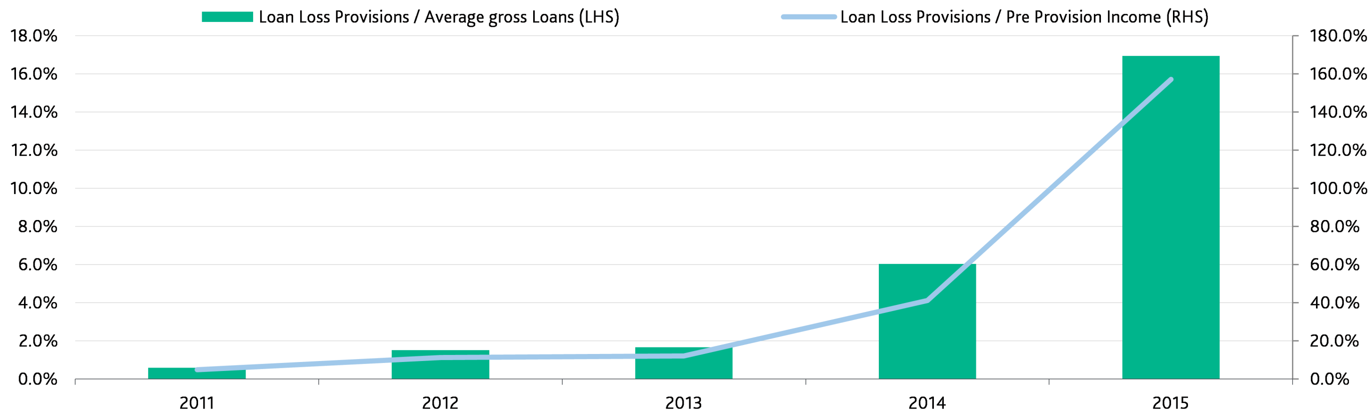
ASSET QUALITY IS UNDER MATERIAL PRESSURE OWING TO EXPOSURE TO UNSECURED RETAIL LENDING AND UNHEDGED FOREIGN-CURRENCY LOANS

Bank of Baku is a medium-sized bank among over 40 commercial banks operating in Azerbaijan. Headquartered in the City of Baku, the capital city of Azerbaijan, the bank is the country's leading provider of consumer loans, with the largest retail loan portfolio among privately owned financial institutions. Around 80% of the bank's loan book was composed mostly of consumer loans, car loans and credit cards as of year-end 2015. Concurrently, unsecured consumer lending amounted to 74% of the bank's loan book under IFRS.

Bank of Baku's asset quality weakened in 2015, following two waves of manat depreciation. This led to an increase in the bank's credit costs to 16.8% of average gross loans in 2015, up from 6.0% in 2014 and 1.7% in 2013. The drastic depreciation of the manat in February and December 2015 adversely affected asset quality, as most of the bank's foreign-currency loans (representing 34% of the total portfolio as of year-end 2015 under local GAAP) were held by unhedged borrowers. However, we note that provisions exceeded 120% of problem loans as of year-end 2015.

Exhibit 3

Credit Costs Surged in 2015



Source: Moody's Financial Metrics

We expect that material pressure on the bank's loan portfolio will persist throughout 2016, because accelerated consumer price inflation, along with an increase in unemployment has affected individuals' real disposable income and, as a result, their capacity to service debt. The bank's problem loan ratio will likely deteriorate further, as the bank's gross loan book is steadily declining and has already contracted by 26% in H1 2016 under local GAAP.

PERSISTING PRESSURE ON PROFITABILITY AMID ELEVATED CREDIT COSTS AND FOREIGN-EXCHANGE LOSSES

The bank's focus on high-margin consumer-lending business has provided it with robust core profitability in previous years. However, this trend has reversed since the middle of 2015, driven by increased credit costs and incurred foreign-currency revaluation losses following the manat depreciation in 2015. Bank of Baku posted a AZN37.3 million net loss in 2015 compared to a net profit of AZN40.7 million in 2014. This was largely driven by heavy provisioning charges and a foreign-exchange revaluation loss owing to the bank's unhedged short foreign-currency position.

Based on the bank's most recent reports, we note credit costs have been on a declining trend since Q2 2016. We expect that credit costs will remain elevated in the next 12-18 months owing to individuals' deteriorated ability to service debts, while the recovery of unsecured loans will be difficult in the challenging operating environment in Azerbaijan. Concurrently, we expect a material contraction of the bank's pre-provision income owing to ongoing loan book amortisation.

To mitigate the negative trends, the bank has focused on cost efficiency since Q2 2015, resulting in its cost-to-income ratio amounting to 35.5% in 2015. The bank has also tightened its underwriting standards in order to contain credit risk. In spite of these steps, it is likely that the pressure from credit costs will cause the bank to be loss-making or break-even at best in the next 12-18 months.

ADEQUATE CAPITAL BUFFER AND PROVISIONING COVERAGE

In our view, with regulatory Total CAR of 19.5% and a Tier 1 ratio of 13.5% reported as of 1 July 2016, Bank of Baku has a sufficient capital cushion against unexpected losses, which may materialise. We consider its provisions of 24.0% of gross loans as of year-end 2015 as adequate to absorb expected credit losses. The bank's historically robust provisioning coverage of over 100% of problem loans in 2014-15, along with adequate pre-provisioning profitability (PPI/average assets of 9.3% in 2015) and expected deleveraging offset adverse pressure on the bank's loss-absorption cushion.

The bank has a relatively diversified shareholder structure, with no single party owning a controlling stake in the equity. The largest shareholder is NAB Holding (35% equity stake), a Turkey-based company that also has interests in a variety of businesses in Azerbaijan, including car dealerships, consumer electronics and tourism. The remainder is dispersed between local businessmen.

Having incurred a net loss of AZN37.3 million and paid out dividends of AZN33.6 million in 2015, the bank's Tier 1 and Total capital adequacy ratio (CAR) declined to 9.2% and 10.3%, respectively as of year-end 2015, compared with 11.9% and 20.6% a year before. In Q1 2016, the shareholders provided a seven-year subordinated loan of USD14.3 million. This has bolstered the bank's total capital adequacy.

ROBUST LIQUIDITY CUSHION AMID LOAN BOOK AMORTISATION; LIMITED REFINANCING RISKS

Over the recent year, Bank of Baku has relied on customer deposits as the key source of funding which formed 79% of its liabilities as of year-end 2015. The bank's wholesale funding amounted 19% of total non-equity funding at year-end 2015, represented either by secured deposits from the Central Bank (in essence swap transactions) or long-term state financing of projects related to small and medium-sized enterprise and mortgage lending. The bank's wholesale funding bears limited refinancing risks.

Bank of Baku has materially improved its liquidity cushion to 33.1% of the balance sheet as of H1 2016, from 24.1% as of year-end 2015, largely driven by the amortisation of the loan portfolio. Liquid assets are mostly held in as foreign-currency placed either with the Central Bank of Azerbaijan or banks from OECD countries.

We expect that Bank of Baku's liquidity cushion will remain robust over the next 12-18 months, amid the ongoing deleveraging of the bank's balance sheet, along with cautious liquidity management since the first wave of the manat depreciation in February 2015.

Notching Considerations

Global Local-Currency Deposit Rating (Joint Default Analysis)

Bank of Baku's B3/Not Prime long- and short-term GLC ratings do not factor in any probability of government support in the event of a stress situation.

Foreign-Currency Deposit Rating

We assign B3/Not Prime foreign-currency deposit ratings to Bank of Baku, at the same level as the bank's GLC deposit ratings.

CR Assessment

We have assigned a Counterparty Risk Assessment (CR Assessment) of B2(cr)/ Not-Prime(cr) to Bank of Baku.

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 expected loss; 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 (e.g., swaps), letters of credit, guarantees and liquidity facilities.

In most cases, the starting point for the CR Assessment, which is an assessment of the ability to avoid defaulting on its operating obligations, is one notch above the bank's adjusted BCA, which represents our view of the probability of a bank failing on its obligations without considering government support. We then add the same support assumptions as applied to deposit ratings. As a result, the CR Assessment of Bank of Baku is one notch higher than its deposit ratings.

NOTE ON DATA

Unless noted otherwise, all figures shown in this report are sourced from the bank's latest annual and interim financial reports, and additional information from the bank. In addition, where indicated through the document we use reference to Moody's Banking Financial Metrics, which are based on our own chart of account, and are adjusted for analytical purposes. Please refer to the documents entitled "Financial Statement Adjustments in the Analysis of Financial Institutions" published on 15 June 2015.

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 4

OJSC Bank of Baku

Macro Factors							
Weighted Macro Profile	**Weak -**	**100%**					
Financial Profile							
Factor		**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency							
Asset Risk							
Problem Loans / Gross Loans		19.6%	caa2	←→	caa2	Expected trend	
Capital							
TCE / RWA		9.2%	b3	←→	b3	Expected trend	
Profitability							
Net Income / Tangible Assets		-5.3%	caa3	↑↑	caa2	Expected trend	
Combined Solvency Score			caa1		caa1		
Liquidity							
Funding Structure							
Market Funds / Tangible Banking Assets		17.1%	b2	←→	b1	Market funding quality	
Liquid Resources							
Liquid Banking Assets / Tangible Banking Assets		19.6%	b3	↑↑	b1	Expected trend	
Combined Liquidity Score			b2		b1		
Financial Profile					b3		
Business Diversification					-1		
Opacity and Complexity					0		
Corporate Behavior					0		
Total Qualitative Adjustments					-1		
Sovereign or Affiliate constraint:					Ba1		
Scorecard Calculated BCA range					b3-caa2		
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 Assessment	1	0	b2 (cr)	0	B2 (cr)	--
Deposits	0	0	b3	0	B3	B3

Source: Moody's Financial Metrics

Ratings

Exhibit 5

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Negative
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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