CREDIT OPINION

16 July 2024

Update

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RATINGS

OJSC Bank of Baku

Domicile	Baku, Azerbaijan
Long Term CRR	Ba3
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
Long Term Deposit	B1
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 rating upgrade to B1

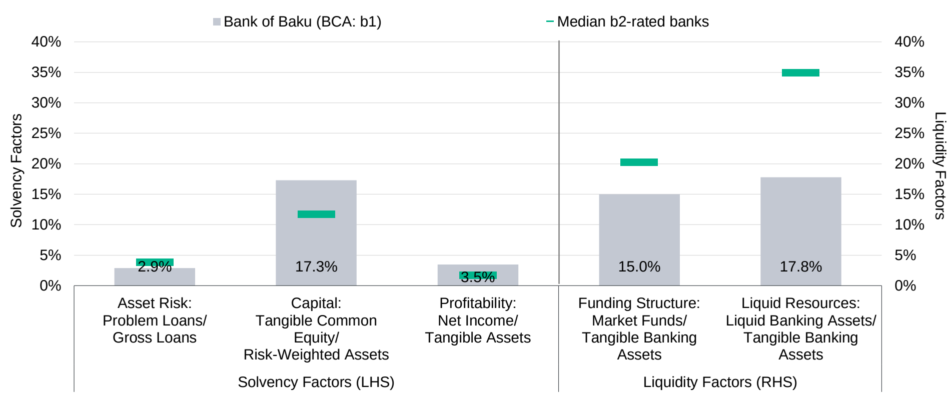
Summary

OJSC Bank of Baku's (BoB) long-term local- and foreign-currency deposit ratings of B1 are on par with the bank's b1 Baseline Credit Assessment (BCA) and do not benefit from any external support because of our assumption of low probability of government support from the Government of Azerbaijan (Ba1 positive).

BoB's b1 BCA reflects improved asset quality and profitability in recent years. At the same time, the BCA is constrained by the bank's business model focused on the unsecured consumer lending segment, which is sensitive to economic cycles, as well as its modest liquidity cushion.

Exhibit 1

Scorecard ratios



Source: Moody's Ratings

Credit strengths

- 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
- Moderate reliance on market funds
- Modest liquidity buffer

Outlook

The stable outlook on BoB's long-term deposit ratings reflects our expectation that the bank will maintain its robust credit metrics over the next 12-18 months.

Factors that could lead to an upgrade

» BoB's BCA and long-term bank deposit ratings could be upgraded if it significantly improves its liquidity and funding profile while maintaining sound solvency.

Factors that could lead to a downgrade

» BoB's ratings could be downgraded or its outlook changed to negative if there is an erosion in its financial fundamentals, such as liquidity, asset quality or profitability.

Key indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

	12-23[2]	12-22[2]	12-21[2]	12-20[2]	12-19[2]	CAGR/Avg.[3]
Total Assets (AZN Million)	868.6	694.4	519.5	419.4	373.9	23.5[4]
Total Assets (USD Million)	510.9	407.9	305.7	246.8	220.4	23.4[4]
Tangible Common Equity (AZN Million)	163.7	143.5	112.7	84.9	68.5	24.3[4]
Tangible Common Equity (USD Million)	96.3	84.3	66.3	50.0	40.4	24.3[4]
Problem Loans / Gross Loans (%)	2.8	2.6	3.2	8.0	13.6	6.1[5]
Tangible Common Equity / Risk Weighted Assets (%)	17.3	18.1	21.2	27.7	26.6	22.2[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	10.3	9.3	9.8	19.9	31.9	16.2[5]
Net Interest Margin (%)	10.7	11.1	9.5	9.2	7.6	9.6[5]
PPI / Average RWA (%)	2.6	4.0	3.7	3.3	2.3	3.2[6]
Net Income / Tangible Assets (%)	3.5	5.8	6.4	3.3	6.5	5.1[5]
Cost / Income Ratio (%)	68.4	60.2	67.4	75.5	81.5	70.6[5]
Market Funds / Tangible Banking Assets (%)	15.0	18.8	21.6	24.2	22.8	20.5[5]
Liquid Banking Assets / Tangible Banking Assets (%)	17.8	13.0	20.9	30.5	31.8	22.8[5]
Gross Loans / Due to Customers (%)	125.1	152.6	155.6	138.9	143.9	143.2[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 Ratings and company filings

Profile

OJSC Bank of Baku (BoB) is a small bank among the 23 commercial banks operating in Azerbaijan. As of March 2024, it held a countrywide market share of 1.9%, based on total assets of AZN923 million ($543 million).

The bank is headquartered in Baku, the capital city of Azerbaijan, and operates a network of 19 branches. BoB has historically been focused on providing consumer loans. As of 31 December 2023, loans to individuals accounted for around 93% of the bank's gross loan book and were, in turn, dominated by unsecured consumer lending (74% of the total).

BoB has a shareholder structure, with no single party owning a controlling stake. The largest shareholder is NAB Holding (with a 35% equity stake), a Turkiye-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 Hikmat Ismayilov (31.11%), “Azpetrol Neft Shirketi” LLC (28.89%), and Elchin Isayev (5%).

Detailed credit considerations

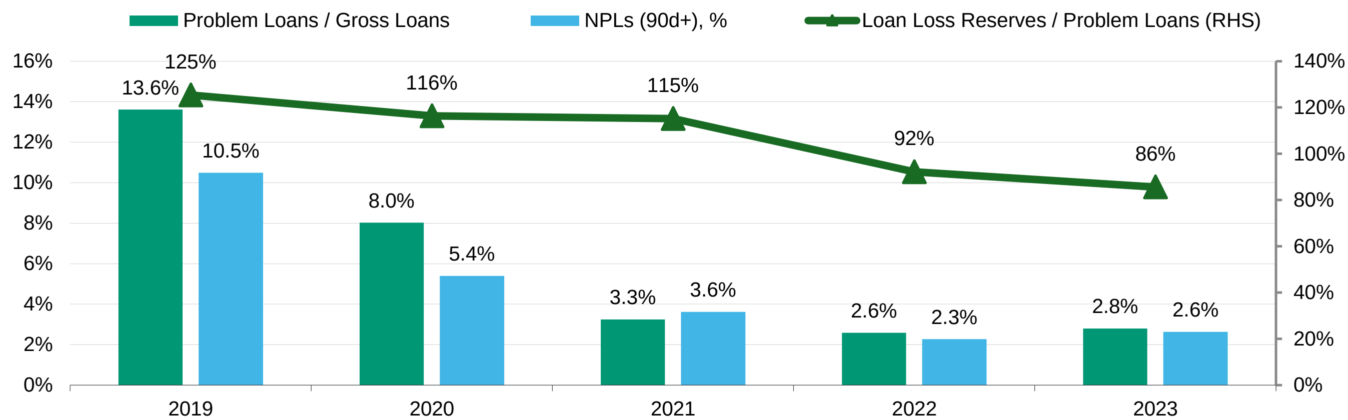
Increased asset risk from the bank's focus on unsecured consumer lending

The assigned Asset Risk score of b2 reflects BoB's concentration in unsecured lending (consumer loans and credit cards), which makes its asset quality vulnerable to economic shocks. In the current favourable economic environment, we expect its problem loan (PL) ratio to remain broadly flat and fall within the 3%-4% range over the next 12-18 months.

Since 2019-20, BoB has significantly strengthened its risk management and tightened its underwriting standards. The share of BoB's PL (defined as stage 3 and POCI lending) improved substantially in recent years to 2.8% as of year-end 2023 from 8.0% as of year-end 2020 because of the workout of legacy problems and a denominator effect triggered by a rapid expansion of the loan book.

Exhibit 3

BoB's asset quality has improved steadily from 2019



Source: Moody's Ratings

BoB's large consumer loan book, where about 92% of the loans were granted to individuals (including entrepreneurs) as of year-end 2023, will continue to strain its asset risk. The bank targets the low- to middle-income households employed in the informal economy, among others, which are particularly vulnerable to any decline in business activity and have access to limited public support. In addition, most of the loans are unsecured, which hinders recovery rates. At the same time, the bank's PL coverage ratio of 86% as of year-end 2023 provides a good buffer to absorb likely losses. In addition, the bank's exposure to foreign-currency loans is negligible at about 2% of net loans as of Q1 2024.

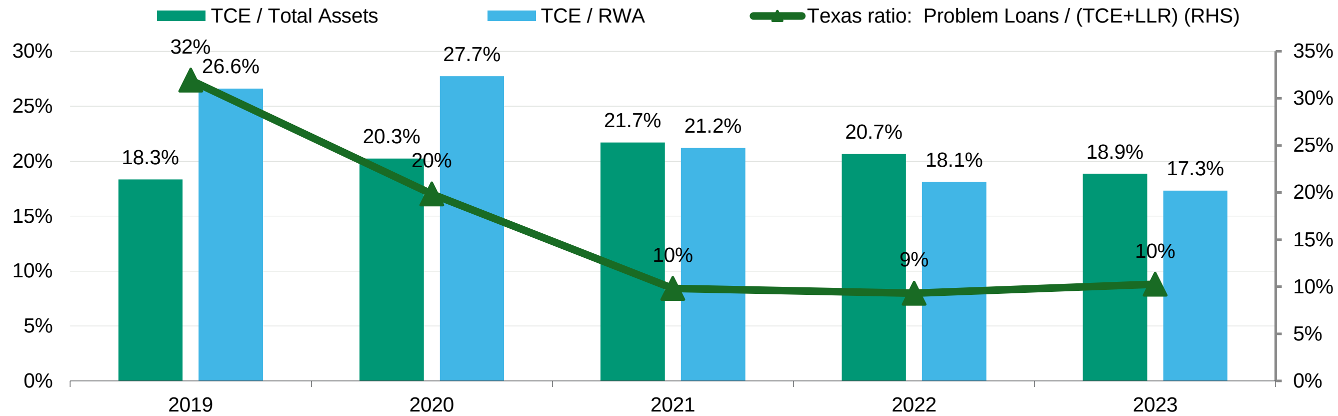
Capital adequacy will decline steadily but will remain far above the regulatory minimum

BoB's capital adequacy is one of its credit strengths, so we assigned a Capital score of ba3. We expect erosion in the bank's capital over the next 12-18 months amid ongoing rapid business expansion and dividend payouts. Its robust capital adequacy is supported by its strong retained earnings.

As of year-end 2023, BoB reported tangible common equity (TCE)/risk-weighted assets (RWA) of 17.3%, despite a 17% growth in the gross loan book. The bank's solvency also benefits from its low leverage. The bank's TCE/total assets was 18.9% as of year-end 2023. As a proportion of total assets, the bank has one of the highest share of RWA/total assets, of 109%, compared with an average of 82% among its domestic peers we rate. This high ratio is attributed to risk weights applied to high credit risk loans (such as consumer loans, credit cards, microloans and so on) exceeding 100%, per local regulatory requirements.

Exhibit 4

Capital adequacy remains robust despite rapid growth in loan book



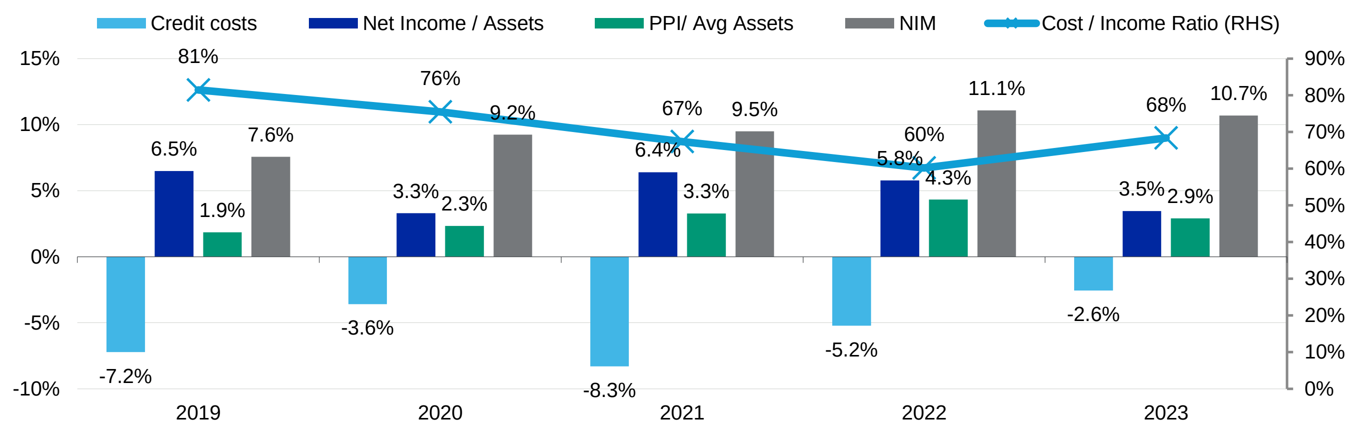
Source: Moody's Ratings

Strong bottom-line profitability supported by strong net interest margin and release of provisions

We expect BoB's return on tangible assets to moderate over the next 12-18 months because of ongoing pressure on its net interest margin (NIM). Its Profitability score of ba3 reflects our expectation and a two-notch downward adjustment for the highly volatile historical profitability as a result of the high-risk nature of its business model and significant off-balance sheet recoveries.

Exhibit 5

Strong profitability is driven by strong NIM and provisions recovery



Source: Moody's Ratings

In 2023, BoB posted net income of AZN30.1 million under IFRS, which equates to a return on tangible assets of 3.5%. Strong profitability is supported by strong recurring revenue following the balance-sheet cleanup and the replacement of the legacy problematic loan portfolio. Newly issued loans are of a better quality and generate stable net interest income (NII). In 2023, the bank's NII amounted to AZN64.9 million, which was 22% higher than that in 2022. At the same time, because of the likely full repayment of the cheap central bank's loan in 2024 and overall high competition for depositors in the local market, we expect an increase in funding costs and a narrowing of the NIM.

In addition, the bank continued to release loan loss reserves at AZN15.6 million in 2023 (down from AZN24.7 million in 2022), which contributed about 41% of the pretax income. Since 2019, BoB has recovered a significant amount of its PLs restructured under the President's Decree published in 2018. We expect a significant reduction in provisions recovery over the next 12-18 months, which will be balanced by the strengthening of the NII generated by the new part of the loan portfolio.

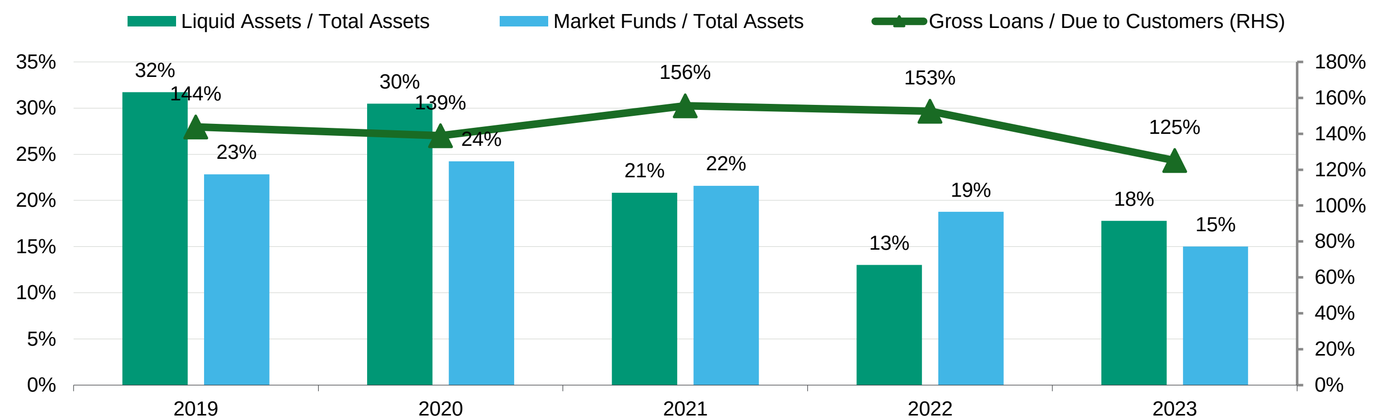
Modest liquidity buffer along with moderate reliance on market funds from the state

We expect a decline in the share of market funds because of the full repayment of the central bank's credit line in 2024, and ongoing customer deposit growth over the next 12-18 months. We assign a Funding Structure score of ba3 in line with expected trends.

As of year-end 2023, customer deposits accounted for 75% of BoB's total liabilities, while market funds, including state funds financing, stood at 15%. The deposit portfolio is granular, and largely represented by retail deposits. Foreign-currency customer accounts decreased to 14% of its total accounts as of Q1 2024. We consider these funding sources stable and subject to modest refinancing risk. However, despite the stability of these funds, the bank's loan-to-deposit ratio remained high at 125% as of year-end 2023.

Exhibit 6

BoB's reliance on market funds has decreased steadily, although it remains moderate



Source: Moody's Ratings

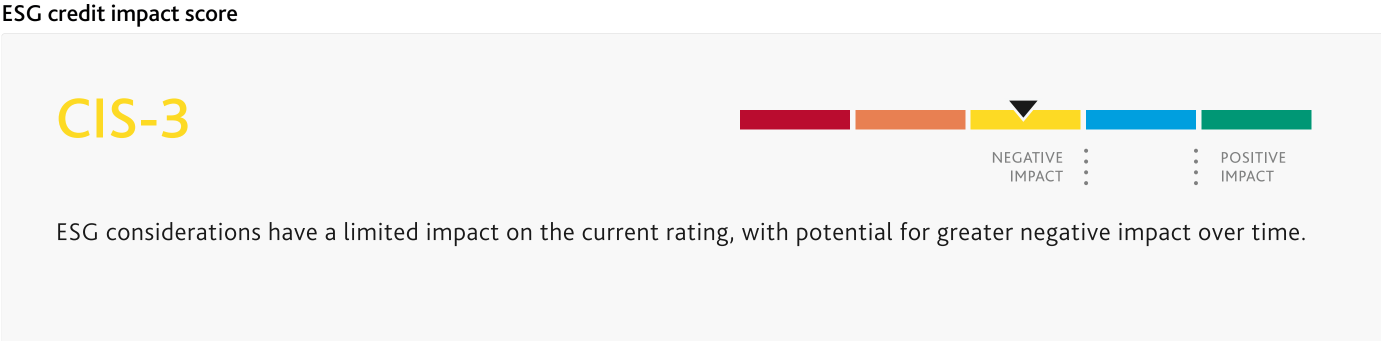
We expect liquidity buffers to remain modest in line with historical figures, which drive our assigned score of b2. According to IFRS, BoB's liquidity buffer was modest at 18% of the bank's tangible assets as of year-end 2023, slightly up from 13% as of year-end 2022. Although this buffer is modest compared with similarly rated regional and global banks, liquidity risks are mitigated by the short-term duration of the loan book (37% of loans or 26% of assets mature within a year according to the local GAAP report as of year-end 2023).

ESG considerations

OJSC Bank of Baku's ESG credit impact score is CIS-3

Exhibit 7

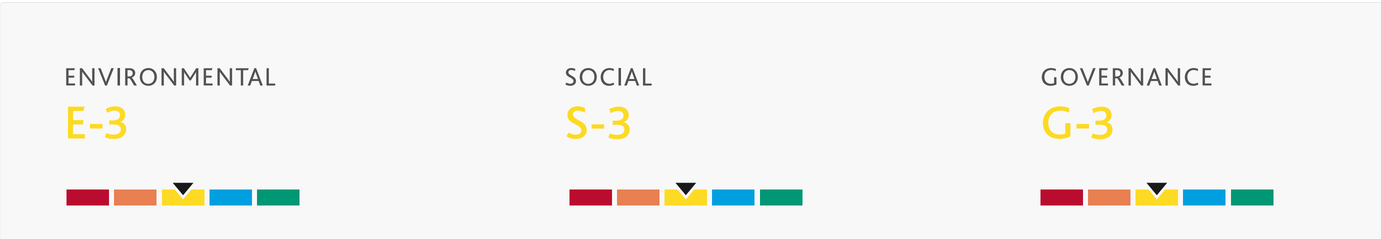
ESG credit impact score



Source: Moody's Ratings

OJSC Bank of Baku's **CIS-3** indicates that ESG considerations have a limited impact on the current credit rating with potential for greater negative impact over time reflecting the bank's moderate governance risks related to a concentrated ownership structure. The credit impact of environmental and social risk factors on the bank's ratings is limited.

Exhibit 8
ESG issuer profile scores



Source: Moody's Ratings

Environmental
OJSC Bank of Baku faces moderate environmental risks. Although the bank operates in Azerbaijan, where hydrocarbons play an important role for the overall economy and government revenue, it has a limited direct lending to carbon-intensive sectors being largely focused on unsecured retail business. The bank has low exposure to physical climate risks because of its limited lending to the agricultural sector.

Social
OJSC Bank of Baku faces moderate social risks related to customer relations, tightening regulatory and compliance standards, and the impact of potential technological disruptions associated with an increasingly digitally active customer base. However, the bank is generally focused on intermediation with simpler product ranges with few identified conduct issues and has been subject to looser regulatory scrutiny on consumer protection. Demographic and societal challenges include the risk of further military conflict between Armenia and Azerbaijan.

Governance
OJSC Bank of Baku faces moderate governance risks, stemming from its concentrated ownership structure and track record in credit risk management. The bank was severely hit by the 2015-2016 financial crisis in Azerbaijan, which resulted in heavy losses, erosion of capital and balance-sheet deleveraging. The bank has strengthened its risk management over the recent years and currently demonstrates an appropriate level of financial strategy. Its current compliance and reporting are in line with industry practices and adequate for its business complexity.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Support and structural considerations

Government support considerations
Because of 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.

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 significantly differ from that suggested by raw data alone (although 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 9
Rating Factors

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	2.9%	ba3	↔	b2	Loan growth	Unseasoned risk
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel I)	17.3%	ba1	↓↓	ba3	Expected trend	
Profitability						
Net Income / Tangible Assets	3.5%	baa2	↓↓	ba3	Expected trend	Earnings quality
Combined Solvency Score		ba1		b1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	15.0%	ba3	↑	ba3	Expected trend	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	17.8%	b2	↔	b2	Expected trend	
Combined Liquidity Score		b1		b1		
Financial Profile				b1		
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				ba3 - b2		
Assigned BCA				b1		
Affiliate Support notching				0		
Adjusted BCA				b1		

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	ba3	0	Ba3	Ba3
Counterparty Risk Assessment	1	0	ba3 (cr)	0	Ba3(cr)	
Deposits	0	0	b1	0	B1	B1

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

Ratings

Exhibit 10

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Stable
Counterparty Risk Rating	Ba3/NP
Bank Deposits	B1/NP
Baseline Credit Assessment	b1
Adjusted Baseline Credit Assessment	b1
Counterparty Risk Assessment	Ba3(cr)/NP(cr)

Source: Moody's Ratings

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