MOODY'S
INVESTORS SERVICE

CREDIT OPINION
11 August 2023

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	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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CLIENT SERVICES

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Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

OJSC Bank of Baku

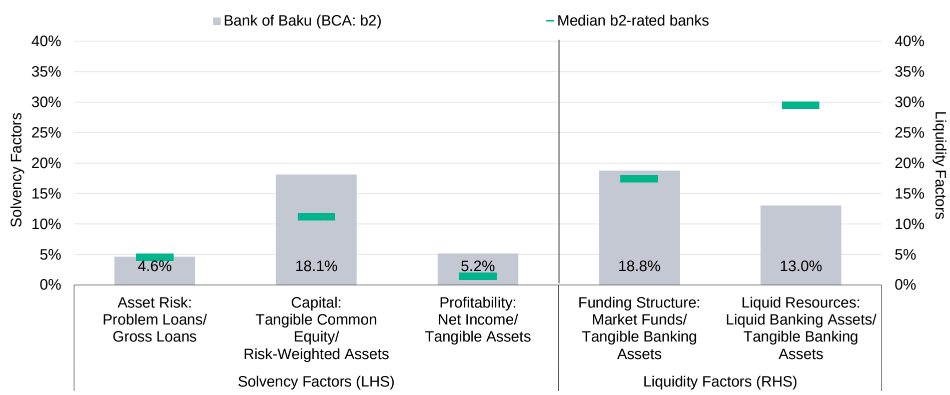
Update following rating action

Summary

OJSC Bank of Baku's (BoB) 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 given our assumptions of low government support from the Government of Azerbaijan (Ba1 stable).

Bank of Baku's b2 BCA reflects improved asset quality and profitability through the pandemic and lockdowns as well as expected improvement of the bank's standalone credit profile in the next 12-18 months. At the same time, the BCA is constrained by the bank's focus on unsecured consumer lending segment, as well as its relatively weaker funding profile and modest liquidity cushion.

Exhibit 1
Scorecard ratios



Source: Moody's Investors Service

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

» High reliance on market funds

» Modest liquidity cushion

Outlook

The positive outlook on the bank's long-term deposit ratings reflects our expectation that the bank is well placed to ensure recent improvements are sustainable over the outlook period.

Factors that could lead to an upgrade

» BoB's BCA and long-term bank deposit ratings could be upgraded if there is a significant improvement in the bank's liquidity and funding profile while maintaining sound solvency.

Factors that could lead to a downgrade

» The positive outlook on BoB's long-term bank deposit ratings could be changed to stable if the bank's financial fundamentals, such as liquidity, asset quality or profitability, eroded.

Key indicators

Exhibit 2

OJSC Bank of Baku (Consolidated Financials) [1]

	12-22[2]	12-21[2]	12-20[2]	12-19[2]	12-18[2]	CAGR/Avg.[3]
Total Assets (AZN Million)	694.4	519.5	419.4	373.9	289.4	24.5[4]
Total Assets (USD Million)	407.9	305.7	246.8	220.4	170.6	24.4[4]
Tangible Common Equity (AZN Million)	143.5	112.7	84.9	68.5	22.7	58.5[4]
Tangible Common Equity (USD Million)	84.3	66.3	50.0	40.4	13.4	58.4[4]
Problem Loans / Gross Loans (%)	2.6	3.2	8.0	13.6	54.8	16.5[5]
Tangible Common Equity / Risk Weighted Assets (%)	18.1	21.2	27.7	26.6	8.0	20.3[6]
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	9.3	9.8	19.9	31.9	99.8	34.1[5]
Net Interest Margin (%)	11.1	9.5	9.2	7.6	5.6	8.6[5]
PPI / Average RWA (%)	4.0	3.7	3.3	2.3	0.5	2.7[6]
Net Income / Tangible Assets (%)	5.8	6.4	3.3	6.5	9.2	6.2[5]
Cost / Income Ratio (%)	60.2	67.4	75.5	81.5	95.1	75.9[5]
Market Funds / Tangible Banking Assets (%)	18.8	21.6	24.2	22.8	16.9	20.9[5]
Liquid Banking Assets / Tangible Banking Assets (%)	13.0	20.9	30.5	31.8	8.9	21.0[5]
Gross Loans / Due to Customers (%)	152.6	155.6	138.9	143.9	237.2	165.6[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 the 24 commercial banks operating in Azerbaijan. As of 31 December 2022, it held a countrywide market share of 1.8%, based on total assets of AZN794 million ($467 million).

The bank is headquartered in Baku, the capital city of Azerbaijan, and operates a network of 19 branches. Bank of Baku has historically been focused on providing consumer loans. As of 31 December 2022, loans to individuals accounted for around 90% of the bank's gross loan book and were, in turn, dominated by unsecured consumer loans (66% 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 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 Mr Hikmat Ismayilov (31.11%), "Azpetrol Neft Shirketi" LLC (28.89%) and Mr Elchin Isayev (5%).

Detailed credit considerations

Elevated asset risk stems from the bank's focus on risky consumer lending

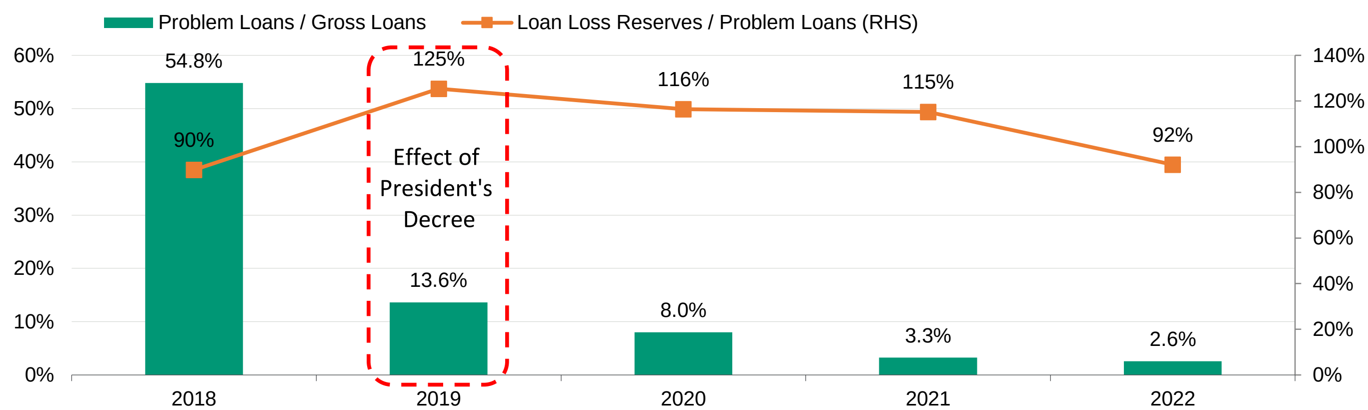
The assigned Asset Risk score of b3 reflects the bank's concentration in unsecured lending (consumer loans and credit cards), which makes its asset quality vulnerable to any economic shock. However, the share of BoB's problem loans (PLs; defined as stage 3 lending) improved substantially in recent years to 2.6% at the end of 2022 from 8.0% at the end of 2020 thanks to work-out of legacy problems as well denominator effect caused by rapid loan book expansion. The strong loan growth will likely increase formation of new problem lending in the next 12-18 months.

On top of this, 6.9% of gross loans at year-end 2022 comprised loans restructured following a 2019 Presidential decree (these loans were accounted as purchased and originated credit impaired loans net of loan loss reserves). We expect that at least a quarter of these restructured loans will be resolved and collected by the end of 2023 as per management guidance.

BoB's large consumer loan book, with about 90% of the loans granted to individuals (including entrepreneurs) as of year-end 2022, will continue to strain the bank's 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 are subject to limited public support. In addition, the majority of the loans are unsecured, which hinders recovery rates. That said, BoB's PL coverage ratio of 92% as of year-end 2022 provides a good buffer to absorb expected losses. In addition, the bank's exposure to foreign currency loans is negligible at less than 1% of net loans at the end of 2022.

Exhibit 3

Asset risk remains elevated despite the bank's low PL ratio and robust coverage by reserves



Source: Moody's Investors Service

Since 2019-2020, BoB has significantly strengthened its risk management and tightened underwriting standards. However, rapid loan book expansion of 40% and 47% in 2021 and 2022, respectively will expose the bank to asset quality deterioration once the portfolio starts to season.

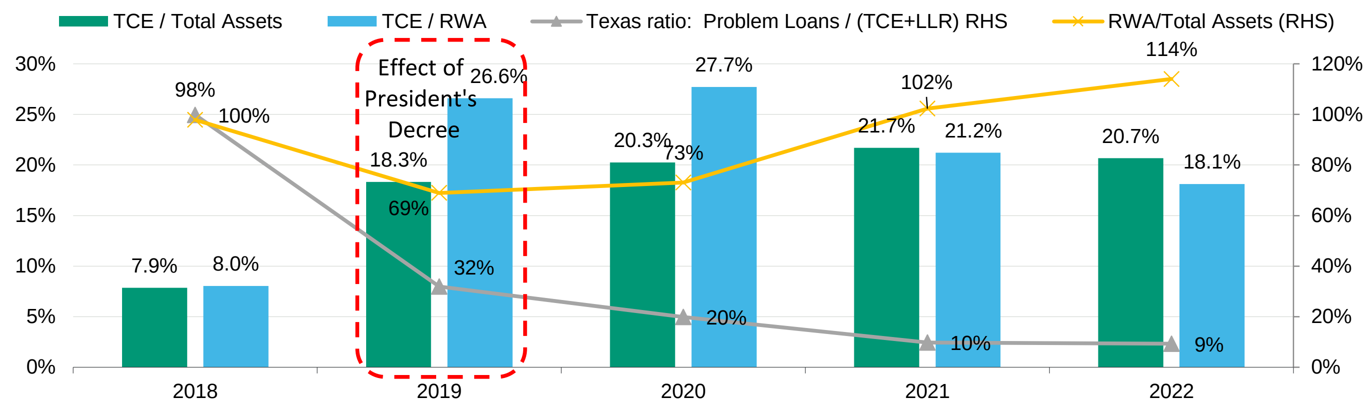
Our assigned Asset Risk score of b3 captures our expectation that the bank's problem loan ratio will not exceed 3-4% in the next 12-18 months, as well as 2-notches downward adjustment for rapid loan book growth and unseasoned portfolio credit risk.

Capital will remain robust

We view BoB's capital adequacy as one of its credit strengths and assign a Capital score of ba2. This reflects our expectation that the bank will retain its robust capital buffer over the next 12-18 months and will continue dividend payouts similar to those made in the last two years. As of year-end 2022, BoB reported tangible common equity (TCE)/risk-weighted assets (RWA) ratio of 18.1%, despite strong loan book growth.

The bank's solvency also benefits from its low leverage. The bank's TCE to total assets ratio was 20.7%. As a proportion of total assets, BoB has the highest share of RWA/Total Assets at 114% compared to an average of 63% for its rated domestic peers, which is attributed to over 100% risk-weights applied to high credit risk loans (consumer, credit cards, microloans etc). The bank's robust capital adequacy is supported by its strong retained earnings.

Exhibit 4
Capital adequacy remains robust despite rapid loan book growth

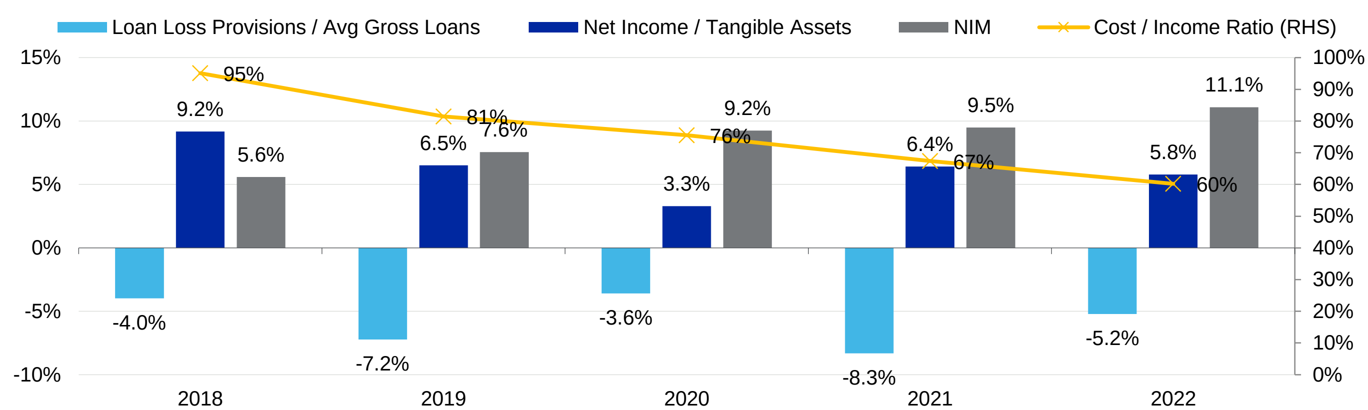


Source: Moody's Investors Service

Strong bottom-line profitability supported by improved NIM and ongoing recovery of restructured loans

In 2022, BoB posted net income of AZN40.1 million under IFRS, an equivalent of return on tangible assets of 5.8%. Strong bottom-line profitability was supported by an increase in recurring revenue following the balance sheet clean-up and the replacement of the legacy problematic loan portfolio with new loans that are of better quality and generate stable net interest income (NII). In 2022, the bank's NII amounted to AZN64.9 million, which was 48% higher than in 2021, and accounted for 98% of net revenue.

Exhibit 5
Very strong profitability was driven by strong NII and provisions recovery



Source: Moody's Investors Service

In addition, the bank continued to release loan loss reserves at AZN24.8 million in 2022 (down from AZN27.3 million in 2021) which contributed about half of pre-tax income of AZN50.9 million. Since 2019 BoB has recovered a material amount of its problem loans restructured under the President's Decree. We expect a significant reduction of provisions recovery in the next 12-18 months, which will be balanced by strengthening NII generated by the healthy part of the loan portfolio.

BoB's operating expense increased 25% in 2022 following rapid expansion of loan portfolio. However, its operating efficiency improved as the bank posted cost-to-income ratio of 60% in 2022 down from 67% in 2021; and the ratio of operating expense to total assets of 5.7% and 6.1% over same periods. Heavy operating costs are mainly attributed to labour-intensive loan origination with relatively small average loan tickets and problem loan collection processes.

We expect a steady increase of BoB's funding costs in the next 12-18 months following annual repayments of the Central Bank of the Republic of Azerbaijan (CBAR)'s loan at 0.1% p.a. due in 2024. Despite expected pressure on its net interest margin (NIM) the bank will preserve its strong pre-provision profitability owing to an increasing share of healthy loan portfolio. In our central scenario BoB will remain highly profitable over the next 12-18 months as rapid loan growth will bring in strong revenue amid a stronger economic background in Azerbaijan. We expect revenue growth to outpace operating costs growth, supporting profitability, notwithstanding our view that credit costs will rise.

We expect BoB's return on tangible assets will remain strong in the next 12-18 months and assign Profitability Score of ba2 to reflect our expectations as well as highly volatile historical profitability owing to high-risk nature of the bank's business model.

Modest liquidity cushion along with still high reliance on market funds from the state

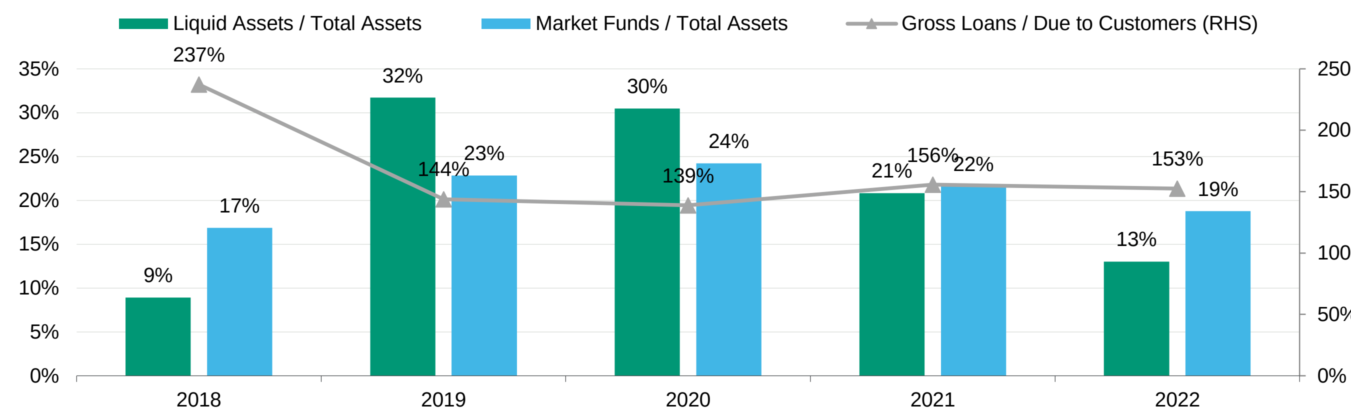
As of year-end 2022, customer deposits accounted for 68% of BoB's total liabilities. The deposit portfolio is granular, and 93% represented by retail deposits. In 2022, Bank of Baku's customer deposits increased by 50% compared with a banking system average of 25% for the same period.

Dollarisation of deposits remained high, with 24% of customer deposits being denominated in foreign currency, predominantly US dollars as of year-end 2022. This share, however, is below the system average of 47%. Also, these deposits are fully covered by liquid foreign-currency assets in the form of cash placements with CBAR, dues from banks and foreign-currency denominated securities.

As of year-end 2022, BoB's ratio of market funding to total liabilities was 19% down from 22% a year before (Exhibit 6). Market funding included AZN38 million loan from the CBAR received in 2019 for five years at a 0.1% p.a. against an equivalent amount of overdue retail loans restructured under the President's Decree. Another AZN47 million was received from the national funds for entrepreneurship, mortgage and agriculture support.

Exhibit 6

BoB's reliance on market funds is steadily decreasing, although remains high



Source: Moody's Investors Service

We consider these funding sources stable and subject to modest refinancing risk. However, despite the stability of these funds, BoB's loan-to-deposit ratio remains high at 153%, compared with an average of 67% for its domestic peers. We expect a gradual decline of the bank's reliance on market funds owing to rapid customer deposit growth. We assign a Funding Structure score of b2 to reflect the expected trends.

According to the IFRS, BoB's liquidity buffer was modest at 13% of the bank's total assets as of year-end 2022 largely due to rapid loan book growth. Its liquid assets comprised cash and cash equivalents (58% of the total), due from financial institutions (26%) and Azerbaijan's government bonds (16%). We estimate that the share of liquid assets improved to 16% of total assets as of mid-2023 based on local GAAP reports. We expect BoB's liquidity cushion will fall within 15-20% of total assets range in the next 12-18 months. Assigned Liquidity score of b3 reflects these expected trends.

ESG considerations

OJSC Bank of Baku's ESG Credit Impact Score is Moderately Negative CIS-3

Exhibit 7
ESG Credit Impact Score

CIS-3
Moderately Negative

For an issuer scored CIS-3 (Moderately Negative), its ESG attributes are overall considered as having a limited impact on the current rating, with greater potential for future negative impact over time. The negative influence of the overall ESG attributes on the rating is more pronounced compared to an issuer scored CIS-2.

Source: Moody's Investors Service

OJSC Bank of Baku's ESG Credit Impact Score is moderately negative (**CIS-3**), reflecting the negative impact of governance risks on the credit ratings. Governance risks arise from 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

ENVIRONMENTAL
E-3
Moderately Negative

SOCIAL
S-3
Moderately Negative

GOVERNANCE
G-3
Moderately Negative

Source: Moody's Investors Service

Environmental
OJSC Bank of Baku faces moderately negative exposure to 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 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 moderately negative 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 geopolitical conflict escalation related to Nagorno-Karabakh region.

Governance
OJSC Bank of Baku faces moderately negative 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

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

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)

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 9

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	4.6%	b2	↑↑	b3	Loan growth	Unseasoned risk
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel I)	18.1%	ba1	↓	ba2	Expected trend	
Profitability						
Net Income / Tangible Assets	5.2%	baa3	↔	ba2	Expected trend	Earnings quality
Combined Solvency Score		ba2		b1		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	18.8%	b2	↔	b2	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	13.0%	b3	↑	b3	Expected trend	
Combined Liquidity Score		b2		b2		
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				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 10

Category	Moody's Rating
OJSC BANK OF BAKU	
Outlook	Positive
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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