JSC Pasha Bank Georgia

Rating report

Issuer rating

B-

Outlook

Stable

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Disclosure/warning

This rating report is accessible to the general public.

Summary and Outlook

The bank's issuer rating of B- reflects the following assessments:

- **Business model assessment: Focused (Low)**. Pasha Bank Georgia, a subsidiary of OJSC Pasha Bank Azerbaijan, is a small player in the competitive Georgian banking sector. In January 2024, the bank decided to discontinue its mass retail banking activities and to refocus on commercial and investment banking. Its retail portfolio was sold in March 2024. We consider this strategic change to be credit positive because the bank wants to focus on a niche market where it has technical expertise and a positive business track record.

- **Operating environment assessment**: **Constraining (High).** Georgia is a small emerging economy that, despite gradual improvements and reforms in recent years, still lags behind regional peers in some macroeconomic indicators. Recent political tensions have not yet changed the economic outlook so far but they remain an area of attention. The regulatory framework is generally aligned with the Basel framework and the sophistication of banking regulation and supervision is improving.
- **Long-term sustainability assessment (ESG factor): Constrained**. The implementation of the bank's digital strategy, which is key to the success of the refocusing strategy, as well as governance considerations, in light of recent strategic changes and senior management turnover, deserve attention.
- **Earnings and risk exposures assessment: Constraining (-1 notch)**. The bank's ability to generate consistent and predictable earnings has improved but has not yet been tested over an extended period of time. In 2023, the bank reported its first profit after four consecutive years generating recurrent losses. This positive trend continued in 2024.
- **Financial viability assessment: Limited (-1 notch)**. The bank has been subject to several recapitalisations in the past two years, as a result of persistent losses. Given the challenge to generate capital organically, distance to regulatory capital requirements is tightly managed. The refocusing strategy and prospects of stabilizing financial performance should help the bank to strengthen its capital position.
- **External support: Moderate support (+1 notch).** Group membership is a positive credit rating factor, as it provides operational support and strategic oversight for the implementation and execution of the updated medium-term strategy.

The Stable Outlook reflects our view that the risks to the current rating are balanced.

The upside scenarios for the rating and Outlook:

- A sustained improvement of the bank's earnings capacity.
- Strengthened capital adequacy metrics.
- Evidence of increasing strategic importance, which could lead to a higher likelihood of extraordinary parent support in case of need.

The downside scenarios for the rating and Outlook:

- Signs that the strategic importance of the bank for the group is being questioned, for instance in case of failure to execute on the new medium-term strategy, which could lead to a lower expectation of extraordinary support in case of need.
- The bank's capital position reducing further, closer to the minimum capital requirements.

Rating drivers

<table>
<tr><th colspan="2">Rating drivers</th><th colspan="30">Assessment</th></tr>
<tr><td rowspan="7">STEP 1</td><td>Operating environment</td><td colspan="6">Very constraining</td><td colspan="6">Constraining</td><td colspan="6">Moderately supportive</td><td colspan="6">Supportive</td><td colspan="6">Very supportive</td></tr>
<tr><td>Low/High</td><td colspan="15">Low</td><td colspan="15">High</td></tr>
<tr><td>Business model</td><td colspan="6">Narrow</td><td colspan="6">Focused</td><td colspan="6">Consistent</td><td colspan="6">Resilient</td><td colspan="6">Very resilient</td></tr>
<tr><td>Low/High</td><td colspan="15">Low</td><td colspan="15">High</td></tr>
<tr><td>Initial mapping</td><td colspan="30">b</td></tr>
<tr><td>Long-term sustainability</td><td colspan="6">Lagging</td><td colspan="6">Constrained</td><td colspan="6">Developing</td><td colspan="6">Advanced</td><td colspan="6">Best in class</td></tr>
<tr><td>Adjusted anchor</td><td colspan="30">b</td></tr>
<tr><td rowspan="4">STEP 2</td><td>Earnings capacity & risk exposures</td><td colspan="6">Very constraining</td><td colspan="6">Constraining</td><td colspan="6">Neutral</td><td colspan="6">Supportive</td><td colspan="6">Very supportive</td></tr>
<tr><td>Financial viability management</td><td colspan="5">At risk</td><td colspan="5">Stretched</td><td colspan="5">Limited</td><td colspan="5">Adequate</td><td colspan="5">Comfortable</td><td colspan="5">Ample</td></tr>
<tr><td>Additional factors</td><td colspan="6">Significant downside factor</td><td colspan="6">Material downside factor</td><td colspan="6">Neutral</td><td colspan="6">Material upside factor</td><td colspan="6">Significant upside factor</td></tr>
<tr><td>Standalone rating</td><td colspan="30">ccc</td></tr>
<tr><td>STEP 3</td><td>External support</td><td colspan="30">Moderate support: +1 notch</td></tr>
<tr><td colspan="2">Issuer rating</td><td colspan="30">B-</td></tr>
</table>

Credit ratings

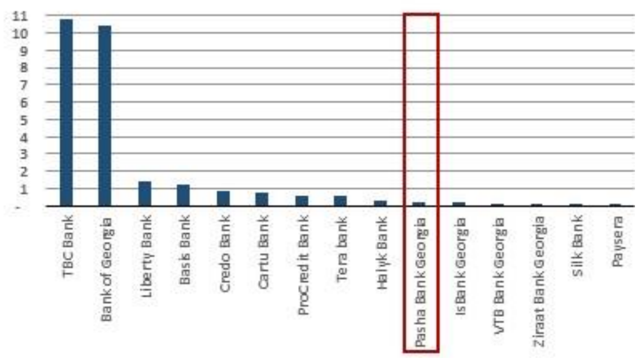
		Credit rating	Outlook
Issuer	**JSC Pasha Bank Georgia**		
	Issuer rating	B-	Stable
	Short-term debt rating	S-4	Stable

Business model

Pasha Bank Georgia is a small domestic bank, with GEL 526m (about EUR 178m) in total assets as of March 2024 and less than 1% market share in terms of net loans as of YE 2023.

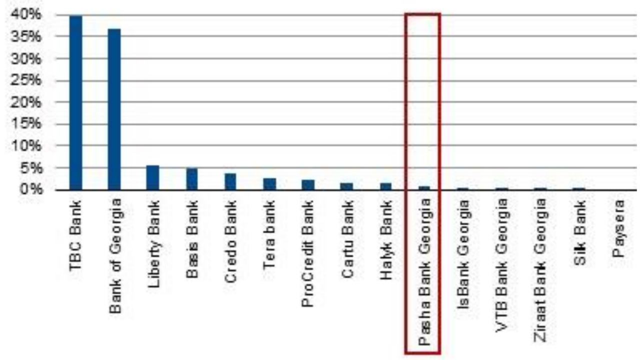
'Focused – low' business model assessment

Figure 1: Georgian banks ranked by total assets (year-end 2023, EUR bn)



Source: NBG, Scope Ratings

Figure 2: Georgian banks ranked by market share of net loans (year-end 2023)

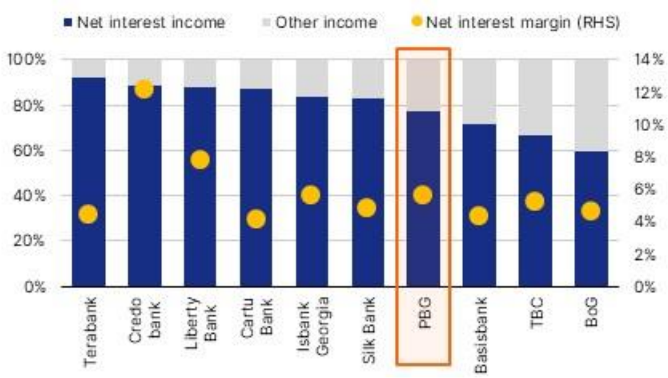


Source: NBG, Scope Ratings

Since its foundation, Pasha Bank Georgia's main strategic focus has been to support its parent bank's efforts to develop corporate and commercial lending with Azerbaijani companies operating in Georgia.

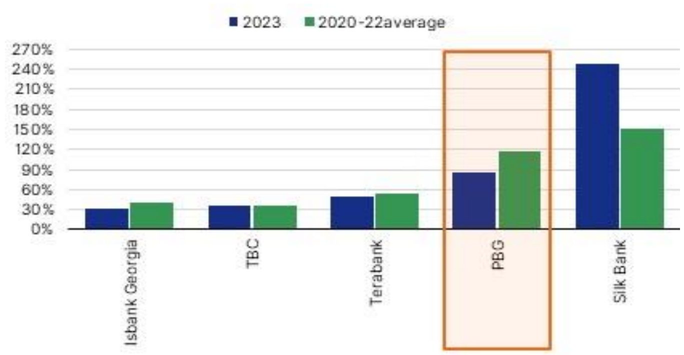
The bank is currently undergoing a re-shaping of its business model. Under its new medium-term strategy (2024-2026) the bank will focus on corporate and commercial banking services and products. Pasha Bank decided in January 2024 to discontinue mass retail lending activities, made up mainly of unsecured consumer loans. Pasha Bank Georgia sold this business to Liberty Bank in March 2024. As a result, the branch network will be downsized but the bank also wants to develop alternative channels such as internet banking.

Figure 3: Revenue profile, peer comparison



Source: SNL, Scope Ratings

Figure 4: Cost-to-income ratio, peer comparison



Source: SNL, Scope Ratings

Under the bank's medium-term strategic plan, net interest income will remain the bank's main source of revenue, with fees representing a minor portion. Providing loans with an attractive interest rate and interacting with clients via a user-friendly banking interface are two pillars of the updated strategy.

Operating environment

Focus on JSC Pasha Bank Georgia's country of domicile: Georgia (BB/Stable)

Economic assessment:

- The Georgian economy is experiencing a strong recovery and robust medium-run growth potential. The growth of recent years has well exceeded this trend rate, benefitting from strong services-sector exports, financial inflows, transit trade and favourable arrivals of skilled workers from Russia, Belarus and Ukraine. After very strong real growth of 10.6% in 2021, 11.0% 2022, and 7.5% in 2023, growth is expected to stay strong at 7.5% this year before 5.4% next year.
- Russia's invasion of Ukraine creates significant economic uncertainties given the strong trade linkages of Georgia to the warring counterparties. So far, the economy has weathered the crisis exceptionally well.
- In addition, the economy is vulnerable to external shocks due to its small size alongside elevated reliance upon external funding and elevated dollarization.
- The Georgian parliament adopted a new foreign-agent law in May 2024, which was a source of political tensions in the country. It remains to be seen to what extent prolonged political tensions could alter economic momentum in the country.

Key economic indicators	2021	2022	2023	2024E	2025F
Real GDP growth, %	10.6	11.0	5.0	7.5	5.4
Inflation (HICP), % change	9.6	11.9	2.5	1.6	2.9
Unemployment rate, %	20.6	17.3	16.4	13.5	13.0
Policy rate, %	10.5	11.0	9.5	7.5	7.0
Public debt, % of GDP	49	39	39	40	39
General government balance, % of GDP	-6.0	-2.6	-2.3	-2.6	-2.2

Source: Scope Ratings

Soundness of the banking sector:

- Commercial banks in Georgia play a major role in the domestic financial sector representing 91% of financial sector assets as of December 2023.
- As of end-December 2023, 15 banks operate in Georgia. The Georgian banking sector is highly concentrated with the two largest banks representing almost three quarters of total banking sector assets.
- The domestic banking system is characterised by a moderate level of cost efficiency and improving asset quality indicators. Non-performing loans continue to decline with an average NPL ratio standing below 2% as of May 2024.
- The banking sector has traditionally exhibited high profitability, with an average RoE of about 17% since 2012 due to overall lending volume growth and increasing net interest income.
- Georgian banks are well capitalised, maintaining satisfactory capital buffers above minimum requirements.
- The National Bank of Georgia supervises the microfinance organisation sector, but we consider that regulations are less stringent than for banks. The regulatory framework for microbanks has recently been enacted and is better aligned with the banking regulatory framework

Banking system indicators	2019	2020	2021	2022	2023
ROAA, %	2.9	1.3	3.0	3.3	3.6
ROAE, %	20.3	10.2	22.1	22.8	24.8
Net interest margin, %	5.3	4.4	4.8	5.2	5.8
CET1 ratio, %	13.3	12.5	14.3	17.3	22.8
Problem loans/gross customer loans, %	4.3	5.4	3.9	3.1	2.6
Loan-to-deposit ratio, %	124.3	114.9	119.0	102.8	106.9

Source: SNL, Scope Ratings

Long-term sustainability (ESG-D)

'Constrained' long-term sustainability assessment

The operational risks attached to the implementation of the bank's digital strategy, which is key to the success of the refocusing strategy, as well as governance considerations, in light of recent strategic changes and senior management turnover, deserve attention and mainly explain our assessment.

Governance

We consider that the overall corporate group, to which the bank belongs, has a complex structure. The highly concentrated shareholding structure is a source of potential influence on the conduct of the strategy. On a positive note, the bank has a two-tier corporate governance structure, with a Supervisory Board comprised exclusively of non-executive directors, and a Board of Directors comprised of executive members of the bank. Pasha Bank has four committees to support its governance.

In September 2023, the CEO and Chairman of the Board of Directors resigned, with the new CEO and a new CFO appointed in October 2023.

Digitalisation

The bank's IT infrastructures are at an early stage of development and a competitive weakness. While the bank offers internet and mobile banking platforms, covering most of the common products and services for day-to-day banking for its business customer, it needs to continue investing to improve core systems and plans to introduce new corporate digital channels.

Environmental

Sustainability initiatives have been part of the bank's strategy since 2015. Pasha Bank Georgia has strengthened this area since 2020, after the launch of its first ESG report, in line with National Bank of Georgia's requirements. In 2022, PBG adopted an environmental and social risk management system policy in line with industry standards. We note the further enhancement of ESG initiatives in the last years. As of December 2023, the bank's share of green loans in its total outstanding portfolio amounted to about 10%.

Social

We generally consider that social considerations are less relevant from a credit standpoint for financial institutions. Pasha Bank Georgia has undertaken several strategic changes in recent years. These include the most recent decision to discontinue and sell its mass retail lending activities, which require the proper rightsizing of the workforce.

Figure 5: Long-term sustainability overview table[1]

	Industry level			Issuer level						
	Materiality			Exposure			Management			
	Low	Medium	High	Low	Neutral	High	Weak	Needs attention	Adequate	Strong
E Factor		◇			◇				◇	
S Factor	◇				◇				◇	
G Factor			◇			◇		◇		
D Factor			◇			◇		◇		

Source: Scope Ratings

[1] The overview table illustrates how each factor informs our overall assessment. Materiality refers to our assessment of the credit relevance of each factor for the banking industry. Exposure refers to what extent the bank is exposed to risks or benefits from opportunities compared to peers, given its business model and countries of operation. Management refers to how we view the bank's navigation through transitions.

Earnings capacity and risk exposures

'Constraining' earnings capacity and risks exposures assessment

Financial performance is on an improving trend but the bank's capacity to absorb credit risk through operating income is still limited. We believe that the implementation of the updated strategy will help the bank to maintain this positive trajectory.

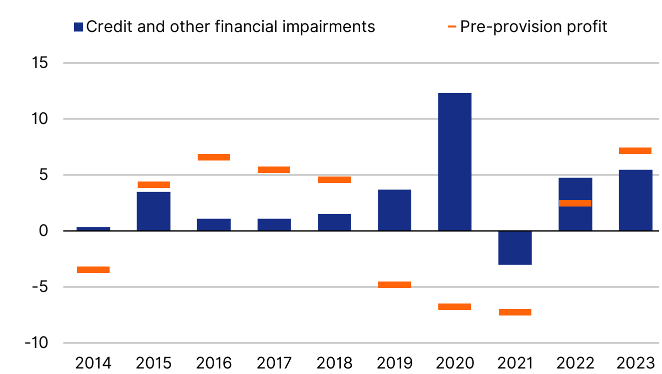
In 2023, the bank reported its first profit after four consecutive years generating recurrent losses. This positive trend continued in 2024. This improvement was due to volume growth, positive impact on high interest rates, higher non-interest income as well as impairment reversals.

Credit reversals resulted from the repossession of collaterals and some Stage 3 repayments of commercial clients, as well as a change in the ECL calculation, specifically related to LGD rates in retail loans decreasing from 100% to 85%.

This recovery in profitability continued in H1 2024. Pasha Bank Georgia reported a net profit of GEL 3.2m (compared to a net loss of GEL 1.3m in H1 2023), which was practically double that of 2023, and at practically the same level as the results of 2017 and 2018. The bank's main drivers for this recovery in profitability in H1 2024 were significantly lower provisions, higher FX income and higher other operating income. Pasha Bank Georgia is also focusing on optimising operating expenses. The bank's annualised ROAA and ROAE amounted to 1% and 6% in H1 2024 (vs -0.5% and -2.5% in H1 2023)

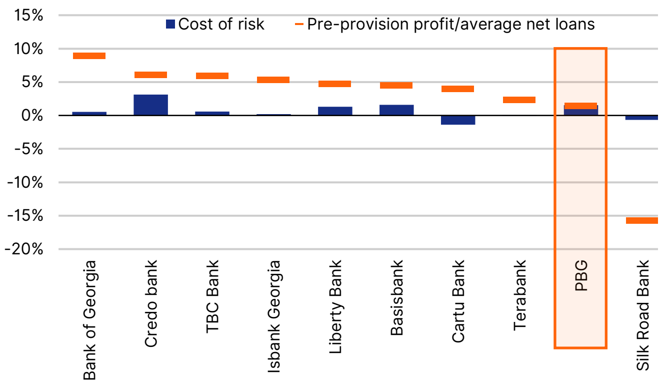
The strategy to focus on Azerbaijani companies operating in Georgia exposes the bank to concentration risks. The breakdown of its loan book by economic sectors is largely aligned with its parent's loan book. In addition, as of December 2023, the ten largest related group of borrowers represented about 41% of the total gross loan portfolio (38% in 2022).

Figure 6: Pre-provision income and provisions (GEL m)



Source: SNL, Scope Ratings

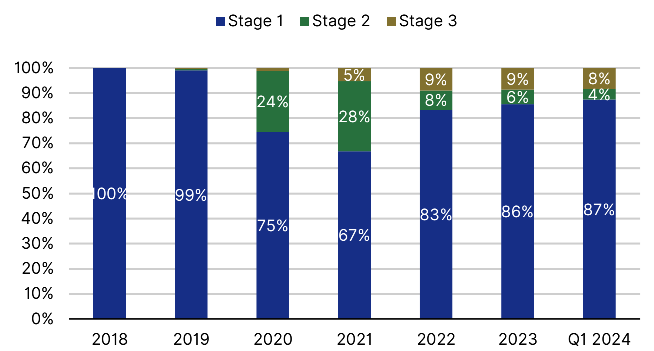
Figure 7: Peer comparison



Note: Three-year averages based on 2021-2023.
Source: SNL, Scope Ratings

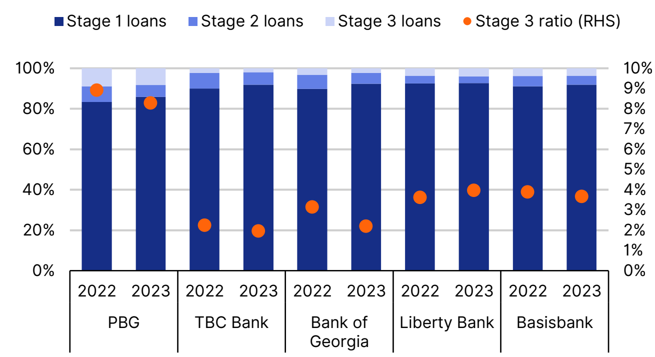
Asset quality indicators have worsened since 2020 due to the impact of pandemic. In Q1 2024, the Stage 3 ratio, including POCI loans, and Stage 3 coverage ratio remained at 8% and 24% respectively. Pasha Bank Georgia targets a NPL ratio of about 4%, thanks to more selective underwriting criteria and the clean-up and sale of its mass retail lending activities. The cost of risk decreased significantly since its 2020 peak, standing at 0.8% annualised for H1 2024.

Figure 8: Gross loan portfolio by stage (%, 2018-Q1 2024)



Source: Company data, Scope Ratings

Figure 9: Asset quality - peer comparison



Source: SNL, Scope Ratings

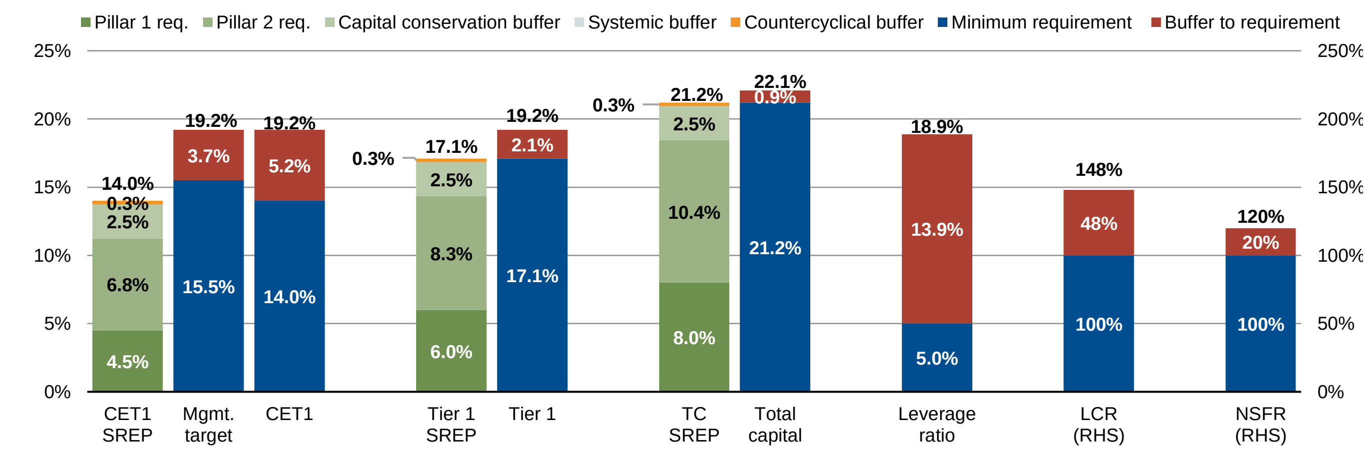
Financial viability management

'Limited' financial viability management assessment

The bank benefited from two capital injections in 2023, the first one in the form of 5-year maturity extension of USD 5m subordinated debt, which qualifies as Tier 2 capital under the NBG Basel III requirements and the second one in the form of a capital injection of about GEL 8m from its shareholder Pasha Holding.

As of Q1 2024, Pasha Bank Georgia had a modest buffer above minimum capital requirements about 90 bp above the central bank's requirement. Core Tier 1 capital ratio and Tier 1 capital ratio both amounted to about 19%, 520 bp over its core Tier 1 capital requirement and 210 bp over its Tier 1 capital requirement. Management wants to maintain a buffer of 150 bp above requirement.

Figure 10: Overview of distance to requirements as of Q1 2024

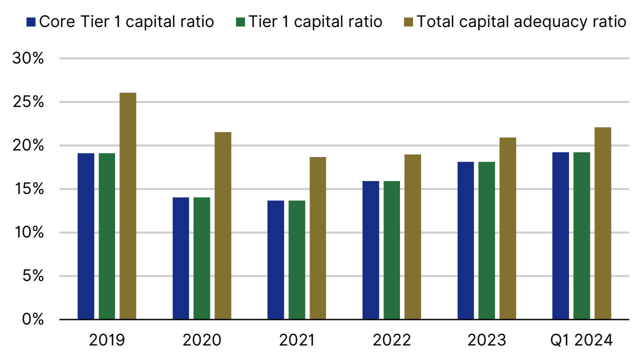


Source: Company data, Scope Ratings

We expect Pasha Bank Georgia's capital ratios to improve in the medium term with the sale of mass retail lending activities. An improved financial performance will also facilitate organic capital generation and reduce the need for capital injections.

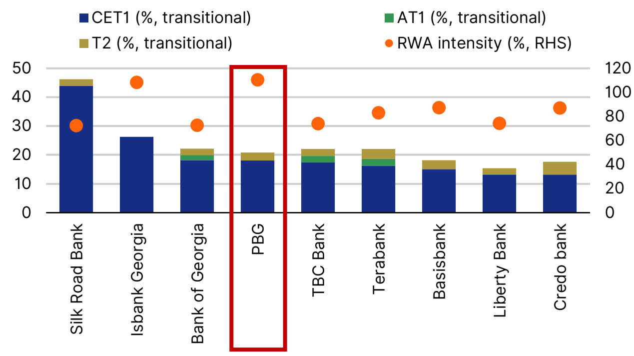
In terms of liquidity, Pasha Bank Georgia comfortably meets its requirements with a combined liquidity coverage ratio (local and foreign currency) of 148% as of Q1 2024. The net stable funding ratio stood at 120% in Q1 2024, in line with the 5-year average during the period 2019-2023. The bank expects to maintain similar liquidity levels during the medium-term strategic period.

Figure 11: Capital profile (2019-Q1 2024)



Source: Company data, Scope Ratings

Figure 12: Capital profile – peer comparison (YE 2023)



Source: SNL, Scope Ratings

Pasha Bank Georgia's funding structure remains tilted towards customer deposits (current and demand accounts as well as time deposits). They represented about 70% of the bank's total funding as of December 2023. Funding from credit institutions and subordinated debt represented 22% and 7%, respectively, as of December 2023.

We note the material concentration in the bank's funding (mostly deposits) towards related parties. The bank wants to diversify further its funding sources by attracting additional corporate deposits, which may prove to be costly, and via bond issuances. So far, the bank has not yet issued any bonds.

External support

The external support assessment balances our views that while acting independently, the bank would still benefit from extraordinary group support in case of need.

'Moderate support: + 1 notch' external support assessment

We view Pasha Bank Georgia as a strategic asset for Pasha group and a key subsidiary of OJSC Pasha Bank Azerbaijan.

The group has a policy of non-interference with the subsidiaries' daily operations. Despite the absence of an explicit guarantee or legal commitment from Pasha Holding LLC, it has experienced continuous group support. Examples include an about GEL 8m equity injection in September 2023 and the extension of the subordinated loan.

Meanwhile, we note that Pasha Bank Georgia is a small subsidiary for the group, representing about 4% of total assets of the consolidated OJSC Pasha Bank as of December 2023 and that a failure to improve financial performance in a sustained manner may question its strategic importance.

Financial appendix

I. Appendix: Selected financial information – JSC Pasha Bank Georgia

	2019Y	2020Y	2021Y	2022Y	2023Y
Balance sheet summary (GEL m)					
Assets					
Cash and interbank assets	147,621	85,636	93,042	109,469	101,575
Total securities	26,902	46,525	42,245	44,251	65,881
of which, derivatives	422	302	186	390	651
Net loans to customers	297,785	320,118	294,973	350,885	336,106
of which, non-loan items at amortised cost	0	0	0	0	0
Other assets	19,980	21,125	15,735	13,905	28,810
Total assets	**492,288**	**473,404**	**445,995**	**518,510**	**532,372**
Liabilities					
Interbank liabilities	110,130	131,091	123,135	106,687	90,139
Senior debt	5,575	10,528	6,147	3,772	3,135
Derivatives	230	640	332	935	786
Deposits from customers	241,708	210,222	201,987	272,031	288,855
Subordinated debt	27,589	31,742	30,222	26,559	27,716
Other liabilities	4,719	6,097	5,094	5,711	9,426
Total liabilities	**389,951**	**390,320**	**366,917**	**415,695**	**420,057**
Ordinary equity	102,337	83,084	79,078	102,815	112,315
Equity hybrids	0	0	0	0	0
Minority interests	0	0	0	0	0
Total liabilities and equity	**492,288**	**473,404**	**445,995**	**518,510**	**532,372**
Core tier 1/ common equity tier 1 capital	94,604	71,776	65,001	96,574	106,263
Risk-weighted assets	495,111	511,914	475,591	555,258	586,989
Income statement summary (GEL m)					
Net interest income	17,960	18,352	18,350	26,398	35,228
Net fee & commission income	601	835	56	1,028	2,308
Net trading income	4,106	5,029	2,463	9,448	9,442
Other income	299	239	549	305	170
Operating income	**22,966**	**24,455**	**21,418**	**37,179**	**47,148**
Operating expenses	27,773	31,238	28,689	34,695	39,982
Pre-provision income	**-4,807**	**-6,783**	**-7,271**	**2,484**	**7,166**
Credit and other financial impairments	3,675	12,308	-3,039	4,747	5,466
Other impairments	0	0	0	0	0
Non-recurring income	NA	NA	NA	NA	0
Non-recurring expense	NA	NA	NA	NA	0
Pre-tax profit	**-8,482**	**-19,091**	**-4,232**	**-2,263**	**1,700**
Income from discontinued operations	0	0	0	0	0
Income tax expense	578	162	-226	0	0
Other after-tax Items	0	0	0	0	0
Net profit attributable to minority interests	0	0	0	0	0
Net profit attributable to parent	**-9,060**	**-19,253**	**-4,006**	**-2,263**	**1,700**

Source: SNL, Scope Ratings
Note: Figures above may differ from reported figures.

II. Appendix: Selected financial information – JSC Pasha Bank Georgia

	2019Y	2020Y	2021Y	2022Y	2023Y
Funding and liquidity					
Net loans/ deposits (%)	123.2	152.3	146.0	129.0	116.4
Liquidity coverage ratio (%)	NA	NA	NA	NA	NA
Net stable funding ratio (%)	124.5	127.0	113.8	130.8	123.7
Asset mix, quality and growth					
Net loans/ assets (%)	60.5	67.6	66.1	67.7	63.1
Problem loans/ gross customer loans (%)	0.3	1.2	5.3	8.9	8.3
Loan loss reserves/ problem loans (%)	682.2	415.1	84.7	51.3	55.6
Net loan growth (%)	57.7	7.5	-7.9	19.0	-4.2
Problem loans/ tangible equity & reserves (%)	0.8	4.4	18.6	28.7	23.6
Asset growth (%)	50.5	-3.8	-5.8	16.3	2.7
Earnings and profitability					
Net interest margin (%)	4.5	4.0	4.2	5.6	7.0
Net interest income/ average RWAs (%)	4.1	3.6	3.9	5.2	6.5
Net interest income/ operating income (%)	78.2	75.0	85.7	71.0	74.7
Net fees & commissions/ operating income (%)	2.6	3.4	0.3	2.8	4.9
Cost/ income ratio (%)	120.9	127.7	133.9	93.3	84.8
Operating expenses/ average RWAs (%)	6.3	6.2	6.1	6.8	7.4
Pre-impairment operating profit/ average RWAs (%)	-1.1	-1.3	-1.5	0.5	1.3
Impairment on financial assets / pre-impairment income (%)	NM	NM	NM	191.1	76.3
Loan loss provision/ average gross loans (%)	1.5	3.8	-0.9	1.4	1.5
Pre-tax profit/ average RWAs (%)	-1.9	-3.8	-0.9	-0.4	0.3
Return on average assets (%)	-2.2	-4.0	-0.9	-0.5	0.3
Return on average RWAs (%)	-2.0	-3.8	-0.8	-0.4	0.3
Return on average equity (%)	-8.5	-20.8	-4.9	-2.5	1.6
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	19.1	14.0	13.7	17.4	18.1
Tier 1 capital ratio (%, transitional)	19.1	14.0	13.7	17.4	18.1
Total capital ratio (%, transitional)	26.0	21.5	18.7	19.3	20.9
Leverage ratio (%)	18.0	14.4	14.2	15.8	17.8
Asset risk intensity (RWAs/ total assets, %)	100.6	108.1	106.6	107.1	110.3
Market indicators					
Price/ book (x)	NA	NA	NA	NA	NA
Price/ tangible book (x)	NA	NA	NA	NA	NA
Dividend payout ratio (%)	NA	NA	NA	NA	NA

Source: SNL, Scope Ratings
Note: Figures above may differ from reported figures.

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Applied Methodologies

Financial Institutions Rating Methodology, February 2024

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