JSC Silk Bank

Rating report

Issuer rating

B-

Outlook

Stable

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Table of contents

Summary and Outlook
Rating drivers
Credit ratings
Business model
Operating environment
Long-term sustainability (ESG-D)
Earnings capacity and risk exposures
Financial viability management
Financial appendix

Summary and Outlook

Silk Bank's issuer rating of B- reflects the following assessments:

- **Business model assessment: Focused (Low)**. Silk Bank is a niche commercial bank operating exclusively in Georgia. The bank is currently engaged in a profound strategic transformation of its business model to develop its franchise in the highly competitive retail, consumer banking, micro- and SMEs segments, mainly via digital platforms. The assessment reflects the bank's limited product diversification and limited execution track record.
- **Operating environment assessment**: **Constraining (Low).** Georgia is a small emerging economy lagging regional peers on some macroeconomic indicators (e.g. unemployment rate, GDP per capita, economic diversification), despite gradual improvements and reforms in recent years. The assessment also reflects the specificities of the bank's niche target markets and high degree of competition in segments where competitors, such as fintechs or consumer credit companies, are not subject to the same degree of regulatory oversight than licensed banks.
- **Long-term sustainability assessment (ESG factor): Developing**. The strategic initiatives to develop digital capabilities is the main driver of this assessment. Silk aims to operate as an innovative digital bank, investing in the development of its digital infrastructure and capabilities. This, if executed well, could provide a competitive advantage and position the bank as a clear challenger to the largest established banks in the market.
- **Earnings and risk exposures assessment: Constraining**. The implementation of the strategic change is still at an early stage. Given the required investments, the bank was loss-making in 2022-2023 and will likely continue to be loss-making for a prolonged period of time. This is a constraining factor for the rating.
- **Financial viability assessment: Comfortable**. Silk Bank's large capital base and adequate liquidity are a rating strength. The high levels of excess capital and liquidity are aimed to fund the growth strategy. While the current buffers are due to decrease along with the deployment of the strategy and growth of the loan book, Scope considers that maintaining buffers well above the minimum requirement levels is a prerequisite given the bank's currently weak operating performance and the material execution risk of the business plan.

The Stable Outlook reflects Scope's view that the risks to the current rating are balanced.

The upside scenarios for the rating and Outlook:

- A track record of sustained positive earnings capacity.
- A successful business diversification through a greater product offering and enhanced customer franchise.

The downside scenarios for the rating and Outlook:

- A material erosion of capital and/or liquidity buffers.
- A material deterioration of asset quality metrics, or a riskier financial profile stemming, for instance, from a higher risk appetite or the ambition to growth faster than expected.
- Heightened strategic execution risk which could jeopardise the long-term viability of the bank.

Rating drivers

	Rating drivers	Assessment					
STEP 1	Operating environment	Very constraining	Constraining	Moderately supportive	Supportive	Very supportive	
	Low/High	*Low*			*High*		
	Business model	Narrow	Focused	Consistent	Resilient	Very resilient	
	Low/High	*Low*			*High*		
	Initial mapping	**b-**					
	Long-term sustainability	Lagging	Constrained	Developing	Advanced	Best in class	
	Adjusted anchor	**b-**					
STEP 2	Earnings capacity & risk exposures	Very constraining	Constraining	Neutral	Supportive	Very supportive	
	Financial viability management	At risk	Stretched	Limited	Adequate	Comfortable	Ample
	Additional factors	Significant downside factor	Material downside factor	Neutral	Material upside factor	Significant upside factor	
	Standalone rating	**b-**					
STEP 3	**External support**	Not applicable					
Issuer rating		**B-**					

Credit ratings

		Credit rating	Outlook
Issuer	**JSC Silk Bank**		
	Issuer rating	B-	Stable

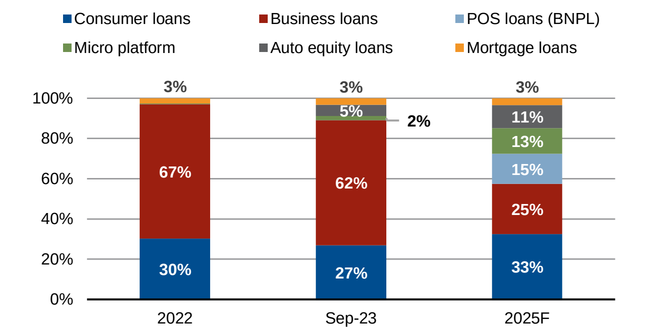
Business model

Silk Bank is a small domestic bank, with approx. GEL 180m in total assets as of March 2024 and less than 1% market share in terms of net loans. Its loan portfolio is mainly made of loans to MSMES (59%) as well as consumer loans (about 13%) as of March 2024. The bank is less present across Georgia than most of its competitors, but it intends to become a challenger digital bank, developing digital distribution channels that will contribute to its customer reach.

'Focused - low' business model assessment

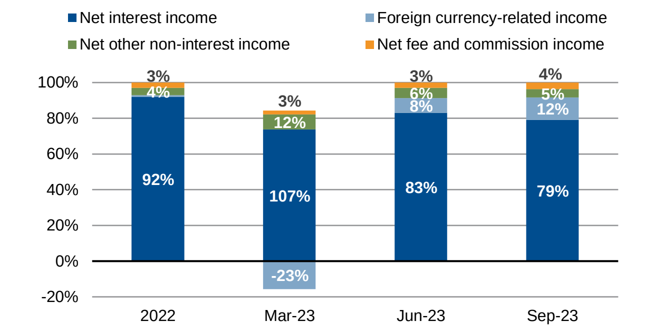
The bank is engaged in a profound transformation of its business model, both in terms of product diversification and customer base. It wants to focus on niche segments, which are currently underserved by domestic commercial banks, such as: i) self-employed and entrepreneurs; ii) MSMEs; iii) underbanked population; iv) Georgian nationals abroad; and v) international visitors and migrants.

Figure 1: Silk Bank's expected loan book split by product type (2022-2025F)



Source: Company data, Scope Ratings

Figure 2: Silk Bank's revenues split by type

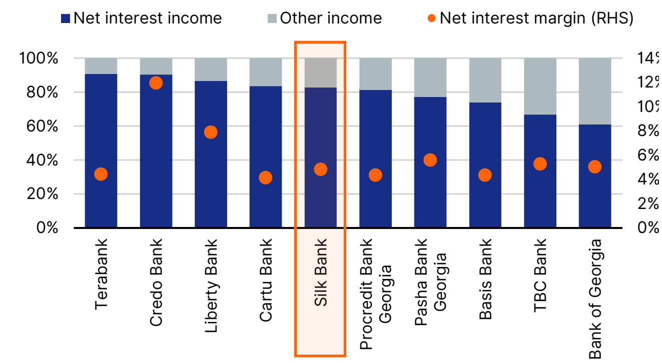


Source: Company data, Scope Ratings

Silk ambitions to develop a business model mainly relying on interest income and wants to attract clients by offering lower fees and commissions than competitors.

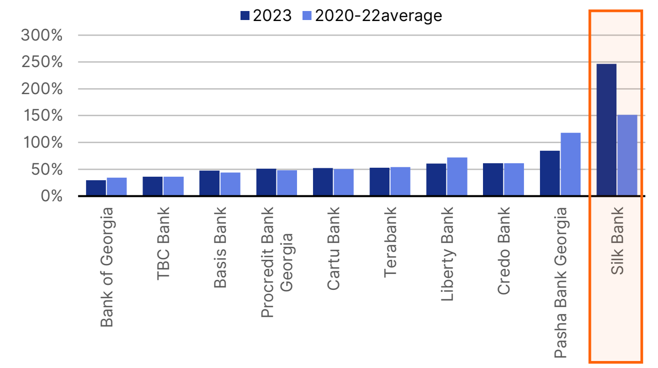
The bank's strategic business goals are: i) achieving stable profitability thanks to rapidly growing loan portfolio and customer base; ii) increasing market share in the MSME and retail banking segments; and iii) enhancing financial service accessibility for individuals with limited current usage of banking services. While competing on price, the bank also claims a competitive advantage in its personalised services due to its smaller size, its capacity to address swiftly customers' needs given its streamlined decision-making process.

Figure 3: Revenue profile – peer comparison



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

Figure 4: Cost to income, peer comparison



Source: SNL, Scope Ratings

Operating environment

Focus on Silk Bank'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)

'Developing' long-term sustainability assessment

We consider the bank's exposure to digital and governance factors to be high, because of the operational risks attached to the bank's objective to operate as challenger digital bank and the highly concentrated shareholding structure and potential influence on the conduct of the strategy.

Digitalisation

Developing digital capabilities is a key component of the bank's growth strategy. Silk Bank intends to operate as a challenger in digital banking within the Georgian financial sector, mirroring international models of fintechs and digital banks that claim to provide a better customer-service experience, faster approvals and a more digital-friendly approach. The bank has decided to fully digitalise most of its products and services offered to its customers. It has made significant investments to develop its digital infrastructure and capabilities, from processes to systems, tools, platforms and technologies.

Governance

We consider governance issues to be adequately managed. The bank has a two-tier corporate governance structure, with a supervisory board comprising six members, of which three are independent members, including the chairman, and a board of directors comprising top management members of the bank. Two committees, on risk management and audit, report to the bank's supervisory board.

Environment

Sustainability initiatives are part of the new strategy and include an optimised usage of resources and minimal energy consumption. Following the launch of its first ESG reporting, Silk Bank has strengthened its sustainability focus in line with National Bank of Georgia's requirements. The bank intends to spend approx. 5% of its net income on CSR projects focused on environmental sustainability and education.

Social

As of March 2024, the bank operates with a small branch network compared to peers (four branches in total). This light setup reflects its digital strategic focus. Silk plans to open two additional branches in summer 2024.

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			◇			◇			◇	

[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.

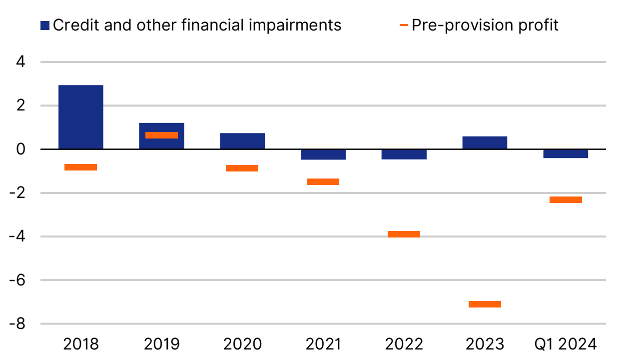
Earnings capacity and risk exposures

'Constraining' earnings capacity and risks exposures' assessment

Silk Bank's medium-term plan focuses on strengthening its digital capabilities to increase automation and achieve higher operational efficiency, including synergies within the broader Silk Road Group. However, Silk Bank was loss making in 2022 and 2023 and given the required investments it will likely continue to be loss-making for a prolonged period of time. Other elements affecting the cost base are the high payroll costs, marketing and client acquisition expenses, as well as SaaS costs for the digital platform.

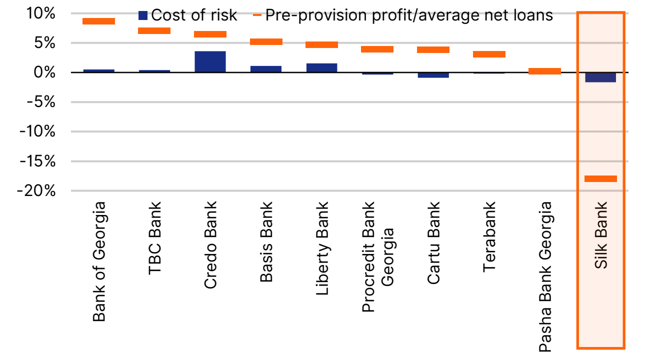
Costs will absorb a large portion of revenues in 2024 and 2025. As a result, the bank is unlikely to break even before 2026.

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



Source: SNL, Scope Ratings

Figure 7: Peer comparison

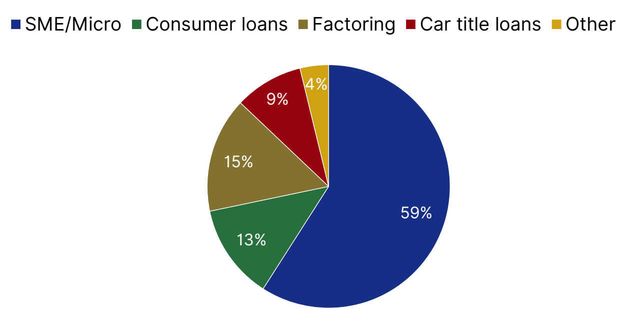


Note: Three-year averages based on 2021-2023.
Source: SNL, Scope Ratings

With the plan to increase the share of unsecured consumer loans, which by nature are higher risk compared to guaranteed or collateralised loans, asset quality will remain an area of attention. On a positive note, the portfolio of consumer loans should remain very granular.

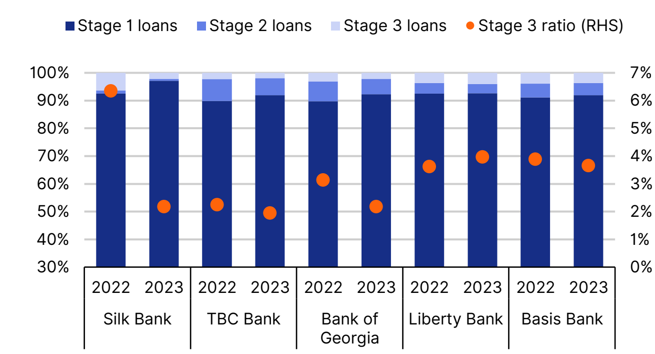
We expect also that cost of risk will be slightly higher than peers given the plan to grow not only consumer and auto loans but also loans to riskier categories of clients such as MSMEs and individual entrepreneurs. Therefore, we expect the bank's ability to generate stable and growing earnings to be a result of the successful implementation of the strategic change, still at an early stage.

Figure 8: Gross loan book split by product type (Q1 2024)



Source: Company data, Scope Ratings

Figure 9: Asset quality - peer comparison



Source: SNL, Scope Ratings

Financial viability management

'Comfortable' financial viability management assessment

We expect Silk Bank's capital ratios to reduce gradually as excess capital will serve to fund the rapid expansion of the loan book. Meanwhile, we understand that the bank intends to maintain at least a 2.5% buffer above its minimum capital requirements in the medium term. In our view, maintaining buffers well above the minimum required levels is a prerequisite given the bank's limited size in absolute terms and the material execution risk of the business transformation. Shareholder support in the form of capital injections may partially offset this trend.

We consider that the availability of shareholder support in the form of capital injections to fund the growth is a key part of the strategic plan. Silk Bank's Tier 1 Capital increased in April 2024 due to the transfer of subordinated debt amounting to GEL 3.5m from its main shareholder into the bank's equity. The objective of the strategy is to transform the bank into a profitable and self-sustained business unit. Therefore, we do not factor potential extraordinary shareholder support as a source of rating uplift.

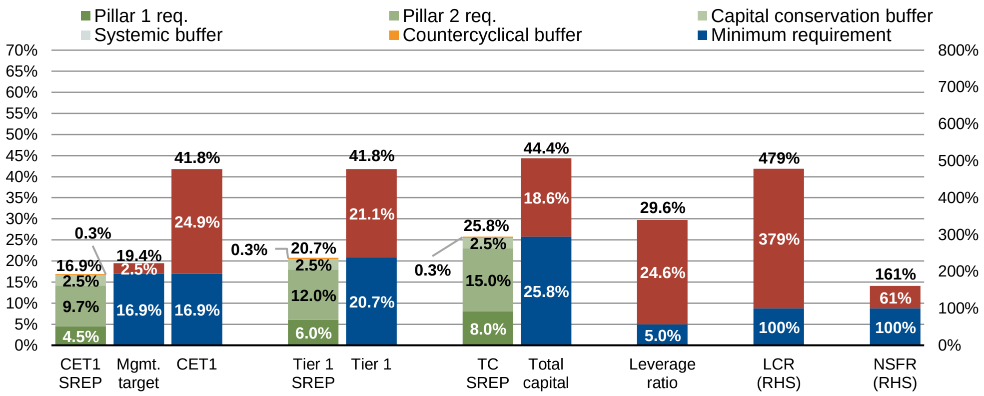
In terms of liquidity, Silk Bank comfortably meets its requirement currently, with a combined liquidity coverage ratio (domestic and foreign currency) of approx. 480% as of Q1 2024 (vs approx. 300% in Q1 2023), well above the 100% minimum ratio required by the National Bank of Georgia. The bank expects these high levels of liquidity will steadily decline over time but will at all times remain comfortably above the minimum regulatory requirements.

The bank's net stable funding ratio (NSFR) amounted to 161% as of Q1 2024 (vs 169% in Q1 2023) Silk Bank also anticipates a gradual reduction of its the NSFR over time to approx. 120% in 2025.

Silk Bank plans to fund the rapid growth of its loan book with a matching growth of its customer deposits thanks to an attractive pricing strategy. It will likely put pressure on net interest margins and therefore limit the bank's ability to generate higher revenues in the short term.

The bank's deposit base is concentrated. A large portion of current accounts and term deposits relates to a single state-owned investor. With the growing diversification of the customer base, this concentration is due to reduce. We view positively the bank's access to intra-group funding while it develops its capacity to operate as a self-funded bank.

Figure 10: Financial viability dashboard – overview of positioning vs key regulatory requirements (March 2024)



Source: Q1 2024 Pillar III quarterly report, Scope Ratings

Financial appendix

I. Appendix: Selected financial information – JSC Silk Bank

	2019Y	2020Y	2021Y	2022Y	2023Y
Balance sheet summary (GEL'000)					
Assets					
Cash and interbank assets	24,055	6,802	16,417	12,363	54,107
Total securities	19,967	41,902	40,845	32,185	27,214
of which, derivatives	NA	NA	NA	NA	NA
Net loans to customers	13,147	10,943	14,938	18,797	55,240
Other assets	24,724	27,847	25,427	24,411	30,528
Total assets	**81,893**	**87,494**	**97,627**	**87,756**	**167,089**
Liabilities					
Interbank liabilities	0	12,500	23,258	10,027	298
Senior debt	0	0	0	0	0
Derivatives	NA	NA	NA	NA	NA
Deposits from customers	17,919	9,406	9,575	14,238	98,648
Subordinated debt	0	0	2,501	2,879	2,879
Other liabilities	1,224	2,635	888	3,622	6,047
Total liabilities	**19,143**	**24,541**	**36,222**	**30,766**	**107,872**
Ordinary equity	62,750	62,953	61,405	56,990	59,217
Equity hybrids	0	0	0	0	0
Minority interests	0	0	0	0	0
Total liabilities and equity	**62,750**	**62,953**	**61,405**	**56,990**	**59,217**
Core tier 1/ common equity tier 1 capital	50,191	49,016	49,632	48,511	53,096
Risk-weighted assets	64,897	56,341	66,480	57,240	120,853
Income statement summary (GEL'000)					
Net interest income	4,715	4,285	3,334	3,441	4,130
Net fee & commission income	334	268	414	89	17
Net trading income	1,162	267	1,323	39	702
Other income	0	0	0	0	0
Operating income	**6,211**	**4,820**	**5,071**	**3,569**	**4,849**
Operating expenses	-5,517	-5,565	-6,263	-7,583	-11,955
Pre-provision income	**694**	**-745**	**-1,192**	**-4,014**	**-7,106**
Credit and other financial impairments	-1,208	-744	485	469	-592
Other impairments	0	0	0	0	0
Non-recurring income	62	0	0	167	74
Non-recurring expense	0	-146	-309	0	0
Pre-tax profit	**-452**	**-1,635**	**-1,016**	**-3,378**	**-7,624**
Income from discontinued operations	-196	554	42	-11	480
Income tax expense	184	11	55	-537	-149
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	**-464**	**-1,070**	**-919**	**-3,926**	**-7,293**

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

II. Appendix: Selected financial information – JSC Silk Bank

	2019Y	2020Y	2021Y	2022Y	2023Y
Funding and liquidity					
Net loans/ deposits (%)	73.4%	116.3%	156.0%	132.0%	56.0%
Liquidity coverage ratio (%)	238.0%	236.0%	355.0%	239.4%	656.3%
Net stable funding ratio (%)	163.0%	188.0%	181.0%	167.5%	159.8%
Asset mix, quality and growth					
Net loans/ assets (%)	16.1%	12.5%	15.3%	21.4%	33.1%
Problem loans/ gross customer loans (%)	20.2%	16.7%	9.9%	6.4%	2.2%
Loan loss reserves/ problem loans (%)	70.3%	67.9%	78.2%	72.1%	124.4%
Net loan growth (%)	-17.8%	-16.8%	36.5%	25.8%	193.9%
Problem loans/ tangible equity & reserves (%)	4.8%	3.2%	2.6%	2.2%	2.1%
Asset growth (%)	7.9%	6.8%	11.6%	-10.1%	90.4%
Earnings and profitability					
Net interest margin (%)	8.6%	7.3%	5.1%	5.1%	4.1%
Net interest income/ operating income (%)	75.9%	88.9%	65.7%	96.4%	85.2%
Net fees & commissions/ operating income (%)	5.4%	5.6%	8.2%	2.5%	0.4%
Cost/ income ratio (%)	-88.8%	-115.5%	-123.5%	-212.5%	-246.5%
Impairment on financial assets / pre-impairment income (%)	-174.1%	99.9%	-40.7%	-11.7%	8.3%
Loan loss provision/ average gross loans (%)	-6.4%	-4.8%	3.4%	2.1%	-1.2%
Return on average assets (%)	-0.6%	-1.3%	-1.0%	-4.2%	-5.7%
Return on average equity (%)	-0.7%	-1.7%	-1.5%	-6.6%	-12.6%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	NA	NA	NA	NA	NA
Common equity tier 1 ratio (%, transitional)	77.3%	87.0%	74.7%	84.8%	43.9%
Tier 1 capital ratio (%, transitional)	77.3%	87.0%	74.7%	84.8%	43.9%
Total capital ratio (%, transitional)	77.7%	87.3%	79.0%	90.5%	46.3%
Leverage ratio (%)	70.0%	64.0%	57.0%	59.4%	32.0%
Asset risk intensity (RWAs/ total assets, %)	79.2%	64.4%	68.1%	65.2%	72.3%

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

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Applied methodology

Financial Institutions Rating Methodology, February 2024

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