International Bank of Azerbaijan: Why the South Caucasus's largest bank has requested restructuring?

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CONTENT

INTRODUCTION ................................................................................................................................. 3
BRIEF INTRODUCTION ABOUT THE INTERNATIONAL BANK OF AZERBAIJAN ......................... 6
MACRO DYNAMICS OF IBA ............................................................................................................. 10
FINANCIAL CONDITION OF IBA AFTER DEVALUATION ............................................................ 15
Analysis of asset structure ............................................................................................................ 16
Analysis of assets for 2015 ............................................................................................................ 19
Analysis of assets in the first half of 2016 .................................................................................... 22
Dynamics of liabilities ................................................................................................................... 26
Liabilities of IBA for the first half of 2015 .................................................................................... 27
Liabilities of IBA for 2015 ............................................................................................................. 29
Liabilities of IBA for the first half of 2016 .................................................................................... 31
Financial indicators at the end of 2016 ....................................................................................... 32
FOREIGN LIABILITIES OF IBA: RESTRUCTURING SHOULD NOT HAVE BEEN REQUIRED ........... 34
CONCLUSION .................................................................................................................................. 39
REFERENS .................................................................................................................................... 42
INTRODUCTION

The devaluation of Azerbaijan’s national currency, the manat, in February 2015, was the culmination of a series of long-term problems found within the “International Bank of Azerbaijan” Open Joint Stock Company (hereafter referred to as IBA). Assets that had lost value and sharply increased commitments added to other key factors, such as mismanagement of governance, trust, and corruption mechanisms on the part of the government and the negligence of supervisory bodies, and together resulted in the resignation of IBA’s Chairman of the Board, Jahangir Hajiyev, by a decision of the Bank's Supervisory Board taken on March 18, 2015. It was then decided to privatize IBA, with a thorough rehabilitation preceding, by the Decree of the President of the Republic of Azerbaijan, dated July 15, 2015, on “The measures for rehabilitation related to the preparations for privatizing the state-owned shares of the International Bank of Azerbaijan OJSC". It should be noted that in the early 2000s, international financial institutions and local experts considered privatization as the only way to avoid a series of negative consequences foretold after a close observation of the bank’s operations.

From 2015 - 2017, for the purpose of rehabilitating IBA – increasing its capital, supporting liquidity, etc. – the Bank was provided with a total of 11.665 billion manat of financial support, or about 19.4% of the country's GDP. Concurrently, several of the bank’s customers, who illegally gained large amounts of credit for hopeless projects on a fraudulent basis through illegal collaboration, were brought to justice and a small portion of losses recovered. However, these measures had not been enough to save IBA from default.

Finally, on May 11, 2016, IBA addressed its creditors and requested a $3.343 billion USD debt restructuring, with discounts (deductions) on certain debts (“ABB”ASC, 2017). 29.9% of the debt belonged to the State Oil Fund of the Republic of Azerbaijan (SOFAZ) and 70.1% to foreign creditors, including Cargill ($715 million USD), Credit Suisse ($287.1 million USD ), and City ($205 million USD).

As mentioned above, over the past 3 years, sufficient state support has been provided for the rehabilitation of IBA. Nevertheless, the Bank's request for restructuring raises questions and causes concerns, while this appeal endangers both the international credit rating of the organization itself and the country’s independent credit rating as a whole. Credit downgrading is a sensitive topic at present, while it can weaken the reputation of the country as a reliable partner and increase the cost of borrowing, a bad turn of events at a time when there is a need for the support of global financial institutions in order to meet timely obligations on a number of major projects. Lutz Roehmeier, head of the Landesbank Berlin Investment Securities Department, responded to
Bloomberg's prompts for a reaction to the news of restructuring, saying: "Lenders are very angry" (Bloomberg.com, 2017). Moody's rating analysts said the restructuring demand was "inexpedient", and it had led to a worsening of the situation in Azerbaijan (BBC.Azərbaycanca, 2017). Additionally, some foreign lenders protested the bank's approach to local and foreign creditors (The Wall Street Journal, 2017). One should not be so naive as to imagine that those at the head of the decision-making process did not predict all possible results beforehand, while undertaking their decision. Yet, it should be interesting enough for everyone involved to now watch the ensuing reactions unfurl.

In fact, what is actually happening at IBA? In order to answer this question and make an analysis of the financial condition of the bank, research was conducted exploring the dynamics of macro indicators, both before and after the devaluation, with an assessment of the real situation. Taking into account that IBA is one of the largest agencies managing public funds in Azerbaijan, the subject is quite relevant for a wide range of stakeholders, including the local community and international financial institutions.

This research paper consists of six sections: introduction, four major chapters, results and, finally, a short series of questions remaining after conducting the research. The first part contains a brief presentation of relevant information, such as the history of the development of IBA and its importance in the banking sector of Azerbaijan. The goal of the first section is to provide background information about the subject of the research.

In the second part, the bank's macroeconomic financial indicators (assets, liabilities, capital and so on.) for the period 2001-2016, and its trends of periodic development have been analyzed. Taking into consideration that the manat’s devaluation is the main factor which makes the bank’s problems worse and uncontrollable, the third part of the study covers the quality of financial flows, bank assets and liabilities, cash flow, loan portfolio, customer account dynamics, and periodic impacts of government support, exploring the situation to understand the actual outcomes. In the fourth part, the government's restructuring plans and the actual financial condition of IBA have been compared. Meanwhile, significant factors, such as the level of liquidity, asset quality, and grouping of debt maturity, were assessed for the time when the bank requested restructuring. The goal was to identify the reasons for the necessity of restructuring. Thus, as a result of the analysis, it was found that, in fact, the liquidity level of IBA allowed for the execution of liabilities without restructuring.

In general, it was concluded that factors such as the bank’s auditors, members of the supervisory board and other controlling bodies of the state, including the Chamber of Accounts of the Republic of Azerbaijan, failed to perform their duties in a proper and effective manner, and
were the main reasons for the increase of public expenditures for the rehabilitation of the bank. It can be inferred that due to the inefficiency of aforementioned measures of restraint, the restructuring request may be caused by reasons other than a liquidity shortfall. Throughout it has become apparent, that the bank's accountability mechanisms are poorly organized; its annual audit reports for the year 2016, have not yet been published at time of writing (03.08.2017), despite the fact this is a violation of relevant legislation.
BRIEF INTRODUCTION ABOUT THE INTERNATIONAL BANK OF AZERBAIJAN

On January 10, 1992, the “International Bank of Azerbaijan” OJSC (IBA) was founded on the basis of the official branch of the USSR's Vneshekonombank in the Republic of Azerbaijan; its ownership was split, 50.2% by government securities and 49.8% by the private sector. The Bank operates under license No 2 of the National Bank of the Republic of Azerbaijan (currently referred to as the Central Bank of the Republic of Azerbaijan), dated December 30, 1992. At present, with its 36 local and foreign branches, 39 departments, and 1,400 employees, it is the largest bank in Azerbaijan and, in fact, in the entire South Caucasus region. For this reason, IBA is considered to be a systemic bank of the country. IBA is a main employer in both private and public sectors and the leading institution for lending and other banking services; it has demonstrated an entrepreneurial position in financing many domestic and foreign investment projects. Its main activities include: commercial banking, trading operations with foreign and derivative financial instruments, securities, loans, and giving guarantees.

The Decree of the President of the Republic of Azerbaijan "On Additional Measures Related to Deepening the Reforms in the Financial-Banking System in the Republic of Azerbaijan" of March 1, 2005, stipulated the reduction of the state-owned share-envelope of IBA by up to 50%. This Decree also foresaw an increase of the authorized capital of the bank by as much as double. The goal was to strengthen the competitiveness of the state and private sector in the financial banking sector of the Republic of Azerbaijan through the deepening of cooperation and the creation of modern management challenges. Concurrently, increased privatization was calculated to accelerate the flow of investment into the financial banking sector. At that time, the authorized capital of the bank was 124.1 million manat, of which 59.87% or 74.3 million manat was owned by the Ministry of Finance of the Republic of Azerbaijan. Fitch rating agency affirmed the bank's long-term rating at "BB-". It should be noted that in 2005, 51.3% of the aggregate assets of the banking sector of Azerbaijan, 21.5% of aggregate equity capital, 93.1% of total corporate deposits, and 53.5% of aggregate credit investments in the country's economy were produced by IBA.

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The systemic importance of IBA, as well as the management of public funds in the bank has been a constant focus of its public debate over the past years. The Bank's performance (low level of transparency in funding management, access to high risk categories of projects, high appreciation of subjective impacts, and constant upkeep of corruption elements) was alarming and both local and foreign experts saw privatization as the only way to solve the abovementioned problems.

On 1 April 2017, the authorized capital of IBA was 1.2413 billion manat\(^6\) ($0.720 billion USD).\(^7\) The share of state-owned enterprises in the authorized capital of the bank amounted to 95.05\%, or 1.180 billion manat. It should be noted that as of April 1, 2017, 76.73\% of bank shares were owned by the Ministry of Finance of the Republic of Azerbaijan.\(^8\) Thus, the shares issued by the IBA on January 23, 2013, were raised by the Ministry of Finance for the purpose of increasing the authorized capital by 600 million manat.\(^9\) The other 4.95\% of the authorized capital was owned by non-governmental organizations, at 0.4\%, and 4.55\% by individuals.\(^10\)

During 1995-2009, the Bank co-operated with the international audit company PricewaterhouseCoopers as an external auditor.\(^11\) In 2010, as the winner of the bank's tender, Deloitte Azerbaijan began to perform its external auditor functions.\(^12\) The bank even tried to experiment with other banking models, bringing Islamic banking to Azerbaijan for the first time in 2012, but failing to gain momentum for these initiatives.\(^13\)

At present IBA's subsidiaries include the following:

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\(^6\) International Bank of Azerbaijan, Shareholders, 01.04.2017, review date: 09.06.2017
\(^7\) The conversion was made on 01.04.2017 at an official exchange rate of USD / AZN.
\(^10\) International Bank of Azerbaijan, Shareholders, 01.04.2017, review date: 09.06.2017
\(^11\) International Bank of Azerbaijan, Shareholders, 01.04.2017, review date: 09.06.2017
\(^12\) International Bank of Azerbaijan, "External Auditor", review history: 09.06.2017
\(^13\) Azernews.Az, "Azerbaijan becomes regional bank of Islamic banking", 10.10.2012
- MBA-Moscow Bank - operates in the field of universal banking in the Russian Federation.
- International Bank of Azerbaijan - Georgia - operates in the field of universal banking in Georgia.
- Azericard - carries out card processing service in the Republic of Azerbaijan.
- International Leasing Company - the largest company offering leasing services in the Azerbaijani market.
- Inter PIK - operates in the field of sports in the Republic of Azerbaijan.

IBA has 100% share in each of the above listed institutions.\footnote{International Bank of Azerbaijan, "Participation in subsidiaries", review history: 09.06.2017 https://www.ibar.az/az/about-bank/disclosure-of-information/part-in-subsidiaries/}

Fluctuations in global energy markets which rippled the Azerbaijani economy, seen by the sharp decline in public revenues, devaluation of the national currency, and a decline in liquidity in the private and public sectors, have revealed the following serious shortcomings in IBA's activities:

- incompetent management;
- inadequate investment policy;
- widespread corruption;
- poor quality of assets
- low liquidity, and so on.

All of these problems have detracted from the sustainable development of IBA and, ultimately, resulted in a political decision on the bank's privatization in July 2015.\footnote{Official web-site of the President of the Republic of Azerbaijan, Decree of the President of the Republic of Azerbaijan on measures to improve the preparation of state-owned stocks of the International Bank of Azerbaijan for the privatization, 15.07.2015 http://president.az/articles/15836}

A few months ago, on March 18, 2015, Jahangir Hajiyev, Chairman of the Management Board of IBA, was dismissed from his post at a General Meeting of the Bank's Supervisory Board.\footnote{Trend News Agency, "Jahangir Hajiyev was relieved of the chairmanship of the International Bank", 18.03.2015 http://az.trend.az/azerbaijan/politics/2375698.html} Although the official decision on the removal of Hajiyev has been linked to his health problems, not soon after his dismissal, a criminal case was formulated and, thereafter, public opinion followed that the decision on his removal was related to the illegality of the IBA. After being removed from the position of chairman, he and several associates serving in positions of responsibility were accused of several crimes, including those under Articles 179.3.1, 179.3.2 (large scale embezzlement by
the organized group), 308.2 (abuse of office capacity), 309.2 313 (fraud), 228.1 and 228.4 (illegal acquisition, transfer, sale, storage, transportation of weapons, its components, ammunition, explosives and devices). The criminal case was presided over by the Baku Grave Crimes Court and lasted more than a year, ending on 14 October 2016. The accused were found guilty and Hajiyev was sentenced to 15 years. According to the court decision, Hajiyev was to pay 63 million manat for the restoration of damages caused to IBA.\(^\text{17}\) Regardless, many mysteries surrounding the internal workings of the bank are still unsolved.

\(^{17}\) Trend News Agency, "Jahangir Hajiyev was sentenced to 15 years in prison (UPDATED-2)". 14.10.2016 https://az.trend.az/azerbaijan/society/2670999.html
MACRO DYNAMICS OF IBA

The bank’s financial statements have been analyzed to provide a more accurate description of the factors that led to its default. For this purpose, statistical data on the dynamics of macroeconomic indicators such as assets, liabilities, loan portfolio structure, structure of liabilities to lenders, investment portfolio directions, state support, profit, and loss over the past years have been statistically assessed.

During the period 2001-2013, a rapid increase in bank assets (approximately 24 times) was recorded. Factors contributing to the growth of the bank’s assets, such as government support, increase of share emission, increase in borrowing capacity, and revaluation of infrastructure capital, played an important role in raising capital in this period. Thus, in the period 2007-2013 alone, 150 million manat, or $187 million USD, were allocated from the state budget for the purpose of increasing the authorized capital of the bank.\(^\text{18}\) It should be noted that the deterioration of the financial position of the bank since 2014, has resulted in the further intensification of the government's support of the bank. Thus, the bank received a total of 782 million manat, or $529 million USD, from the state starting from the first quarter of 2014 until the beginning of 2017, when it asked for restructuring, in order to support its capital and adapt to existing requirements.\(^\text{19}\)

**Diagram 1: Dynamics of total assets of IBA yearly, million manat**

![Diagram of total assets of IBA from 2001 to 2016](https://www.ibar.az/site/assets/files/3434/20170523_-iba_investor.presentation_vf.pdf)

Source: International Bank of Azerbaijan, 2017


[https://www.ibar.az/site/assets/files/3434/20170523_-iba_investor.presentation_vf.pdf](https://www.ibar.az/site/assets/files/3434/20170523_-iba_investor.presentation_vf.pdf)


[https://www.ibar.az/site/assets/files/3434/20170523_-iba_investor.presentation_vf.pdf](https://www.ibar.az/site/assets/files/3434/20170523_-iba_investor.presentation_vf.pdf)
In 2015, assets of the bank increased by 4458.5 million manat, compared to the end of 2014. That is, the devaluation of the national currency by 49.6% in 2015, caused a large increase in the share of the value of the bank's foreign currency assets; however, the IBA’s total assets decreased in terms of foreign currency. The corresponding figure was $8,797.0 million USD in 2015, whereas in 2014 the figure was $11733.1 million US. In other words, by the end of 2015, the assets of the bank decreased by 25% in terms of foreign currency.

Except for a 1.8% reduction in 2009, commitments of IBA increased by about 35 times in the period between 2001-2015. The key factor in the 23-fold increase in liabilities during the 2001-2014 period was the increase in deposits and savings, foreign borrowing, and so on. In 2015, however, the bank's liabilities grew by 52%, due to sharp devaluations. And in 2016, the bank's assets declined both in national and foreign currencies, mainly due to overnight lending.

It should be noted that this paper is only able to analyze the structure of the bank’s assets on the basis of data available for the first half of 2016, while the consolidated financial statement of IBA for the end of 2016 has not been disclosed. As of June 30, 2016, the total assets of the bank amounted to 14,192.38 million manat. 36.1% of total assets were loans to customers, 23.1% to banks and other financial institutions, and 16.1% cash and cash equivalents.20

Diagram 2: Dynamics of total liabilities of IBA by year, in million manat

Source: International Bank of Azerbaijan, 2017

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A sharp increase in liabilities led to a shortage of bank liquidity and a lack of capital. The increase occurred mainly in the savings and deposits of bank clients and the value of emissive securities. Compared with 2014, customer accounts increased by 71.1%, or 2,949,466 manat, in 2015. However, the net increase in customer accounts for the same year was only 480,279 manat.\(^{21}\)

As a result of the devaluation, the bank's foreign debt grew by 44.7% in manat terms. However, in the analysis of its reports, it is clear that the bank paid $541,887 of its foreign debt in 2015.\(^{22}\) In general, the share of foreign debt in total liabilities of the bank, at the end of 2015, was 17.5%.

Relevant increases also occurred on securities issued by the bank. As a result, the financial stability of the bank was considerably weakened.

Over the past years, the bank's capital has grown steadily. The main source of capital increase was government support; for this purpose, 832 million manat were allocated between 2013-2017. The goal was to bring the bank's capital adequacy up to the requirements of the Central Bank.

**Diagram 3: The dynamics of equity capital of IBA yearly, in million manat**

![Diagram 3: The dynamics of equity capital of IBA yearly, in million manat](source)

**Source:** International Bank of Azerbaijan, 2017

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\(^{22}\) Note: This calculation is determined by the conversion of debt by the official exchange rate of the ADB to the end of 2014 and 2015.
During 2001-2014, the net profit of IBA was 355.145 million manat. Nevertheless, without talking into account losses of 110.6 million manat in 2010, during this period, the bank has continuously turned a profit. Totally, the bank gained a net profit of 465.75 million manat in 13 calendar years. However, the global financial crisis in 2008 had a negative impact on the bank's assets. In 2010, the bank had been forced to increase reserve funds of customer loans by 49.4%, or 78.7 million manat, compared with 2009. Additionally, in percentage terms, the bank’s income dropped by 6.2%, while expenses in percentage terms went up by 48.4%, or 55.1 million manat. Therefore, in 2010, the bank closed with a loss.

Diagram 4: IBA net profit/losses for years, in million manat

Source: International Bank of Azerbaijan, 2017

Since 2015, there have been several fluctuations in the economy and two sharp devaluations, which have seriously worsened the bank's financial standing. As could be expected, the bank reported a loss of 812.187 million manat in 2015, 322.804 million manat in the first half of 2016, and 737 million manat in the second half 2016. In 2015, only in exchanging foreign currency, the bank reported an increased loss of approximately 10 times, representing 89 million manat, compared to 2014. In 2016, the acute trend in the relevant direction increased 14.6 times,
to 1300 million manat, in comparison with 2015. How can these observations not raise eyebrows, for, how can it be possible that, during the period in 2015, when volatility in financial markets was greater, observed losses were several times smaller than the later period in 2016.

The loss on foreign currency positions of the bank, in the first half of 2016, amounted to 72.861 million manat.²³ One interesting point is that, in the first half of 2015, despite the devaluation of the national currency by 25.2%, the bank’s losses in this period amounted to 11.5 million manat. It can therefore be understood that after the devaluation, extreme dollarization further weakened the bank’s open currency position. It should be noted that, the bank’s open currency position at the end of 2014 was $1.4 billion USD, which is more than the coefficient applied by the Central Bank of the Republic of Azerbaijan for that period.

In general, the profit and loss estimation of IBA shows that, during the period of 2001- the first half of 2016, the Azerbaijani state lost 779.8 million manat. However, this indicator has increased even further. According to preliminary estimates, the loss of the international banking group (including subsidiary banks of the IBA) at the end of 2016 amounted to 1.9 billion manat.²⁴ This means that in the second half of 2016, IBA should have suffered an additional 765 million loss. According to last year’s results, the public loss of IBA’s activity over 16 years exceeds 1.5 billion manat.


²⁴ International Bank of Azerbaijan, “International Bank of Azerbaijan the next stage of the recovery process begins” 11.05.2017  
FINANCIAL CONDITION OF IBA AFTER DEVALUATION

Inefficient activities of IBA and traditional deficiencies in governance and laws together have become unmanageable due to the increased pressure of the manat’s devaluation. Thus, the situation in the bank in early 2015 became a serious threat to the country's financial and banking sector. The government took note of this observation and has begun to take some steps to ameliorate the situation.

The international bank group's current financial position is mainly explained by two factors:

I. Long-term incompetent management, corruption and patronage

II. Devaluations that took place in 2015

It should be noted that the activity of IBA has always been at the center of public attention, particularly for its shortcomings in management, proven corruption, inefficient management of funds, and others, which have occasionally become a subject of public discussion, especially when considering the option of privatization. Yet, only in 2015, after the bank's serious problems were glaringly enlarged by the manat’s devaluation, was a political decision made to privatize the bank.

Finally, on 15 June 2015, 4 months after the date of the first devaluation, the President of the Republic of Azerbaijan signed the Decree “International Bank of Azerbaijan” Open Joint – Stock Company on the privatization of state-owned shares for the implementation of rehabilitation measures”, after which the government's actions towards privatization of the bank accelerated.25

Even so, there were serious concerns about the bank's financial standing for the mentioned period. Table 1 shows the changes in the structure of the bank’s assets since the beginning of 2015, revealing the effects of fluctuations in the world economy on the Azerbaijani economy.26 It should be noted that during this period Deloitte & Touche, LLC was performing its external auditor function and has since issued an opinion that each consolidated financial statement recorded was in accordance with international financial reporting standards.27

http://president.az/articles/15836
26 Mark: the last consolidated financial information was 30. 06.2016. In the last one, a structural analysis of the changes in the bank's assets over the past year was not possible.
27 Mark: you can find the consolidated financial statements on the official website of “IBA” OJSC.
Analysis of asset structure

Analysis of the asset structure of the bank shows that two months before the February 2015 devaluation, 85.4% of bank assets consisted of loans and advances to customers, 6.4% of cash, and 3.1% of infrastructure investments [see: Table 1]. For this period, only 4.3% of the bank's loan portfolio, or 377.8 million manat, were impaired loans. The share of overdue loans in the portfolio was 8.6%; however, the total delay for the banking sector in the country was 5.3%. In general, the share of overdue and impaired loans in the portfolio was 12.9%. It should be noted that the share of corporate customers in the loan portfolio of the bank was 88% for the relevant period, 94.4% in impaired loans and 88% in overdue loans. In addition, the share of overdue loans exceeding 360 days was 59.6%, or 447 million manat.

Table 1: IBA Open Joint-Stock Company assets structure (31.12.2014-30.06.2016)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>593195</td>
<td>416984</td>
<td>1597696</td>
<td>2289342</td>
</tr>
<tr>
<td>Mandatory cash balances in national / central banks</td>
<td>9678</td>
<td>12326</td>
<td>15334</td>
<td>11909</td>
</tr>
<tr>
<td>Due from other banks</td>
<td>303639</td>
<td>302056</td>
<td>102028</td>
<td>3285740</td>
</tr>
<tr>
<td>Loans and advances to customers</td>
<td>7854991</td>
<td>9352608</td>
<td>5635583</td>
<td>5135769</td>
</tr>
<tr>
<td>Financial assets at fair value through profit or loss</td>
<td>14997</td>
<td>7448</td>
<td>906</td>
<td>7319</td>
</tr>
<tr>
<td>Other debt and securities</td>
<td>45355</td>
<td>45963</td>
<td>29298</td>
<td>----------</td>
</tr>
<tr>
<td>Sellable investments</td>
<td>5287</td>
<td>-----</td>
<td>97</td>
<td>36166</td>
</tr>
<tr>
<td>Due from Aqrarkredit CJSC</td>
<td>-----</td>
<td>-----</td>
<td>5628923</td>
<td>2842432</td>
</tr>
<tr>
<td>Investments in associates</td>
<td>348</td>
<td>348</td>
<td>187</td>
<td>----------</td>
</tr>
<tr>
<td>Buildings, equipment and intangible assets</td>
<td>283627</td>
<td>312718</td>
<td>322741</td>
<td>252600</td>
</tr>
<tr>
<td>Current income tax asset</td>
<td>4076</td>
<td>7971</td>
<td>16946</td>
<td>21008</td>
</tr>
<tr>
<td>Provisional income tax asset</td>
<td>24300</td>
<td>83589</td>
<td>58503</td>
<td>348</td>
</tr>
<tr>
<td>Other financial and insurance assets</td>
<td>23650</td>
<td>190630</td>
<td>210028</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>35625</td>
<td>24969</td>
<td>39005</td>
<td>309747</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>9198768</strong></td>
<td><strong>10757610</strong></td>
<td><strong>13657275</strong></td>
<td><strong>14192380</strong></td>
</tr>
</tbody>
</table>

Source: International Bank of Azerbaijan, 2017
At the end of 2014, unsecured loans of the bank amounted to 12.6% of the portfolio, and in the following years, these assets were the main source of losses for the bank. Apparently, even before the devaluation, risk assets in the credit portfolio of IBA were quite high. As a whole, 25.5% of the bank's loan portfolio was unsecured, overdue and nonperforming loans.

In the first half of 2015, the Central Bank of the Republic of Azerbaijan made a decision to devalue the national currency by 25.2%, resulting in a sharp decline in the quality of bank assets. The effects of the devaluation on the financial position of the bank can be separated into two categories to better understand their nuances:

I. Direct influence of exchange rate changes on the bank's assets and liabilities;

II. Effects of devaluation on macroeconomic outcomes and bank's portfolio.

The general Azerbaijani public believes the manat’s devaluation is the main reason for the current financial situation of IBA. As such, even this observation is not so straightforward and must be further explored for a more complete understanding.

The direct impact of exchange rate changes on the bank's assets and liabilities is dependent on the bank's open currency position for the concerned period. However, due to the shortage of information publicly available, this research will not be able to evaluate the open currency position of IBA on February 26, 2015, at the time of the devaluation, but rather will refer to the reports of December 31, 2014, about 2 months before. The currency structure of the banking group's assets and liabilities for the relevant period is as follows:

Table 2: IBA’s currency structure of assets and liabilities at the end of December 2014, in thousands of manat

<table>
<thead>
<tr>
<th>Currency type</th>
<th>Monetary financial and insurance assets</th>
<th>Monetary financial and insurance commitments</th>
<th>Swap contracts in foreign currency</th>
<th>Net position</th>
</tr>
</thead>
<tbody>
<tr>
<td>AZN</td>
<td>4502986</td>
<td>2717272</td>
<td>-</td>
<td>1785714</td>
</tr>
<tr>
<td>USD</td>
<td>3200376</td>
<td>4571418</td>
<td>37280</td>
<td>(1333762)</td>
</tr>
<tr>
<td>EUR</td>
<td>937145</td>
<td>971012</td>
<td>(129491)</td>
<td>(163358)</td>
</tr>
<tr>
<td>RUB</td>
<td>180663</td>
<td>101684</td>
<td>-</td>
<td>78979</td>
</tr>
<tr>
<td>Other</td>
<td>29622</td>
<td>100405</td>
<td>85602</td>
<td>14819</td>
</tr>
<tr>
<td>Total</td>
<td>8850792</td>
<td>8461791</td>
<td>(6609)</td>
<td>382392</td>
</tr>
</tbody>
</table>

Source: International Bank of Azerbaijan, 2017
As seen above, at the end of 2014, 49.1% of bank assets were in foreign currencies, of which 67.8% of liabilities also fell into this category. In total, the bank’s assets equaled 4.348 billion manat and their liabilities equaled 5.745 billion manat in foreign currencies. The open currency position of the group was equivalent to 1.4 billion manat. It should be noted that this is actually a violation of the open currency position of the Central Bank of the Republic of Azerbaijan. Even in its December 2014 report, the bank conceded that its open currency position should not exceed 20% of total capital in all currencies. Had the group's management not contributed to the gross violation of its own norms, the bank’s open currency position would not have been more than 137.3 million manat, which would have reduced damage of the direct effects of the devaluation by a factor of almost 10.

Although there is no published data detailing where individual losses occurred, only the total losses suffered by the bank, it can be inferred that the direct loss from the first devaluation was 472.9 million manat, given no change in the group's open currency position. The group's consolidated statements indicate that for the first half of 2015, as a result of the impact of exchange rate changes on cash and cash equivalents, 124.6 million manat was generated in the first half of the year. In other words, taking exchange rate profits into account, the direct effect of the manat’s devaluation on the bank’s total assets can be reduced to 348.3 million manat. In addition, the foreign exchange gains for the relevant period amounted to 16.7 million manat and foreign exchange losses, 11.5 million manat.

It should be noted that in the consolidated report of the group for the first half of 2015, the total losses suffered amounted to 197 million manat. In other words, the consolidated loss for the period, including the direct impact of the first devaluation, was 33.7% of the group's equity. As a result of the reduction in the group's liquidity, the total support needed for 1 month amounted to 1.633 billion manat, for the next 1-6 months, 2.21 billion manat would be needed, and in 12 months, 2.976 billion manat. However, during the ensuing 12 months, 3.311 billion positive

liquidity has been identified. In other words, it is clear from the report that during the period until June 2016, the bank needed around 3 billion manat of liquidity support.

It should be noted that in the first half of 2015, the amount borrowed from international financial institutions increased by 43.5%, to AZN 2243 million.

Analysis of assets for 2015

On December 21, 2015, the Central Bank of Azerbaijan decided to devalue the national currency an additional 32.2%, please see Figure 1 for reference. Negative effects of the first devaluation notwithstanding, the second devaluation at the end of 2015 further increased the losses of the group and played a significant role in reducing its asset quality.

Figure 1.

Thus, the structure of assets has undergone serious changes as a result of both devaluations and, concurrently, the measures aimed at improving the IBA. In general, by the end of 2015, the group's assets increased by 48.5%, compared to the end of 2014, and by 26.9%, compared to the first half of 2015. Changes in the structure of its assets occurred mainly in three directions. Thus, in the background of the first devaluation, in particular, the bank's cash funds increased by 1 billion manat, or 2.7 times, compared to 2014. Despite the fact that during the reporting period in the

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second half of 2015, the amount of loans and advances to customers fell sharply, to 39.7%, or 3.717 billion manat. The reason for this is a letter dated December 28, 2015, referring to the purchase of a problem loan of 5.3 billion manat by Aqrarkredit CJSC from IBA.

In such a way, the group managed to reduce its problem assets by 5.3 billion.\textsuperscript{34} The bank's consolidated financial statements indicate that the transfer of provision of loan impairment amounted to 784 million manat during the sale of the loan agreed with Aqrarkredit CJSC.\textsuperscript{35} This reduced the real value of the impairment of loans created during the year to 164.5 million manat.

The impact of the changes on the loan portfolio in the foreign exchange rate in 2015 amounted to 92.5 million manat.

As of the end of 2015, 41.2% of the group's assets were loans and advances to customers, 41.2% to Aqrarkredit CJSC and 11.7% to cash and cash equivalents. Apparently, by the end of 2015, the volume of IBA’s loan portfolio in its assets decreased by 44.2%, as a result of transferring the bank’s problem assets.

Despite the relapse of a large part of troubled assets, there has also been a significant increase in the group's impaired loans. Compared with the beginning of the year, the volume of these impaired loans increased by 257.3 million manat, or 68.1%. As a result, the share of these funds in the loan portfolio of the group increased from 4.3% to 9.7%. It should be noted that, while 88% of bank loans were owned by corporate clients at the end of the reporting year, the share of these entities in the impaired loans was 94.4%, meaning that the group suffered damaged mostly by corporate clients.\textsuperscript{36} However, the transfer of troubled assets had a positive impact on the nominal volume of overdue, but not impaired assets. As a result, compared to the beginning of the year, 79.9 million manat, or a 10.7% decrease, was recorded in the total volume of these types of assets. Nevertheless, the share of overdue loans in the loan portfolio increased by 1.6 percentage points, to 10.2%. The reason for this is the decrease in the total portfolio.


At the same time, it should be noted that 48.7% of overdue – but not impaired – loans, outstanding over 360 days, cost the bank 326.2 million manat. This represents a 27% decrease in nominal expression, compared to the beginning of the year.

At the end of 2015, the share of unsecured loans in the group's loan portfolio sharply increased to 1.9 billion manat, or 29% of the total portfolio. However, at the end of 2014, this figure was 1.09 billion manat, or 12.6%. Even though the group had been limiting its lending during the year 2015, with the impact of the devaluation, there had been a sharp rise in the manat equivalent of unsecured loans.

Table 3: Currency structure of IBA’s assets and liabilities at the year-end of 2015, in thousands of manat, 31.12.2015

<table>
<thead>
<tr>
<th>Currency type</th>
<th>Monetary financial and insurance assets</th>
<th>Monetary financial and insurance commitments</th>
<th>Swap contracts in foreign currency</th>
<th>Net position</th>
</tr>
</thead>
<tbody>
<tr>
<td>AZN</td>
<td>9787665</td>
<td>2392032</td>
<td>-</td>
<td>7395633</td>
</tr>
<tr>
<td>USD</td>
<td>3077016</td>
<td>9408076</td>
<td>679027</td>
<td>(5652033)</td>
</tr>
<tr>
<td>EUR</td>
<td>155276</td>
<td>846517</td>
<td>(663413)</td>
<td>(1354654)</td>
</tr>
<tr>
<td>RUB</td>
<td>147786</td>
<td>185763</td>
<td>-</td>
<td>(37977)</td>
</tr>
<tr>
<td>Other</td>
<td>52150</td>
<td>44601</td>
<td>(14708)</td>
<td>(7159)</td>
</tr>
<tr>
<td>Total</td>
<td>13219893</td>
<td>12876989</td>
<td>906</td>
<td>343810</td>
</tr>
</tbody>
</table>

Source: International Bank of Azerbaijan, 2017

At the same time, the 2nd devaluation further weakened the open currency position of the bank in its assets and liabilities. As a result, by the end of 2015, 74% of the bank's assets were in AZN, with only 18.6% of their liabilities in AZN. For the same period, 73% of the bank’s liabilities were denominated in US dollars and 6.6% in Euro, which precipitated the bank's weak currency position for the next period. Seeing as the national currency’s value depreciated an additional 12% after devaluation, it was not difficult to predict that the bank would post losses in 2016. However, it should be noted that for the same period, dollarization had become a common tendency throughout the country, and the process could not be prevented by any efforts of the group. Thus, the open currency position of the bank reached $4.743 billion USD, which is 3.4 times more than in the beginning of the year.
It should be noted that changes in the foreign exchange rate had also led to the creation of profits in the group's cash and cash equivalents. So, in the year 2015, the group received a revenue of 326.4 million manat. As a result, revenue compensated for some of the group’s losses in the second half of the year, causing a loss of AZN 607.6 million. In total, the group's aggregate loss in 2015 amounted to 823.6 million manat.

A structural analysis of the group's assets has shown that at the end of 2015, the amount of non-risk assets (cash and cash equivalents, mandatory reserves placed by the Central Bank, funds from Aqrarkredit CJSC) amounted to 7.227 billion manat, or 53% of total assets. The group needed to take steps to improve its assets and increase its liquidity and, thus, the Decree "On measures to improve the preparation of state-owned stocks of the International Bank of Azerbaijan for the privatization” was signed by the President of the Republic of Azerbaijan on June 15, 2015, enabling the transfer of poor (problem) assets to Aqrarkredit CJSC. As a result, the group agreed to transfer 5.3 billion manat of assets in the first stage. Aqrarkredit CJSC had to obtain compensation from securities placed by the Central Bank.

It is clear from the financial statements of the bank that in the first month of 2016, there was a need for liquidity support to the amount of 3.319 billion manat in order to fulfill all of its obligations. It should be noted that this amount reflects the situation after the cash inflow of 500 million manat from Aqrarkredit CJSC. The bank's liquidity shortage amounted to 2.657 billion manat, including 2.678 billion at the end of 2016. However, the total deficit amounted to 212.5 million manat, including 5.629 billion manat to be paid by Aqrarkredit CJSC.

Analysis of assets in the first half of 2016

Group assets continued to grow in the first half of 2016. Consequently, the consolidated financial statements as of 30 June 2016, show that the volume of assets increased by 535 million manat, or by 3.9%, compared to the end of 2015. 16.1% of assets were cash and cash equivalents.

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36.2% of loans and advances to customers, 20% to Agrarkredit CJSC, and 23.5% from other banks. As can be seen, the weakening of loan rates resulted in a decrease in the loan portfolio by 500 million manat, or 8.9%. It should be noted that, in the first half of 2016, the impairment loss on interest bearing assets amounted to 19.6 million manat, which is approximately 17 times less than in the corresponding period of 2015 (first half of 2015: 328.3 million manat). However, the revaluation of the foreign currency position of the bank was 72.8 million manat, which is 6.3 times more than in the corresponding period of 2015. 99.7% of this loss originated from the group's irresponsible banking activities.

At the same time, it is also known that by the end of the first 6 months of 2016, the volume of investments (purchased bonds) increased by 373 times, compared with the beginning of the year. During this period, the bank decided to deposit a certain amount of funds against credit risk.

One of the significant increases occurred in cash and cash equivalents. Compared to the beginning of the year, the amount of this indicator increased by 43.9%, or 692 million manat. As a result, as of June 30, 2016, the balance of cash and cash equivalents of the group reached 2289.3 million manat. This is approximately 5.5 times more than in the first half of 2015. The reason for the increase was due to payments from passive lending and Agrarkredit CJSC. The total amount of funds received from Agrarkredit CJSC at the end of the period amounted to 4580 million manat. It should be noted that the changes in the foreign exchange rate amounted to 68.6 million manat in foreign currency; in 2015, the corresponding figure was 124.6 million manat. Thus, the reason for IBA’s huge losses can be attributed to the bank not conducting proper risk assessment before placing their cash assets in the chosen currencies.

89.7% of the total loan portfolio fell on corporate clients. The amount of loan impairment for the period amounted to 849.8 million manat, which is due to the rapid growth of problem assets. According to Deloitte's opinion, the total loss of the group as of June 30, 2016, amounted to 1.67 billion manat, of which 322.8 million manat as the loss of the first half of 2016 alone.

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The majority of the group's losses were due to the weakening of its loan portfolio quality. Thus, the rapid increase in the volume of troubled loans resulted in the increase of expenses on reserve allocations in this direction. At the same time, the decrease in demand in the real estate market and the depreciation of the value of property owned by the group amounted to 127.7 million manat.

On a positive note, the non-risk assets of the group increased compared to the beginning of the year. The volume of non-risk assets was made up of 2.289 billion manat in cash and assets, 3.18 billion manat in the Central Bank of the Republic of Azerbaijan (in deposits), 431.9 million manat in obligatory reserves in the Central Bank of the Republic of Azerbaijan, 36.1 million manat for sale, and 2.842 billion manat provided by Aqrarkredit CJSC, altogether totaling only 8.2 billion manat, or 58% of total assets. As can be seen, in the first half of the year, positive internal dynamics were observed. Non-interest-bearing assets for the period exceeded 60% of the group's total liabilities.


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Diagram 5: Specific weight of IBA’s risk-weighted assets on total assets and liabilities, as of 30.06.2016


The group did not provide a complete description of its financial situation, as it did not provide liquidity indicators (contractual maturity analysis of assets and liabilities) in its consolidated statement of June 2016. Nevertheless, the bank published its predictions for 2016 in its 2015 year-end report, in which the volume of assets reached by the end of the first six months of 2016 was expected to amount to 1980 million manat and the liabilities 4316 million manat. Taking into account that Aqrarkredit CJSC's payment to the bank in the first six months of the year should have amounted to 4580 million manat, and in the beginning of the period, cash and cash equivalents were 593.2 million manat, reserves at the central bank -9.7 million manat, receipts from other banks -193.1 million manat. It should be noted that there would have been no liquidity problem in the case of a zero payment on loans and advances to customers. Because of the above-mentioned unaccounted debts, the group's debts for the first six months of 2016 amounted to 5376 million manat, 14.5% more than its liabilities for that period. Thus, the group's liquidity in the second half of the year had to be further strengthened, compared to the beginning of the year.

In general, analysis shows that IBA’s losses from devaluation were considerably less than the bank’s total losses. Thus, devaluation seriously weakened the country’s business activity by creating stagnation in the economy. Moreover, loans denominated in foreign currencies increased by more than 2 times in terms of manat, which weakened the ability of customers to repay them. This factor significantly reduced the bank’s portfolio quality. In general, in order to mitigate the above problem and improve the bank's assets, it transferred a balance and off-balance sheet assets totaling 9930 million manat to Aqrarkredit CJSC. Yet, despite this transfer, the group had still come under bankruptcy, largely influenced by new devaluation factors.
Dynamics of liabilities

Devaluations have a significant impact on the structure and volume of liabilities of IBA as well. Firstly, they prompted a massive dollarization of savings and deposits, both before and after they actually took place, which led to a sharp increase in debt during the depreciation of the national currency and a weakening of the currency position of the group. Secondly, the debt of the bank to foreign financial institutions rose accordingly.

Table 4: Structure of IBA liabilities, (31.12.2014-30.06.2016)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments to other banks</td>
<td>1864962</td>
<td>1896912</td>
<td>1800844</td>
<td>1669425</td>
</tr>
<tr>
<td>Customer Accounts</td>
<td>4144678</td>
<td>4657700</td>
<td>7094114</td>
<td>8175442</td>
</tr>
<tr>
<td>Debt securities issued</td>
<td>400927</td>
<td>602730</td>
<td>893654</td>
<td>788018</td>
</tr>
<tr>
<td>Other borrowed funds(^{44})</td>
<td>1563366</td>
<td>2242765</td>
<td>2262979</td>
<td>1984846</td>
</tr>
<tr>
<td>Current Income Tax Liability</td>
<td>3372</td>
<td>1735</td>
<td>115</td>
<td>-----------</td>
</tr>
<tr>
<td>Provisional Income Tax Liability</td>
<td>23716</td>
<td>38853</td>
<td>42889</td>
<td>110732</td>
</tr>
<tr>
<td>Other financial and insurance liabilities</td>
<td>66353</td>
<td>43943</td>
<td>66355</td>
<td>-----------</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>23305</td>
<td>31035</td>
<td>23242</td>
<td>122975</td>
</tr>
<tr>
<td>Subordinated debt</td>
<td>421505</td>
<td>720108</td>
<td>759043</td>
<td>771995</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>8512184</strong></td>
<td><strong>10235781</strong></td>
<td><strong>12943235</strong></td>
<td><strong>13623433</strong></td>
</tr>
</tbody>
</table>


\(^{44}\) Note: the indicator on this category shows the borrowings from the international financial institutions, with the deduction of loans received from NFES. International Bank of Azerbaijan, "Consolidated Financial Statements for the Year Ended 31 December 2015", Date of Review: 23.07.2017, p 27, https://www.ibar.az/site/assets/files/1641/konsolidasiya-edilmi_maliyy__hesabatlar__v__auditor-r_yi-31-dekabr-2015-1.pdf
Liabilities of IBA for the first half of 2015

As can be seen in Table 4, liabilities increased by 20.2%, or 1724 million manat, in the first half of 2015, compared to the end of 2014:

- Other borrowed funds: 679.4 million manat
- Customer accounts: 513.0 million manat
- Subordinated debt: 298.6 million manat
- Debt securities issued: 201.8 million manat

Our analysis shows that the group's foreign currency debt to international financial institutions at the end of 2014 was 1355.5 million manat, or 1729 million USD. The 47.2 million manat, or $60.3 million USD, of this debt had to be paid by January 14, 2015, right before devaluation. If we accept that the amount of the above-mentioned debt was repaid, the sum of liabilities under the relevant category for the first devaluation – which took place on 26.02.2015 – was 1668.7 million USD, resulting in a loss of 443.9 million manat. As can be seen, the foreign debt of the group for the first half of 2015 was $153.2 million USD. Also, on April 28, 2015, the group received syndicated loans from a foreign bank worth $97.5 million USD and 98.5 thousand EUR. At the same time, compared to the beginning of 2015, the volume of term liabilities received by the group from other financial institutions increased by 44.9% in terms of manat, compared to 10.4% in terms of foreign currencies.

<table>
<thead>
<tr>
<th>Table 5: IBA’s long-term liabilities from other financial institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>968.9 million</td>
</tr>
</tbody>
</table>


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45 Note: Loans from the National Fund for Support of Entrepreneurship were deducted from the amount of debt related to the "other borrowed funds" category of the Group's liabilities
As can be seen, the bank’s USD-dominated debt increased by 137.5 million in the corresponding category, and the EUR-denominated debt decreased by 16.2 million, but in terms of manat there was a 425.9 million increase.

As noted above, one of the important factors of increasing liabilities over the relevant period was the subordinated debt dynamic; liabilities in this category of debt increased by 298.6 million manat. The main reason for the observed growth was the subordinated debt received from the Central Bank of the Republic of Azerbaijan on February 27, 2015, with a maturity of 250 million manat over six years.48 However, at the date of devaluation, the Bank had more than 89 million manat in foreign subordinated debt that reflected the bank's loss due to exchange rate fluctuations.

The increase in issued debt securities was more than 201 million manat. It is enough to note that IBA issued a 500 million USD49 Eurobond in June 2014, thanks to which the debt burden due to the first devaluation increased by about 133 million manat. The other part of the increase was the first tranche of a $250 million EUR commercial bond program generated on January 29, 2015, amounting to 67.5 million manat on February 27, 2015.50

As of June 30, 2015, the group's liability for maturity was 2677.9 million manat for the first month, 2030.8 million manat for 1-6 months and 2144 million manat for 6-12 months, totaling 6852.7 million manat. The group's one-year liquidity deficit was 2976.5 million manat, or 43.4% of liabilities for that period. Thus, as a result of the analysis, we can note that the first devaluation was one of the key factors that increased the group’s liabilities in the first half of 2015. The reason for this is the fact that the currency position of IBA was $1400 million USD more than the norm.

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Liabilities of IBA for 2015

The increase in liabilities became more acute in the second half of 2015. The main reason for the increase was the Central Bank's second-largest (32.2%) devaluation, which took place on December 21, 2015. As a result, the group's liabilities in the second half of the year increased by 2707.5 million manat, or 26.5%, and by 4431 million manat, or 52%, for the whole year. For comparison, note that the national currency's depreciation rate was 49.6% during the course of the entire year.

It should be noted that 2 months prior to devaluation, 49.5% of the group's liabilities were owned by various financial institutions of the Republic of Azerbaijan and its citizens and 50.5%, or 4268.5 million manat, belonged to foreign citizens and their financial institutions. The net balance of the bank in view of its assets and liabilities for that period was positive, amounting to 3398.3 million manat domestically (domestic assets exceeding domestic debt) and a negative 3009.3 million manat to foreign entities. The placement of a majority of domestic assets in the local currency and a high volume of foreign liabilities in foreign currencies constituted the main source of loss of the group. Nevertheless, it should be noted that the increased risk of economic fluctuations since the last quarter of 2014 led to the rapid dollarization of internal liabilities, which further increased the overall loss.

By the end of 2015, 42.8% of liabilities, or 5513.4 million manat, belonged to citizens and financial institutions of foreign countries. The net deficit of assets and liabilities to foreign countries rose to 4974.9 million manat. In other words, in comparison with the beginning of the year, there was a 65.3% increase observed. The main reason for the increase was devaluation.

It should be noted that the annual growth of the group's liabilities occurred mainly in customer accounts, issued debt securities, loans received from international financial institutions, and subordinated debt.

Table 6: Growth in IBA liabilities

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>30.06.2015</th>
<th>30.06-31.12.2015</th>
<th>Total</th>
<th>Annually, with percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer Accounts</td>
<td>513.0</td>
<td>2436.4</td>
<td>2949.4</td>
<td>+71.1</td>
</tr>
<tr>
<td>Issued debt securities</td>
<td>201.8</td>
<td>290.9</td>
<td>492.7</td>
<td>+123</td>
</tr>
<tr>
<td>Other borrowed funds(^{52})</td>
<td>679.4</td>
<td>20.2</td>
<td>699.6</td>
<td>+44.7</td>
</tr>
<tr>
<td>Subordinated debt</td>
<td>298.6</td>
<td>38.9</td>
<td>337.5</td>
<td>+80</td>
</tr>
</tbody>
</table>


Thus, during our analysis, it became clear that the group was exposed to a 250 million manat loss in the second half of the year and 383 million manat loss for the whole year. In total, 16.7 million manat of issued securities was placed in Azerbaijan, and 876.9 million manat was placed in other foreign countries; foreign placement is one of the factors that increased the annual loss by the increasing currency risk.

During the course of the year, the main source of growth was customer liabilities. Thus, 66.6% of total liability growth occurred in this direction. Since the currency structure of customer accounts liabilities has not been disclosed in the group's statements, we have tried to build it ourselves. As a result of the devaluation and ensuing economic upheavals, over the course of 2015, the savings and deposits in the bank weakened; more funds were withdrawn in the country. Corporate clients, at least in this case, showed activity as individual customers. In sum, the group's liabilities on customer accounts could not be increased by 71% due to additional deposits and savings; therefore, the main reason for the increase in customer accounts is devaluation.

It should be noted that the group's loans from international financial organizations at the end of 2015 amounted to 2056 million manat, or $1324.5 million USD, 403.5 million USD, or 23.3%, less than the beginning of the year. The reason for the decline is that 459.3 million USD worth of syndicated loans should have been paid before the end of 2015. In addition, $75.34 million of loans received from other financial institutions were refunded. The volume of Euro loans also increased in this category, by 41.3 million EUR, or 26.3%.

However, the volume of debt received from international financial institutions in manat terms increased by 51.7% (700.5 million manat). 15.5% of the debt related to the debt to be paid

\(^{52}\) Note: the indicator on this category shows the borrowings from the group's international financial institutions, with the deduction of loans received from NFES. International Bank of Azerbaijan, “Consolidated Financial Statements for the Year Ended 31 December 2015”, Date of Review: 23.07.2017, p 27
in 2016. A final financial statement for 2016 has not yet been published at the time of this analysis, which makes it difficult to clarify the fulfillment of this obligation.

Subordinated debts in the second half of the year resulted from debts to OECD member country residents. Thus, in comparison with the beginning of the year, debt in this direction increased 2.2 times. As a whole, subordinated debts over the year were comprised of a 6-year debt of 250,000 manat from the Central Bank and the debt from residents of OECD member countries and the devaluation to this debt.

By the end of 2015, the group's classification of liabilities indicated that the group's total receivables at the end of 2016 amounted to 8846.2 million manat and its liabilities totaled 9058.6 million manat. During the course of 2016, 5628.9 million manat, or 63.6%, of total receivables were paid from Aqrarkredit CJSC, and 1597.7 million manat, or 18%, of the proceeds from those funds were placed in the Central Bank and other financial institutions. In total, 1371.4 million manat, or 15.5%, were loans and advances to customers. Thus, considering that there are no receipts from other assets and including receivables from customers, the maximum net liquidity deficit of the group for 2016 could have been 1832.1 million manat.53

The total liability of the group for the year was 3818.3 million manat; the receivables for that period amounted to 4373.7 million manat. In the event of default or impairment of these assets, the group's total liquidity deficit could have amounted to 5650.4 million manat. However, it is clear from the reports that the group had been able to fully transfer the loans and advances to Aqrarkredit CJSC, which were 97.5% of assets related to the term after 2016. In other words, the debt was repaid by the state.

Liabilities of IBA for the first half of 2016

First of all, it should be noted that in the first half of 2016, there was no significant change in the rate of the national currency [see also: Figure 3].54

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53 Note: This figure may be slightly higher for the national currency devaluation during 2016
54 Central Bank of the Republic of Azerbaijan
https://www.cbar.az/other/azn-rates?act=betweenForm&from%5Bday%5D=28&from%5Bmonth%5D=12&from%5Byear%5D=2015&to%5Bday%5D=28&to%5Bmonth%5D=7&to%5Byear%5D=2017&rateID=usd
Compared to the end of 2015, at the beginning of 2016, the major increase in liabilities occurred on customer accounts. Thus, the amount of loans in this category increased by 1081.3 million manat over the first six months of the year. Despite the decrease in some other areas, the total liabilities of the group increased by 680.2 million manat. It should be noted that the increase in customer accounts occurred due to an increase in term deposits; thus, liabilities of the relevant category increased by 1324.8 million manat, compared to the beginning of the year. Also, in the structural analysis of the group’s liabilities on customer accounts, it was revealed that growth in this direction occurred on the part of government agencies and state-owned enterprises. It is known from the annual report of the State Oil Fund of the Republic of Azerbaijan (SOFAZ) for 2016, that the entity made a term deposit of $1000 million USD in IBA in 2016.\(^{55}\) We believe that the increase in liabilities was due to the deposits made from this source.

Reports demonstrate that the bank fully fulfilled syndicated loan liabilities in the first half of 2016. As a result, there were no debt liabilities under this category by June 30, 2016. The volume of loans received from international financial institutions amounted to 1795 million manat, an increase of approximately 0.5%, compared to the beginning of the year.

Financial indicators at the end of 2016

It stands to be repeated that the last report made publicly available by IBA was a consolidated one, filled with compact financial information covering the first half of 2016. However, the final consolidated audit report for 2016 has not yet been disclosed, despite the expiration of the deadline given by the Financial Market Supervisory Authority of the Republic of Azerbaijan. In the audit report for the first half of 2016, important information such as the group's liquidity shortfall, the currency structure of assets and liabilities, and so on, was not disclosed. For

this reason, this report is based on an annual audit report for 2015, and on the basis of relevant information such as a request for a group restructuring, and so on.

The restructuring plan prepared by the Group indicates that the total assets at the end of 2016 amounted to 12,103 million manat. 45% of the assets, or 5290 million manat, were loans and advances to customers. 2600 million manat of these loans were in foreign currencies and the other part in the national currency. The assets worth 5000 million manat were from other banks, of which 4900 million manat, or 98%, belonged to the Central Bank. By the end of 2016, cash assets of IBA amounted to 1400 million manat and 900 million manat equivalent of it was kept in foreign currencies, including USD.56

The group's liabilities at the end of 2016 decreased by about 1%, to 12804 million manat, compared to the beginning of the year. 7182 million manat, or 56%, of liabilities were accounted for by customer accounts, 2 million manat of debts to other banks, and $3600 million USD in loans such as debt securities, subordinations, and so on. A total of 8500 million manat of the group's liabilities were in foreign currencies, including 4400 million as part of the debt on customer accounts and 1800 million of bank debt. This was 66.4% of the group's assets at the exchange rate for the reporting period. Thus, the group's currency position at the end of 2016 amounted to 5000 million manat, or $2800 million USD.57

It is clear from the reports that in 2016, the group faced a loss of 1,300 million manat on currency exchange.58 One of the most interesting realizations is that in 2015, in a period of two major devaluations and sharp dollarization, the corresponding loss was only 89 million manat,59 or 14.6 times less than that in 2016. This is one of the questions that the group, including its key shareholder, the government, must clarify.

FOREIGN LIABILITIES OF IBA: RESTRUCTURING SHOULD NOT HAVE BEEN REQUIRED

It should be noted that after the devaluation, IBA received state support in the amount of 11665 million manat, or 7495 million USD. This is a serious indicator, while it is 19.4% of the GDP of the country in 2016. At the same time, it should be noted that the total amount of government support was 26.7% higher than the pre-devalued bank assets.

Table 7: Financial support of the government to IBA

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2016</th>
<th>2017/may</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital support</td>
<td>AZN</td>
<td>US Dollar</td>
<td>AZN</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>14</td>
<td>51</td>
</tr>
<tr>
<td>Funds paid to Aqrarkredit CJSC against transferred debts</td>
<td>2480</td>
<td>2114</td>
<td>7450</td>
</tr>
<tr>
<td>Other</td>
<td>-------</td>
<td>-------</td>
<td>-------</td>
</tr>
<tr>
<td>Total</td>
<td>2496</td>
<td>2128</td>
<td>7501</td>
</tr>
</tbody>
</table>

As can be seen, 9.93 million manat was provided by Aqrarkredit CJSC only for the transfer of toxic assets of the group, as a means of support. In addition, 667 million manat was allocated to increase capital. Additionally, the State Oil Fund of the Republic of Azerbaijan (SOFAZ) made a deposit of $1,000 million USD to support liquidity. As has been pointed out, support for the group's recovery was 37%, or 3200 million manat, more than the total liabilities of the group during the pre-devaluation period.

Despite all this, the group has demanded the restructuring of its foreign liabilities and debt to SOFAZ. The restructuring plan was filed with the Nasimi District Court. In order to initiate the process, the approval of the Financial Market Supervisory Authority of the Republic of Azerbaijan is needed. The Nasimi District Court decided on 4 May 2017, to allow the group to request restructuring approval from the Financial Market Supervisory Authority. The group's restructuring request was publicized on May 11, 2017.

The restructuring requirement of the bank was $3343.4 million USD, or 70%, of the liabilities in foreign currencies, and 46.2% of total liabilities at the end of 2016. $1,000 million USD of the aforementioned debt belongs to SOFAZ. The first part of the debt, $500 million USD, would have to be paid on the date of disclosure of the restructuring plan on May 11, 2016. Another $394.76 million USD portion belonged to other foreign lenders, including $100 million USD subordinated debts, which would have to be paid until the date of restructuring.

<table>
<thead>
<tr>
<th>Maturity date</th>
<th>Amount of payment⁶³</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Other debts, in million USD</td>
</tr>
<tr>
<td>2017</td>
<td>819.4</td>
</tr>
<tr>
<td>2018</td>
<td>264.0</td>
</tr>
<tr>
<td>2019</td>
<td>769.2</td>
</tr>
<tr>
<td>2020</td>
<td>7.2</td>
</tr>
<tr>
<td>2021</td>
<td>13.5</td>
</tr>
<tr>
<td>2022</td>
<td>1.4</td>
</tr>
<tr>
<td>2024</td>
<td>250.0</td>
</tr>
<tr>
<td>2025</td>
<td>87.0</td>
</tr>
</tbody>
</table>

A significant portion of maturity dates for the debts which should be restructured fall in the 2017-2019 period. So, $2852.6 million USD of the total debt should be paid during these years, which is 85.3% of the total amount.

Although bank managers and the government had previously made statements about the possibility of restructuring foreign debt, we believe that the bank had, in fact, been able to execute its obligations. As a result of our analysis, it was determined that the group was able to liquidate 11.688 billion manat, including financial support from the government, in the second half of 2016 and the beginning of 2017 [See also: Figure 4].

https://www.ibar.az/site/assets/files/3434/20170523_-_iba_investor_presentation_vf.pdf
⁶³ Note: Debt amounts refer to April 18, 2017
Firstly, in July 2016, Aqrarkredit CJSC fulfilled its obligation to pay 2,842.4 million manat. After 30 June, 2016, IBA acquired 8,197.8 million manat of liquid assets, if we take cash and cash equivalents, minimum reserves, assets borrowed from the Central Bank, and available-for-sale investments into account. Additionally, in the second half of 2016, additional funds worth 1,822 million manat were acquired from Aqrarkredit CJSC, which was not reflected in assets for the first half of the year. In January 2017, the Ministry of Finance allocated 600 million manat to ensure the International Bank’s capital adequacy. Also, in 2017, other aid to support the bank totaled 1,068 million manat. Thus, the total amount of funds that the group could liquify by 11

May 2016, amounted to 11.688 billion manat,\(^{68}\) or 85.7% of the total assets of the bank in June 30, 2016. In other words, if the maturity date for the debt repayments of 30 June 2016 had to be repaid within the next 11 months, the bank's liquidity deficit would only be 1935 million manat. However, as it is known from the restructuring plan, foreign liabilities and liabilities on SOFAZ's deposits amounted to 2,448.6 million dollars, or 4335.8 million manat, which had maturity dates in the period between the second half of 2017 and 2025. This observation reveals that IBA was able to actually pay off its debts on May 11, 2017, when it requested restructuring.

Foreign creditors have been notified of the intent to restructure, including interest on certain debts. As a reaction, on May 12, 2017, a New York court ruled in favor of IBA. According to its decision, foreign creditors in the USA cannot require any assets of the bank during the voluntary restructuring of its foreign liabilities.\(^{69}\)

Later on, Fitch and Moody's international rating agencies decided to reduce IBA’s ratings. In fact, this was the expected decision, while the group has waived its obligations. Fitch downgraded IBA’s rating from BB to CCC\(^{70}\) and Moody's to Caa\(^{3}\). Fitch has also included IBA on the “Rating Watch Evolving” list. On May 24, Fitch downgraded the IBA's long-term foreign currency issuer default rating from the CCC to the “RD”, meaning "Restricted Default".\(^{72}\)

On May 23, 2017, a meeting was held with several of IBA’s foreign lenders in London. The Minister of Finance of the Republic of Azerbaijan, Samir Sharifov, who participated in the meeting, linked the bank’s current financial situation with the illegal actions of its former managers and Azerbaijan’s currency devaluations. The Minister also noted that the government had agreed to transfer $2.334 billion USD in foreign liabilities to the Azerbaijani state.\(^{73}\)

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\(^{68}\) Qeyd: hesəblama aparıqların aktivlər üzərə dəqəq mənbələrdən dəyişilmələr nəzərə alınmamış.


\(^{70}\) Fitch Ratings, “Fitch Downgrades International Bank of Azerbaijan to ‘CCC’, Places on Rating Watch Evolving”, 15.05.2017

\(^{71}\) International Bank of Azerbaijan, “Restrukturizasiya ilə əlaqədar Azərbaycan Beynəlxalq Bankının reytinqlərinə yenidən baxılıb”, 16.05.2017

\(^{72}\) Fitch Ratings, “Fitch Downgrades International Bank of Azerbaijan to ‘RD’, 24.05.2017

\(^{73}\) International Bank of Azerbaijan, “Londonda Azərbaycan Beynəlxalq Bankının xarici kreditərləri ilə görüş keçirilib”, 23.05.2017
On June 7, 2017, a London court decided to allow for the protection of the assets and rights of IBA from foreign creditors during the voluntary restructuring process.74

A meeting of IBA’s creditors was held on July 18, 2017 in which 94.1% of the creditors of the group participated. The proposed voluntary restructuring plan was approved with the support of 93.9% of participants. Thus, according to the plan, foreign lenders will be able to obtain other state-guaranteed financial instruments starting from September 1, 2017.75 Thus, the restructuring procedure for IBA's foreign liabilities will have successfully begun.

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CONCLUSION

During the investigation of the financial statements and audit opinions of IBA, the following results were obtained:

1. *Poor management and weak control of supervision* – Factors such as a lack of transparency of the activities of IBA and large scale corruption and sponsorship, as well as the fact that the main members of the supervisory board, which has the right to oversee the government’s stock market, caused a significant part of the group’s assets to be problematic. The Ministry of Finance and its refusal to take responsibility for its shortcomings is not the only structure at whom to point fingers, while external companies too have been providing audit services to the group, and have, for many years, overlooked the continuation of such deficiencies. Thus, a weak reflection of the group’s shortcomings in their audit reports led to the passive allowance of their continuation, and has not resulted in adequate public oversight and creditors’ assessments of the bank’s activities. In addition, the Chamber of Accounts of the Republic of Azerbaijan, which exerts control over public funds, has not carried out deeper audits IBA in recent years, contributing to the inadequacy of addressing the deficiencies of the organization and the expansion of the scale of damage.

2. *Failure to take adequate measures, despite the continuous violation of requirements of banking legislation and the norms of the Central Bank of Azerbaijan* – factors such as high currency violation and weak capital adequacy were repeatedly violated by IBA. Auditors’ warnings about such cases were answered by the group’s managers’ argument that the National Bank of Azerbaijan would not apply any sanctions or other penalties to the group. Indeed, the bank has not faced any sanctions for its breaches of regulatory norms. This laxity on the part of the group’s board led to serious damage in terms of the bank’s practices. Thus, the open currency position of the bank being above the required level at the beginning of 2015, led to 10 times more damage in the face of the first devaluation than it would have otherwise.

3. *Inefficiency of rehabilitation process* – the rehabilitation of IBA totaled 11665 million manat, or $7495 million USD. In other words, the total amount of state support was 26% higher than the total assets of the group 2 months before the end of 2014, 37% more than the total liabilities of the group, and 19.4% of the GDP in 2016.
4. **Lack of credit and investment policies** – direct damage to IBA from the devaluation of the manat was less than total losses. Although the bank’s position was seriously weakened after the start of 2015, the rapid expansion of its problems due to the increase of economic fluctuations and general economic contraction was due more to the weakening of the bank’s loan portfolio and lack of proper assessment for financing investment projects, rather than the devaluation itself.

5. **Imbalance in the geographical position of assets and liabilities** – the placement of the main share of IBA’s assets in the country and, therefore, in the local currency, yet, the large volume of foreign currency liabilities constituted the main source of loss for the group. Thus, the net position of the bank’s domestic assets and liabilities at the end of 2014 was a positive 3398.3 million manat (the volume of domestic earnings exceeding the domestic debt), while the net position of the bank’s international assets and liabilities was a negative 3009.3 million manat (indicating less foreign assets than foreign liabilities). Thus, devaluation had a high probability of affecting the geographical structure of liabilities. As a result, the net deficit of foreign assets and liabilities increased to 4974.9 million manat by the end of the 2015. In other words, in comparison to the beginning of the year, it increased by 65.3% in nominal terms.

6. **Liquidity of the group at the date of restructuring allowed the repayment of obligations according to schedule** – IBA had 8,197.8 million manat in liquid assets after June 30, 2016. In addition, in the second half of 2016, 1822 million manat were transferred from Aqrarkredit CJSC to IBA, and it should be noted that this amount is not reflected in the assets reported for the first half of year. In January 2017, 600 million manat was allocated to the IBA by the Ministry of Finance in order to secure capital adequacy. Additionally, in 2017, the volume of other aid to support the group was 1068 million manat. Thus, the total amount of funds that the group could liquify by May 11, 2016, amounted to 11 billion 688 million manat. This amount represents 85.7% of the total assets of the bank as of June 30, 2016. In other words, if the maturity date for debt repayments of 30 June 2016, had to be repaid within the next 11 months, the bank’s liquidity deficit would only be 1935 million manat. However, as it is known from the restructuring plan, only external liabilities and SOFAZ’s liabilities amounted to $2448.6 million USD or 4333.5 million manat, which will need to be repaid in the second half of 2017-2025. This gives grounds to say that IBA was, in fact, able to pay off its debts on May 11, 2017, when it requested restructuring.
**Remaining Questions**

1. Why did IBA request to restructure its foreign liabilities, while, as found, the bank was able to repay its foreign liabilities in a timely manner.

2. The losses of IBA on currency exchange in 2015 amounted to 89 million manat, while the corresponding amount for 2016 was 1.3 billion manat. How could it happen that despite two major devaluations of the manat and subsequent sharp dollarization, the losses in 2015 were 14.6 times lower than in 2016.


2. Central Bank of the Republic of Azerbaijan, The conversion was made on 01.04.2017 at an official exchange rate of USD / AZN. https://www.cbar.az/other/azn-rates?act=betweenForm&from%5Bday%5D=13&from%5Bmonth%5D=3&from%5Byear%5D=2017&to%5Bday%5D=13&to%5Bmonth%5D=6&to%5Byear%5D=2017&rateID=usd


10. Trend News Agency, "Jahangir Hajiyev was sentenced to 15 years in prison (UPDATED-2)", 14.10.2016


18. Central Bank of the Republic of Azerbaijan https://www.cbar.az/other/azn-rates?act=betweenForm&from%5Bday%5D=28&from%5Bmonth%5D=12&from%5Byear%5D=2015&to%5Bday%5D=28&to%5Bmonth%5D=7&to%5Byear%5D=2017&rateID=usd


https://www.fitchratings.com/site/pr/1023650


https://www.fitchratings.com/site/pr/1024142

29. International Bank of Azerbaijan,“Londonda Azərbaycan Beynəlxalq Bankının xarici kreditorları ilə görüş keçirilib”, 23.05.2017
