Emerging Debt Insights

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The International Bank of Azerbaijan

Executive Summary

Quasi-sovereign defaults, particularly when independent of the sovereign, are rare. In this report I examine the curious case of the International Bank of Azerbaijan (IBA), the latest quasi-sovereign idiosyncratic defaulter. [2] IBA, a 91% government-owned bank, in May forced a “voluntary” restructuring upon creditors and its own sovereign wealth fund even as its BB+ rated sovereign continued servicing its own debt. The case carries some similarities to that of BTA Bank, a Kazakh bank, in the way it engineered a similar restructuring via the same financial advisors in 2014. So, while surprising to us as Boston-based bond investors, we imagine it was more surprising still for the Development Bank of Kazakhstan, an investor in the IBA bonds, which found itself crammed down alongside us. When these rare events happen, it’s useful to review the event through the lens of our investment process. We make two observations from which we derive two conclusions:

Observation 1: We had incorrectly estimated Azeri decision makers’ utility function, placing insufficient weight on non-financial, perhaps political factors.

Conclusion 1: We need to remain vigilant and maintain a healthy cynicism in assessing policymakers’ utility function, being wary of agendas that may portend losses for current creditors, and apply additional hurdle rates for such investment uncertainty. We add the Azeri government and its related quasis to our high uncertainty bucket.

Observation 2: The cross-border bankruptcy method used to “voluntarily” cram down foreign currency creditors calls into question the assumption that US and UK law bond documentation can be relied upon to deliver “expected” outcomes (e.g., collective action clause thresholds, respect for seniority of claims).

Conclusion 2: Until international courts and legal systems devise counter-methods for dealing with such bad-faith loopholes, investors such as ourselves should assume the worst outcome. We are watching IBA’s ongoing legal proceeding with interest.

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[1] With help from Carl Ross and Tina Vandersteel.

[2] Of the nearly 350 corporate defaults in the emerging markets since 1999, 15 were quasi-sovereign defaults, 5 of which defaulted independently of their governments. Even rarer, IBA becomes only the second quasi-sovereign ever to default idiosyncratically while other quasi-sovereigns from the same country remained current on their debt.

Background and Overview

In May 2017, the government of Azerbaijan simultaneously announced the passing of a new local corporate bankruptcy law and the restructuring of its largest bank, the International Bank of Azerbaijan.[3] This came as a surprise to foreign bondholders, including us because: 1) the bank itself, while weak, was not insolvent; 2) the sovereign's *willingness* to support it had been well in evidence for more than a decade; 3) the BB+ sovereign's *ability* to support it was clear; and 4) the bond documentation offered reasonable defense for creditors. These are the four main pillars of our quasi-sovereign investment process.

At the time of the announcement, we assessed the additional (beyond the sovereign) default risks of IBA to merit a risk-neutral spread over the sovereign of 105 bps. At the time, the IBA 2019 bonds that we held paid a market spread that was 140 bps over Azeri sovereign bonds maturing in 2024, justifying an overweight. Given the ~10% NPV loss to those bonds as a result of the recent restructuring, the perfect hindsight ex-ante risk-neutral spread should have been 154 bps when the bonds were issued in 2014, significantly higher than our 105 bp assessment.

IBA in the Context of our Research Process

Our quasi-sovereign risk assessment process rests on three financial and strategic factors, coupled with a careful review of bond documentation. Exhibit 1 is the overview.

Exhibit 1: GMO's Methodology for Assessing Bank Credit Risk in Emerging Countries

Financial & Strategic Factors			Issue Characteristics
Stand-Alone Credit Quality	**Sovereign's Willingness to Support**	**Sovereign's Ability to Support**	
▪ Capital Adequacy	▪ Ownership Structure	▪ Economic Structure	▪ Issuer Ability to Change Terms
▪ Asset Structure	▪ Role in the Economy	▪ Fiscal Sustainability	▪ Creditor Rights and Enforcement Features
▪ Asset Quality		▪ External Liquidity	▪ Additional Support, if any
▪ Earnings			
▪ Liquidity			
▪ Financial Volatility			

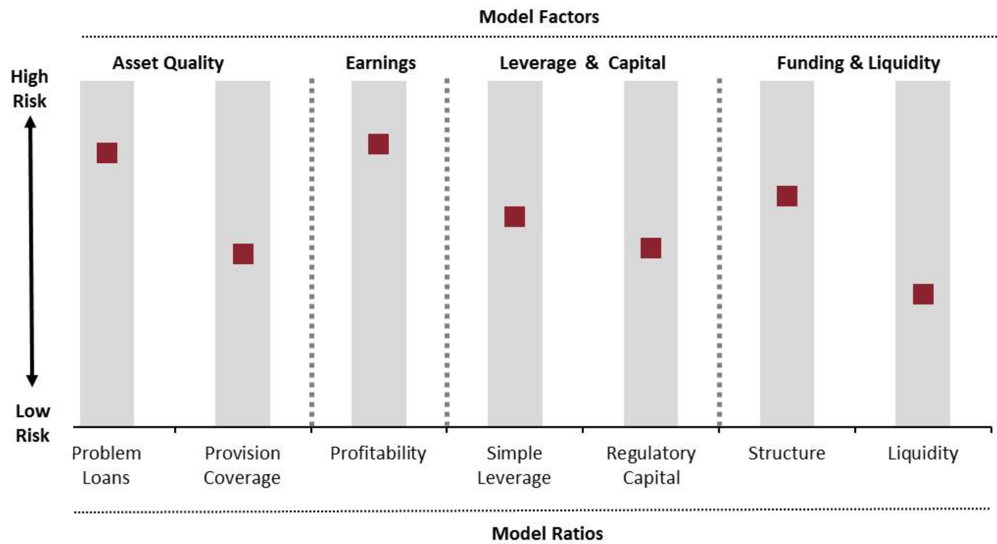
[3] For an overview of the legal methods used, please see the Appendix.

Stand-Alone Credit Quality: *while weak, did not indicate insolvency; liquidity was ample*

I have been following IBA for many years, including my time at the World Bank, during which I performed analytical work on this bank as a part of Financial Stability Assessment Program.[4] Azerbaijan is a former member of the Soviet Union, a major oil producer, and was hit hard by the precipitous decline in oil prices that began in 2014. By 2015, IBA was hobbled by under-provisioned (and fraudulent) bad loans, prompting the first round of recent government support. Subsequently, the de-pegging of the local currency (manat) led to a more than halving of the currency's value, severely straining the bank's balance sheet, which was comprised of local currency assets and foreign currency liabilities. In addition, going through IBA's financial statements, I identified a large off-balance-sheet exposure that totaled a quarter of its risk-weighted assets. I discussed these issues with management in March 2016 in a due diligence meeting. By May of 2017, when the surprise restructuring was announced, our process scored IBA like a weak, but solvent, financial institution. Importantly, it had ample liquidity from recent government financial injections. We know from past experience that lack of liquidity is the largest predictor of jump-to-default bank failure. Exhibit 2 shows a schematic of IBA's stand-alone credit quality within our model framework. These scores range from low to high risk. The dots in the chart represent IBA's relative positioning among global emerging market banks along the risk spectrum. Its positioning is toward the risky end of the spectrum, but not to the point where we were concerned about bankruptcy. By our assessment, the bank had ample liquidity, capital cushions, and bad loan provisions to counteract asset quality deterioration even after accounting for the off-balance-sheet items. On the other hand, the asset quality and earning levels were clear negatives. We concluded that, thanks to ample liquidity and business strategy, the bank would improve its weaknesses over the next 24 months. We projected that one-off provision charges would wane; that the loan book would be rebuilt over the subsequent quarters; and therefore profitability and asset quality would improve. Even with the benefit of hindsight we believed IBA was solvent and a going concern.

[4] Financial Stability Assessment Programs, jointly prepared by the IMF and the World Bank, assess the stability of the financial system as a whole in a country. They are intended to help countries identify key sources of systemic risk in the financial sector, and implement policies to enhance resilience to shocks and contagion.

Exhibit 2: GMO Quasi-Sovereign Model (Banks): Assessing IBA's Stand-Alone Credit Quality



Sources: IBA, GMO LLC

Sovereign's Incentive to Support – *this may have been our miscalculation*

Assessing a sovereign's willingness to offer financial support to its state-owned enterprises (SOE) could be described as part art, part science. In doing so, our approach is to think about a crude cost-benefit analysis as seen through the lens of the SOE's owner (the government). The inherent challenge is that there are both financial *and* non-financial costs *and* benefits of default, and calculating the cost-benefit analysis requires a calibration (or estimation) of the parameters of the policymaker's utility function. Financial costs and benefits should be easy to quantify but, alas, they are not. Although financial benefits to the sovereign can be proxied by the size of the "haircut" to bondholders, financial costs are trickier. This is due in part to the previously-noted fact that there have been very few idiosyncratic quasi-sovereign defaults over the years. Therefore, there are few data points upon which to quantify, for example, the near- and long-term increases in bond spreads demanded by the market as a result of the default. Policymakers themselves are also unable to truly pre-determine the financial costs of allowing their SOEs to default. Moreover, this calculus can be biased by any number of factors, from the prodding of arm-twisting "advisors" to the reasonable assessment that markets have very brief memories and, in this era of low yields, might quickly forgive and forget.

In the case of IBA, the financial benefits, as we estimate them, are relatively small. The entity saved \$300 million[5] directly via the haircut to bondholders, but the government added \$2.3 billion to its direct obligations, lifting the public debt-to-GDP ratio by 6 percentage points to 42%. We believe the real cost may emerge in the subsequent rounds of Azeri quasi-sovereigns borrowings. Currently, the non-

[5] With a wealth fund that holds \$35 billion in assets (85% of GDP), the government had the means to support IBA, as our sovereign's ability to support pillar assumed.

government guaranteed quasi-sovereign debt stock is roughly $15 billion, and we understand another $30 billion is needed to finalize the pipelines and related expenditures to support hydrocarbons exports. Assuming the existing debt stock is paid down as bonds become due, and therefore not refinanced (a conservative assumption), and $30 billion gets financed as planned, a mere 20 bp increase in post-default borrowing cost would fully wipe out the savings the government realized in this restructuring. Recall that our perfect hindsight risk-neutral figure was 50 bps higher. Indeed, rating agencies reacted negatively to the government's IBA response. Amid the IBA restructuring, Moody's downgraded the country by one notch to Ba2, and S&P put obligations of State Oil Company (SOCAR) on a negative watch, citing added uncertainty around government support. In a recent meeting with a major investment bank's debt underwriting team, we were told that, in fact, the borrowing window for Azeri quasi-sovereigns is effectively shut, implying infinite borrowing costs in the near term.

Non-financial costs and benefits of default are even more difficult to estimate. These may reflect unquantifiable factors such as domestic political risk and regime stability, personal financial incentives of policymakers and cadres close to the regime,[6] reputation, and stigma on the international financial stage. We try to find proxy variables to measure these "unmeasureables." In the case of banks, we consider what makes a bank strategic in the eyes of its sovereign. For example, the nature of the business, the level of government's ownerships stake, and the deposit and lending market share are some of the leading factors, among others, that are observable. While IBA is a commercial bank, it also performed agency-like activities in helping the government with payments around the country. The more agency-like activities a bank performs, the more important it becomes for the policymakers to maintain the institution to in turn carry out such activities. We found it telling that Mr. Samir Rauf oglu Sharifov, the finance minister himself, led the meeting of IBA bondholders in London in May. In other words, IBA is truly a strategic entity for the Azeri government. IBA's restructuring offer gave bondholders the choice among two *sovereign* bonds and one new IBA bond, a further indication of the bank's close link to the government.

While these various factors of willingness to pay are not directly *measureable or always predictable*, they are *learnable*. With the benefit of hindsight, it appears that we underestimated the government's willingness to step in and honor IBA's obligations. Given that we estimated the financial benefits of the default as low, we must be significantly mis-estimating the non-financial considerations in the case of Azerbaijan. It's possible that policymakers sensed the population was tiring of the austerity necessitated by the fall in oil prices, for example, and would view a haircut on foreign bondholders as a political win. Whatever the reason, we will take this into consideration and make the relevant adjustments when analyzing future Azeri bond issues.

[6] An often-cited speculation (and it is speculation) for why Venezuela is taking the other path – not defaulting – on its debt is that individuals close to the regime may hold significant positions in the bonds. Our team wrote about the Venezuela case in "Venezuela: Implications of Default Forestalled," dated December 2016.

***Issue Characteristics –** this, too, may have been our miscalculation. We need to watch developments in IBA's ongoing legal case to refine our approach to viewing the sanctity of UK and US bond documentation in cases of cross-border bankruptcy.*

Another important aspect of our investment process is a careful review of the bond documentation. Exhibit 3 is an excerpt from our bond documentation review process. The exhibit shows how the newly-passed Azeri bankruptcy law altered the rights Eurobonds granted to creditors. The modifications allowed the debtor to change the agreed-upon terms and conditions in ways that would never be possible in the international courts. Most outrageously, perhaps, non-Eurobond holders could influence the Eurobond creditors' financial outcome by simply approving their own deal that paid them par.

Exhibit 3: GMO Quasi-Sovereign Bond Documentation Review Excerpt

Structure	UK Law Bond Indenture	Azeri Restructuring Law
Ability to change the terms:		
Collective Action "cram-down clause": what's the threshold to change the restricted items?	75.1%	66.7%
Who can vote to change the restricted items?	Eurobond noteholders (only)	IBA can bundle any class of creditors, while holding the right selectively to exclude others within the same class, for voting purposes.
Treatment of creditors		
Pari passu clause	All senior unsecured creditors receive the same treatment.	IBA can treat same class investors differently by offering them varying economic outcomes. Some senior unsecured investors were offered a par claim while others were apportioned a ~10% NPV loss.
Hierarchy of capital	No loss can be apportioned to senior investors before the junior claims are wiped out.	Breached. Junior investors can recover some portion of their initial investment amount (in this case 50 cents on the dollar) even after the senior investors are apportioned loses.
Bundling of different classes of investors for voting purposes	Not allowed	Junior and senior creditors were treated as one.
Allowing a related party, a depositor, to vote even though no other depositors were included in the voting	Not allowed	Azeri sovereign wealth fund (SOFAZ), a depositor, was allowed to vote in the restructuring proposal. SOFAZ was the only depositor that was allowed to vote.
Dispute resolution		
Does the issuer submit to a major jurisdiction for lawsuit?	Yes, UK law.	No, Azeri law supersedes the UK law.

Our Conclusions

1. We need to remain vigilant and maintain a healthy cynicism in assessing policymakers' utility functions, being wary of agendas that may portend losses for current creditors, and apply additional hurdle rates for such investment uncertainty. Azerbaijan is first on our list, given its fact pattern.

2. We will watch the case of IBA carefully to see how cross-border bankruptcies evolve. Until international courts and legal systems devise counter-methods for dealing with such bad-faith loopholes, investors such as ourselves should assume the worst outcome.

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Appendix

IBA's financial advisors, who you may recall were the same as in the BTA (a Kazakh bank) case of 2014, may have been emboldened by having "gotten away" with an effective foreign creditor cram-down at that time. Granted there are meaningful differences between the two cases. BTA was a privately-owned bank when it ran into trouble during the Global Financial Crisis. The Kazakh government had stepped in to prevent a contagion. Instead of a blanket bailout for senior creditors (used extensively by the developed world regulators at the time), the Kazakh government decided to share the pain with creditors. Around $12 billion of bonds and commercial debt was reduced to $4 billion. The external debt of the Kazakh banking sector, which was 26% of GDP when the crisis struck, was roughly halved. By contrast: 1) IBA had been a majority government-owned institution since its inception in 1991, with the government, as IBA's shareholder, responsible for mismanagement; and 2) Azeri government debt stock increased by $2.3 billion as it assumed IBA's liabilities. We consider the Azeri government's outcome to be worst of both worlds: the government's debt stock rose by 6% and now, just as SOCAR's borrowing needs rise; it may have to pay an uncertainty premium for mistreating investors.

Therefore, the real similarity with the BTA case is the playbook used by financial "advisors" Lazard Freres/White & Case to enable this "voluntary" cross-border corporate restructuring.

1) Step 1: Declare bankruptcy in the debtor's country. If no restructuring laws exist, write and pass a law that either strips off or waters down the international creditors' rights governed by the Eurobonds.
2) Step 2: Validate the local restructuring process by obtaining a Chapter 15 proceeding in the UK/US. In this step, the international courts merely rubber-stamp the restructuring case, with the idea that it will review the plan itself in the second phase.
3) Step 3: Get the bondholders to accept the proposed terms by offering some incentives (e.g., early bird allocation rights, paying a fee).
4) Step 4: Cram down the terms and conditions on the non-yielding creditors using the watered-down collective action clause threshold in the newly-passed local law.
5) Step 5: Gamble that no bondholder objects in the international courts so that the debtor will never have to come back to UK/US court for the second phase of a Chapter 15 proceeding where the plan itself would seek validation. In BTA's case, there were no objecting bondholders that carried the case to the second phase. This freed defaulters to move on scot-free.

In IBA's case, the group of creditors that hold a blocking share of the Eurobonds (25%+) plan to commence proceedings in the United Kingdom and United States. Unless IBA proceeds quickly with the second phase of the Chapter 15, these "hold-out" bondholders may be able to get IBA's international bank accounts frozen. Barring an out-of-court settlement, the IBA legal representatives will be forced to defend the terms of the restructuring. We believe this would be challenging for the reasons laid out in Exhibit 3. The outcome, or the timing, of this case is uncertain but will surely establish legal precedent that may diminish future legal uncertainties in quasi-sovereign investments.