

Ukrainian Distressed Debt Market: New Investment Opportunities

By YULIA KYRPA and BOHDAN DMUKHOVSKYY



Overview of the distressed debt market in Ukraine

The variety and volumes of distressed debt currently available for purchase in Ukraine are likely to be the most attractive over the last decade. This is due to a number of reasons that have had an impact on the Ukrainian economy, including its banking sector. The roots of the current financial distress originate from the global financial crisis of 2007-2008, which was further intensified in Ukraine by the political turmoil of 2013-2014 and the military operations in the East and South of the country that started in 2014. These factors led to the bankruptcy of a significant number of Ukrainian banks, a cautious lending policy of the banks that remained solvent and significant hardships for the refinancing of debt of Ukrainian borrowers in domestic and in international financial markets.



Since 2014, the National Bank of Ukraine (the “NBU”) and the Deposit Guarantee Fund (the “DGF”), which, among others, is responsible for the management of resolution procedures of insolvent banks, have started bank resolution procedures with respect to more than 90 banks, almost all of which are now subject to liquidation. In early 2017, the NBU announced that the banking system “purification” period is over and no more substantial bank insolvencies are expected in the coming years, unless the Ukrainian economy becomes subject to any further stress from outside factors.

In the period from 2014 to 2016, the DGF acquired a debt portfolio in an amount exceeding UAH 400 billion (approximately U.S.\$15 billion), containing the assets of the insolvent banks, the biggest part of which consists of loans provided to Ukrainian borrowers (in excess of UAH 300 billion, approximately U.S.\$11.4 billion).

The DGF is planning to sell all these assets within the next four to five years to cover:

- claims of the insolvent banks’ creditors, and
- the DGF’s indebtedness to the Ministry of Finance of Ukraine which as of the end of 2016 amounted to more than UAH 125 billion (approximately U.S.\$4.5 billion) and consisted of the principal and interest accrued on the loans extended by the Ministry of Finance of Ukraine to the DGF from the state budget in order to compensate the amounts of individuals’ deposits insured by the state.

Under the current regulatory regime, the amount of assets that the DGF has been able to sell has been comparatively low. For example, in the first nine months of 2017 the DGF managed to sell loans in the aggregate amount of UAH 11,800 million (approximately U.S.\$445 million) for the total purchase price of UAH 2,889.1 million (approximately U.S.\$109 million). Since 2014 the DGF has sold only approximately 15% of the total loan portfolio under its management. It is expected, however, that by the end of 2017 the DGF will significantly accelerate the sale of assets through implementation of sales mechanisms that are discussed below in detail.

Thus, the DGF has already become the major market player on the sell-side in the Ukrainian distressed debt market. The banks that remained solvent also have high levels of non-performing loans (the “NPLs”), reaching up to 30% of their balance sheets. The solvent banks, however, generally choose to manage their NPLs internally.

Legislative and regulatory framework

When investing in NPLs, either purchased from the DGF or a solvent bank, buyers need to consider certain legislative and regulatory requirements in order to comply with when structuring the transactions.

Registration Requirements

In particular, Ukrainian regulations¹ require registration with the NBU of a loan provided by a foreign entity or individual to a Ukrainian resident. Until recently, registration was not feasible without the borrower's cooperation. Due to liberalization of applicable regulations in early 2017², a borrower's cooperation is no longer mandatory. However, the registration requirement still applies. In practice, this means that any assignment of loans from Ukrainian banks, including DGF-managed banks, to foreign investors must be registered with the NBU. The registration process requires a submission of a formal application to the NBU together with the relevant transaction documents and takes approximately one month after the date of filing with the NBU.

Other Restrictions and Possible Solutions

There are also certain restrictions with respect to the loans provided or acquired by foreign creditors that need to be considered, in particular:

Temporary prepayment prohibition (may be lifted in 2018 depending on macro-economic factors)									
Limitation on the maximum interest rate	Fixed interest loans:								
	<table border="1"> <thead> <tr> <th>Term</th> <th>Interest Cap</th> </tr> </thead> <tbody> <tr> <td>Up to 1 year</td> <td>9.8% per annum</td> </tr> <tr> <td>1 to 3 years</td> <td>10% per annum</td> </tr> <tr> <td>More than 3 years</td> <td>11% per annum</td> </tr> </tbody> </table>	Term	Interest Cap	Up to 1 year	9.8% per annum	1 to 3 years	10% per annum	More than 3 years	11% per annum
	Term	Interest Cap							
	Up to 1 year	9.8% per annum							
	1 to 3 years	10% per annum							
More than 3 years	11% per annum								
Floating interest loans:									
<table border="1"> <thead> <tr> <th>Term</th> <th>Interest Cap</th> </tr> </thead> <tbody> <tr> <td>Up to 3 years</td> <td>3-month LIBOR + 750 bps</td> </tr> </tbody> </table>	Term	Interest Cap	Up to 3 years	3-month LIBOR + 750 bps					
Term	Interest Cap								
Up to 3 years	3-month LIBOR + 750 bps								

To avoid these restrictions and the loan registration procedures, foreign investors usually establish an SPV in Ukraine that purchases the loan portfolios on their behalf. Establishing a Ukrainian SPV usually helps to solve these matters as the loan registration requirement is not applicable to local creditors irrespective of the nationality/domicile of their ultimate beneficial owners.

Until recently, only duly registered Ukrainian financial institutions were entitled to purchase loans at the auctions held by the DGF. However, this requirement was abolished in January 2017. The only applicable restriction for the potential buyers is that the borrower itself and any of its guarantors are not entitled to purchase loans from the DGF. It is also worth noting that non-registration of a Ukrainian SPV as a financial institution puts some limits on its capacity in relation to the acquired loans. In particular, after an acquisition of a loan (including a loan from a DGF-managed bank) by such SPV, interest on the outstanding amount of such loan will no longer accrue³.

In addition, in order to receive payments in foreign currency, the SPV needs to obtain a general foreign currency license. Alternatively, an SPV may engage a solvent Ukrainian bank to receive the payments in foreign currency on behalf of the SPV and convert them into UAH before transferring the funds to the SPV.

When considering whether to incorporate an SPV, an investor should also take into account certain temporary restrictions imposed by the NBU, which include, in particular, a temporary prohibition on payment of dividends abroad by the SPV, which the NBU partially softened in 2016 and in April 2017 and expects to lift soon completely. In particular, the NBU changed the regulation from a complete prohibition on dividends payment to permission for payment of those dividends that were calculated for 2014-2016 in the amounts not exceeding U.S.\$5 million per month.

NPL Assignment Procedures

Apart from the above considerations, the NPLs assignment and sale procedure are rather straightforward. The seller and the buyer normally enter into a written loan sale or assignment agreement. This agreement only needs to be notarized if specifically agreed by the parties or if the loan is secured by a mortgage. Upon execution of the agreement and payment of the purchase price, all rights and obligations under the loans and the underlying security agreements are transferred to the buyer and the buyer will need to be registered by the notary in public registers instead of the seller as the new mortgagor and pledgor.

Loan sale transactions normally do not raise any antimonopoly regulation issues and do not require prior clearance with the Antimonopoly Committee of Ukraine or other authorities.

Distressed debt portfolio acquisition strategies

For the purposes of organizing sales of the NPLs, the DGF established a special Consolidated Asset Sales and Management Office at the end of 2015, which is in charge of all procedures related to the sale of loans by DGF-managed insolvent banks. Other offices within the DGF structure remain in charge of implementation of other bank resolution procedures, collection of fees from the bank-participants of the deposit insurance system and distribution of guaranteed deposits.

According to applicable law⁴, the DGF may sell the assets via an auction or directly to an interested buyer. The value of the assets available for sale directly to an interested buyer must not exceed UAH 32,000 (approximately U.S.\$1,000). Such values are appraised by an independent appraiser contracted by the

DGF. Accordingly, NPLs above this *de minimis* threshold are always sold via auctions.

Until October 2017, the loans were sold only via the English forward action (i.e. an open-outcry ascending auction) for single loan sales. Recently, the DGF has approved special regulations allowing additional types of auction:

- English forward auction for portfolio loan sales;
- Dutch auction for single loan sales; and
- Dutch auction for portfolio loan sales.

English forward action for single loan sales

The DGF has developed an auction process in partnership with the Ukrainian online sales system called ProZorro.Sale. The system was developed at the initiative of the Ministry of Economic Development and Trade of Ukraine in cooperation with Transparency International, the DGF and the NBU to create a platform for buyers of state and/or municipal owned property and has been already recognized internationally for its innovative approach⁵. This is the first centralized online platform used for the sale of state property in Ukraine with the potential for strong transaction analytics, including big data techniques.

ProZorro.Sale is a centrally managed dynamic database of information regarding the lots put up for sale by state authorities, including the DGF. The database is managed by the NGO “Transparency International Ukraine”. A bidder may receive access to the database through any of the 30 private local Ukrainian sales platforms that have been accredited by the DGF and cooperate with the central database on equal terms. The auction includes two stages: (i) the bidders provide sealed bids, and (ii) the sealed bids are opened and disclosed to other participants (redacting the bidders’ names), and a few rounds of open bidding are held.

Such integration of the DGF’s auctions into one platform significantly improved the speed of sales and removed certain corrupt practices which commonly happened within the framework of former procedures. At the same time, until recently, ProZorro.Sale processed auctions only on the principle of English forward action for single loan sales, i.e. allowed only one ascending auction for each asset. The overall volume of sales, therefore, remained low taking into account a huge portfolio of assets of the insolvent banks and its quick depreciation.

Portfolio sales and Dutch auction

In order to overcome the drawbacks of the ascending auctions for single loan sales, the DGF is currently finalizing the legal and technical infrastructure for alternative auction types:

- English forward auction for portfolio loan sales;
- Dutch auction for single loan sales; and
- Dutch auction for portfolio loan sales.

The DGF intends to try different combinations of these types of auctions to reach the maximum sales volumes per month. For example, single loans may be sold through either an English or a Dutch auction, or pooled into portfolios in such a way so that they are comprised of high-value loans provided to affiliated corporate borrowers and/or borrowers from the same business sectors and include the security package related to such loans. It is therefore expected that the new auction types will attract strong international investment and will significantly increase sales volumes.

Alternative strategies

Applicable law⁶ also allows several other ways for acquisitions of distressed loans from the DGF. These alternatives, however, are legally and procedurally more complicated and time-consuming. For instance:

- an investor may purchase an insolvent bank from the DGF together with its loan portfolio. As evidenced by few completed transactions, in practice, this scenario is more attractive to investors who expect to be doing banking business in Ukraine rather than to engage in asset enforcement and/or restructuring; and
- a solvent Ukrainian bank may purchase a loan portfolio of an insolvent bank together with the related obligations of such insolvent bank. A recent notable deal of this kind involves an undertaking by Taskombank to pay out insured deposits of individual depositors of the insolvent Diamantbank equal to UAH 1.2 billion (approximately U.S.\$45 million) in exchange for title to the same amount of Diamantbank’s loans. To implement structures like this, a foreign investor will need to partner up with a local Ukrainian bank.

Considering the above, a sophisticated buyer should be able to execute a deal aimed at profitable portfolio acquisition, having invested sufficient time in the due diligence exercise followed-up by the development of an appropriate enforcement strategy.

Debt recovery strategies: restructuring vs. enforcement

Prior to an acquisition, a reasonable investor should also understand the potential recovery strategies in relation to the target portfolio. In light of recent financial distress, Ukrainian authorities have revised and significantly updated the legal framework for both restructuring and enforcement procedures⁷.

Restructuring

Restructuring is generally a preferable option in relation to loans granted to Ukrainian businesses which are in strategic default. Indeed, many medium-sized and large Ukrainian companies have decided to default intentionally on the loans from Ukrainian banks immediately after they became aware of the NBU's decision to start resolution procedures in relation to the insolvent banks. In many cases, such businesses also have their core assets pledged in favour of the insolvent banks and still have cash on hand.

When going for the restructuring option, an investor may choose either to restructure the indebtedness based on the general provisions of contract and civil law or to use a special regulation, the so-called "Kyiv Approach". The choice of the "Kyiv Approach" provides the borrowers with a number of benefits, which are not available in general civil law procedures, for example: tax incentives, prompt resolution of disputes, elimination of bankruptcy risks and alignment of the commercial interests of multiple creditors. The "Kyiv Approach" aims to incorporate the best practices of the "London Approach"⁸ into Ukrainian legislation.

The relevant Law of Ukraine "On Financial Restructuring" (the "Restructuring Law"), dated 14 June 2016, establishing the "Kyiv Approach", entered into force on 19 October 2016 and will remain effective until October 2019⁹. The Restructuring Law provides for a voluntary restructuring procedure which may be pursued by borrowers unable to fulfil their financial obligations. The following are key features of the Restructuring Law:

New Special Administrative Bodies	Special non-governmental bodies have been established for the administration and coordination of the restructuring process as well as resolution of disputes: these are the Secretariat, the Supervisory Council and the Arbitration Committee.
Creditors' List	At least one domestic or foreign financial institution which provided or acquired the loan has to be included into the creditors' list. The proceedings are initiated by the borrower who also determines the list of creditors involved in the restructuring. The list must include state bodies that are creditors of the debtor (for instance, tax authorities) and those financial institutions not affiliated with the borrower, which own 50% or more of the borrower's debt. Other creditors are included at the borrower's sole discretion.
Affiliates	The parties affiliated with the borrower who have their own monetary claims against that borrower are excluded from voting at the creditors' meeting when the decision on the approval of the restructuring plan is adopted.
Plan Approval	The restructuring plan has to be approved by all creditors involved in the restructuring or by 2/3 of the creditors and the arbitrators appointed by the Arbitration Committee. The Arbitration Committee selects arbitrators from the list approved by the Supervisory Board that includes highly reputable lawyers with significant experience in arbitration and commercial/financial matters. While resolving the case regarding approval of the restructuring plan, the arbitrator shall take into account written comments of all creditors and issue his/her decision with eighteen days as of receipt of the filing from the debtor.
Plan Binding Force	The conditions of the approved restructuring plan are mandatory and binding for all creditors involved, the borrower, its related parties and guarantors (the approved conditions are not mandatory for other creditors).
Tax Incentives	Tax incentives for parties participating in the restructuring. These advantages attract many borrowers to participate in the procedures envisaged by the Restructuring Law, which has increased the number of successful debt restructurings in Ukraine.



Enforcement

Enforcement may be preferable over restructuring in relation to the loans secured with valuable collateral, which does not constitute a part of the debtors' core business, or in relation to insolvent debtors, whose financial rehabilitation is not feasible. When proceeding with the enforcement option, an investor may run into a number of legal loopholes and malevolent practices that allow Ukrainian borrowers to avoid or substantially delay the repayment of debt. Such impediments include the initiation of bankruptcy proceeding by the borrower, a corrupt judiciary and ineffective enforcement system. Hence, investors should be aware of such legal impediments in advance in order to minimize their effect on the expected return from the deal.

The Ukrainian Parliament has taken significant steps towards implementation of a reform of the court system. In particular, in 2016, a law was passed¹⁰, providing, among others, for:

- an establishment of the new anticorruption and intellectual property courts;
- new principles of competitive selection of judges;
- the examination of thousands of judges¹¹;
- weakening the immunity of judges; and
- the reappointment of judges to the Supreme Court on a competitive basis.

Most of the provisions of the law have been successfully implemented to fight corruption in Ukraine's judicial system.

As to enforcement proceedings, in 2016, the Parliament passed two laws aimed at substantial reformation of the Ukrainian enforcement system: (i) the Law "On Enforcement Proceedings"; and (ii) the Law "On Agencies and Persons Engaged in Enforcement of Court Decisions and Decisions of Other Bodies" (together, the "Enforcement Laws").

The main novelty of the Enforcement Laws is an introduction of the institute of private enforcement officers – qualified specialists entitled to enforce court decisions and decisions of other governmental bodies alongside the State Enforcement Agency (except for certain types of decisions specified by the Enforcement Laws, such as decisions involving the state, governmental bodies or state-owned enterprises, decisions on property seizure, home eviction of individuals, etc.). In 2017, the first private enforcement officers began providing their services to lenders.

Other progressive initiatives include, among others, (i) formation of the Unified Debtors Register, which is already operational and accessible to the public at the following address: <https://erb.minjust.gov.ua>, (ii) computerization of enforcement procedures (including electronic registration of documents and documentation of all decisions and procedural acts in the system), (iii) increasing the liability of debtors within enforcement proceedings, as well as (iv) an increase in the amount of penalties which may be imposed by enforcement officers.

Certain other legal loopholes, such as limited powers of secured borrowers in bankruptcy procedures, still have not received sufficient attention from the Ukrainian Parliament and are not expected to be remedied in the near future. These factors should be considered by an investor when deciding on the pricing of NPLs and a post-closing strategy.

Market exit strategies: peculiarities of the secondary distressed debt sales

Investors' exit strategies may include a re-sale of the NPL portfolio to other interested parties. In order to complete such a re-sale, an NPL-holder must be registered as a financial institution in Ukraine. Moreover, unlike with the initial purchase, the subsequent purchaser of the NPLs must also have the status of a financial institution or a bank in Ukraine in order to be able to dispose of a loan.

In order to obtain the status of a financial institution, the NPL holder needs to be registered with the National Commission for Regulation of the Financial Services Markets (the "FMA"). Registration procedures include, among others, requirements relating to the internal regulations, personnel, accounting and reporting systems, technical equipment and capital. In addition, a financial institution is not allowed to engage in business other than the provision of financial services. Applicable regulations¹² set forth capital requirements for certain categories of financial institutions. In particular, a financial institution's own capital shall not be less than:

- UAH 3 million (approximately U.S.\$100,000) for applicants planning to engage in one category of financial services; and
- UAH 5 million (approximately U.S.\$200,000) for applicants planning to engage in two or more categories of financial services.

Registration procedures may take from two to six months. In light of the above requirements, it is recommended to plan exit strategies in advance prior to the completion of the NPL purchase transaction, and to decide whether the investor intends to re-sell the NPLs further. In case the re-sale of the NPLs is anticipated, an incorporation of an SPV in Ukraine in the form of a financial institution will be required.

In conclusion, given the significant development of the NPL market in Ukraine over the past two years, strengthened by the consistent improvement of the legal framework, the Ukrainian NPL market has become more attractive for foreign investors. However, purchase and exit strategies should be carefully structured to mitigate local risks in light of the relatively new and untested regulatory innovations. ■

1. Regulation on the Procedure for Receipt of Foreign Currency Loans by Residents from Non-residents and Extension of Foreign Currency Loans by Residents to Non-residents, as approved by the Order of the Board of the National Bank of Ukraine, No. 270 dated 17 June 2004, as amended
2. Order of the Board of the National Bank of Ukraine "On Amendment of Certain Regulations of the National Bank of Ukraine", No. 26 dated 23 March
3. It is worth noting that interest still accrues on the loans of the banks while they are managed by the DGF
4. Art. 51 of the Law of Ukraine "On Deposit Guarantee System", No. 4452-VI dated 23 February 2012, as amended.

5. For instance, it is a winner of the Citi Tech for Integrity Challenge (T4I) Award.
6. The Law of Ukraine "On Deposit Guarantee System", No. 4452-VI dated 23 February 2012, as amended
7. In particular, the Ukrainian parliament passed the Law of Ukraine "On Financial Restructuring", No. 1414-VIII dated 14 June 2016, and the Law of Ukraine "On Enforcement Proceedings", No. 1404-VIII dated 02 June 2016, as amended
8. A set of informal guidelines on a collective process for voluntary workouts to restructure debts of corporates in distress, developed under the leadership of the Bank of England, is generally referred to as the "London Approach"
9. The Restructuring Law terminates on this date. Depending, however, on the macroeconomic situation in Ukraine, its effectiveness may be extended by the parliament.
10. The Law of Ukraine "On Court System and Status of Judges", No. 1402-VIII dated 02 June 2016, as amended
11. Special anti-corruption authorities have been created (e.g. National Anticorruption Bureau of Ukraine), which perform examination of all judges based on their public tax declarations and re-examination of professional fitness of judges
12. Section XI of the Regulation on the State Register of Financial Institutions as approved by the Order of FMA, No. 41 dated 28 August 2003, as amended



▼ **Yulia Kyrpa** is a partner at Aequo. Yulia focuses on M&A in the banking and financial sector, bank lending, structured and trade finance transactions, and transactions involving distressed debt and debt restructuring procedures. She also has extensive experience in the handling of complex banking regulatory issues, securities transactions, insurance, as well as real estate and construction matters.

Yulia holds a Master of Law from Taras Shevchenko National University in Kyiv, Ukraine and obtained her MBA from Heriot-Watt University in Edinburgh, United Kingdom. During the financial crisis, Yulia developed a number of innovative legal products in demand by banks, financial institutions and corporations. FT Innovative Lawyers (Europe) 2015 named Yulia "an outstanding specialist in the field of banking and finance law, at a time of immense challenges" and listed her among Top 10 Legal Innovators of the Year in Europe.



▼ **Bohdan Dmukhovskyy** is a senior associate at Aequo. Bohdan has extensive experience in advising financial institutions, international payment systems, insurance companies and professional securities markets participants with respect to various regulatory and corporate law matters. He is also an expert in complex cross-border M&A transactions in the financial sector as well as due diligence exercises, debt restructuring, bank resolution procedures and distressed debt transactions. Bohdan also has significant experience with project finance, securities, derivatives, and corporate governance matters. Bohdan holds a Master of Law from Ivan Franko National University in Lviv, Ukraine and received his LL.M. from the Georgetown University Law Center where he specialized in securities and financial regulation.