

# NPL Boosters

*"Every cloud has a silver lining"*  
(English proverb)

According to economic studies the Ukrainian banking system has not yet recovered after several waves of crisis, the most notable of which occurred in 2008 and 2014. However, since 2019 the Ukrainian market has been attracting increased attention of investors. And while, until 2018, the vector of investments was aimed at bank deposits and bank shares, last year the palm on investment attractiveness passed unconditionally to Non-Performing loans (NPLs). This was facilitated by several factors, many of which lie on the legal ground.

## NPL-Growth Factors

(1) The economic crisis of 2008, which evolved into the economic disruption of 2014, resulted in a substantial deficit of liquidity in the Ukrainian economy and technical default of a great number of enterprises as well as their failure to service their bank loans. Consequently, a large number of NPLs have accumulated in the system. According to the National Bank of Ukraine, as of the beginning of 2020 non-performing loans (NPLs) in Ukraine came to 48.4%. Though gradually shrinking since 2018, the level has remained quite high in recent years.

(2) The policy of the National Bank of Ukraine after 2014 has been aimed at cleaning the existing bank market which, along with the economic downturn, led to forced withdrawal of 100 banking institutions from the market. Consequently, the assets of such banks, including NPLs were transferred for management by the state-run Deposit Guarantee Fund. This, in turn, (a) made it practically impossible to restructure banking loan debts due to the lack of specialized legislation and (b) reduced activity and effectiveness of NPLs recovery by insolvent banks which are subordinate to the Deposit Guarantee Fund, with the latter predetermined, among other things, with ineffective models of financing legal services of outsourcing (as a rule, simultaneous use of the fixed "success fee"). To sum up, any work with regard to NPLs was suspended until their sale by the Deposit Guarantee Fund, which seemed in the situation almost the only reasonable solution.

(3) The launching of NPL sales through the ProZorro e-procurement system, especially according to the method of Dutch auction, has made buying NPLs not only transparent, but also available. The peculiarity of such auction was lowering the price. In other words, the top priority for the Deposit Guarantee Fund was to guarantee the sale of the lot in question, enabling customers to compete for the lowest price which, at the same time, would help them win. This is the reason why discounts in such sales of NPL are more than attractive. According to Svitlana Rekrut, acting head of the Deposit Guarantee Fund, the majority of NPLs are sold by the Deposit Guarantee Fund at a price not exceeding 4% of the nominal value (the discount is more than 96%). In some cases, particularly

when loans of several borrowers, which might have been issued by different insolvent banks, in the total nominal value of more than billion hryvnias were combined into one lot, the discount exceeded 99%. For example, the only bidder and winner of the "Dutch" auction to sell a 10-billion hryvnias pool of assets of 10 bankrupt banks, which was held on July 22, 2019, was Credit Investment Group Ltd with a bid of 91.96 million hryvnias.

## Crisis Management

The main risk is related to the condition of the collateral security and the status of the debtor itself. More than of 98% of all loans of currently insolvent banks are past due, i.e. non-performing. The bulk of borrowers stop servicing their loans within the first month of provisional administration.

Often the debtor is in bankruptcy proceedings, and in some cases it is closed down and the property is transferred to another entity. Therefore, an investor should enjoy the most fascinating legal work on "debris removal" and untangling of everything that was done by the debtor during the times of insufficiently effective debt management by the Deposit Guarantee Fund.

Based on the experience our company has acquired, only a comprehensive combating strategy will ensure success and the utmost result with the highest percentage of recovered debts. It will simultaneously include several directions of protection. It is worth noting that each of them has recently seen positive legislative breakthroughs aimed at protecting the rights of the creditor/affected party.

(a) A high-quality comprehensive legal audit of NPL assets for likely risks. Apart from the required legal expertise, using information from official state registers (court rulings, real estate titles, mortgages and liens, pre-trial investigations, etc.) as well as information from a "data room" created on behalf of the insolvent bank by the Fund for a specific lot, and answers to lawyers' enquiries.

(b) Non-judicial protection. Non-judicial foreclosure on the collateral – the option ignored by the banks controlled by the Deposit Guarantee Fund due to the risk of liability for discretionary decisions (mostly in regard to the cost to acquire or alienate the collateral without legal proceedings) is the fastest way to protect one's own rights. This way became even more attractive for investors after 4 February 2019, when the Law of Ukraine *On Amendments to Certain Legal Acts of Ukraine on Resumption of Lending* was adopted. The aforementioned law was aimed at resuming lending, it significantly reinforced rights of creditors and increased foreclosure possibilities, having eliminated most of the legislative collisions in loan and mortgage relations, which had been benefiting the creditor for a long time. As far as such collisions goes, it was important to set the priority of mortgage over other liens which could arise afterwards and block non-judicial foreclosure.

(c) Judicial protection and bankruptcy. As to aggressive judicial tactics serving as grounds



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for a new owner of NPLs and depending on the current state of debt and security, one should not forsake instruments provided for by laws on bankruptcy which have sided with the creditor. Last year the country, and especially creditors, were presented with the *Bankruptcy Procedures Code*, which came into effect on 22 October. If we are talking about corporate bankruptcy, I would single out 5 novelties most expected by the market: (a) lifting of the minimum threshold for the initiation of proceedings; (b) the possibility for a creditors committee to revoke the insolvency officer of the case at any time, thereby gaining full control over the case; (c) limitation of the moratorium on creditors' claims to 170 days; (d) unification of the procedure for selling the debtor's property at electronic auctions; (e) new mechanisms of liability of management of the debtor.

(d) Using instruments of criminal prosecution. The active anti-corruption policy of the state has promoted the growth of criminal procedure mechanisms which could be used in fighting not only corrupt officials, but also financial fraud and unscrupulous debtors. Instituting criminal proceedings and recognizing the affected creditor, conducting active investigative operations, detection and attachment of the debtor's assets, his beneficiaries and officials, with the likelihood

of entrusting such assets to third persons, is often the only prompt and effective means available for restoring financial discipline.

## Prospects

Despite the fact that the assets of the majority of banks currently managed by the Deposit Guarantee Fund are at the final phases of sale, we expect further growth of the NPLs market due to the deeper economic crisis caused by COVID-19 and lower financial discipline of debtors. Thus, according to IMF Managing Director Kristalina Georgieva, the world has entered a recession as bad or even worse than the one in 2009. A key concern about the long-lasting impact of the sudden stop in the world economy is the risk of a wave of bankruptcies and layoffs.

If the policy of the National Bank of Ukraine and the country's banking legislation do not undergo changes which would support troubled banks, not all banking institutions are expected to withstand a new crisis inflicted by the pandemic. Thus, the market may be subjected to a new wave of bankruptcies that would precondition the sale of a new portion of banking NPL.

Significant shifts are also expected in state-owned banks. Thus, on 14 April of 2020 the Cabinet of Ministers of Ukraine approved the Order

on Certain Issues of Management of Problem Assets by Banks in the Public Sector which, in particular, set out the peculiarities of selling NPLs on the balance sheets of state banks at a price lower than their balance sheet value. The government has regulated that NPLs at such auctions must be sold through open and transparent trading (auction) and may not be sold/alienated to the debtor/counteragent, final beneficiary owner/counteragent, pledger, surety or a related person. Our forecast is that such decision will substantially increase the domestic market of NPLs because, according to estimates made by the National Bank of Ukraine, state-owned banks have accumulated approximately 75% of all NPLs in the sector (around 45% of them are managed by PrivatBank).

At the same time, with reserves covering only 95% of non-performing loans, the latter will not affect financial results and the capital of banks and, therefore, may be significantly discounted at their public sales. Taking into account the fact that valuable industrial facilities and agricultural assets are collateralized under the aforementioned NPLs of state banks, we can predict another wave of growth of investments in the NPLs sector.