

Cleaning up Banks Balance Sheets from Non-performing Loans: Legal Issues and Trends

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Within the period of financial crisis Ukrainian banks started implementation of various instruments for cleaning up their balance sheets from non-performing loans in order to solve liquidity issue and to continue lending without additional capital injections.

Such instruments usually allow banks to release provisions created to secure their non-performing loan portfolios, to ensure compliance with the ratios set out by the National Bank of Ukraine, as the regulator of the Ukrainian banking system, and, consequently, to improve the financial standing of banks.

To achieve the above goals the following instruments are being widely used in the Ukrainian banking market in 2009 and early 2010.

Distressed Debts Trading

Distressed debts trading, being one of the most popular trends in the market, quickly got a lot of attention from Ukrainian banks and collection agencies, while sophisticated investors focused on distressed debt acquisitions.

Structural considerations

Ukrainian law provides for two possible options to dispose of non-performing loans (i.e. loan claims): through entry into either a factoring or an assignment agreement (both are governed by the *Civil Code of Ukraine*). The main difference between the following options is described in Chart I below.

Chart I: Disposal of non-performing loans

	Factoring Agreement	Assignment Agreement
1. Loan claims value	Discounted value of the loan (i.e. value below par) to be paid by the assignee (the factor)	No less than the par value of the loan to be paid by the assignee
2. Acquirer of loan claims	The assignee (the factor) should be established as a bank, or a non-banking financial institution (registered by the State Commission for Regulation of Financial Services Markets)	No special requirements to the assignee are envisaged by Ukrainian law
3. Consent of the debtor/ restrictions envisaged by the loan agreement	No consent of the debtor is required. Restrictions for an assignment stipulated by loan agreements (if any) are not applicable to the given case, therefore, factoring could be made even in case of the said contractual restrictions	The debtor's consent is not required, unless otherwise stipulated by the loan agreement
4. Further (secondary) assignment	Can be performed through further factoring agreement only	Can be performed through further assignment or factoring agreement



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In case of sale of non-performing loans through either a factoring or an assignment agreement, the underlying security will be automatically transferred to the factor/the assignee by operation of law. However, to enhance security, certain contractual arrangements in respect of pledge/mortgage claims also need to be made. Besides, both of the above scenarios require re-registration of encumbrances created over the collateral in the state encumbrances' registers.

According to standard market practice, Ukrainian banks usually choose two different structures/options to dispose of their distressed debts:

(i) sale of non-performing loans to a related SPV (i.e. usually an LLC, which is a non-banking financial institution, established by the bank, its shareholders or other companies within the group). Such status of a non-banking financial institution is required to continue accrual of interest after acquisition of the loan portfolio by the said SPV and is to be obtained through its registration with the State Commission for Regulation of Financial Services Markets;

(ii) sale of non-performing loans to a non-related party (usually being a collection agency enjoying the status of a non-banking financial institution for the same reason).

The first structure is usually preferred by international banking groups with Ukrainian subsidiaries. Such groups are often inclined to write-off distressed debts from the balance sheet of the bank, but to keep them within the group (e.g. through assignment

of such loans to a related SPV) in order to avoid any reputational risks which could potentially arise within the enforcement process. The second reason is to keep non-performing loans portfolio within the group is to prevent any losses from being reflected in the bank's financial statements as applicable in the case of sale of such loans to a non-related company below their par value.

However, sale of distressed debts to a non-related company at a discounted value (that is, usually substantially below par) has certain advantages due to the following reasons: (i) the least complicated option to get rid of distressed assets in terms of structuring the transaction, compared to the transaction with the SPV, being a related party; (ii) no enforcement is required once the distressed debts portfolio is sold to a non-related collection agency; (iii) no restrictions as to related parties transactions apply to the given case; (iv) no investment restrictions, arising in case of establishing the SPV as the bank's subsidiary, need to be observed in the process of structuring the transaction.

Key Legal Issues

In terms of distressed debts sale, the following legal issues arising in the process of planning and structuring the transaction need to be observed.

Banking Secrecy Issues

A properly-drafted loan agreement governed by Ukrainian law usually contains the borrower's permission to the lender to disclose banking secrecy information to potential assignees or factors which have signed a confidentiality agreement with the lender. Therefore, no complications with disclosure of banking secrecy information will arise if the loan agreements entered into with the borrowers envisage the bank's rights to make the respective disclosure of banking secrecy information in case of loan claims' sale (either through assignment or factoring). Should no such clauses be contained in the loan agreements, prior written consent from the bank's clients would be required to observe banking secrecy rules prescribed by Ukrainian law. Consequently, the lender needs to make sure that such consent is obtained prior to actual transfer of the loan and the documents related thereto.

Foreign Currency Control Implications

Given that Ukrainian foreign currency control regulations prohibit settlements between Ukrainian residents in any currency other than Ukrainian hryvnias (UAH), the sale of foreign currency loan claims will require: (i) an individual license from the National Bank of Ukraine for settlements between Ukrainian residents in a foreign currency; (ii) special contractual arrangements — to allow the foreign currency loan claims to be paid in UAH.

Debts' Transfer to Solvent Borrowers

Transfer of overdue loans together with the underlying security to solvent borrowers with a sound financial reputation is also currently being used by certain Ukrainian banks as a part of their strategy to deal with distressed loan portfolios. Such transfer must be carried out with the mutual consent of the lender and its borrower, being in default. The main advantages of the said transaction for the new solvent borrower are: (i) access to borrowed funds on favorable conditions (e.g. interest rate lower than the average rate in the market); (ii) obtaining title to collateral previously acquired by the original borrower at a value below its current market value.

Structural Considerations

Transfer of overdue loan and the attached security usually requires the following sequence of actions to be carried out within one business day in order to reduce possible risks associated with the change of the debtor under the loan:

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(1) conclusion of a debt transfer agreement by the bank, the original borrower and the new borrower;

(2) conclusion of a collateral sale and purchase agreement by the original borrower, as the owner of collateral, and the new borrower. No termination of collateral created over the property which is subject to sale is required in the given case, as according to Ukrainian law requirements, all encumbrances established prior to sale remain valid for the new owner of the property. If, however, real property is subject to sale, a ban for its alienation, imposed by a notary under the respective application of the lender, needs to be lifted prior to such sale;

(3) offsetting mutual payment obligations under the sale and purchase agreement between the original borrower and the new borrower (usually actual payment made by the new borrower for the purchased collateral is insufficient, as he is obliged to repay the bank loan);

(4) conclusion of additional agreements to collateral agreements (i.e. pledge and mortgage agreements) between the bank and the new owner of collateral — to introduce amendments in respect of the new pledgor/mortgagor under such agreements followed by imposition of the new ban for alienation of immovable property.