# Ukrainian Post-Crisis Banking System: Ways of Solving Operational Issues

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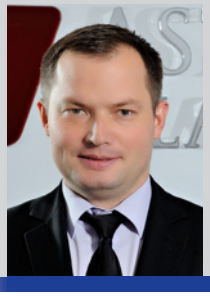

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Management of distressed assets remains one of the major issues in the operation of the banking system of Ukraine in this post-crisis period. To overcome the consequences of the crisis on the Ukrainian financial market, it is very important to enhance corporate risk management in the banking sector by adopting both national experience and best international practices of distressed assets management so as to restore successful debt financing.

Nearly all financial institutions have suffered from the post-crisis syndrome known as mass loan default. This is primarily due to insufficient legal mechanisms regulating property preservation, which often results in the lack of the debtor's liquid assets before a court issues a debt collection order.

Unfortunately, a variety of substantial gaps still remain in Ukrainian legislation that are often misused by unfair debtors in quasi-legal schemes to avoid debt returns and responsibility for such failure to repay debt. In particular, the rights of creditors within the bankruptcy procedure are significantly limited, whereas the concept of surety remains ineffective. Besides, banks are always at risk of losing mortgaged property as a consequence of unauthorized construction, and the procedure of debt collection from inherited property remains unregulated. Legislative gaps allow for the alienation of the debtors' property without prior consent of the mortgagee, as well as suspension of a mortgage by a court order despite the debtor having an outstanding debt with the creditor.

Thorough analysis of the *On Renewal of the Debtor's Solvency or Declaring it Bankrupt Act of Ukraine* and case law related to bankruptcy cases allows us to conclude the following. There are a number of abuses in the bankruptcy proceedings, with the fundamental principles of law being disregarded when applying legislation, as well as encouraging illegal actions by unfair debtors. Thus, courts often misuse their right and interpret current legislation quite vaguely and arbitrarily, terminating bankruptcy proceedings in case of partial repayment of the creditors' indisputable claims.

The amendments made by legislators to the *Civil Code of Ukraine* on 4 November 2012 have become crucial in protecting the rights of creditors. The amendments include, among others, the obligation of a court to attach the debtor's mortgaged property in case the loan agreement or the mortgage agreement is recognized by the court as invalid. This gives the creditors additional means of influencing unfair debtors. Such innovations should ensure the creditor that the debtor would not be able to avoid its obligations under any circumstance. However, according to the explanations provided by the Higher Commercial Court in its letter of information as of 27 December 2012, such amendments shall only be applied to those legal relations that arose after 4 November 2011. Therefore, the legislator's purpose was neutralized by law-enforcement practice, with the creditor being exposed to the risk that an unfair debtor would utilise the loan facility, a loan agreement would be recognized as invalid and the mortgaged property would be alienated in favour of third persons.

Considering the above, we affirm that a wide range of key remedies and instruments exist that the debtor in Ukraine may choose at its own discretion to avoid civil responsibility. These include, firstly, the termination of the co-debtors' liability for the violation of borrowers' obligations due to the incomplete and unclear definitions of the relevant civil law provisions governing surety relationships. Secondly, the concept of public encumbrance over the debtors' property in case of the recognition of the mortgage agreement as invalid shall also be applied to the debtor's bankruptcy proceedings. Thirdly, parties to bankruptcy proceedings might exercise influence on their creditors, namely, deprive a pledged creditor of its control over the method and price of sale of collateral, whereby such creditor would have no right to identify any further bankruptcy proceedings. Besides, the current downsides are that case law appears to inure to the benefit of unfair debtors whose debts are written off from a bank's reserves, and the termination of mortgage relationships due to the liquidation of property guarantors.

Despite the above-mentioned legislation issues, the banks themselves should reconsider their own approach to the origin of distressed assets. Banks should conduct a detailed economic analysis prior to any debt restructuring by exploring, *inter alia*, whether they can access and comprehend a client's business, any potential prospects for business development, concern of business owners in the development of their business, the availability of a long-term business plan and real liquid collateral to fully or still excessively offset a bank's credit risks.

A positive foreign experience of dealing with distressed assets should also be taken into account. Loan debt restructuring has proved to be the most efficient and successful method of all, which includes, *inter alia*, loan extension, change of loan currency, review of a loan repayment scheme, granting a repayment holiday, etc.

At the same time, the German and Swedish experience of establishing so-called banks of distressed assets is valuable too. In practical terms, such a bank is normally a company (usually public entity) that manages distressed assets. The basic principle of such banks is to divide distressed assets of a bank into "good" and the "bad" assets with subsequent purchase of "bad" assets. Distressed

assets banks helped insolvent banks to restore their financial position through the sale of their distressed assets at the negotiated price. The advantages of such an approach are that a bank is fully involved in the distribution of loan portfolio income, improving identification, evaluation and regulation of loan portfolio risks, etc.

The debt collection business functions in full in Ukraine these days. However, it has nothing to do with the international approach to the creation of distressed assets banks. The former are private enterprises aimed primarily receiving personal benefits rather than leveraging an insolvent bank's balance sheet.

Unfortunately, all of the above-mentioned issues undermine the banking system, forcing Ukrainian banks to limit the amount of loans that they extend to the real economy sector and write off non-performing loans out of bank reserves to improve the quality of the assets amid economic recession. Such losses are likely to outweigh direct losses originating from outstanding debts.

One of the ways to overcome such problem could be adoption of Draft No. 2286-a *On Amending Some Ukrainian Legislative Acts to Regain Trust between Borrowers and Creditors,* which is currently under consideration by the Ukrainian Parliament. The Draft is intended to enhance bankruptcy proceedings and protection of the creditors' rights within the proceedings. The Draft, therefore, will allow for minimization of the use of controlled bankruptcy schemes and the debtor's property sale at understated prices to the parties involved, create favourable conditions to ensure the transparency and competitiveness of the sale of property at the highest possible price, ensure additional protection of the creditors' property rights under surety agreement and in the case of succession, root out dubious schemes of unauthorised construction preventing the withdrawal of the mortgaged property that was constructed or reconstructed without proper authorization.

Implementation of efficient schemes of loan repayment within the Ukrainian banking system will facilitate the restoration and growth of loans to be extended to real economy sector and add to reducing the cost of loan resources. Thus, the enactment of Draft No.2286-a is of strategic importance both for banks and for Ukraine's economy in general.

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