



Focus
Ukraine

Markets
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Bad assets and non-performing loans

Cleaning-up the banking sector has reshaped it remarkably. Financial stability in the market has been achieved; however, the process will not be complete without cleaning the balance sheets of the banks. Banks have accumulated UAH1tn (\$40bn) of bad loans. This compares with the country's GDP, which is around UAH2.5tn (\$100bn). This amount of bad loans includes portfolios of both working and insolvent banks, as well as loans accounted for on the balance sheets of parent companies of Ukrainian banks with foreign capital.

Svitlana Rekrut, Deputy Managing Director at Deposit Guarantee Fund (DGF), announced the results of the first auction for the sale of bad loans through American sites that occur every morning. Results were discouraging; no agreement was reached on either of the two loan pools. There were nine participants for the first pool, none of whom ended up submitting a final bid. Three bids were submitted for the second pool; however, all of them were below the acceptance price. Rekrut believes the extremely poor quality of assets pledged to these loans is the main reason for the unsuccessful outcome.

DGF feels the main goal—expanding the base of potential investors—will be reached by bringing in foreign investors.

Potential buyers of bad assets can be divided into two groups: the borrower itself who wants to redeem debts at a discount, and true investors that de-facto could be buying a ticket for a protracted war. Rekrut complains about the lack of buyers, especially in the second category. Without tangible changes in the judiciary system and the institution of a state executor, the prices of sold assets will remain low.

At the same time, allowing borrowers in default to buy their loans back with a heavy discount sends a signal to all other borrowers to cease paying on their loans.

Kateryna Rozhkova, Deputy Governor, National Bank of Ukraine (NBU), divides non-performing loans into two unequal categories. The first is retail borrowers. Almost all NPLs in this category are FX mortgages. Parliament has not yet adopted legislation that would abolish the moratorium on mortgage collection with the simultaneous introduction of a mechanism for restructuring these loans.

The second group is the corporate sector, where the main problems are. According to the NBU, there are UAH254bn (\$10bn) of bad loans on banks' balance sheets that are available for restructuring or sale. These are predominantly from large business groups that have debts with both working and insolvent banks. As a rule, these borrowers pursue all possible ways through the courts to avoid paying their debts. However, borrowers are trying to service those loans where there is a valuable collateral. Rozhkova believes that most of these borrowers are working businesses.

This leaves banks and borrowers in an unfortunate situation. Banks, despite having good liquidity indicators, cannot resume lending due to lack of trustworthy borrowers.

READ FIRST THE DISCLOSURES SECTION (ON LAST PAGE) FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

A sad situation: banks lack good borrowers, and shady debtors lose access to credit resources

Borrowers who were able to avoid repayment of their obligations due to the unfair bankruptcy of legal entities that received loans cannot now obtain credit for their business. Creating a credit register will help banks in the future refuse such borrowers.

Markus Sanders, Director of consulting company Alvarez and Marshal, offers a look at the experience of Central European countries, which in the late 90s also went through a banking crisis and subsequent bank nationalizations. The state is not a good manager in nationalizing banks; it needs rapid privatization and/or the sale of assets on the books of nationalized banks. In the Czech Republic, there were three ways to solve the problem of bad loans:

- assets management companies for bad loans that received about 10% of all bad loans for further collection, sale, or write-off.
- packaging and selling assets in pools, similar to today's DGF's attempts to sell large asset pools through American marketplaces.
- rapid privatization of the residual, cleaned banks.

All these steps required political will, which was present in the Czech Republic, and which still needs to be formed here, in Ukraine. It was difficult for the Czechs to take these steps, but they helped create one of the region's highest GDP growth rates.

ProZorro's goal is to guarantee transparency in sales. The search for customers is a private function

Oleksiy Sobolev, Project Manager of ProZorro.Sales stated that successful experience and transparency of their system significantly increased both the confidence in the DGF and boosted the amount of sales. Currently, UAH37bn (\$1.4bn) worth of assets are available for sale. The Fund, along with the Kyiv School of Economics, has developed a mechanism for introducing a hybrid Dutch auction, where the asset price is equal to book value, and it gradually decreases until the final round, where, once again, they hold their bets in a closed mode, this time on the upside.

Sobolev cited the recent example of an investor who bought an asset for UAH 24 million (\$0.9m) at DGF's auction and, after several months, sold it to a new owner along with the project of the shopping centre that included a hotel for about UAH52m (\$4m).

The Fund sees ProZorro as a platform for sales, but the project does not search for clients, or promote properties. The functions are performed by trading platforms that are connected to the system.



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