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Bank Recovery Law: Ukraine's Pill for Financial Shockwaves?

Since the end of 2008, Ukraine's banking sector has faced unprecedented challenges resulting from the worldwide and regional financial crises. Until recently, matters related to the financial recovery of Ukrainian banks have been dealt with in an ad hoc fashion. In an attempt to facilitate the resolution of bank rehabilitation matters in a more permanent and consistent manner, the Ukrainian Parliament enacted the Act of Ukraine On Amendments to Certain Laws Regarding Peculiarities for Financial Recovery Measures for Banks, No. 1617-VI, of 24 July 2009 (Bank Recovery Law).

Enactment of the Bank Recovery Law was one of the International Monetary Fund's (IMF) conditions for Ukraine to obtain the next tranche of funding from the IMF and was a precondition to state recapitalization of some Ukrainian banks experiencing severe financial difficulties. The Bank Recovery Law went into force on 5 August 2009. The major provisions are described below.

Extended NBU Authority to Introduce Temporary Administration of Banks

The discretionary powers of the National Bank of Ukraine (NBU) to appoint temporary administrators have been broadened. The Bank Recovery Law (i) lowers the threshold for when the NBU must appoint an administrator of a Ukrainian bank and (ii) introduces additional reasons why the NBU may appoint an administrator.

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Contacts:

[Peter Z. Teluk](#)
+380.44.220.1414

[Kateryna S. Kokot](#)
+380.44.220.1402

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The NBU now is obliged to appoint a temporary administrator in case of a threat to the creditworthiness of a bank. Previously, the threat needed to be "substantial" (see Act of Ukraine On Banks and Banking Activity, No. 2121-III, of 7 January 2000 [Banking Law]). Though the NBU Regulation No. 369, On Use by NBU of the Means of Influence for Violation of Banking Legislation, of 28 August 2001 contains detailed guidance as to what constitutes a "substantial threat to creditworthiness," neither the Banking Law nor NBU Regulation No. 369 provides any guidance as to the qualification of "a threat to creditworthiness." Moreover, NBU Regulation No. 369 still contains the rule pursuant to which the NBU is obliged to appoint a temporary administrator in case of a "**substantial** threat" to the creditworthiness of a bank.

Also, the Bank Recovery Law expands the right of the NBU to appoint a temporary administrator by introducing the following additional grounds for such an appointment:

- If a bank decreases its regulatory capital by 30 percent within a six-month period (previously, it had to be shown that the bank also violated at least one economic ratio established by the NBU);
- If within five business days (previously, 15 business days) the bank fails to perform 10 percent or more of its overdue obligations;
- If the bank performs high-risk transactions that cause or may cause a loss of assets or income; or
- If the bank breaches money laundering laws.

Creditors Beware – Wider Authorities of Temporary Administrator

The Bank Recovery Law permits a temporary administrator to act unilaterally to assign demand rights, assign debt, reorganize a bank and engage in other actions under a financial recovery program of the bank **without notifying or receiving the consent of the bank's shareholders, debtors or creditors (depositors)**. The bank's shareholders and depositors do not have the right to demand termination of agreements entered into with the bank or early performance of bank obligations or to recover losses that result from a bank performing measures as part of a financial recovery program overseen by a temporary administrator.

Thus, creditors, without having any say in the matter, may end up with a completely different party than they bargained for on the other side of the transaction. There might be a number of reasons why a creditor would not wish to deal with the assignee or be wary to do so. For instance, there might be regulatory restrictions that prevent such a creditor from contracting with the new party, or there might be other difficulties of a commercial or legal nature that arise as a result of such an assignment.

The Bank Recovery Law establishes new rules regarding reorganization of the bank by a temporary administrator through divestiture. In particular, the rules requiring a minimal amount of charter capital (currently €10 million) and requiring a bank to form its charter capital only through monetary contributions do not apply to a successor bank created as a result of the reorganization of a bank by a temporary administrator through divestiture. The amount and procedure of formation of the charter capital of such a successor bank should be determined by the NBU. The temporary administrator must sell such a successor bank before completion of the temporary administration procedure.

New Moratorium Term

The Bank Recovery Law changes the maximum moratorium term for fulfillment of creditors' claims from six to three months, thus decreasing the term for which a bank may freeze a creditor's funds. The NBU has the right to extend, by six months, the moratorium for satisfaction of claims of creditors of a bank if the moratorium existed as of the date the Bank Recovery Law went into effect. The NBU used this provision immediately by prolonging by half a year the moratorium on satisfying the demands of creditors of several banks, including such large banks as Nadra Bank and Ukrprombank.

Previously the moratorium applied only to creditors' claims for which the due date of fulfillment occurred before the imposition of the moratorium. The Bank Recovery Law eliminates such a requirement, and now the moratorium may be applied to claims coming due after the imposition of the moratorium.

The Bank Recovery Law provides the NBU with the right to impose a moratorium fully or partially. The Bank Recovery Law does not contain any guidance as to what is a full or partial moratorium. However, it can be assumed from this wording that the NBU may exclude certain bank obligations from the moratorium in addition to those obligations to which a moratorium

does not apply by law. The Bank Recovery Law establishes that the moratorium does not apply to obligations related to the servicing of commercial activity of the bank, including payment of salaries or compensation for damage to the life and health of the bank's employees, as well as the claims of creditors to pay salaries, alimonies, pensions, studentships and social payments within the limits established by the temporary administrator.

Incentives to Buy Distressed Banks

The Bank Recovery Law attempts to entice **financial institutions** to buy troubled banks by providing state financial assistance for such purchases. A potential problem with the wording of the legislation is that all other players in the market seem to be ineligible to receive such financial assistance. As a rule, special purpose vehicles are created for the sole purpose of bank acquisition and may not have the status of "financial institution." The reasons for that include various regulatory restrictions on investments and acquisitions imposed on financial institutions as well as tax, legal and commercial considerations for structuring a bank acquisition. It remains to be seen whether the NBU will issue clarifications dealing with the issue of financial institutions eligible for state financial assistance.

The amount of state financial assistance must not exceed the difference between the obligations to individuals – depositors of the bank limited by the amounts subject to refund by the Deposit Insurance Fund – and the value of the bank's assets alienated from the financial institution. The value of the bank's assets sold to the financial institution must be determined by independent evaluators.

State financial assistance will be funded from the state budget of Ukraine or through the "transfer" of Ukrainian state bonds. The procedure for providing and using state financial assistance and the terms on which such financial assistance will be provided must be established by the Cabinet of Ministers of Ukraine. It is unclear at this time whether the state will actually have or be able to raise funds to assist financial institutions in buying troubled banks.

The Bank Recovery Law introduces a new rule under which a person who is party to an agreement on the transfer of assets or obligations of a bank for which the temporary administrator is introduced is released from making any payments related to alienation/receipt of such assets, obligations for making changes to the state

registers and fees for services provided by state bodies. In practice, it means that the parties to such transactions will be exempt from certain state-mandated fees, such as fees to the Antimonopoly Committee of Ukraine for consideration of the application to grant consent to a concentration, and registration fees with the State Register of Rights to Immovable Property and the State Register of Agreements.

Easier Access to Banking Secrets

The Bank Recovery Law introduces new rules regarding the disclosure of banking secrets. A bank has the right to provide information that constitutes a banking secret to other banks and the NBU to the extent necessary during the extension of loans and bank guarantees.

The bank may now disclose banking secrets to a person (including the persons authorized to act on behalf of the state) from whom the assets and obligations of the bank are alienated during the performance of measures that are part of a bank financial recovery program or during the liquidation procedure. The NBU (or temporary administrator) has the right to provide the Ministry of Finance of Ukraine with information containing banking secrets regarding the banks undergoing capitalization by the state.

The NBU may also exchange banking secrets with banking supervision authorities of another country based on international treaties for the purpose of banking supervision or the prevention of money laundering.

Special Regime of NBU Control

The Bank Recovery Law introduced the notion of a curator into the Banking Law, thus reconciling the Banking Law with NBU Regulation No. 369. The NBU has the right to restrict the activities of the bank by imposing a special control regime over the bank and appointing a curator who should, among other things, closely monitor the bank's activities and give its consent to transactions related to the movement of funds. During the "special control regime" (as well as during temporary administration) the NBU has the right to prohibit the bank from using direct correspondent accounts for settlements or demand that the bank perform settlements solely through a consolidated correspondent account.

Bank Liquidation

The Bank Recovery Law provides a liquidator with broad rights to alienate the bank's assets and obligations. A liquidator may decide how to transfer assets and obligations of a bank without giving notice to or receiving the consent of the bank's shareholders, debtors or creditors (depositors).

Similar to the fee exemptions for the disposal of assets and obligations of the banks under temporary administration, both parties involved in the transfer of assets and obligations of a bank under liquidation are released from paying certain fees to state bodies.

Rehabilitation Bank

The Bank Recovery Law grants the Cabinet of Ministers of Ukraine the right to create a rehabilitation bank based upon the NBU's proposal. The main task of the rehabilitation bank is protection of the interests of the bank's depositors (creditors). A rehabilitation bank is not a participant of the Deposit Insurance Fund.

The Bank Recovery Law is short on details of the functions and responsibilities of the rehabilitation bank, and it remains to be seen how the NBU will delineate the major tasks and regulate the activity of the rehabilitation bank. It is expected that the rehabilitation bank will be used to help "clean" toxic assets from the balance sheets of troubled banks.

Taxation of Deposits of Individuals

The Bank Recovery Law changed the date when interest income derived from an individual's deposits or current accounts will be taxed from 1 January 2010 to 1 January 2013. Considering the massive outflow of funds from the banking system and general distrust of the population towards Ukrainian banks, postponing of the taxation of interest income appears to be a sensible step to take.

Conclusion

The legislative initiatives brought by the Bank Recovery Law, although lacking clarity on some points, appear to provide necessary tools for faster and simplified procedures for the sale, reorganization and liquidation of troubled banks. Time will tell whether the benefits of the Bank Recovery Law will be effectively and smoothly utilized in practice.

For more information regarding the Bank Recovery Law, please contact your principal Squire Sanders lawyer or

one of the lawyers listed in this Alert.



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Leonardo Business Center, 19-21 Bohdan Khmelnytsky St., 16th Floor, Kyiv 01030, Ukraine

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