

## Legal due diligence of non-performing loans in Ukraine

### Introduction

#### 1. Regulation of NPL transactions in Ukraine

#### 2. Purpose of an NPL legal due diligence

#### 3. Inputs on conducting a legal due diligence

#### 4. Results of an NPL legal due diligence

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Acquisition of Non-Performing Loans (hereinafter – NPL) in Ukraine are a complex process, which consists of analytical, financial, and organizational components. This process requires a high level of organization from both the NPL sellers and buyers. Legal risk assessment plays a key role in determining an NPL investment appeal.

#### 1. Regulation of NPL transactions in Ukraine

In Ukraine, the regulation of the NPL transactions is aimed primarily at determining the procedure for selling the NPL, and defining the criteria for affiliation of accrued expenses to the NPL.

The possibility of the NPL acquisition by non-financial companies is another important issue, which has not yet been resolved by judicial practice. Courts ambiguously interpret the civil law and the law on financial activities in Ukraine regarding the legal qualification of agreements on the transfer of claims under the NPL. These peculiarities should be taken into account when structuring transactions (e.g., the establishment of a financial company acquiring the NPL) and when planning individual transactions to acquire the NPL.

#### 2. Purpose of an NPL due diligence in Ukraine

Legal due diligence is a key component of the NPL investment appeal assessment in Ukraine. Legal due diligence allows identifying risks affecting the security prospects of the NPL management, which can ultimately affect the price of the NPL. Deficiencies in the

collateralization, an irregular procedure of granting credit, and the minors registered in the residential property are some of the most common NPL gaps that can completely reduce an NPL investment appeal.

NPL legal due diligence is required not only for potential buyers. The NPL market is rapidly evolving, and it requires standardized approaches to the NPL disclosures by the sellers. NPL legal due diligence at the pre-sale stage verifies and properly structures the NPL disclosure by a seller and makes an NPL investment process more dynamic.

The basic purpose of NPL legal due diligence in Ukraine is to determine the potential risks of NPL management. To achieve this goal, an NPL legal due diligence should establish:

- 1) the parties' legal characteristics: identification of a debtor and a creditor, determination of their corporate structure and beneficiaries (for legal entities), determination of a debtor's and a creditor's connectedness, determination of the current status, location of the parties, availability of restrictions on their activities or disposal of property, etc.
- 2) contractual characteristics: analysis and determination of mutual obligations of the NPL parties, circumstances of their incurrence (conclusion of contracts), the status of documentation of such obligations, terms of contracts, etc.
- 3) characteristics of performance guarantee: analysis and determination of any forms of performance guarantee under the NPL; circumstances and documentation of the emergence of such a performance guarantee, identification of the persons who are not a party to the NPL but who have undertaken to be responsible for performance guarantee by a debtor under the NPL (bail grantors, guarantors); status of a property or the property rights transferred to ensure the performance guarantee under the NPL and the property status of bail grantors (guarantors), etc.
- 4) history record for the fulfillment of obligations: analysis of payments both by a creditor and a debtor according to agreements concluded between them.
- 5) history record of debt enforcement: analysis of all actions of a creditor or the persons authorized by him concerning debt enforcement, history record of the debt service payment negotiations, debt restructuring, results of the claim work, judicial and extrajudicial measures on debt enforcement.

### **3. Inputs on conducting a legal due diligence**

NPL legal due diligence in Ukraine is very similar in its structure to the primary legal analysis of credit operations in the banks. The key

difference between NPL legal due diligence and primary legal due diligence performed when a bank is granting credit is access to the information (inputs) required for such due diligence.

When granting credit, a Ukrainian bank can request and obtain necessary documents and a piece of information from its counterparty (a borrower) and determine the number of such documents independently. During an NPL legal due diligence, such a possibility is close to non-existent.

The main source of inputs for an NPL legal due diligence is an already formed credit file and existing data in the national registers. These sources should be used together and complement each other.

The data that can be obtained from the Ukrainian national registers is determined by their functionality and may be insufficient to identify risks. Moreover, during martial law in Ukraine, access to registers may be fully or partially restricted. Therefore, it is ineffective to be limited to the data from the registers, it is necessary to compare it with the documents of a credit file, to exclude the possibility of erroneous information entered into the registers, as well as to understand its existence and status of the documents required for the management of an acquired NPL.

According to the legislation, banks in Ukraine generate credit documentation (a file) of a debtor for each credit. These documents virtually contain complete information about the NPL.

The bank's credit policy and other internal regulations may include additional documents and a piece of information that shall be included in a debtor's credit file. Therefore, it is also better to review the relevant internal regulations of a creditor.

Inputs for an NPL legal due diligence in Ukraine should be pulled, in particular, from the following information on:

- the loan agreement;
- the lending purpose (a residential mortgage; a purchase of a car; working capital financing; current business needs; a purchase of fixed assets; an investment loan; a blank loan, i.e., a consumer credit, a point-of-sale loan; a card loan; an overdraft, etc.);
- a debtor – an individual, the result of checking his availability and evaluation of his financial solvency;
- a debtor – a legal entity, a bank or a state-funded organization, the result of checking its existence and evaluation of its financial solvency;
- the availability of a guarantors, their financial solvency to ensure performance guarantee under a loan agreement;
- the total amount of a debt under a loan agreement as of the date of the evaluation and its structure details (on the principal amount of debt, interests, commissions, penalties), the number of days overdue (for overdue loan agreements);
- the schedule for the repayment of debts (monthly in equal installments; quarterly in equal installments; annually in equal installments; at

- the end of the term in one amount; an individual schedule for the repayment of debts);
- the amount of an interest rate, type of an interest rate (fixed; floating one), method of interest accrual under a loan agreement, periodicity of interest payable under a loan agreement (monthly; quarterly; annually; at the end of the term; an individual payment schedule), history and procedure of an interest rate change, as determined by an agreement;
  - the amount of commissions and/or penalties, terms, and procedure of their accrual under a loan agreement;
  - the availability and type of collateral under a loan agreement (an integral property complex; a residential mortgage; a non-residential mortgage; a land plot; a construction work in progress; a vehicle; machinery and equipment; other movable property (office equipment, a furniture, goods in circulation and production supplies, consumer goods, etc.), securities (bonds, shares, promissory notes, etc.), a blank loan) legal priority of creditors under a loan agreement regarding debt enforcement at the expense of disposal of the collateral, the results of its last assessment and information on the results of the inspection of its availability and condition;
  - the date and amount of the last loan payment;
  - the financial solvency of a debtor;
  - the availability of a guarantee under a loan agreement, including data on the financial solvency of a guarantor, and property of a guarantor which may be claimed and may be subject to the measures on execution upon the property of a guarantor to ensure the performance guarantee under a loan agreement (by the group of claims under an obligation or a loan portfolio);
  - the subject of the pledge (the mortgage), other security under a loan agreement (for each loan agreement included in the group of claims under an obligation or a loan portfolio);
  - the characteristics of the subjects of the pledge (the mortgage), other security under a loan agreement (for each loan agreement included in the group of claims under an obligation or a loan portfolio);
  - a creditor and a procedure of conclusion of loan agreements by his side, decision making on granting of the loans and a procedure of granting of the loans, a procedure of determination and confirmation of the authority of the creditor's representatives;
  - the valuation of the subjects of the pledge (the mortgage), other collateral under a loan agreement (for each loan agreement included in the group of claims under an obligation or a loan portfolio) or information on the value of these subjects of the pledge (the mortgage), other collateral based on the results of their last valuation with the indication of the valuation date;
  - other information on the debtor's credit history and copies of other credit file documents affecting the management of the acquired NPL, including calculation of the degree of risk of performing obligations under a loan agreement.

It is clear that in bidding procedures, all the above documents and information may be withheld for various reasons. But, in any case, it is necessary to have a basic reference point whereby additional data or a piece of information on the reasons for its absence can be requested from a seller. The lack of such information indicates potential risks and may affect, in particular, an NPL price.

#### 4. Results of an NPL legal due diligence

An NPL legal due diligence in Ukraine shall be finalized with a comprehensive conclusion that includes:

1) description of an NPL legal status which reflects, among other things, the current status of the parties, the current state of contractual relations and performance of obligations, circumstances of conclusion of the contracts between a creditor and a debtor, in particular, security agreements, circumstances and a state of the documentation, other information that has a documentary proof and concerns an NPL legal status;

2) description of the NPL management methods which are permissible considering an NPL's legal status, as well as the measures provided for by the Ukrainian legislation that can be used in the NPL management (a procedure and tools for restructuring, requirements to an NPL acquirer, terms, a value and procedures of enforcement in and out of court);

3) identified risks that may potentially affect the NPL management depending on the method of such management (debt enforcement or restructuring, etc.).

The above-described elements of NPL legal due diligence in Ukraine are basic. The structure of the inputs and methods of legal due diligence also depend on the characteristics of the particular NPL (consumer or commercial loans, the amount of a debt, the presence and condition of collateral, the current status of a debtor, the nature and types of disciplinary measures which have been already faced by a debtor, etc.).

For example, legal due diligence of the pool of consumer loans with insignificant amounts each, along with the inputs being limited to the debtor's identification data and the terms of a loan agreement, has its features. In such a case, legal due diligence will differ significantly from an audit of the claims under a loan agreement with a legal entity-a debtor, whereby the obligations are secured by commercial real estate.

European practice recommends different criteria for determining the depth and methodology of an NPL legal due diligence. The criteria could include the amount of debt, nature of a collateral (a commercial or a residential property), peculiarities of lending (for example, in the case of mass consumer lending the quality of the information received from a borrower is extremely low). Based on these criteria, a specific NPL due diligence strategy can be determined.

We should also take into consideration that during an NPL legal due diligence in Ukraine information about a debtor and his connection with debt as well as about a creditor has to be verified. Credit irregularities can also pose a risk for the NPL's further management. Such irregularities can include, for example:

- improperly executed decision of a bank's credit committee;
- the absence of the consent of a supervisory body in cases stipulated by a bank's Charter;
- failure to comply with the procedures established by a bank's credit policy;
- connection of a debtor or his beneficiaries with the beneficiaries of a creditor.