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Research Note

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Privatbank

Bailout and bail-in: is there any value left in Eurobonds?

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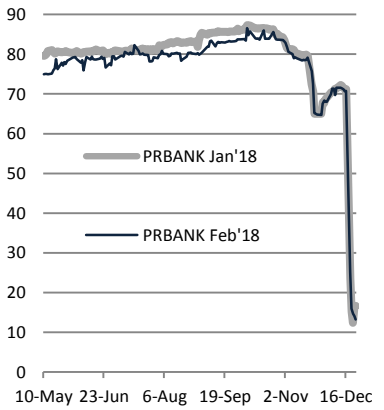
Bond prices, % of par



Source: Bloomberg

The fate of Privatbank's Eurobond holders was decided back in summer 2015 by the National Bank of Ukraine (NBU) and the IMF. Namely, at that time, the NBU and the IMF were fully aware of a huge potential gap in Privatbank capital, and based on this they should have understood the high risk that Privatbank would be nationalized (a bailout by private shareholders in the amount of more than UAH 100 bln would have been unrealistic.) So they decided instead to place the burden upon the holders of PRBANK Eurobonds.

Since then, the holders had little chance to recover the bonds' value, in our view. But they were not only unaware of their role in the bank's planned bail-in, but also were deprived of potential opportunity to reduce their exposure to the banks' bonds. That summer, the NBU forced Privatbank to extend Eurobonds that were due in September 2015 and February 2016. Meanwhile, the legislative amendment outlining the bail-in process of the Eurobond holders of Privatbank was approved in July 2015, with little attention being paid.

Bondholders also were misinformed by the bank, its auditor and the NBU about the bank's real situation in 2015-2016. For instance, the NBU's May 23 press release hid the information that the bank was not meeting its liquidity requirements, stating that its liquidity position was "satisfactory." It also failed to report that the bank was delaying with fulfilling its recapitalization program.

Even during the week after the bank was publicly declared insolvent on Dec. 19, none of the participants in the Privatbank nationalization project had addressed bondholders to explain what was going on.

As a result, **the holders of PRBANK bonds are the only creditors who lost 100% of their investment.** All the other creditors (depositors, members of the P2P program, related parties) have de facto secured 100%+ recovery of their exposure to the bank, which is a violation of the equal treatment principle. Even further, we view the government to be violating the law with its populist-style recovery of the bank's unsecured "liabilities" to individuals under the P2P program.

All the above creates a **pretext for noteholders to demand satisfaction of their rights**. To their disadvantage, Ukrainian legislation protects the Ukrainian government, which also has the support of the IMF and World Bank. Their strength is - they can appeal their case to the international investment community (since Ukraine's MinFin is still aiming to enter the international bond market), which may determine the unfair treatment of noteholders to be an impediment. Another advantage to the bondholders is the Ukrainian government may end up seeking support from international investors in its inevitable media and court battles with the former owners of Privatbank. Based on this, as well as the government's intention to give special treatment to P2P creditors breaching (amending) Ukrainian legislation, we believe the government could consider breaching its rules again and rethink its position to the benefit of the Eurobond holders.

Below we offer our thoughts about the Privatbank nationalization in the form of questions and answers.

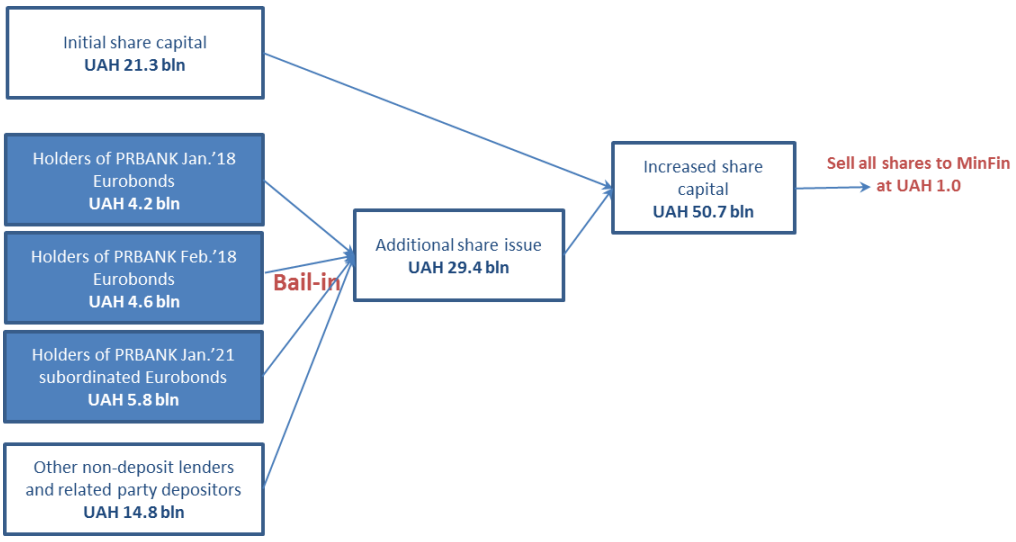
1. How did the bail-in process of Privatbank liabilities occur?

The order of events was as follows:

1) On Dec. 18, the Ukrainian Cabinet ruled to nationalize Privatbank.
2) On Dec. 19, Privatbank was recognized insolvent by the NBU. Subsequently, the State Deposit Guarantee Fund took control of the bank.
3) Referring to Ukrainian legislation on nationalization procedure of a failed bank, and based on the information provided by the NBU, the Fund:
   a. Wrote down (provisioned) some portion of Pritavbank's loan portfolio. The exact number was not disclosed, but the amount of provisioning could be as high as UAH 148 bln.
   b. **Converted UAH 29.4 bln in liabilities of Privatbank into the bank's shares (a bail-in)**. This amount includes, based on our estimates:
      - UAH 4.6 bln (USD 175 mln) in PRBANK notes maturing in Feb.'18.
      - UAH 4.2 bln (USD 160 mln) in PRBANK notes maturing in Jan.'18. These notes had an initial maturity in Sept.'15, but were restructured in September last year.
      - UAH 5.8 bln (USD 220 mln) in subordinated PRBANK notes maturing in Feb.'21. These notes (initial amount outstanding was USD 150 mln) were due in Feb.'16, but were restructured in November 2015. Before the restructuring, the bank's shareholders issued an additional USD 70 mln of these notes and fully purchased them.
      - UAH 14.6 bln of liabilities of the bank to related parties.

   The initial amount of liabilities that were subject to bail-in was UAH 31.2-32.0 bln, based on various statements from the NBU. However, of that amount, **the government lost UAH 1.8-2.6 bln** (or up to USD 100 mln) in just the last week in the form of withdrawals of related party deposits, according to NBU head (leaving UAH 29.4 bln bailed-in).
4) The resulting capital of Privatbank following the loan-loss provisioning and bail-in has become negative (the exact number is not available). By law, that allowed the Fund to sell 100% of the bank's shares for UAH 1.0 to the Finance Ministry. The deal was concluded on Dec. 21.

Illustration of the bail-in process



2. On what basis can English-law-bondholders be classified as affiliated to Privatbank's previous owners?

De jure, nobody classifies Privatbank bondholders as affiliated persons.

Article #41[1] of the ***law of Ukraine on the State Deposit Guarantee System*** grants the possibility for the Deposit Guarantee Fund to exchange "unsecured liabilities that are not deposits" (Eurobonds fit this definition) into a failed bank's equity as a part of a bank's nationalization. The same law enables the Fund to treat in the same way the related-party depositors of the failed bank.

From this standpoint, Eurobond holders share equal risks with related-party depositors (lenders) of the bank that is subject to nationalization. Therefore, some Ukrainian officials (including the finance minister) see no material difference between Eurobond holders and related-party lenders. Therefore, in their statements addressing the Ukrainian public (aiming to simplify their message), most Ukrainian officials were only referring to related-party lenders when describing the bail-in exercise.

At the same time, we suspect that the Fund, which was the ultimate decision-maker on the bondholder bail-in, was not fully aware of the fact that bondholders are not necessarily related parties. Implicit proof of that is that the Fund did not address the bondholders to explain its decision and the related consequences.

3. Does the Ukrainian government have any rights to convert the Privatbank notes, all subject to English law, selectively under the pari passu clause?

According to the article 41[1] of the ***law of Ukraine on the State Deposit Guarantee System***, the Fund **has a right (not obligation)** to covert the unsecured non-deposit liabilities of a failed bank into equity. In the case of Privatbank, the Fund decided to exercise this right.

As indicated in the answer to the fifth question, the government was not sure of whether it would use its right to bail in the bondholders.

4. When and how was Ukrainian legislation amended to allow for bailing-in the failed bank's Eurobond holders?

The initial edition of article #41[1] of the ***law of Ukraine on the State Deposit Guarantee System*** (adopted on **July 4, 2014**) assumes that authorities have a right to convert into equity only the failed bank's obligations to insiders (the owners of a large stake and members of the supervisory board, board of directors, and audit committee).

Article #41[1] was amended on July 16, 2015, now stipulating that the Fund has also the right to convert unsecured non-deposit liabilities of the failed bank into equity, in case of its nationalization.

We believe such an amendment was requested by the IMF and the World Bank. The proof of this can be found in the IMF memorandum following the first review of the IMF's EFF program with Ukraine. The extract from this memorandum (dated **July 21, 2015**) is below:

> 13. Our contingency planning is being enhanced to minimize the fiscal costs associated with downside risks. To this end, the NBU and Finance Ministry have agreed with IMF and WB staff on a set of strategic and operational principles that will guide the resolution of systemically important banks. These principles have established that:
> ...
> b. The NBU and Finance Ministry will take the lead in assessing tentative resolution options, taking into account viability criteria and including the bail-in of non-deposit, unsecured creditors in line with best international practices.

Now it's clear that such an amendment was designed specifically for Privatbank's nationalization.

5. When and how were the bondholders able to learn about the true situation in Privatbank?

Although the NBU was aware of huge potential capital gap in Privatbank and was prepared for a possible bail-in as early as mid-2015, the justified suspicions that something was wrong with the bank surfaced in the public only a year later.

Interestingly enough, the nationalization and bail-in scenario of "unsecured non-deposit lenders" of a failed "systemically important bank" was first mentioned explicitly in the IMF's July 2015 memorandum that was made public the next month. At that time however, there were eight systemically important banks in Ukraine (including six private banks), so it was not exactly clear which bank the government was referring to at that time.

The first public cause for concern emerged in late December 2015, when Privatbank's largest shareholder, Igor Kolomoisky, said in an interview to the politico.eu news site that NBU Head Valeria Gontareva told him she sees the bank's capitalization need at "128 billion hryvnias, and then the next (day) she says, no, it's 15 billion."

Since then, the NBU issued a couple of statements insisting that everything was fine with Privatbank (see question #6).

Concern in the public was effectively dampened until Oct. 3, 2016, when the text of a revised IMF memorandum was made public. That memorandum again contained the idea of the nationalization of a "systemically important bank," including a bail-in of bondholders. This time, there was only one non-state "systemically important bank" in Ukraine – Privatbank.

Yet again, a lack of clarity accompanied the October memorandum as the part of the document that was prepared and signed by the Ukrainian side contained no mention of bailing-in unsecured non-deposit lenders (unlike the July 2015 memorandum):

> The selected option will: … fully write down existing shareholders … ; secure a bail-in from all liabilities to related parties.

… However, the part prepared by the IMF (staff report) mentioning the bank's nationalization was written in a different way:

> Public funds will be injected only after shareholders have been completely diluted and **non-deposit, unsecured creditors** and related deposits are **bailed-in**.

Therefore, the contradicting statements of the October memorandum provided no clear answers as to whether the government was willing to bail-in the bondholders. It seems like the IMF staff was advocating this idea, while the government was trying to avoid it.

6. Did the NBU mislead the bondholders in 2015 and 2016?

For sure, the NBU was hiding material information on the bank's situation from the public and from the bank's lenders.

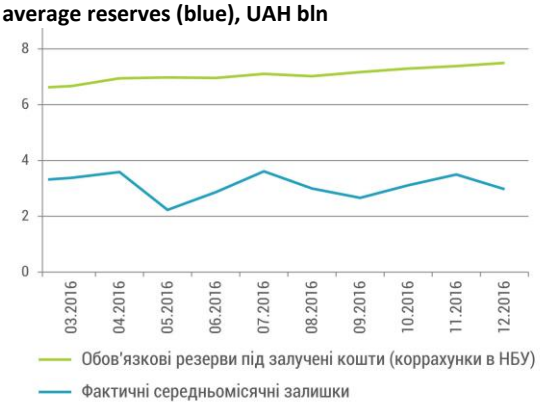
The capital gap of Privatbank, as a result of stress testing, was equal to 46% of the bank's total assets as of Apr. 1, 2015 – it was a material finding that was hidden from bondholders.

Instead, the NBU issued several messages in 2015 and 2016 hinting that Privatbank is fulfilling all its regulatory requirements. Namely:

- At a Dec. 29, 2015 press conference, NBU Governor Valeria Gontareva told journalists that the bank has excessive liquidity and has fully implemented its recapitalization program for 2015.
- In a special press release on May 23, 2016, the NBU stated that the bank had previously "met all the necessary conditions to secure the ability to further perform banking operations."

  It also stated that "**the bank's liquidity position is currently satisfactory**." The latest statement **was not true**, as can be seen from the chart presented by the NBU on Dec. 19, 2016:

  Required reserves at correspondent account with NBU (green) and actual monthly average reserves (blue), UAH bln



  The same statement said that "Privatbank agreed to a three-year recapitalization plan with the NBU and is currently engaged in vigorous efforts to implement it." It also said that "the NBU conducts a continuous monitoring of the bank's activities as a whole and exercises control over the implementation of the recapitalization program by the bank." But it failed to say that as of the date of the report, Privatbank was delaying with the implementation of its recapitalization program (the delay with repossessing of collateral, which should have been done by April 1, 2016 as part of recapitalization exercise, was reported in the bank's semi-annual report in late August. It repossessed the collateral only in early June, according to the bank).

So, the NBU was not only hiding material information on Privatbank from the public, but also issued statements distorting the real situation in the bank.

7. The bondholders accepted restructuring the bank's Sept.'15 notes on Sept. 7, 2015 and restructuring of the bank's subordinated Feb.'16 notes on Nov. 11, 2015. Did the NBU, the bank and other involved parties hide material information about the bank's potential problems that might have affected the decision of bondholders in approving the bonds' restructuring?

We believe – yes. The NBU's stress-testing, which revealed a potential capital gap in the bank of UAH 113 bln (officially accepted in late 2015 or early 2016), was launched in May 2015. As of early September 2015, the NBU had preliminary results indicating the problem, in all likelihood. Had the regulator shared such results with the bondholders, we are sure they would have reached a different decision regarding the restructuring.

Instead, the government was preparing legal grounds to bail-in the bondholders. The respective amendment to the article #41[1] was made in July 2015 (refer to question #4). From what we know, no one informed the bondholders about such an amendment.

8. Did the NBU force Privatbank to restructure its 2015 and 2016 notes?

It looks like it. Privtabank's website contains two documents from the NBU that indicate the central bank indeed forced the bank to restructure its 2015 and 2016 notes:

Resolution #329 of May 21, 2015 said:

> Oblige the Bank to take measures for entering into transactions to amend the terms of borrowing under the Bank's external debt obligations owed to UK SPV CREDIT FINANCE PLC and STANDARD BANK PLC due in 2015 and 2016, respectively.

A letter from NBU first deputy governor dated Aug. 5, 2015, describing foreign currency restrictions for the banks that were in place at that date, and a strict recommendation to not breach them in order to fulfil repayment of the notes:

> …if the Bank's fulfillment of its foreign currency obligations leads to exceeding such restrictions, the Bank must fulfill such obligations using only its own foreign currency funds (which were not bought or borrowed from the National Bank of Ukraine).
>
> We would like to emphasize that in case of violation by the Bank of regulations adopted by the National Bank of Ukraine, the National Bank of Ukraine is entitled to apply sanctions provided for in Article 73 of the law of Ukraine "On banks and banking activities" to the Bank and/or to its management. *[Article #73 assumes a wide range of punishment for the bank, starting from expressing of a written concern and up to declaring the bank insolvent].*

This last letter was a response to a letter by the Privatbank CEO to the NBU that most likely claimed the bank's intention to repay its Sept.'15 notes. Our conclusion is the bank had the intention to repay the 2015 Eurobonds on time, but the NBU forced it to implement the restructuring.

At the same time, we are not sure whether Privatbank had the financial capability, or enough dollar liquidity, to repay the notes smoothly.

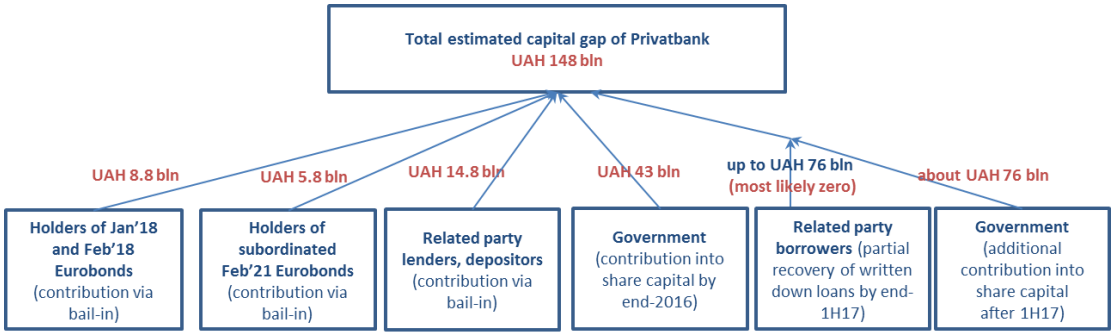
9. Did the Ukrainian government discriminate to the disadvantage of PRBANK bondholders as compared to the other creditors of Privatbank?

Yes. In fact, the bondholders were the only lenders to the bank that recovered 0% of their value. All the other sides enjoyed a recovery rate of 100% or more.

Namely, following the nationalization:

- All Privatbank depositors are fully covered;
- Related parties (as a single class) were bailed-in by about UAH 18.3 bln, but effectively granted the right to not repay up to UAH 160 bln in their liabilities to the bank. We see little chance the related party borrowers will return up to UAH 76 bln in loans or allocate collateral that will lead to a capital gap reduced by UAH 76 bln, as the government "expects." (See the next question for more details.) So, the recovery rate of related parties exceeds 100% by far;
- All non-related Eurobond holders are fully diluted;
- No one else is intended to be diluted.

Government's view on how Privatbank's capital gap will be replenished



Recovery rate for all Privatbank creditors*	
P2P "lenders" under Privatbank mediation**	Infinity
Related parties	~ 800%
Depositors	100%
Bondholders	0%

** Ratio of money they received to the balance value of Privatbank obligations*
*** See question #10 for more details*

10. Did the government violate its own rules of the game during the Privatbank nationalization?

We have noticed signs of flagrant violations of law in an intention of the Ukrainian government to fully recover the "investments" of individuals under the P2P program led by Privatbank.

The government is intending to fully compensate (or has already done so) the "investments" of the participants of the P2P program that was led by Privatbank. Based on this program, individuals were lending directly to other individuals, with the mediation of Privatbank (via the offices of Privatbank and the bank's electronic platform). Such operations, mediated by well-recognized bank, created the illusion for individuals that they are merely placing deposits with the bank at generous interest rates.

Liabilities to such "depositors" were not recognized on Privatbank's balance sheet. **So, they are not only "unsecured" and are "not deposits" (like Eurobonds), but they are also not the bank's liabilities.**

In spite of this, the NBU decided that "P2P deposits" will be fully compensated, though there is no regulation that allows doing so. Most likely, the recognition of such "deposits" will require adoption of a special law.

And the amount under consideration is huge, comparable to any issue of PRBANK Eurobonds. Namely, total "deposits" under the P2P program are estimated by the NBU at UAH 5.5 bln (USD 200 mln). Notably, all such "deposits" emerged after Mar. 1, 2016, and the NBU did nothing to prevent them growing to the enormous size of UAH 5.5 bln in less than one year.

In our view, such consideration by the government, which is politically motivated, creates a good precedent for Eurobond holders.

11. Does the deal made between the former Privatbank owners and the Ukrainian government secure any related-party loan repayments or a collection of collateral?

Based on information from the NBU, the former owners of Privatbank signed some guarantee letter (as part of the nationalization plan) assuring they will pass to the bank hard collateral securing their bank borrowings that will fill part of the bank's capital gap for up to UAH 76 bln by end-1H17.

In our view, such a guarantee letter is not enforceable, and no collateral will be collected. The recent case of withdrawal of related-party deposits (by more than UAH 2 bln "in recent days," according to the NBU head, refer also to question #1), which were subject to the bail-in, suggests that the former owners are not cooperative at all.

12. Why did Privatbank's auditing firm, PwC, report the bank's low exposure to related parties (about 17% of corporate loans under IFRS, not 97%, as claimed by the NBU)?
Why did PwC fail to disclose a risk of absence of hard collateral under most of the bank's loans?

Privatbank often took a creative approach and generally bent banking rules and regulations if they were set explicitly. In this case, most likely, PwC did not bother to apply principles and overlooked the creative accounting that bent the rules (but did not necessarily break them). The auditor simply looked the other way instead of performing an independent evaluation of the quality of the bank's loan portfolio and collateral.

The fact that no PwC report made any mention of the NBU's estimate of the bank's exposure to related parties was the result of non-recognition by the bank of the NBU's treatment of related parties. To our knowledge, the NBU failed to agree with the bank (in due course) of the size of the exposure to related parties.

Also, in our view, PwC not only ignored the fact of absence hard collateral, but also manipulated the evaluation of soft collateral. Otherwise, it's hard to

explain such a huge difference in capital gap estimated by the NBU (UAH 148 bln) and by PwC (zero).

Also, we believe, PwC should have provided information to the public that almost all the bank's corporate loans had close to 100% probability of default (otherwise, the value of the collateral would not have been that important).

Moreover, we believe PwC had to disclose the bank's potential capital gap as revealed by the NBU (and agreed upon with the bank), as this is very material information. Nothing had been done, so we believe the auditor should share the responsibility for misinforming the bank's creditors, even though it might appear that PwC violated no law.

13. Is there any chance for bondholders to recover something from the notes?

Setting aside legal issues (we are not legal experts), we believe there is a room for negotiations with Ukrainian government aimed at recovering the bondholders' position, based on:

- The fact the bondholders were not informed about recognition of the bank's insolvency (the event of default, based on the bond prospectus) on time and in due course. So, the bondholders were deprived of the possibility to try to accelerate the repayment of notes, as stipulated in the bond issue prospectuses.

- The fact that the bondholders were the only party that lost 100% of the value of their investment in the process of nationalization, whereas all the other involved parties got 100%+ of their exposure in the bank, which is a flagrant violation of pari passu treatment (see question #9).

- The fact that the Deposit Guarantee Fund was not obliged by any law to bail-in the bondholders. The Fund might have even been misinformed by the initiators (NBU) of the fact that the bondholders are not related parties of Privatbank (see question #2).

- The fact that the government flagrantly and unlawfully decided to save the "liabilities" of Privatbank related to the P2P project (see question #10), while at the same time applying "rule of law" to the bondholders. The attempt to save "P2P liabilities" creates a valuable precedent for Eurobond holders.

- Understanding that the government will bear an extra UAH 5.5 bln in costs in an unlawful recovery of "P2P depositors", and on the way to preparing for nationalization it managed to lose about UAH 2 bln of withdrawn related-party deposits (see question #1). This suggests the government is being very flexible in estimating its costs of the Privatbank nationalization, meaning it also does not rule out some repayment to bondholders.

- Suspicion that the bondholders were selected to bear the full burden of the bank's collapse back in summer 2015 and they were deprived of their right to get repaid their 2015 and 2016 notes when due. There is also suspicion that the bondholders were misinformed on the true situation in the bank

and their future role in its bailout in 2015 (before the note restructuring) and in 2016 (refer to question #6), which adversely affected their ability to refuse the debt restructuring and protect their investment in other ways, ahead of the bank's insolvency recognition.

- Our understanding that the government is afraid of spoiling relationships with international creditors as it is still seeking to enter international bond markets, maybe even this year.

- Our expectation of heavy attacks (media and legal) on the government and National Bank from the former owners of Privatbank and the understanding that the government wants to secure backing from international creditors in this battle.

A logical unfolding of events suggests that:

- **PRBANK notes maturing in January 2018 should have the highest recovery rate of all the notes**. The holders of these notes had a chance to get them fully repaid in September 2015, but instead agreed to their restructuring, which was likely imposed by the NBU. Before the restructuring, they were misinformed about all the bank's emerged risks.

- **PRBANK notes maturing in February 2018 deserve a smaller recovery rate** - the holders of these notes had little chance to get them repaid in 2015-2016.

- **Subordinated PRBANK notes maturing in February 2021 should have the smallest recovery rate**, primarily due to their nature and also due to the clear presence of true related parties among the bondholders (USD 70 mln of the total USD 220 mln issue was bought by the bank's related parties in 2015).

As the bank's liabilities to bondholders have been already converted into shares that are currently owned by the government, the recovery of their value will demand special regulation from the government or even parliament. That complicates the recovery significantly.

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