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Research Note

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Privatbank Eurobonds

New court hearing ahead

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A new hearing on Privatbank's bailed-in 2018 Eurobonds has been scheduled in the London Court of International Arbitration (LCIA) on about Feb. 15, according to Madison Pacific, the bond's trustee.

According to the trustee's Jan. 27 report, it is asking the court to:

- Hear the trustee's statement proposing to "lift stay on bail-in defence." Based on this defence, the bank's obligations to bondholders will be discharged in case the Bank of England recognizes the bonds' bail-in. The trustee is likely to insist that it is high time for Privatbank to pay as there is no more reason to wait for any ruling of the Bank of England in favour of the Ukrainian bank.

- Hear certain individual bondholders' statements claiming entitlement to receive payments from Privatbank. In particular, we guess that both those bondholders who did not identify themselves by August 2019, and those who identified themselves but were denied by the bank, are trying to reinstate their rights to be paid.

The first item, if resolved in favour of the trustee (which looks likely), might allow bondholders to expect a soon repayment from the bank, but only those who have been recognized by the bank as entitled to receive compensation. However, the hearing about the entitlement of certain individual bondholders (those whom the bank suspects in being related to the former shareholders of Privatbank, as well as those who have not identified themselves) may take a lot of time, thereby theoretically allowing the bank to further postpone payments to any bondholders.

Bonds subject to litigation in London

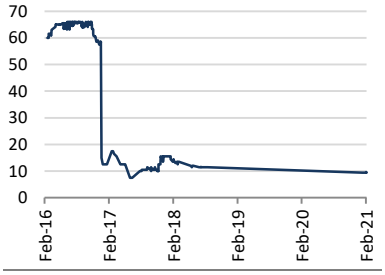
PRBANK 10.25% 2018	
Amt. outstanding	USD 160 mln
Maturity	23-Jan-2018
Mid-price	32.5%
Unpaid coupon, % of par:	
On June 14, 2019	28.8%
On Feb. 04, 2021	45.7%

PRBANK 10.875% 2018	
Amt. outstanding	USD 175 mln
Maturity	28-Feb-2018
Mid-price	35.4%
Unpaid coupon, % of par:	
On June 14, 2019	30.3%
On Feb. 04, 2021	48.2%

Subordinated bond

PRBANK 11% 2021	
Amt. outstanding	USD 220 mln
Maturity	09-Feb-2021
Mid-price	9.5%
Unpaid coupon, % of par:	
On Feb. 04, 2021	49.4%

PRBANK'21 price, % of par



Source: Bloomberg

Brief history of bailed-in Eurobonds

Ukraine's leading financial institution Privatbank was recognized as insolvent in December 2016. Soon after that, the government decided to nationalize and bail out the bank. The terms set by parliament involved the Deposit Guarantee Fund – acting on behalf of shareholders and some of the bank's related parties – exchanging the bank's UAH 29.4 bln (USD 1.1 bln) in obligations for the bank's new shares (the bail in). Then the Deposit Guarantee Fund sold all the bank's shares to the Finance Ministry for a symbolic price of UAH 1. The ministry spent an additional UAH 155 bln (USD 5.5) during 2016-2017 to increase Privatbank's equity.

Among the bailed-in obligations of the bank were three issues of Privatbank Eurobonds at a total amount of USD 555 mln (including USD 335 mln in senior notes due in January and February 2018 and USD 220 mln in subordinated notes maturing in February 2021). The holders of USD 335 mln in senior Eurobonds have been fighting the bail-in in London courts since 2017.

In July 2019, the LCIA ruled that these senior bondholders (USD 335 mln outstanding) should be repaid, but only in case: (1) the bank's bail-in defence is unsuccessful and (2) the particular bonds were not held for the benefit of the bank's former owners or entities owned or controlled by them as of June 14. All the bondholders were requested to identify themselves by Aug. 13, 2019 and prove that they are not related to the bank's former main shareholders, Igor Kolomoisky and Gennady Bogolyubov.

In September 2020, a hearing in the LCIA brought no progress on lifting the banks' bail-in defence, nor provided any clarity about bondholder entitlements to receive compensation from the bank. A February 2021 hearing has been reportedly scheduled to shed some light on these outstanding issues.

Payments are unlikely to come soon

In its "bail-in defence," Privatbank is hoping that the bail-in of senior Eurobonds, which was performed based on Ukrainian legislation, will be recognized by the Bank of England based on the English Bank Recovery and Resolution Order. In our view, there is little chance that the Bank of England will recognize the bail-in, meaning that Privatbank's "bail-in defence" is nothing but an attempt to postpone any payment to bondholders for as long as possible:

- The National Bank of Ukraine requested in 2017 that the Bank of England recognize the validity of Privatbank's bail-in, based on our information. If the Bank of England had the intention of adopting the positions of Privatbank and the Ukrainian government, it would have had ample opportunity to do so during this period since the request's filing.

- We see enough reasons for the Bank of England to refuse the bail-in recognition. We provide our arguments on that in the last section.

Meanwhile, we see a high probability that the upcoming court hearing won't result in Privatbank making payments to bondholders, even in case the court rules not to wait for a resolution of the Bank of England. This is because there are unresolved issues related to two other groups of bondholders: those whom Privatbank refused to pay by suspecting them as acting on behalf of the bank's former shareholders (some of whom might disagree with the bank's position) and those who failed to identify themselves by Aug. 13, 2019 (whose right to receive any payments on their Eurobonds is unclear now). Taking into account that the discussion about payment entitlement for such groups of bondholders could take a lot of time, the bank might insist that no payments to any bondholders should be made until the final list of entitled bondholders is agreed upon.

The bank looks especially interested now in dragging out the time before any payment to bondholders is made as the maturity date on Privatbank's 2021 subordinated notes is approaching (Feb. 9). The bank's failure to repay subordinated notes for USD 220 mln by maturity will allow bondholders to demand payment in the courts (based on various reports, the 2021 noteholders have not been able to sue Privatbank before maturity). However, in case the holders of 2018 notes do not receive any compensation soon, the Ukrainian government might adopt the expectation that the holders of the 2021 notes will become discouraged from suing the bank.

Payments to exceed par value of the bonds

As we understand it, the LCIA's decision of June 2019 was a partial ruling ordering Privatbank to pay its senior bondholders (under the conditions that the bank's bail-in defence is unsuccessful and bondholders are not related to the bank's former shareholders) the notional amount and interest at the level of the coupons up to the date of payment (or at least up to the date of the ruling).

The potential liability of Privatbank to senior bondholders has thereby accumulated to:

- At least 128% of par, and up to 146% of par for the USD 160 mln bonds matured in January 2018.

- At least 130% of par, and up to 148% of par for the USD 175 mln bonds matured in February 2018.

While the free trading of PRBANK senior bonds is limited due to the LCIA ruling that might restrict payment eligibility depending on the date of the bond's purchase, no such trading restriction exist for the subordinated bonds.

For this reason, we expect a surge in the market prices of the subordinated bonds as soon as the holders of the senior bonds get paid. As of today, the subordinated bonds are trading below 10% of their par value, while the potential payments on them (providing subordinated bondholders win their case against Privatbank and are recognized as eligible to be paid) are close to 149% of their notional value and keep growing.

Why Bank of England is likely to refuse recognition of the Privatbank bail-in altogether

The procedure of Bank of England's recognition of Privatbank's bail-in is stipulated by The Bank Recovery and Resolution Order of 2014, specifically by its Chapter 6 (Recognition of third-country resolution actions, articles 89H – 89J). Part (4) of the Order's article 89H stipulates that:

Recognition of the action (…) may be refused only if the Bank and the Treasury are satisfied that one or more of the following conditions are satisfied:
…
(c) under the third-country resolution action creditors (including in particular depositors) located or payable in an EEA state would not, by reason of being located or payable in the EEA state – receive the same treatment as creditors (including depositors) who are located or payable in the third country concerned and have similar legal rights;
…
(e) recognition would be unlawful under section 6 of the Human Rights Act 1998 (public authority not to act contrary to Human Rights Convention) or contrary to a provision of EU law.

Also, the Privatbank resolution's anticipated results should be "*broadly comparable to results which could have been anticipated from the exercise of a stabilization option in relation to an entity in the United Kingdom*," as stipulated by paragraph (7) of the section.

In our view, the bail-in of Privatbank bondholders meets conditions (c) and (e) of part (4) of section 89H, meaning that there are enough grounds for the Bank of England to refuse the recognition of the Eurobonds' bail-in.

Paragraph (c): Privatbank bondholders were treated worse than some of their peer entities (international lenders and even "related parties")

1. **Privatbank Eurobond holders were treated worse than the bank's other senior creditors solely due to the way the Eurobonds were structured.**

Eurobonds were issued in the form of loan participation notes: Ukraine's Privatbank created a British SPV (called UK SPV Credit Finance Plc) which issued bonds (LPNs). The SPV provided money raised from the bonds' placement in the form of loans to the bank.

The SPV falls under the definition of "related party" to the bank under Ukrainian legislation (as it had been created by the bank and was fully owned by it). Solely for this reason, all the loans of SPV Credit Finance to Privatbank were exchanged into the bank's shares (bailed-in) in December 2016.

Therefore, **Eurobond holders (who were indirect lenders to Privatbank via UK SPV Credit Finance) were treated worse that other international lenders of Privatbank, e.g. Cargill (whose loans were not bailed-in).** In our view, this happened solely because:

- the way Ukrainian legislation on the bail-in was written, only the bank's obligations to related parties were allowed to be exchanged into new shares of insolvent Privatbank, while
- bondholders (via UK SPV Credit Finance), although having equal rights as other international creditors like Cargill, were recognized as related parties of Privatbank under Ukrainian law. Meanwhile, there were no legal reasons to recognize Cargill (as well as other direct international lenders) as a related party.

2. Privatbank Eurobond holders would have avoided the bail-in had the bonds been structured under Ukrainian law.

Should Privatbank place local bonds under Ukrainian legislation instead of LPNs (issued via intermediary SPV), the government would have no legal reasons to bail them in, as the bond issuer would be the bank itself, not its SPV that falls under definition of "related party." Therefore, English-law bondholders were treated worse than they would have been treated had they held bonds under Ukrainian law.

3. Privatbank bondholders were treated worse than some other members of their "peer group," or "related parties."

The bank fully wrote down all the international bonds (via conversion into equity of all the loans provided by UK SPV Credit Finance), while some other entities recognized as related parties had not been bailed-in or recovered their assets.

3.1 Not all the related parties have been bailed-in

The process of selection of related parties for the bail-in was neither clear nor transparent. Privatbank bailed in only its liabilities to former shareholders and to no more than 100 related parties (including the Eurobond issuer UK SPV Credit Finance), while in fact there should have been much more than 100 entities recognized as related parties to Privatbank.

The bail-in of all creditors was made via private placement of new Privatbank shares:

- According to article 15 of Ukraine's Law on Joint Stock Companies, in the event a company's book value of equity is less than its share capital (which was the case for Privatbank), it can only make a private placement of shares (but not a public placement).
- A public placement of shares (as an alternative to a private placement) can only be made via an offering of new shares to a list of persons who have not been defined ahead. This is not the case of Privatbank, for whom the list of "new shareholders" had been predetermined.

Private placement can be made to no more than 100 non-shareholders:

- According to part II of the State Securities Commission's Order on Increase/Decrease of Share Capital of a Public or Private Joint Stock Company, private placement can be only made via offering of new shares to existing shareholders and a predetermined list of no more than 100 other entities.
- The bank and the government did not violate this order, based on our information. Otherwise, the placement of new shares would have been recognized as illegal, and/or had not been registered by the commission.

We acknowledge that there is **no proof** that the list of related parties to Privatbank included more than 100 entities, as the National Bank's resolution #105 of Dec. 13, 2016 (which provides the full list of recognized related parties) is not public. However, our sources indicate that the list was much longer than 100. **Indirect proof** of that are:

- The actual amount of bailed-in accounts, or UAH 29.4 bln, appeared to be smaller than Privatbank's liabilities to related parties, as reported by the National Bank before the bail-in was completed (at least UAH 31.2 bln).
- There is evidence that some persons recognized as related parties avoided the bail-in. For instance, deposit of Rakhmil Surkis for UAH 514 mln was not bailed-in (as reported by local media), even though other members of the Surkis family (with even smaller deposits) have been bailed-in as related parties.

3.2 Rights of some bailed-in related parties have been restored

Some individuals who were recognized as related parties and bailed-in were able to withdraw their money from the bank, based on the rulings of Ukrainian courts. For instance, members of the Surkis family won appeals in first- and second-tier courts against the bail-in and, according to report of Interfax-Ukraine, withdrew their previously bailed-in deposits for UAH 1.1 bln in 2018. However, we acknowledge that this is not the end of story, as the Supreme Court cancelled the ruling of the lower courts on this case in June 2020. The hearing, therefore, was sent to a first-tier court for a new trial, with unclear outcomes for the Surkises.

Paragraph (e): Bondholders' bail-in does not look compatible with some of the norms of Ukrainian and EU legislation

- Ukraine's Constitution (article 41) stipulates that forceful alienation of private property can be only applied for the motives of social necessity, as stipulated by law and on the condition of full compensation (which was not made). Also, such alienation with compensation is only possible in case of martial law and state of emergency (which was not the case).

- Article I of the Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms (which the English regulation refers to) stipulates that:

  "*No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law (…) The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties*". The public interest of the bail-in looks unclear, and even more unclear is the need to "penalize" bondholders, and not penalize other persons, like some of the related parties (whose assets were untouched) and former shareholders of the bank.

- It also does not look fully compatible with Ukraine's Law on System of Guarantees of Individual Deposits (based on which the bondholders were bailed-in). The law's article 41-1 (in case a bank is recognized as insolvent and the government decides to bail it out) allows the Deposit Guarantee Fund to conclude, on behalf of related parties, agreements on the purchase of the bank's additional shares using its unencumbered liabilities to such parties. The issuer of Privatbank Eurobonds, UK SPV Credit Finance (registered under English law) falls under the definition of "related party" to the ban under Ukrainian law. However, by applying such a definition (which resulted in the bail-in of Privatbank's bondholders), the government ignored the fact that UK SPV Credit Finance was a special vehicle to issue the bank's Eurobonds to professional international investors under English law, as well as the fact that ultimate lenders to the bank, via the SPV, were international investors, most of which were not related parties to the bank.

- As has been indicated by the rulings of the first- and second-tier Ukrainian courts in the case of THEO Worldwide against Privatbank, the bail-in of Eurobonds might have been unlawful due to the encumbered nature of Privatbank's obligations under the loan agreement with the SPV. Ukraine's Law on System of Guarantees of Individual Deposits only allows for bail-in of unencumbered bank liabilities. However, THEO Worldwide was able to prove that the bank's obligations to UK SPV Credit Finance were "encumbered," as the SPV has "charged" its rights and claims against Privatbank under the loan agreements in favour of the bonds' trustee. Therefore, the trust agreements between UK SPV Credit Finance and the trustee constitute an "encumbrance" over the right of claim of UK SPV Credit Finance against Privatbank.

However, we warn that THEO Worldwide's legal position has been put under question by Ukraine's Supreme Court, which expressed its doubts about correspondence of the word "encumbrance" in Ukrainian legislation to the word "charge" in the trust agreements.

The Supreme Court sent the case in November 2020 to a first-tier court for a new trial, with an unclear outcome and timing of new decisions on this case. In our view, the arguments about encumbrance, supported by first- and second-tier courts, do not look solid. However, taking into account that Privatbank is paying special attention to this court case, with international courts possibly doing so as well, we think these arguments are worth mentioning.

- The bail-in also does not look compatible with the No Creditor Worse Off (NCWO) principle, as stipulated by Article 74 of EU's Bank Recovery and Resolution Directive (BRRD) of 2014. Namely, following the bail-in, all the assets of bondholders have been nullified, which does not look like the best outcome as compared to a theoretical event of the bank entering into normal insolvency proceedings.

  In particular, if the bank had been liquidated, the bondholders would have been able to engage and participate directly in the potential recovery of assets allegedly misappropriated by the former Privatbank shareholders. In such an event, bondholders would have a chance to gain more than zero. For instance, based on Privatbank's information, its claims against former shareholders Kolomoisky and Bogolyubov in England, Cyprus, the U.S. and Israel total more than USD 10 bln. If such claims had been successful, compensation to the bank would have fully covered the bank's liabilities (its total liabilities ahead of the nationalization were USD 9.3 bln) and its financial gap (which was USD 6.6 bln, filled by the bailed-in creditors and the state in 2016-2017).

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