

Recovery:

Recovery Prospects From Bank Defaults In Kazakhstan, Russia, And Ukraine Are Still Uncertain

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Recent sizable bank defaults in Kazakhstan, Russia, and Ukraine (KRU) indicate, in Standard & Poor's Ratings Services' view, the lengthy recovery process facing the banks' creditors. This is despite some progress, most notably in Russia, from the previous decade (please see "Recoveries From Russian Bank Defaults Have Been Little And Late," published on May 19, 2008, on RatingsDirect).

We believe that recoveries could be restricted and unpredictable, largely because of limited bank supervision and what we see as inconsistent legal frameworks for bankruptcy and bank restructuring in KRU. In our view, this situation may be exacerbated by the approach of the banks' management and what appears to be asset stripping before default, as has been alleged in some recent bank liquidations. These aspects, together with other factors, have historically constrained our ratings on KRU banks.

Although the KRU banking systems display characteristics similar to those of more mature market economies, they have retained, in our view, their somewhat unusual and shifting logic, rooted in personalities, politics, and what we regard as opportunistic funding policies. We consider that this, together with factors such as what we see as structural weaknesses in the banking systems, unpredictable insolvency regimes, and underdeveloped corporate governance could leave the creditors of many defaulted KRU banks with only meager recoveries. We expect the average recovery rate to be less than 40% through the cycle, with strong disparities in individual cases. A recently achieved debt-restructuring agreement for one of the largest bank defaults in the Commonwealth of Independent States, that of BTA Bank J.S.C. (D/--/D), underlines this assessment.

In our view, recoveries may be even lower in 2010 and 2011, owing to the likely continuation of weak economic conditions in KRU. Generally, recovery rates are lower in a recession and higher during an expansion. We believe that government bail-outs could partly mitigate low recovery rates, particularly in Russia. Unlike the Republic of Kazakhstan (foreign currency BBB-/Stable/A-3; local currency BBB/Stable/A-3) and Ukraine (foreign currency CCC+/Stable/C; local currency B-/Stable/C), the Russian Federation (foreign currency BBB/Stable/A-3; local currency BBB+/Stable/A-2) is, in our view, more inclined to support or orchestrate takeovers of defaulted banks, enhancing recovery prospects for the banks' creditors.

Historically Muted Recovery Rates Have Recently Improved, But Are Likely To Be Lower In the Near Term

The Central Bank of Russia (CBR) has reported that since the establishment of an extensive banking system in the country in the late 1980s, about 1,500 credit organizations were liquidated at an unweighted average recovery rate of about 10% for all categories of creditors. From early 2002 until July 2009, 191 banks were liquidated in Russia at an average debt-recovery rate of 7%. The recovery rate has been significantly higher over the past few years, thanks, we believe, to regulatory and legal enhancements and a more favorable economic environment until the end of 2008. Based on the CBR's data, we estimate that the weighted average recovery rate for unsecured institutional

creditors of the 71 Russian banks liquidated during 2008 and in the first half 2009 was 47%.

From 2004 to November 2009, the Agency of the Republic of Kazakhstan on Regulation and Supervision of Financial Market and Financial Organizations, which has been in charge of winding up Kazakhstan's defaulted banks since 2004, completed the liquidation proceedings of 14 banks, resulting in unsecured institutional creditors recovering an unweighted average of 32%. In 2008 and the first nine months of 2009, the National Bank of Ukraine (NBU) completed the liquidation of 11 banks and stated that the weighted average recovery was 37% for all categories of creditors, with significantly lower recoveries for the least prioritized unsecured institutional creditors. However, this data refers only to liquidated banks and, we believe, would look somewhat stronger if rescued banks and banks after distressed debt restructuring are included.

The Main Factors That May Constrain And Delay Recoveries

In our view, several factors are likely to limit recoveries for creditors of defaulted KRU banks and prolong the recovery process. They include:

- Arbitrary insolvency regimes and bureaucratic legal frameworks;
- The limited ability of regulators to act on problematic banks sufficiently in advance of their defaults to reduce asset erosion;
- An opportunistic debt culture;
- The possibility of further cases of asset stripping or fraudulent practices, as has been alleged in some bank liquidations;
- Underdeveloped corporate governance and risk management;
- Substantial differences between the book and market values of assets because of generous accounting valuations;
- Financial reporting manipulation;
- Erosion of recovery amounts for institutional creditors, owing to priority claims (primarily retail depositors, staff, and liquidation costs);
- Shallow and narrowly traded markets, which make sales of the banks' often illiquid assets impossible or inefficient;
- Creditors' difficulty in securing legal representation on liquidation or debt restructuring;
- The complexity of obtaining complete information on assets after the introduction of temporary administration, resulting in delays in court proceedings: and
- Deteriorated asset quality in KRU and underprovisioning, resulting in credit losses and diminishing liquidation values of banks' assets.

According to Russia's Deposit Insurance Agency, only 6% of the book value of 168 Russian banks liquidated from the beginning of 2005 until midyear 2009 was recovered. We assume that the majority of liquidated KRU banks were insolvent or had significant financial difficulties long before their effective default or license withdrawal. There have been allegations that the management and shareholders of such banks, anticipating financial problems, strip the banks' liquid assets. This has in certain cases led to the commencement of legal proceedings. Premeditated and fictitious bankruptcies are often difficult to prove and prosecute, and punishment of individuals involved in premeditated insolvency has been rare.

In our view, shareholders and government authorities in KRU frequently exert their influence on insolvency proceedings, which can be to the detriment of creditors, particularly during the restructuring process of the defaulted

banks. We believe that a lack of transparency in decisions taken by bankruptcy administrations may also hamper creditors' recoveries. Decision-making may, in our view, be subject to the interests and agendas of various groups, which can be difficult for outsiders to understand, participate in, or monitor, which in turn can obstruct creditors. This view is consistent with our long-standing opinion about the lack of maturity of the supervisory and regulatory frameworks in these countries, which constrains our ratings on KRU banks. Moreover, a lack of consistency in legal enforcement, in our view, tends to restrict the predictability of creditors' rights in KRU.

Recent Default Cases Highlight Recovery Difficulties

We see better recovery prospects for creditors if problem KRU banks are restructured rather than liquidated, as demonstrated by recent cases involving sizable amounts. Still, we believe restructuring would only be effective if this process is amicable, relatively rapid, and adequately managed, with cooperation among creditors, bank shareholders, management, and regulators. After restructuring, efficient management of the restructured bank is, in our view, also vital to ensuring continued repayments. We acknowledge, however, that this task might be challenging, given that the business and organizational structures of defaulted banks are often disrupted. Recovery rates are difficult to measure, and they depend on assumptions about the scope of the defaulted organization, the time value of money, interest rates, exchange rates, and other factors.

Several insolvency cases highlight the recovery difficulties after a KRU bank's insolvency:

- BTA Bank J.S.C. (BTA; D/--/D), Kazakhstan

With total assets \$18 billion at year-end 2008, BTA was the largest bank in Kazakhstan and still has a market share by assets of about 20%. At the end of April 2009, BTA announced a debt standstill, deferring payment on medium- and long-term obligations. This is despite the Kazakh government's acquisition of a 75.1% stake in BTA through Samryk Kazyna (not rated), a holding entity for state-owned companies, after BTA breached regulatory liquidity and capital requirements in mid-February 2009. BTA's outstanding consolidated liabilities targeted in the restructuring totaled about \$10 billion. In 2009, Kazakh prosecutors issued an arrest warrant for the bank's former CEO on suspicion of embezzlement of about Kazakhstani tenge (KZT) 83 billion (about \$550 million).

On Dec. 7, 2009, BTA signed a principal commercial-terms agreement with its creditors' steering committee. We understand a restructuring plan for senior debt instruments, including most bonds and bank loans amounting to \$7.7 billion, is likely to be approved by creditors by March 23, 2010. The proposed restructuring package comprises:

- A cash repayment, providing a 12.3% recovery;
- New senior debt instruments (a rescheduling of 30% of the principal) at a 70% discount with an eight-year tenor and a four-year grace period, providing creditors 10.5% in cash interest per year;
- A new 15-year subordinated debt instrument (a rescheduling of 6.6% of the principal) with a ten-year grace period, providing 7.2% in cash interest annually;
- A share of equity (8.7% of total equity) and recovery notes; and
- Write-off of all default interest accrued through to March 31, 2010.

According to our rating definitions, we assign a 'D' rating if we believe that any default will be a general default and that the obligor will fail to pay all or substantially all of its obligations as they fall due (see "Rating Implications Of

Exchange Offers And Similar Restructurings, Update," published on May 12, 2009). We treat distressed exchange offers to restructure debt obligations as equivalent to default, even though investors may accept the offer and no legal default occurs.

- Temirbank JSC (D/--/D), Kazakhstan

With total assets of about \$1.6 billion on Sept. 30, 2009, Temirbank is BTA's subsidiary and the eighth largest bank in Kazakhstan, accounting for 3% of the system's assets. In November 2009, Temirbank missed interest payments on its \$300 million Eurobond. We understand that the bank also defaulted on two related-party deposits totaling KZT7.7 billion (approximately \$51.3 million) due to BTA. In November 2009, Temirbank announced the following restructuring terms (customer deposits were excluded from the restructuring plan):

- An offer to holders of Eurobonds maturing in 2011 and 2014 of 14.25% plus accrued interest up to Nov. 22, 2009 (4.45% and 4.7764% for the 2011 and 2014 notes respectively). International bondholders should receive 20% of ordinary shares on a pro rata basis in addition to a previously offered 20% cash payment. We understand this group of creditors will receive new notes totaling \$60.75 million. Holders of the new notes should have the right to redeem them at par, plus accrued interest, on the fifth anniversary of the issue and will receive 14% interest per year;
- Domestic bondholders' should receive new notes with extended maturities at reduced interest rates. The same applies to Samruk-Kazyna's and BTA Bank's exposure to Temirbank; and
- Trade finance creditor CoBank's claim is likely to be limited by 37.3%.

- Alliance Bank JSC (D/--/D), Kazakhstan

With total assets of \$8.6 billion at year-end 2008, Alliance was ranked No. 4 in Kazakhstan by assets and had a 14% market share in retail loans. In April 2009, Alliance announced a debt standstill and initiated debt restructuring, owing to a significant liquidity shortage. In July 2009, prosecutors started legal proceedings against the bank's former CEO on suspicion of fraud to the tune of KZT17 billion (about \$112 million). In September 2009, the bank's former Deputy CEO was arrested for misappropriation of \$1.1 billion.

The debt-restructuring plan was approved by the Eurobondholders on Dec. 11, 2009, and by the creditors' committee on Dec. 15. This restructuring plan, which should cover \$4.2 billion of Alliance's wholesale debts, is scheduled to be finalized by March 1, 2010, and offers creditors the following options:

- An upfront cash payment of 22.5% of the debt (holders of Islamic-type debt instruments will receive 21.5%);
 - Rollover of 50% of the debt for seven years at a reduced interest rate;
 - Rollover of 100% of the debt for 10 years with a grace period of seven years at a reduced interest rate;
 - Rollover of 100% of the debt for 13 years with a grace period of 10 years at a reduced interest rate (20-year rollover for tenge-denominated debt); or
 - Conversion of perpetual bonds, senior debt, and subordinated debt into preferred shares after a debt discount of 80%, 75%, and 77.5% respectively.
- Astana Finance JSC (not rated), Kazakhstan

With total assets of about \$2.5 billion as of year-end 2008, Astana Finance is one of the largest financial groups in Kazakhstan and is involved in banking, mortgage, insurance, leasing, microfinance and brokerage. In May 2009, the group's holding company initiated the restructuring of its foreign and domestic debts totaling about \$2 billion. As of

May 2009, Samruk-Kazyna owned about 26.5% of Astana Finance's holding company, which, in our view, holds no implications for the recovery prospects of Astana Finance's creditors.

We've been informed that Astana Finance is planning to sign a restructuring term sheet with its foreign creditors' steering committee in January 2010, offering senior foreign debtholders a new Eurobond with a tenor of seven years, which provides 35% recovery of the outstanding principal and interest accrued. Along with this Eurobond, senior foreign creditors should receive recovery loan notes that allow 60% of any recoveries above the book value of Astana Finance's net assets after the restructuring. Moreover, senior debtholders should receive shares in Astana Finance after the debt restructuring is completed. Domestic bondholders have been offered a 20-year debt rollover, but this proposal is currently under dispute.

- Valyut Tranzit Bank OJSC (not rated), Kazakhstan

A former top-15 Kazakh bank by assets, Valyut Tranzit had its license withdrawn in December 2006 because of systematic breaches of domestic banking requirements and suspicion of fraudulent activities by the bank's management. We believe unsecured creditors could recover only 22% of their exposures as of Sept. 30, 2009, but the process is still under way.

- Eurokommerz Factoring Co. (not rated), Russia

With total assets of about \$2 billion as of midyear 2008, Eurokommerz was the largest factoring company in Russia and had a market share of almost 30%. In the fourth quarter of 2008, the company had liquidity problems and missed its wholesale debt and client payments. According to its financials for first-quarter 2009, Eurokommerz's outstanding wholesale debt amounted to about \$1 billion. Eurokommerz is currently subject to legal proceedings and, in our opinion, recovery prospects are uncertain.

- Bank Ukraine JSC (not rated), Ukraine

Until 2008, the collapse of Bank Ukraine was the only notable liquidation in the Ukrainian banking system since the country became independent from the former Soviet Union in 1991. In the late 1990s, deterioration of the bank's asset quality led to a liquidity shortage and high credit losses. In 2000, the system's regulator, the NBU, introduced temporary administration for one year to stabilize the bank's position. These measures failed and Bank Ukraine was put into liquidation. The liquidation process took more than six years, with all categories of creditors recovering only about one-half of their exposures. Unsecured institutional creditors had even lower recovery rates.

- Nadra Bank (not rated), Ukraine

With total assets of \$3.6 billion as of March 1, 2009, Nadra ranked among the top 10 banks in Ukraine and had a market share of 3.1% by total assets. On Feb. 10, 2009, Nadra was put into temporary administration (for one year) because of liquidity problems. A moratorium was placed on credit obligations of about \$0.9 billion, initially for six months, but this was prolonged to February 2010. At the end of November 2009, Nadra obtained approval for the restructuring of \$175 million of Eurobonds from the largest bondholders. The proposal includes a limited cash payment, together with the write-off of part of the principal and new notes issued with a grace period. The creditors' committee has to approve the final restructuring proceeds. There is extremely limited public disclosure on the restructuring terms.

- Prominvestbank (not rated), Ukraine

Prominvestbank, a top-10 Ukrainian bank, experienced a significant run on deposits at the end of September 2008. It reported total assets of \$3.4 billion at the beginning of 2009. In early 2009, a Russian state corporation, Vnesheconombank (foreign currency BBB/Stable/A-3; local currency BBB+/Stable/A-2) took over 75% of Prominvestbank and subsequently increased its ownership to 94%. This has helped Prominvestbank repay its debtholders and resume operations.

- Alfa-Bank Ukraine (ABU; CCC+/Negative/C), Ukraine

Ranking among the top 10 Ukrainian banks (with assets of \$3.5 billion), ABU completed a distressed debt exchange of three loan participation note issues totaling approximately \$1 billion, representing about one-third of its total liabilities, in August 2009. This was an "on par" debt exchange, but with an extension of the maturity dates on the notes. We understand that ABU continues to honor its debt obligations, including the restructured loan participation notes. We downgraded ABU to 'SD' on the restructuring and later raised our long-term rating to 'CCC+' after the restructuring was completed.

- First Ukrainian International Bank (FUIB; not rated), Ukraine

In November 2009, FUIB--with total assets of \$2.2 billion as of Oct. 1, 2009, and ranking among the top 15 Ukrainian banks--issued a restructuring proposal to holders of its \$275 million Eurobond issue, due in February 2010. The bank has proposed the following changes:

- A maturity extension to Dec. 31, 2014;
- A coupon-rate increase to 11%, with quarterly, instead of semiannual, coupon payments; and
- Partial redemption of \$17 million of the principal on Feb. 16, 2010.

A noteholders' meeting was conducted on Dec. 15, 2009, and the required approval of two-thirds of the noteholders was achieved.

- KIT Finance (not rated), Russia

KIT Finance was a top-30 Russian bank and had assets of about \$4 billion at the beginning of August 2009. It experienced difficulty in honoring its share sale-and-repurchase agreements in September 2009 and was bailed out by government-related corporation Russian Railways (JSC) (BBB/Stable/--). KIT Finance continues to operate.

- Svyaz Bank (not rated) and GLOBEXBANK (BB-/Stable/B), Russia

Svyaz Bank is a top-20 bank and GLOBEXBANK a top-60 financial institution. With total assets of \$4.4 billion and \$1.7 billion respectively at midyear 2009, these banks were two of the hardest hit by deposit withdrawals in the fourth-quarter of 2008. They were both taken over by state-owned Vnesheconombank. The central bank, CBR, funded the financial rehabilitation of GLOBEXBANK and Svyaz Bank by placing deposits of \$2 billion and \$2.5 billion, respectively, with Vnesheconombank. We understand that both banks still operate. In our view, these cases accentuate the importance of government intervention to the recovery prospects.

State Support Improves Recovery Rates

Standard & Poor's classifies KRU as "supportive" countries that are likely to provide aid to failing private-sector banks (see "Banking Industry Country Risk Assessment: Russia," published on Sept. 24, 2009, and "Kazakh,

Russian, And Ukrainian Banks Face Another Tough Year Of Poor Asset Quality And Thin Liquidity," published on May 19, 2009). However, this assessment does not contribute to any uplift to our ratings on private-sector banks in KRU.

Our credit ratings on financial institutions in KRU incorporate an assumption of ongoing implicit government support. Nevertheless, in our opinion, the KRU governments' ability to support their banking industries could be constrained by fiscal and institutional factors. Despite instances of direct support to defaulted banks, we still consider the outcome of state aid to be uncertain, owing to what we regard as unpredictable decision-making by insolvency administrators.

In our view, the KRU governments might be inclined to step in to prevent the closures of some large private-sector banks, but without necessarily ensuring that the banks make timely payments on their obligations; a factor that is crucial to our ratings assessment. Government support and intervention, we believe, depend on market circumstances in KRU and would likely aim to reassure depositors and investors. The failures of BTA, Alliance, Temirbank, and Astana Finance, which together represent more than 35% of Kazakhstan's banking system by assets, indicate to us the limits to the support that the government is willing and able to provide, even to systemically important banks. We also regard shareholders' standing and potential backing as key to recovery prospects, although they are not assured. In our view, the ability of problem banks to generate sufficient cash flows in the medium term to satisfy all their outstanding obligations, without external aid, is fairly limited, given significantly deteriorated asset quality, weakened profitability, and strained liquidity.

We believe that the KRU governments' initiatives to enhance banking supervision and the bankruptcy framework are critical factors for the future recovery prospects of KRU bank creditors, but progress is still hesitant, in our view. Russia's Deposit Insurance Agency (DIA) appears to have a better recovery track record than that of private liquidation managers. According to CBR information, from 2005 until midyear 2009, the DIA liquidated 100 banks at an unweighted average debt-recovery rate of 26.6%. During the same period, external private managers liquidated 91 credit institutions, yielding an unweighted average debt recovery of only 3.5%. Local authorities in KRU are often closely involved in the debt restructurings of defaulted KRU banks, but are not active in distressed debt exchanges of banks operating as going concerns.

We have observed some improvement in the efficiency of bank supervision and the legal framework for the recovery process in KRU. Nevertheless, this improvement is, in our view, partly cyclical in nature and might weaken in the currently unfavorable environment. We therefore don't expect recovery prospects in KRU to get materially better in the near term. The recent bank defaults in KRU, in our view, underscore the trend toward limited and lengthy recoveries.

Related Research

- Credit Stress Testing Banks In Kazakhstan, Dec. 10, 2009
- High Problem Loans And Provisions Expose Sharp Imbalances In Kazakhstan's Banking Sector, Hampering A Lending Revival, Dec. 10, 2009
- Banking Industry Country Risk Assessment: Russia, Sept. 24, 2009
- Credit Stress Testing Financial Institutions In The Russian Federation, June 17, 2009
- Kazakh, Russian, And Ukrainian Banks Face Another Tough Year Of Poor Asset Quality And Thin Liquidity, May 19, 2009

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- Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009
- Recoveries From Russian Bank Defaults Have Been Little And Late, May 19, 2008
- Debt Recovery For Creditors And The Law Of Insolvency In Ukraine, April 29, 2008
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- Update On Selected EMEA Insolvency Regimes, Jan. 7, 2008
- Bank Rating Analysis Methodology Profile, March 18, 2004

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