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ON THE ROLE OF BANKS IN ENTERPRISE RESTRUCTURING: THE POLISH EXAMPLE

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ABSTRACT

On the Role of Banks in Enterprise Restructuring: The Polish Example*

Governments throughout Eastern Europe have been singularly unsuccessful in dealing with large loss-making SOEs. A more promising approach would create an incentive framework and legal environment where the SOE's major non-government creditor can take the lead in initiating restructuring and the design of a new, viable capital structure. Such a lead bank is much more likely to gain access to the inside knowledge that gives the firm its surplus value as a going concern. The details of such an environment are laid out using the recent Polish attempt to launch a wholesale cleanup of the loss-making SOEs along lines promoted in this paper.

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NON-TECHNICAL SUMMARY

Governments throughout Eastern Europe have been singularly unsuccessful in dealing with large loss-making state owned enterprises (SOEs). Given the long time period that quite reform-minded countries like Salinas's Mexico or Margaret Thatcher's England needed to come to grips with their incomparably smaller enterprise problems, this was perhaps to be expected (a point argued strongly by Alan Walters (1993)). This paper argues a different line than the Walters' plea for government-led gradualism, however. I maintain that governments in Eastern Europe are unlikely to be able to deal constructively with loss-making SOEs at all, slowly or quickly.

I also argue strongly against an extremist *laissez faire* alternative, wholesale application of the bankruptcy proceedings. Such an approach is unnecessarily destructive, especially in the East European context, where past and current losses may well have been due to distorted incentives rather than to bad management or outright insolvency. Although most bankruptcy laws allow for restructuring, the very limited capacity of the court system in Eastern Europe and the near impossibility of removing liquidation bias from the bankruptcy code argue against this solution.

Instead, a more promising approach would create an incentive framework and legal environment where the SOE's major non-government creditor can take the lead in initiating restructuring and the design of a new, viable capital structure. Such a lead bank is much more likely to gain access to the inside knowledge that gives the firm its surplus value as a going concern, which in turn makes it better placed than the govermment in assessing long-term viability. The details of such an environment are laid out using the recent Polish attempt to launch a wholesale cleanup of the loss-making SOEs along lines promoted in this paper.

A standard reply to a call for commercial bank involvement in enterprise restructuring, much like Western investment banks do in periods prior to bankruptcy, is that East European banks do not possess the necessary skills. This is in most cases not a useful answer, for at least two reasons: First, it is not really the relevant question. At issue is not whether they are good enough, but whether there is anybody else who is better. Given the dismal record of government involvement in large-scale enterprises under communism, and long-standing problems of regulatory capture in the West, the government itself is not obviously a good candidate. Anyhow, successful restructuring should really be part of a privatization exercise; for obvious reasons, the more influence future owners have and the less influence goes to past owners, the better the chance that the restructuring exercise does not need to be repeated. I return to this issue below, since there are other, deeper and Eastern-Europe-specific arguments in the same direction. The second point is that in many countries a subset of

commercial banks is improving rapidly. This holds true for countries as diverse as the Czech Republic and Poland on the one hand and Russia on the other.

Nevertheless, it is true that assigning such an important role to commercial banks makes financial sector reform commensurately more urgent. There is little doubt that if either enterprise reform or bank reform is to have any chance of success, they had better be undertaken jointly.

The Polish financial and enterprise reform package is to date an apparent success. This suggests that the decentralized, non-government approach to dealing with loss-making SOEs promoted here has a chance of success; that is more than can be said of the more traditional, government-oriented approaches advocated and tried elsewhere.

1 Introduction

This paper deals with the role of commercial banks in the restructuring and privatization of loss making state enterprises (SOEs). Dealing with loss making SOEs has emerged as the dominant issue in Eastern Europe. Many of the macroeconomic problems in the area can be traced to the fiscal consequences of funding SOE losses. Healthier enterprises are dragged in when supplier credit goes unpaid. And banks have seen their loan portfolio deteriorate as loss making SOEs stopped servicing their debt.

Dealing with the consequent liquidity problems in the financial sector by simply recapitalizing the banks through transfer of interest earning assets, although tried in several countries, clearly only makes matters worse. Doing so signals to enterprises that loans can go unserviced without adverse consequences, and destroys any collection incentives the banks might have had. Thus finding a solution to the enterprise problem, or at least isolating the banking system from its consequences, is a prerequisite for a lasting restoration of viability to the financial system.

That conclusion will by now not generate much controversy. But this paper goes further by arguing for a reverse link too: a lasting solution to the enterprise problem is not going to be within reach without active involvement of the banking system, both during enterprise reform and afterwards. This is by no means an a priori obvious issue. The question of who should be the "agent of change" in dealing with loss making SOEs has generated much controversy. Should the government establish centralized control, letting the banks get on with the job of lending to new and newly privatized enterprises? Or is the Government likely to just extend subsidies and state control, arguably the way all problems started?[1]

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[1] I will not attempt to survey the somewhat scattered literature on these topics. A view radically different from what I argue here can be found in Mckinnon (1991). Mckinnon wants the state to take sole responsibility in ensuring governance in state enterprises, like under communism, and wants to explicitly isolate the SOEs and the banks from each other. He furthermore argues for continued protectionism to shelter SOEs from competition. Dittus (1993) provides a more balanced view of the various arguments pro and con bank involvement in corporate restructuring.

I will argue strongly against a dominant role for the government as an agent of change. The history of Europe is littered with government run adjustment programs; in fact European unification started with a restructuring program for the steel and coal sectors, a program that in forty years has made no visible progress. And the government control that such a role would imply is exactly what Eastern Europe since the abolishment of communism is trying to get away from.

Can or should commercial banks then play the role of agent of change? And if so, what needs to be done to actually implement such an approach? Does the banking system itself need reform before it can act in enterprise restructuring and privatization? What if enterprises are so large and their political support so strong that banks and enterprise turn the tables on the government and lobby for continued subsidies instead of slimming down the firm and adjusting it to new circumstances? These are the key questions covered in this paper. In doing so, I will go beyond theory and draw on the experience gained during the design of an imaginative enterprise and financial sector restructuring program designed recently in Poland and implemented since August 1993.

The paper is organized around three sets of issues. In the next section, I sketch why enterprise restructuring and privatization is unlikely to succeed without bank involvement, at least in the case of loss making enterprises. Section 3 then discusses the incentive problems and legal issues that need to be resolved before banks will be able and willing to actually do so. Section 4 discusses how to deal with the white elephants; enterprises that are hopelessly loss making but so large and regionally concentrated that they hold their creditors hostage rather than the other way around. And Section 5 discusses the reforms necessary in the banking system itself that need to complement such a process. Both sections draw heavily on the Polish experience with exactly the type of scheme I am advocating here. Section 6 concludes.

2 Who should be the Agent of Change for Loss Making SOEs?

The much debated question, should privatization precede or follow

restructuring, is almost certainly not a very relevant question anymore. Most will now agree that if future owners have to live with restructuring measures, it is advisable to give them a controlling influence in the restructuring process. One way of doing that is to include measures to be taken by the Government in the privatization package; another approach would be to simply privatize and let the new owner deal with the problems. All that is fine, but the reason why it may be of limited relevance is that those enterprises where serious restructuring is needed will in fact be very difficult to privatize. The Government may want to privatize first, but it may simply fail, particularly when political considerations prevent a very negative price. Privatizing loss makers on a large scale has not really happened anywhere. The government will thus most likely have to address their problem, whether it likes to or not. This may be as an active agent of change, as the major international agencies and some outside academics[2] have often argued; or as a passive player whose role is simply to set the incentive structure that encourages other parties to act, as argued below.

There is a complicating factor in dealing with loss making enterprises that is unique to Eastern Europe. When in the West firms are making persistent losses, either the manager is bad or the firm has no chance even under the best of management. In the first case a take over is called for, and in the second bankruptcy. But in Eastern Europe a third possibility is likely to be most prevalent. Even well managed firms may make losses, not because they cannot avoid them, but because they have as yet no incentive do so. This strongly argues against mechanically liquidating firms because of debts and losses incurred in the past. There is in fact something inherently inconsistent in the simple triage approach advocated for example in Long (1993)[3]: while it stresses the

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[2] See Long (1993) for a view from a prominent World Bank official. See also the round table discussion in EBRD (1993)).

[3] Close down firms that cannot cover their variable costs prior to debt service; forgive debts for firms that can do so but not to an extent that debt service can also be financed from operating income; and privatize firms that generate a positive cash flow even after covering scheduled debt service.

importance of establishing proper profit incentives, it simply assumes that performance under an entirely different incentive structure is nevertheless a good guide to future profitability.

Many have argued that straight bankruptcy would deal satisfactorily with this problem. Selling off assets would preserve the physical infrastructure but allow a new start with a clean slate. But, while liquidation will certainly have to play some role in the restructuring of loss making SOEs, recommending liquidation as a wholesale approach is naive and in practice excessively destructive. The point is that the value of a firm is typically more than the salvage value of its physical assets; that surplus value gets destroyed during liquidation. This is likely to be especially important in Eastern Europe for the reasons mentioned; poor performance in many cases reflects as much distorted management incentives as real insolvency assuming sensible management incentives. This suggests that there may well be positive value to the firm as a going concern, even in the presence of a history of losses.

The special problem this surplus value argument creates for enterprise restructuring is that the information leading to this surplus value typically rests with the current firm's insiders. Removing the insiders from the process, as transferring control to a Government run "hospital" agency would imply, would therefore automatically destroy the surplus value and make liquidation, or, given the political pressures that will likely arise, continuing subsidies, the most likely outcome.

Bringing enterprises back under public sector control, in the most common proposal in a central agency, a "hospital for sick enterprises", typically under the aegis of an industry ministry, creates other problems. The enterprises that became large under the communist regime partially did so because their managers successfully bargained with industry ministry officials for a disproportionally large share of centrally allocated resources. A "hospital" approach would put exactly the managers who have proven to be good at this game under the communist regime back into the same situation. It seems reasonable to expect that they will again be good at lobbying for continuing subsidies.

Moreover, and this adds a pernicious twist, <u>they are the more likely</u>

to successfully bargain for more subsidies, the less they adjust. The reason for that is that bargaining power depends on one's threat point; the more unpleasant the alternative to accommodation is to the government, the more it is likely to be cowed into submission and continuing subsidies. Thus holding up the specter of mass lay-offs is a powerful argument for subsidies in the bargaining process; and trimming down the enterprise would reduce bargaining power commensurately.

Another issue is raised by the fact that banks have an important role to play in corporate governance after restructuring, even in countries with a flourishing equity market.[4] And almost everywhere in the West banks are the main source of both working and investment capital. Add to this that equity markets in Eastern Europe are in their infancy if they are there at all, and the argument only gains strength.

This argues strongly against the traditional way of resolving the enterprise-bank failure link (take the bad loans off the banks' books and park them in a collection agency equivalent, or, as the current jargon goes, a "hospital"). The resulting stigmatization would likely make it very difficult to regain access to the banking system for the firms so isolated, even after they have been restructured.

A final contradiction in such a set up concerns the incentives the officials of such a "hospital" agency would face. Its successful implementation would lead to its quick abolishment. But the jobs and continuing influence of the Agency's officials depend, on the contrary, on its continuing rather than shutting down. It should be no surprise that such agencies in practice stay around much longer than the intention is at their inception. A famous example is the Italian state holding company IRI; statutory obligations to dismantle itself within five years of its start in 1948 have not prevented it from becoming and staying one of the largest industrial conglomerates in Italy to this very day.

A much more efficient way of debt restructuring would use the opportunity to introduce effective private ownership into the process. This suggests that conversion of some of the debt into equity should be the main

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[4] See on this in particular Dewatripont and Tirole (1992).

focal point of the restructuring exercise, rather than debt write downs and full collection of what remains. Debt equity conversion offers a more promising way towards efficient use of the assets controlled by the enterprises than liquidation into a thin capital market and a depressed economy does.

In principle bankruptcy proceedings allow for such restructuring as an alternative to liquidation. However, this rarely works in practice: even carefully crafted bankruptcy laws have a strong liquidation bias built in (Aghion et alii (1992)). For example the US bankruptcy code has "Chapter 11" proceedings, under which incentives are created for creditors to reach a non-destructive agreement on restructuring the firm. In practice such Chapter 11 proceedings end up in liquidation anyhow; Aghion et alii (1992) claim that 95% of such cases go the liquidation route after all.

Another problem with widespread application of bankruptcy is more pedestrian although no less important. Widespread use of bankruptcy procedures would inevitably overload the system and lead to interminable legal delays, thus prolonging the very limbo on ownership and effective control that is behind much of the current SOE crisis to begin with. One should keep in mind that in most countries bankruptcy courts are only now being created, have very little practical experience and are certainly not set up for a massive initial wave of such procedures.

So with the Government out, and mechanical application of bankruptcy law precluded likewise, where does one go? The information problem that needs to be resolved to successfully restructure a loss making enterprise strongly suggests an answer. If the information on which the surplus value of the firm as a going concern is based rests with the firm's insiders, non-destructive restructuring will, one way or another, require those insiders' cooperation.

For small firms (in practice less than about 300 employees), this is fairly straightforward to arrange. A management buy out (MBO) immediately invests the manager with all initiative. Through his new ownership role, he will receive all the benefits of successful restructuring, so no further public involvement is called for: it is now in his own interest to act appropriately on all the information he has about the firm. A number of

practical problems need to be resolved, however, before large scale MBOs, even if only for smaller enterprises, can be implemented.

First of all, other stakeholders might need to be bought off before they will cooperate. This is in particular true for the workers, who would give up much of their former control rights (whether these existed formally or not does not really matter). Giving a minority share to workers is an effective way of coopting them into the scheme.

Second, cash constraints will in many cases prevent the real insiders to bid anywhere near market value. After all, one of the heritages of the communist past is a severely decapitalized private sector; insisting on all-cash sales would therefore severely restrict the pool of potential bidders and may well exclude the most efficient managers. Such wealth constraints are not, however, an argument against auctions or sales as opposed to give aways. While give aways would solve the wealth constraint problem, large scale give aways to insiders will most likely lead to social protests; this is one of the reasons the Hungarian government felt compelled to intervene in the spontaneous privatization process. The answer is to conduct non-cash sales, or partial down payment transactions.

A sale with only partial downpayment relieves the cash constraint but does require the manager to put some of his own capital at risk, thus insuring sufficient management effort (see Aghion and Burgess (1992) on this point). To insure compliance with the financing terms, dividends over the shares not yet paid for could be held in an escrow account; this will increasingly diminish default incentives as the escrow account balance builds up. Moreover, if a bank would finance the purchase in an otherwise debt free corporation, this procedure has the added advantage of creating a mixed capital structure in the firm. This insures proper management control even in adverse times where an equity holder will lose interest or may excessively gamble since all benefits prior to restoration of positive net worth will not accrue to the equity holder.

In two cases this recipe will fail to provide a solution. First, if the firm is too large, debt financing the purchase will result in an amount of debt for the individual manager no financial organization would be willing to extend. Second the firm may already carry a substantial amount

of debt, possibly in excess of the value of its assets inclusive of surplus value as a going concern. If the government is the sole creditor, this does not present any serious issue: the government can simply scale back its claims. However if other creditors exist, particularly private creditors, the potential for <u>creditor conflict</u> will need to be dealt with.

These two cases (in practice they will typically overlap) will in fact cover the majority of loss-making enterprises, at least when weighted by size. In both cases, banks will have to play an important role. In the case of existing debts, banks are likely to be the most important non-government creditor. And, since in most formerly communist countries, banks started off on a regional basis[5], one bank typically dominates. This in turn implies that this "lead bank", like the manager, either possesses or can have easy access to the information necessary to judge the surplus value of the firm as a going concern. All this naturally suggests commercial banks as "agents of change" in all but the smaller loss making SOEs.

The key to bringing about an active role of commercial banks in enterprise restructuring is their position in the creditor ranking. The typical capital structure shows four groups of claimants, in declining order of seniority:

A The Government itself, through tax and social security arrears.

B Commercial Banks, with usually one bank, the offshoot of the central bank office in the regio, the dominant creditor.

C Other enterprises, through Inter-Enterprise Arrears (IEA).

D The Government or one of its agencies, as an <u>equity holder</u>.

This line up suggests three major areas where problems need to be resolved

[5] Typically the first commercial banks were created out of regional offices of the former Central Bank.

before bank-led enterprise restructuring is likely to take off. First, under what kind of incentives are profit-minded banks in fact likely to pursue such an option? This is the key issue and is discussed next, in section 3. Second, firms and banks may find it advantageous to turn the tables on the government and lobby for more government cash rather than go for restructuring. As we discussed before, this option typically leads to serious delay in the restructuring effort, as successful restructuring undermines the argument for continuing public support. How to avoid this problem, which is typically most acute for very large, very labor-intensive, and very regionally concentrated companies, is the subject of Section 4. The third, and final, group of issues stems from the qualification "profit-minded commercial bank" used previously. What does an approach like the one sketched below and implemented in Poland recently require in terms of financial sector reforms? This is covered in Section 5.

3 Getting Commercial Banks to Act as an Agent of Change[6]

An analysis of the incentives facing the different actors in the line up of the previous section suggests 5 key issues that any restructuring package will need to deal with in order to be workable. They involve (1) the role of the Government as most senior creditor and, at the same time, equity holder; (2) The role of creditors junior to the Lead Bank; (3) the role of two groups of insiders that in fact do not feature on this list, workers and managers; (4) the role of outsiders and, potentially, the issue of fresh capital injections; and (5) the need for legal support structures and the relation with regular bankruptcy proceedings. Consider these issues in turn.

(1) The government's role

The dual role of the government and/or its representatives creates a

[6] This section draws heavily on the enterprise and financial sector reform package implemented in Poland from August 1993 onwards.

series of potentially destructive problems. First of all, no bank will take the initiative if most of the benefits will accrue to the public sector that, after all, through its seniority retains first claim on any benefit that might accrue. Thus a key element will have to be a commitment of the government to take a step back as a senior creditor. In the Polish project, this took two forms.

First, the government announced it would not play an active role during the conciliation proceedings (the new name for the procedures created as part of the restructuring package). Tax authorities were represented on the creditor committees created, but as observer. Any final deal did need approval of those authorities, however, to protect to the extent possible without jeopardizing a deal, the Treasury's interest. To avoid last minute problems, transparent instructions to those observers need to be issued on the conditions under which they can refuse to approve a particular deal. Failure to approve a deal would not necessarily scuttle the deal, but bring it to a council of ministers specially created to supervise the whole project.

Instead of playing an active role, and this is the second point, the authorities promised to match any debt reduction agreed upon by the commercial creditors pari passu. This is clearly beneficial to the banks: the market value of their claims goes up when the government cuts back its claims, while the value of the government claims, by virtue of their seniority, is not affected by what the banks do. A promising variant, eventually not pursued in the Polish package, would offer to cut back public sector claims more if as part of the whole restructuring exercise a private owner emerges at the end. This would strengthen the privatization incentives built in the whole set of measures.

A second problem created by the government's dual role of senior creditor AND equity holder is the incentive for the government as senior creditor to protect its equity holdings. This has two destructive consequences. First, a successful restructuring exercise may, even if only as a temporary measure, require a commercial bank to convert its debt into equity. But no bank can reasonably be expected to do so if old equity holders retain their claims. Clearly a D/E conversion implies a step down

in seniority; empirical research in the US on Chapter 11 restructuring suggests what common sense would too, D/E conversions require prior extinction of old equity before any debt holder is willing to so convert its claims. Thus for the government to insist on keeping "social capital" alive means almost certainly that the proceedings will take a destructive, liquidation biased turn. Any incentive for commercial creditors to convert their claims would be negated.

This is destructive since conversion of debt into equity strengthens a creditor's interest in bringing about a revival of the firm's fortunes; the call option characteristic of equity means that a creditor after such conversion would share in any upswing that would be brought about. Thus a public announcement of the government professing its immediate willingness to sell or simply extinguish the existing equity claims it has as part of a successful reconciliation proceeding is crucial for the eventual success of such a procedure.

The second problem is that protecting the government's equity base means privatization is a less likely outcome of the exercise. This is obviously a loss since the whole problem arguably started with the incentive problems created by the incestuous relations between enterprise managers and the bureaucrats assigned to supervise them.

(2) Junior Creditors

The existence of junior creditors creates a strong liquidation bias. Chapter 11 restructuring typically fail because a small creditor files for liquidation anyhow. Small creditors who find their claim fall to zero market value in the process of restructuring have an incentive to go for liquidation; this is not because they would do better there, but because they would likely lose less by comparison than more senior creditors would. Thus a threat of liquidation often is launched mostly to blackmail senior creditors into buying out junior creditors at above market value of the junior claims. The coordination problems that arise subsequently will often trigger the liquidation even if nobody really wanted it. Thus the work out scheme needs to incorporate mechanisms of resolving creditor conflicts that

will not trigger excessive liquidation proceedings.[7]

Two measures are likely to reduce this threat, and both were introduced in the Polish reform scheme. First, for the duration of the conciliation proceedings, complete protection from bankruptcy was granted by legislative means (nobody could file for bankruptcy while conciliation proceedings were in process). Of course such a blanket protection makes it important to put a sharp dead line before which the whole process has to come to an end. In the law setting up the Polish project, conciliation proceedings received a nine months window, after which banks that failed to instigate successful negotiations would lose their claim, by forced sale.

Second, majority creditors need to be able to override any attempt at free riding by minor creditors. Bankruptcy laws typically grant the bankruptcy judge a "cram down" provision, by which the judge can simply impose a solution on hold out minorities. In the absence of a court supervisor, an alternative to such a provision needs to be sought if proceedings are ever to come to an end. In the polish package a drastic solution is implemented: any creditor or group of creditors possessing more than 50% of the outstanding non-equity claims in value terms can impose a solution; and recourse to the courts under bankruptcy law is open only to a creditor or group of creditors owning at least 20% of the value of all outstanding non-equity claims.

(3) Managers and Workers

The important role of banks as major non-government creditors and potential firm insiders does not rule out a role for the other insiders, managers and, to a lesser extent, workers. As to workers, any package deal will likely have to buy off workers opposition through granting of a

[7] This is one of the objections against the Begg-Portes (1992) proposal to take loans to loss making SOEs off the banks' books and transfer them to the Government to auction them off to whomever wishes to collect on them. Their proposal pays no attention to the creditor conflict issue at all and therefore is likely to lead to inaction and delays. Another reason to expect that is that, in their proposal, the initiative for enterprise restructuring is again with the Government in a centralized approach. But of course most governments have already demonstrated that they cannot really come to grips with these problems.

minority stake in the newly formed corporation to workers. This is now routinely done throughout Eastern Europe and presents no special problems as long as (A) it is indeed a minority stake, and (B) the shares are explicitly tradable. Tradability would give workers the long time horizon associated with share holdership: even if they retire from the firm they can lay claim on any expected future profits through the capitalization of such expectations in the value of their shares.

And managers can play a useful role in these proceedings too, the banks' dominance notwithstanding. Conciliation proceedings start with the drawing up of a business plan under the responsibility of the main bank creditor. However, nothing stops the bank to ask the manager to draft a proposal; and while the sharp time limits in the Polish package may in the end force some banks to take an equity stake even if they do not want this in the longer run, they can subsequently consider swapping this equity stake with the managers for new debt. Thus MBOs can certainly be engineered under this program. In fact one of the innovative features of this package is that MBO characteristics can be built in in packages that would normally be considered too large for such constructs.

(4) Outsiders and Fresh Capital Injections

Of course the Holy Grail of all enterprise restructuring in Eastern Europe is securing a foreign equity stake accompanied by a capital infusion. Realism suggests that especially for loss making enterprises one should not count on too much. But the structure of bank-led reconciliation proceedings is uniquely suited to incorporating foreign, or, for that matter, any outside interest if it can be generated.

The business plan with which the proceedings start can form the basis of negotiations with any group of future stake holders, be they internal or external to the firm. And the strong position of the main creditor bank allows creating almost any capital structure desired, so these proceedings form a very good framework for negotiating outside participation. The practical problem in securing such interest is that outside offers are very unlikely to materialize unless existing management cooperates, for the

information asymmetry reasons discussed earlier. This suggests that earlier hopes (van Wijnbergen (1992)) of using such outside offers to bring an element of competition in MBO based restructuring/privatization efforts may have been overly optimistic.

4 Enterprises that are too large to fail

All these various approaches might in the end still leave authorities with companies that nobody wants, even without any of the pre-existing debt attached. If this involves relatively small firms in not too large a number, straight liquidation or just closure is presumably possible. Realism and often simple humanitarian concerns suggests that such drastic actions may not work for very large enterprises or dominant employers in poor regions. Here a more gradual approach to closure is probably unavoidable.

In fact one way of looking at keeping such loss makers temporarily afloat is as a sort of <u>workfare</u>; since the alternative is unemployment, the government could consider keeping the workers at least productively engaged. As long as they produce enough value added to pay the excess of their own wages over what they would cost the government in unemployment pay, [8]/ the government comes out ahead from a fiscal point of view.

The argument against such schemes is the same that has been levied against workfare in the US: by providing dead-end jobs only, workers are not really re-integrated in the economy and may in fact be discouraged from trying to be, since their income hinges on <u>not</u> moving away from where they currently are. The latter disincentive is of course singularly strong when a whole region is affected, unfortunately frequently the case in Eastern Europe.

Thus shielding large enterprises or regionally dominant employers from closure may be efficient compared to the alternative, but only temporarily so. But commercial banks may be singularly ill-suited to

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[8] Inclusive of the administrative costs of unemployment insurance, which are considerable!

implement gradual closure. If the enterprise is big enough to effectively blackmail the government in not closing it down now, there is no reason to expect that a commercial bank (or for that matter the government itself) will be any more successful later. Simply imposing cash constraints is unlikely to be a credible threat; once again, if the government can be blackmailed in putting up the cash now, why should the firm not succeed again once the first allotment runs out?

The special nature of the problem first of all suggests that management of these "workfare firms" should be transferred to an agency that is keenly aware of budget constraints, such as the finance ministry; and second that part of the winding down of the firms should be a major effort to retrain the work force and assist it in finding alternative employment, housing and so on so as to reduce incentives to block closure in the future. Absent such an job search and retraining assistance program, claims of support being only temporary are simply not credible and will almost certainly be broken.

Even if the intertemporal problems (how to make the temporariness credible?) are solved, there are still incentive problems left in setting the total amount available in any given year. Since workfare firms receive public money, there are strong incentives to qualify for that status as a means to escape painful adjustment that other creditors might impose. One approach would be to simply preselect the enterprises, after which this option is closed off. This is very much the German approach to restructuring.

But in countries with less of a civil service tradition (and lower government salaries..), all the incentive problems highlighted before in discussing the government's role would come up again. The political pressure and corruption incentives surrounding the selection process may in many countries argue for an approach where the government has more of a residual role. In such a set up, other creditors would be required to attempt a restructuring, along lines suggested above; the government would then pick from the enterprises where this effort failed and liquidation has become unavoidable, which ones would get workfare status.

But it is crucial, if quantities are not regulated, to stem the

potential influx through the price. Unless admission to "workfare status"[9]/ is made singularly unattractive, the Fund will be oversubscribed and other creditors will not be willing or even able to strike prior restructuring deals even where that would have been possible in the absence of an intervention fund. The point is that if senior creditors hold out the possibility of new money, junior creditors lose the incentives to reduce their claims, particularly if new money is tied to financing needs inclusive of debt service.

The solution is straightforward: access to workfare status (or into the intervention fund) should be made conditional on:

A/ all junior creditors relinquishing their claims;

B/ harsh adjustment measures for both workers and managers, such as mandatory lay-offs, wage freezes, and replacement of top

management. Condition A maintains the incentive for banks to reach a restructuring package that will keep the enterprise out of the intervention fund; and condition B maintains the incentive for workers and managers to cooperate in this attempt. If either one is not imposed before any money is handed out, the creation of an intervention fund will destroy any chance of success of reaching restructuring agreements through the banks or even management buy-outs. Budgetary control over the process will then become impossible to maintain and the privatization objective will be lost.

5 Required Financial Sector Reforms

One important caveat attaches to the proposals outlined above: the schemes rely heavily on proper functioning of the commercial banks. It cannot be stressed enough that fast and substantial progress on the implementation of effective mechanisms of bank supervision is going to be absolutely essential for the success of the scheme.[10] The chaos among the recently created private banks in Poland demonstrates that point

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[9] or into an "intervention fund" as it is called in Poland where a restructuring approach along lines suggested here is about to be tried.

[10] This point is also made strongly by Frydman et alii (1992).

dramatically.

Proper functioning of commercial banks in turn requires at least three things, each discussed in turn.

5.1 Regulation

It is difficult to overestimate the importance of prudential regulation. Any business that starts with taking the customers' money up front instead of after delivered services is potentially prone to fraud. Such problems may range from direct fraud (insider lending) to excessive risk taking by managers, especially if their down side risk is partially covered by de facto deposit insurance. Experience in Chile with unregulated privatization clearly indicates that a major crisis is the unavoidable outcome of an unregulated privatized banking system. Thus privatization of commercial banks should proceed cautiously if at all as long as effective regulatory mechanisms are not in place.

An effective regulatory framework requires first of all implementation of a loan classification and general portfolio assessment system to provide regulators with the necessary warning signals. Such a reporting system needs to be backed up by occasional in depth on site audits to check on compliance and provide a more in depth assessment than mechanical indicators can yield. Such audits are also necessary to safeguard against fraudulent practices such as lending to insiders while disregarding normal standards of prudence. The latter danger is particularly acute if banks can be owned by industrial groups; for that reason many countries explicitly forbid any industrial enterprise to own a bank.

Second, rules and institutions need to be set up, and the people necessary to operate them recruited and trained. Who collects information, implements rules, sets capital adequacy guidelines, rules in ambiguous cases and so on? In many cases these tasks fall to the central bank which anyhow has to deal with the banks because of its conduct of monetary policy.

5.2 Enforcement of Prudential Regulation

A regulatory framework is of little use if compliance is not enforced. This raises two issues. Fist, what is the proper medium term framework for enforcement. Second, since both state owned and private banks are right now far out of compliance with almost any reasonable set of prudential rules, how to deal with the current situation?

A *Issues in the design of enforcement mechanisms*

The main problem with enforcement mechanisms is how to make it as insensitive as possible against political intervention and direct attempts at fraudulent manipulation. Many countries feel that leaving enforcement in the hands of one institution leaves that institution too vulnerable to such pressures. This is especially the case if that institution also is responsible for implementing the prudential regulation, since that actually gives it the tools to circumvent the rules if pressured to do so. Moreover, supervision authorities may very well be tempted to cover up past supervision failures in the hope that a reversal of the problem bank's fortunes will get the bank and the supervision authorities off the hook.

Therefore many countries vest enforcement decisions in a Banking Commission consisting of the finance minister, the Governor of the Central Bank and often securities regulators (in practice, in all but the most important meetings, only their deputies would attend). For example in Mexico financial indicators are reviewed monthly for all banks by the technical staff of the Banking Commission; if particular thresholds are exceeded, the commission has to take various measures; in the most serious cases it seizes control of the bank and transfers it to a restructuring agency (which may but does not have to remove management).

A banking commission usually establish supervision work programs and make enforcement decisions, but relies on Central Bank staff to carry out technical work.There is little doubt that such a commission, on which several agencies are represented, is more difficult to manipulate than an institution where authority in the end rests with one person.

B *Recapitalizing banks*

Bank managers cannot be made responsive to capital value of the bank if there is no capital to begin with. Thus an essential element of banking reform is recapitalization of the banks with enough income earning assets to leave a prudential capital base in place after provisioning for bad loans. Recapitalization through a prolonged period of high spreads between lending and borrowing rates is inefficient; it takes too long and, more importantly, works by taxing successful firms to fund the losses of the unsuccessful enterprises. This procedure could well abort private sector growth before it even starts. An once-off capital infusion based on public debt issue would allow a less destructive way of financing the resulting liabilities.

If bank recapitalization is part of an overall banking reform-cum-enterprize-restructuring plan, as proposed in Poland, it is crucial to do the recapitalization up front, on an ex ante basis, even if it then has to be based on an imperfect assessment of the true value of the loan portfolio.[11] If not, all incentives for the commercial banks to collect anything at all on their claims will be destroyed: with recapitalization ex post, every dollar written off will be replaced by the government with an interest earning asset, so the banks have no incentive at all to try to collect or even to take equity stakes.

Objections to such a recapitalization because of the funding requirements and associated fiscal costs are always misplaced. The crucial point is that such a recapitalization is nothing but a recognition of debts that have already been incurred in the past and thus requires no budgetary allocation (the interest on the debt instruments created of course does).

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[11] Because of the difficulty of assessing loan status, Begg and Portes (1992) propose to simply remove all loans to SOEs from the banks' books. Because of the predominance of such loans in bank portfolios, this approach basically restores the old communist practice of direct government lending to the industrial sector, bypassing intermediaries. It would also vastly overcapitalize banks; e.g. in Poland external, Western auditors after three consecutive audits place the percentage of bad loans at most 30% in aggregate. Note that under the approach proposed here, it only matters to get the aggregate loan quality roughly right, not every individual loan; given the incentive to exaggerate losses and the resulting conservative bias in standard audit procedures, that does not seem impossible.

The argument against keeping such debts off-the-books, which is what a failure to recapitalize sufficiently would do, is that doing so unavoidably leads to unpredictable but highly inefficient ways of servicing the implicit debt. In fact in most cases undercapitalized banks end up being funded through the inflation tax as losses are picked up by the Central Bank. At least when the debts are recognized and their interest costs brought in the budget, an efficient tax structure can be set up to finance those costs.

A more interesting objection is raised by Frydman et alii (1992). They argue that any injection of capital should go to new banks rather than the old ones. They propose to transfer liabilities of the old banks to offset the book value of the bad loans to be removed from their balance sheets, and use any issue of new debt to capitalise the new banks. Although the whole package has zero net present value by design, new banks would still be interested since they immediately gain access to a customer base.

Some questions remain unanswered about this approach, however. It is not clear, given the pervasive capital market problems in Eastern Europe, that an auctioning process to select the new banks for this transfer would in fact produce the best managers or just the ones with the best connections. Second, the size of the bad loan problem, at least in Poland, is such that at most one additional bank could be created if the new bank should be of the same size as the existing 9 commercial banks. A change from 9 to 10 is unlikely to effect a major change in the competitive environment. Finally, they base their view on the claim that even privatization of the old banks will not provide enough of an incentive to bank managers to change their ways. This is in the end a judgment issue; but it is hard to see why, if proper incentives are important enough to completely restructure the economy, it is nevertheless reasonable to assume that applies to everybody except managers of existing banks. Certainly the experience in Mexico with banking reform shows that existing, inefficient state banks <u>can</u> be transformed, even prior to privatization, in much more commercially oriented entities.

5.3 Establish a Proper Incentive Structure for Commercial Banks

Establishing effective bank governance ultimately requires privatization. If quick privatization is not advisable because of the absence of effective supervision and regulation of private banks, a difficult situation is created as was argued before in the discussion of enterprise reform. Any workable solution probably requires at least two elements. First, commercialization with the creation of strong supervisory boards will be necessary so as to allow close monitoring of management.

Second, since monitoring unavoidably is going to be imperfect, managers should receive incentives that point them in the right direction. Profit related pay is one possibility, but is to tightly linked to short term profitability. And especially for banks it is easy to shift losses into the future through refinancing of commercially non-viable loans. Thus profit related pay needs to be complemented by incentives that work on a longer horizon. In the West this problem is typically solved through the issue of stock options exercisable at some much later date. In the Eastern European context such constructs are difficult simply because the shares over which such options should be written either do not exist or are not really publicly traded. An alternative worth considering is, to provide them with the equivalent of stock options: shares in the privatization receipts as part of their annual pay.

5.4 Gradualism in Banking Reform?

Many would by now argue that any reform that can be implemented should go as fast as politicians will allow the reformers to go. But especially in the financial sector some caution may be called for. The reason is that the regulatory framework, to be effective, needs an institutional capacity that takes time to build. Supervisors need to be trained, accounting systems and information networks to be built up, enough qualified personnel needs to be found or trained and so on. Much of that can be done in a relatively short time if enough foreign assistance inclusive on site experts is available, but the whole process is likely to take at least a number of years.

This means that immediate extension of a tough regulatory framework

to all banking activities may simply not be feasible, which in turn would mean that the new system would immediately loose credibility. Even more damaging would be the introduction of deposit insurance, a common feature of all Western banking systems, into such an incomplete regulatory environment.

Several transition issues arise. One approach, followed in Poland and advocated by some (cf Lamdany (1993)) for Russia, starts by extending the new regulatory framework, incentive reform and recapitalization to a subgroup of banks only. In poland, only the nine major banks are part of the wide ranging financial and enterprise sector reform package implemented in August 1993. It should be made clear, of course, as was done in Poland, that banks that have not gone through this reform and recapitalization process, will NOT be covered by deposit insurance. This is necessary both to avoid immediate bankruptcy of the deposit insurance agency and to provide these new banks with a competitive advantage to offset the higher costs due to their regulatory compliance.

A second issue is created by the unusual structure of most banking systems in the East. Typically, there are a number of medium to large commercial banks created out of the former branch offices of the Central bank; one big savings bank holding most household deposits and lending top other banks and/or the government; and a flurry of small new private banks. An argument can be made, at least as long as the supervision capacity in the Central Bank has not yet been built up, to maintain the dominance of the savings bank in the deposit market and keep it out of lending to enterprises. In this manner, household deposits will be less at risk, since savings bank managers are not involved in direct credit to enterprises and the associated temptation to gamble hoping for good times (see in particular van Wijnbergen (1993a) for such an argument in favor of -temporary- narrow banking).

6 Conclusions

Governments throughout Eastern Europe have been singularly unsuccessful in dealing with large loss making SOEs. Given the long time period that quite reform minded countries like Salinas' Mexico or Margaret Thatcher's England needed to come to grips with their, incomparably smaller, enterprise problems, this was may be to be expected (a point argued strongly by Alan Walters (1993)). However, this paper has argued a different line than the Walters' plea for government' led gradualism. I have argued that governments in Eastern Europe are unlikely to be able to deal constructively with loss making SOEs at all, slowly or quickly.

I also argue strongly against an extremist *laissez faire* alternative, wholesale application of the bankruptcy proceedings. Such an approach is unnecessarily destructive, especially in the East European context, where past and current losses may well have been due to distorted incentives rather than to bad management or outright insolvency. Although most bankruptcy laws allow for restructuring, the very limited capacity of the court system in Eastern Europe and the almost impossibility of removing liquidation bias from the bankruptcy code argue against this solution.

Instead, a more promising approach would create an incentive framework and legal environment where the SOE's major non-government creditor can take the lead in initiating restructuring and the design of a new, viable capital structure. Such a lead bank is much more likely to gain access to the inside knowledge that gives the firm its surplus value as a going concern, which in turn makes it better placed than the government in assessing long term viability. The details of such an environment are laid out using the recent Polish attempt to launch a wholesale clean up of the loss making SOEs along lines promoted in this paper.

A standard reply to a call for commercial bank involvement in enterprise restructuring, much like Western investment banks do in periods prior to bankruptcy, is that East European banks do not possess the necessary skills. This is for at least two reasons in most cases not a useful answer. First of all, it is not really the relevant question. At issue is not whether they are good enough, but whether there is anybody

else who is better. Given the dismal record of Government involvement in large scale enterprises under communism, and long standing problems of regulatory capture in the West, the Government itself is not obviously a good candidate. Anyhow, successful restructuring should really be part of a privatization exercise; for obvious reason, the more influence future owners have, and the less influence goes to past owners, the better the chance that the restructuring exercise does not need to be repeated. We return to this issue below, since there are other, deeper and Eastern Europe specific arguments that argue in the same direction. The second point is that in many countries a subset of commercial banks is improving rapidly. This holds true for countries as diverse as the Czech republic and Poland on the one hand and Russia on the other.

Nevertheless, it is true that assigning such an important role to commercial banks makes financial sector reform commensurately more urgent. There is little doubt that if either enterprise reform or bank reform is to have any chance of success, they better be undertaken jointly.

The Polish financial and enterprise reform package is to date an apparent success. This suggests that the decentralized, non-government approach to dealing with loss-making SOEs promoted here has a chance of success; that is more than can be said of the more traditional, government oriented approaches advocated and tried elsewhere.

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