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The Polish Experience with Bank and Enterprise Restructuring

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Poland's program tackled simultaneously bank and enterprise restructuring and dealt decisively with the bad debt stock and flow problem with measures to improve incentives and institutional skills.

Summary findings

Among transition economies, Poland was a pioneer in bank and enterprise restructuring. The main tool it used to implement the restructuring program was the 1993 law on financial restructuring of enterprises and banks, in an approach that encouraged banks to play a central role in enterprise restructuring. Bank recapitalization was linked to improvements in the banks' operating systems aimed at increasing efficiency and loan recovery.

Poland's program to restructure banks and enterprises was successful because it was comprehensive. It tackled banks and enterprises at the same time, dealing both with the bad debt stock problem and the associated flow problem. It made assistance on the stock problem contingent on concrete actions to improve lending practices, with the prospect of possible privatization or liquidation.

The lesson Poland's experience offers is that solving the stock problem through bank recapitalization is necessary but not sufficient. Bank recapitalization without measures to improve performance incentives and bank skills is likely to fail.

Poland was also realistic about isolating "too important to fail" enterprises, providing special

temporary budget support (after progress in key areas) that gave the program political viability. Poland took steps to modernize bank supervision and adopted measures to privatize banks and set up workout units showing genuine interest in changing banking practices.

Poland's banking sector now resembles a modern market economy in structure. Commercial banks have a more than adequate capital base. Banking competition has increased and the sector seems relatively efficient and profitable. The experience of the workout departments has strengthened the skills needed for credit allocation and monitoring.

Some positive results in enterprising restructuring have been linked to the banks' central role in enterprise governance, maintaining incentives to avoid unloading debt on the government, resolving conflicts between creditors to avoid triggering unnecessary liquidations, and preventing unnecessary bankruptcies. But it is unclear whether enterprises are on a healthy path or whether a second wave of bad loans may emerge, especially after a downswing in the business cycle.

This paper — a product of the Financial Sector Development Department — is based in part on the findings of a broader study for the Operations Evaluation Department. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Tomoko Ishibe, room G8-136, telephone 202-473-8968, fax 202-522-3199, Internet address fmontesnegret@worldbank.org. January 1997. (43 pages)

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Summary findings

Among transitional economies, Poland was a pioneer in bank and enterprise restructuring. Poland tackled enterprise and bank restructuring through innovative pro tempore legislation which linked bank recapitalization to improvements in the banks' operating systems aiming at increasing efficiency and loan recovery. The approach encouraged banks in playing a central role in enterprise restructuring. The main tool to implement such a program was the law on financial restructuring of enterprises and banks. In this paper, Fernando Montes-Negret and Luca Papi analyze critically and comprehensively the Polish experience in bank and enterprise restructuring. In particular, the two authors present and discuss pros and cons of the Polish approach, describe the implementation of the program and provide a preliminary evaluation of the results of the program.

Thanks to the program, many steps towards modernizing the banking system have been adopted. The structure of the banking sector resembles now that of a modern market economy. Some main banks have been privatized, the commercial banks participating in the program have a capital base more than adequate, and most bank managers are progressive and market oriented. Competition within the banking system is increasing and the sector seems relatively efficient and profitable. Interest rates spreads have declined and the menu of financial services has increased. Last but not least, the program has contributed to provide banks, mainly through the experience of the work-out departments, with key banking skills to better implement their allocative and monitoring functions.

On the enterprise side it is perhaps too early to assess the final results of the restructuring effort. However, some positive results are linked to the central role of banks in enterprise governance, maintaining incentives to avoid unloading debt into the Government, resolving conflicts between creditors without triggering unnecessary liquidations, and avoiding excessive use of bankruptcy procedures. However, it is not clear yet whether enterprises have been put on a permanently healthy and viable path or whether a second wave of bad loans could emerge in the near future, especially if the upward business cycle were to be reversed.

All in all the assessment is positive. The Polish program was quite successful because it was very comprehensive. It tackled at the same time the banking and the enterprise sector, dealing both with the bad debt stock problem and the associated flow problem. In addition, it made assistance related to the stock problem contingent on concrete actions to improve lending practices and included the prospect of privatization or liquidation. The lesson here is that solving the stock problem through bank recapitalization is necessary but not sufficient. Rather, bank recapitalizations without additional measures to improve bank skills and to provide sound performance incentives are likely to fail. Poland was also realistic in isolating "two important to fail" enterprises providing special and (hopefully) temporary budgetary support that gave political viability to the program. The latter was carefully sequenced; bank recapitalization occurred at the right time when progress in other areas was quite advanced. In this respect, Poland took many steps towards modernizing banking supervision, adopted measures to privatize banks and set up work out units when bank management and ownership were really interested in changing banking practices.

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Introduction

Following the end of the socialist system, Polish enterprises were confronted with serious economic problems. The direct consequence of the distress in the enterprise sector was the emergence and/or recognition of a huge wave of non-performing loans in the banks' portfolios. The nine Polish state-owned commercial banks (SOCBs), created in January 1989 from the earlier state monobank, were seriously affected by the new situation and were faced with a solvency crisis. The number of debtors in financial distress owing money to the SOCBs increased six-fold between 1989 and 1990, five-fold the following year, and doubled in 1992. For the entire banking system, about 28 percent of bank debt was bad (about 5.8 percent of GDP) by end-1992.¹ Furthermore, Poland, as all transition economies, experienced a sharp increase in interenterprise arrears.

The severe distress in the banking and enterprise sectors forced Poland to tackle enterprise and bank problems simultaneously. In some respects Poland was a pioneer in bank and enterprise restructuring and its approach represents an interesting solution which might be a useful point of reference for other countries. This paper analyses critically the Polish experience and it is organized as follows: Section 1 describes briefly the different strategic options to bank and enterprise restructuring; Section 2 presents the legal solution adopted in Poland and discusses pros and cons of the Polish approach; Section 3 describes the implementation of the Enterprise and Bank Restructuring Program (EBRP); Section 4 provides a preliminary evaluation of the results of the program; and Section 5 concludes by drawing some lessons from the Polish experience.

1. Approaches to bank and enterprise restructuring

This section describes briefly some of the main approaches authorities can follow when severe financial difficulties occur in the enterprise and banking sector. The review focuses mainly on the banking sector problems and enterprise restructuring is considered only as a necessary condition to ensure the success of the bank restructuring process.²

Generally speaking, the policy choices for resolving systemic banking problems include: (i) bank closure and liquidation, (ii) regulatory forbearance, and (iii) bank restructuring. Of course these policy options are not mutually incompatible and in practice strategies can entail various combinations of each policy. As a matter of fact, in many countries policy responses to banking problems have often been implemented through a piecemeal process, for instance, restructuring part of the banking sector, closing some small banks and postponing the solution of some other troubled banks.

¹ The nine commercial banks held the bulk of state enterprises bank debt (67 percent in September 1992).

² For a more in depth analysis of bank and enterprise restructuring approaches see, *inter alia*, Saunders and Sommariva (1993), and Sheng (1996).

Bank closure is not a very attractive solution given its political and economic costs and the usual weak financial position of the State in transition and developing economies.³ Bank closures could generate a deposit run with potential effects for the whole banking sector. In most countries, and especially in transition economies where banking sectors are very concentrated, banks in distress often represent almost the entire banking system. Their closure would imply the disappearance of most intermediation systems. In addition, such a solution would worsen an already major unemployment problem.

Regulatory forbearance is a temporary, short-term *fix*, which basically postpones the problem in the hope that a turn-around of the economy would eventually restore enterprise solvency allowing banks to grow out of their problems. To assist in this process, the authorities do not enforce certain prudential regulations (e.g., minimum required capital, reserve requirements, credit exposure limits, loan loss provisions, etc.) or create exceptions for certain banks, credit operations or types of deposits. Banks can attempt to deal with and hide their difficulties by granting new credit, and/or by modifying interest rates. Credit expansion usually includes some sort of rollover of bad loans to loss-making enterprises. Banks can also be willing to pay higher interest rates on deposits to attract fresh money to maintain liquidity without dealing with their problems. This can be an extremely dangerous strategy which can end up in a very distorted resource allocation.⁴

The third option available is to restructure banks—dealing with their portfolio problems. There are several strategies to restructure banks and no strategy is necessarily optimal for all countries or for all banks within a country. The objectives of the government - in terms of policy preferences for the future banking structure, the cost distribution of the restructuring process etc. - and the economic situation of each country require specific tailor-made solutions. Of course, bank restructuring makes sense only when coupled with enterprise restructuring to ensure that scarce financial resources are allocated only to sound enterprises. Every action to implement bank restructuring has to be consistent with a general reform strategy to ensure an appropriate structure of the banking sector. In addition and more importantly, the government should adopt measures to avoid recurrence of bank crises. This can be done by recognizing the causes of banking problems and targeting assistance to the specific causes. Moreover, government assistance must avoid creating moral hazard problem by creating expectations of future assistance. In what follows we present a schematic framework which encompasses the main solutions for solving banking system problems, and provide a brief description of the effects of bank restructuring on the different economic groups involved in the restructuring process.

Enterprises' liabilities towards banks can be the object of interventions by the government and by banks (figure 1). Governments can either assume public enterprise debts or transfer/lend funds to financially-distressed enterprises to enable them to serve their own debts. Tax breaks and lowering regulatory requirements can also help enterprises in solving their financial problems.

3 Of course the situation is different when problem banks are small and therefore have no systemic relevance. In these cases the authorities can choose to close and liquidate small banks leaving owners and creditors to absorb the corresponding loss.

4 The relevance of such a strategy has been empirically confirmed by Sundararajan and Balino (1991).

Figure 1: Approaches to bank-led enterprise restructuring - from the enterprise side

Bankers can deal with firms in financial distress either within the public courts system following formal proceedings for liquidation or bankruptcy, or seeking out-of-court agreements by some sort of informal arrangement between the lender (bank) and the borrower (firm). As a matter of fact, in most countries restructuring experiences mainly occurred by means of informal work outs. There are many reasons to avoid recourse to a formal (court) liquidation of all delinquent borrowers. First, the latter can be a very costly solution because not only it would make non viable enterprises close, but also it would force the liquidation of illiquid but viable enterprises, destroying valuable assets which could not be easily redeployed (given their degree of specialization or the lack of a private sector able to redeploy them more effectively). Second, to the extent that markets for many enterprises' assets are either missing or too thin, trading of bankrupt enterprises' assets can be negligible. Third, a massive recourse to liquidation may also be impracticable given the existing inefficient court and legal systems.

Within informal out-of-court proceedings bankers can tackle enterprises' arrears through different approaches. The main options are the following: debt transfer to other entities, debt-for-debt swaps, equity-debt swaps, and debt sales. Debt can be transferred to an internal workout unit of the same bank, or to another entity which could be either a bank subsidiary or a government agency. Debt-for-debt swaps entails a new contract through which the lender generally provides some more favorable terms to the borrower. The changes in the revised loan contract can involve some debt rescheduling, interest rate reduction, new collateral requirements, agreement on a restructuring plan, etc. The bank can also take an equity stake in lieu of its loan, reducing the seniority of its claim, but increasing its control rights over the enterprise. Debt sale is also an option. This could be done with either another bank or firm's creditor who could buy debt to offset its credit with the enterprise

Figure 2: Approaches to bank and enterprise problems - from the government's perspective

Looking at the different methods governments have followed in assisting banks in distress we can distinguish between operations that are aimed at recapitalizing banks and those that provide banks with liquidity (figure 2). The latter is the most common immediate response to bank problems, but of course it can only provide temporary relief. Bank recapitalization can affect both the assets and the liabilities side. On the asset side the main solution entails a transfer of government securities. The latter can be unrequired, but more often securities are swapped for non-performing loans. On the liabilities side recapitalization can occur through three main solutions: through the purchase of new bank shares, the granting long-term subordinated loans, and the assumption of bank liabilities.

Of course a bank's recapitalization has to be coupled with other measures to avoid the repetition of past problems. Depending on the contingent solutions adopted, bank lenders and borrowers, managers, owners, employees, the monetary authority and the government will be affected and will intervene in different ways.

For instance, depositors can be directly impacted, either through the transfer of their claims from one bank to another or through a partial or total conversion of deposits into government bonds, or through a change in the eligibility of their claims (conversion of short to long-term claims). Depositors could also lose some or all of their claims due to bank liquidation procedures.⁵ Indirect consequences on depositors can occur when deposit interest rates are kept excessively low by means of administrative measures.

Similarly, bank borrowers can be affected indirectly when some sort of administrative intervention modifies the cost and the allocation of bank credit. But direct instruments targeting borrowers are

⁵ We are focusing here on bank deposits held by households and enterprises but bank deposits include also interbank deposits. The latter are rarely protected by deposit insurance schemes. In special cases, however, the authorities intervene to avoid either liquidity problems or drying up of the interbank market.

by far more important. As a matter of fact, insolvent borrowers have often been the main cause of systemic banking problems, especially in transition economies. Direct instruments for borrowers can assume various forms. Direct transfer of funds from the government to enterprises can be a temporary solution for solving enterprise financial problems. Non-viable enterprises can be liquidated, while for those enterprises with a good chance of recovery schemes to facilitate enterprise restructuring are implemented.

Banking problems are often coupled with incompetent or corrupt bank management, and lack of incentives for bank managers and employees. In some circumstances, management replacement can be difficult to implement, if, for instance, the supply of good managers within the country is very scarce. Additional measures can be considered to ensure appropriate incentives and better policies.⁶

Changes in ownership represents one of the major vehicles to reorganize the banking sector. Actions to change bank owners aim at improving bank governance. Given the public dominance of the banking sector in transition economies, bank privatization is the most common solution.⁷ Bank privatization is usually implemented only when banks have been restructured to avoid having to re-nationalize the private insolvent banks.

Government involvement in bank and enterprise restructuring occurs at many levels. The government is directly involved in enterprise and bank reorganization through changing ownership structure, assuming debt, and transferring funds. Indirect government involvement is often carried out through changes in regulations, tax breaks, industrial policy, etc. Finally, monetary authorities have to ensure the adoption of those preconditions which make any restructuring durable. Appropriate financial regulations, strong enforcement and competent banking supervision are essential ingredients to build a sound financial environment.

2. The Polish program and its legal framework

The Polish program was comprehensive and sought to achieve many objectives simultaneously. The government decided to restructure banks and to tackle at the same time the enterprise and bank problems contemplating many solutions and instruments mentioned in the previous section.

The enterprise problems were mainly tackled through bank interventions. In practice, the Polish strategy operated mainly through an informal out-of-court approach under which banks would keep in their books the non-performing loans albeit in a restructured form. A different approach was followed for those (often large) state-owned enterprises (SOEs) whose restructuring was assessed complex and very sensitive from a social and political point of view. For these enterprises an external approach was implemented involving the removal of their delinquent loans from the balance sheet of the originating bank to a governmental "resolution" agency, (Industrial Development Agency (IDA)).

⁶ *Contingent salary increases and reductions, offering of bank shares to managers and employees, or demotion of top management are additional or complementary options to make a successful reorganization a more likely event.*

⁷ *See McNaughton (1992) for a general framework for implementing bank privatization.*

Banks were recapitalized and restructured by means of a comprehensive approach which not only provided banks with government securities, but put in place many of the necessary conditions to make the banking system work. Bank regulation and bank supervision were strengthened significantly. Banks were given temporary powers to lead out-of-court conciliation agreements with financially distressed enterprises. In addition, it was decided early in the process to recapitalize insolvent SOCBs based on thorough portfolio reviews, putting in place the right set of incentives (including rapid privatization) for an efficient and rapid resolution of cases involving distressed SOEs.

Implementation of the EBRP required the development of new regulations that stimulated the banks to play an active role in the enterprise restructuring program. The program gained strong support within both the economic community and politicians, and the government's draft was approved by Parliament in a very short time and without substantial amendments. The support of the World Bank was critical in providing credibility to the initiative and strengthening its effectiveness. The main tool used to implement the program was the Law on Financial Restructuring of Enterprises and Banks (see Annex), which was in force from March 1993 to March 1996. To achieve the program's final goals, the 1993 law has to be regarded as an additional part of the legal system, which already included other more traditional exit processes as bankruptcy regulations, liquidation on the basis of the commercial code, and some forms of conciliation proceedings already in place in the Polish legal framework.

The new regulations provided enterprises with the opportunity to succeed in their restructuring efforts while providing the government with a shock absorber to mitigate the social costs of reorganization of some large SOEs. It also forced the government to assume new responsibilities. A schematic presentation of the financial restructuring opportunities made possible under the law is shown in figure 3.

Figure 3: Bank and enterprise restructuring under the 1993 Law

The two main pillars of the law were the introduction of special instruments to help banks solve problems with financially distressed debtor enterprises and the conditional recapitalization of banks.

The new law provided the banks with three new tools: bank-led conciliation agreements (BCAs), the public sale of bank debts on the secondary market, and the possibility to swap their bad loans

for shares in SOEs (debt-equity swap) (article 1). The BCAs were the most original and far-reaching instrument of the program. According to the law, BCAs were to be used mainly with debtors that were SOEs or joint stock companies in which the state held at least 50 percent of the shares (article 6). BCAs could be used for a limited period of three years (March 18, 1993 to March 18, 1996) as a special mechanism for rescheduling debtors' obligations to the banks and to other creditors (article 37). The new law, which provided banks with quasi-judicial powers in instituting conciliation proceedings leading to a settlement between debtors and creditors (article 5), not only extended the range of obligations that could be included in the agreement, but also made the process simpler and more flexible. And unlike the court proceedings, the BCAs covered part of the enterprises' liabilities to the state, the agreements covering all receivables except social insurance, employment relations, and pension obligations (article 11).

To simplify the procedure and to reduce the ability of small creditors to delay or derail agreements, credit voting rules were modified. In particular, the law stipulated that a voting majority based on outstanding debts was required to approve a BCA (article 20). Under the previous legislation, limits depended on the number of claims and the number of creditors.

To increase flexibility the law provided for a range of possible settlements between the bank and its debtors, including rescheduling of debt repayments; reduction of interest; cessation of interest compounding; conversion of debt to equity; debt forgiveness, including interest; and extension of new loans (article 16).

Under the law, banks were required to make public announcements of the conciliation proceedings they intended to commence (article 14). A bank or creditor initiating a BCA was also obligated to apply to the Ministry of Privatization for transformation of each SOE into a joint stock state treasury company. That provision was intended to allow creditors to convert their debt to enterprise equity and to encourage outside investors to invest in the enterprise paving the way for privatization.⁸ It also had the effect of putting the SOEs under the Control of the Treasury.

In the overwhelming majority of cases, the banks took on the role of managers of the conciliation agreements, defining the terms and conditions. One of these conditions was the obligation to establish a creditors council, which generally included a representative of the Ministry of Finance, the bank, and other major creditors, and often included representatives of the relevant voivodship (municipality) authority. These creditor councils monitored the implementation of the enterprise recovery programs, and they were empowered to file to a court a motion for terminating the conciliation agreement. However, creditors' councils appeared to have done very little in practice. Banks played the main role in supervising the agreement. The law delegated responsibility for monitoring the restructuring program to the lead bank. Under the law, the lead bank had to terminate the agreement if the debtor violated the agreed plan otherwise it becomes liable for any additional losses incurred by other creditors (article 27).

⁸ *Management of entities operating under joint stock status are obliged to exercise care in order to avoid being charged with acting against the interest of their company. When serious losses lead to insolvency, management are required to file for declaration of insolvency.*

Public sale of bank debt in the secondary markets was another option provided by the law⁹ (article 38). Debt could be divested through open tender, public offer, or negotiations following publication of an invitation to negotiate (article 39). The sale of receivables represented a relatively quick way for a bank to clean up its portfolio by assuming an immediate loss; for credits with a low likelihood of recovery, the option also made good business sense. Debt sales were used where effective restructuring seemed unlikely, or where revenues from bankruptcy or liquidation were estimated to be less than the proceeds from the sale of the loan. From the buyer's point of view there were two possible reasons to purchase debt. First, if the buyer was in debt to the bank's debtor, he could net that debt against the purchased debt. Second, the debt could be converted into shares of the debt-ridden company.

The third tool sanctioned by the law provided creditors holding at least 30 percent of a public enterprise's debt with the opportunity to convert their claims into shares thus privatizing enterprises without prior consent of workers' councils (article 43). To do so, however, creditors had to follow a cumbersome procedure and obtain approval from the founding body of each enterprise (articles 44-50).

The law on enterprise restructuring also created the legal basis for bank recapitalization. Under the law, banks were given a limited period to come up with a plan for dealing with their bad loans. The purpose of the recapitalization was to ensure that banks could reach a sufficient capital-asset ratio to further privatization by establishing adequate provisions for irregular loans.

To be eligible for recapitalization, banks had to be state owned (the Treasury had to own at least 50 percent of the bank's shares) and meet the following conditions: a financial report analyzing the quality of the bank's portfolio had to be verified by a prestigious foreign auditing company; irregular credits had to be separated from regular credits; a separate organizational work-out department structure had to be established for irregular credits; and a plan for the restructuring of irregular credits had to be presented (article 52). In each bank the work-out department was required to clean up or restructure all separately classified bad loans extended before the end of 1991. The recapitalization could occur through a transfer to the banks of Treasury bonds or monetary assets from the Ministry of Finance (MOF) (article 52).

The role of the government

The role of the government within the bank and enterprise restructuring plan was twofold. On the one hand, the government took a very active role in the implementation of the EBRP and on the other, the government provided a framework for dealing with and supporting those nonviable SOEs whose immediate liquidation was considered too costly from a social and political point of view.

9 Prior to passage of the law, banks could trade the receivables of a particular borrower among themselves, but the public offer of a loan for sale—necessarily entailing disclosure of the amount involved—constituted a violation of the banking law.

Government representatives designed most of the program and the government participated heavily in bank reorganization. The government also created a new incentive framework to help the banks succeed in their reorganization efforts. Under the government's plan, all nine SOCBs were to be privatized within three to five years. Bank reorganization was accomplished by recapitalization and by providing effective implementation and supervision of the program. Recapitalization was encouraged so that the cost of enterprise restructuring would not undermine the stability of the banking system. To implement and to supervise the program, the MOF appointed new supervisory boards (with heavy representation from outsiders) with a mandate to make managers accountable through a careful monitoring process. In addition, work-out departments were set up and staffed with experts from outside the banks, and external technical assistance was provided by international donors. Accountability was enforced by the banks' supervisory boards and a special unit of the MOF, which monitored performance against the work-out departments detailed business plans.

The creation of a new incentive framework was accomplished through two main channels. First, within the conciliation agreements, the government agreed to modify the seniority of its claims, taking a step back as senior creditor. Second, the government did not play an active role during the conciliation proceedings and agreed to accept any debt reduction applied to other creditors.

The EBRP was applied only where there were good chances for enterprise recovery. Financial cooperation between banks and nonviable enterprises was terminated and nonviable enterprises were liquidated, except where liquidation was considered unfeasible because of political or socioeconomic considerations. Such cases were treated under the terms of a decree, prepared in November 1993, and enacted in October 1995, that allowed special budgetary allocations (through IDA) supporting restructuring or managing the liquidation. The conditionality governing eligibility for government support envisaged a limited access to the mechanism through a set of disincentives.¹⁰ To prevent banks from conditioning conciliation agreements on the provision of budgetary assistance, the decree stipulated that budgetary resources should support a conciliation agreement only if it is conducted by IDA.

3. How valid was the Polish approach and how well was the program designed

How valid was the approach chosen and how well was the program designed? Both the Polish authorities and all of the international organizations involved in Poland agreed on the urgency of bank restructuring and recapitalization. The danger of the huge volume of bad loans undermining the stability of the entire banking system was universally recognized. The desire to avoid large-scale liquidation of enterprises¹¹ and the recognition that the Polish legal system was unable to

¹⁰ To qualify for government help, enterprises had to agree to the following terms: (a) budgetary support to a given enterprise would be provided only once; (b) liquidation or restructuring plans must provide for the divestiture of all nonproductive assets; (c) the effects of the restructuring plan on wages and layoffs must be accepted by the enterprise's unions; (d) the enterprise must be commercialized; (e) the enterprise's ownership rights to its land and buildings must be clarified; and (f) evidence that the budgetary resources would not be used to pay off other creditors' claims must be provided.

¹¹ To the extent that the value of a firm exceeds the salvage value of its physical assets there is a surplus, which can be lost with its liquidation. The surplus value typically rests with the firm's insiders, who have access to all relevant information. Removing the insiders from the process—especially when their poor past performance reflected

cope with the large numbers of distressed enterprises meant that special support to the banks was necessary.

The program was designed to reserve a primary role for banks in controlling enterprise governance, maintain incentives to avoid unloading debt onto the government, and resolve conflicts between creditors without triggering unnecessary liquidation¹². Non-performing loans were kept within banks although they were transferred to special work-out department. Various instruments, mainly within the BCAs' options, were used by banks to recoup non-performing loans from enterprises in distress. In this sense Poland adopted a quasi-decentralized approach as opposed to a centralized approach centered on the role of a new government agency.

A quasi-decentralized approach based on the primary role of banks made sense in Poland for many reasons. First, when the risk of financial distress is high, corporate governance is generally best ensured through credit monitoring (Aghion and Bolton 1992). Short-term credit allows banks to minimize the danger of premature liquidation of potentially viable firms, and to exert strong control over borrowers through frequent roll-over decisions (Baer and Gray 1995). Especially when equity markets are immature, as they are in transition economies, banks should play an important role in corporate governance. Second, the information advantage of banks should allow them to monitor enterprises more effectively during the implementation of the recovery programs and to agree to debt-equity swaps only when there are strong reasons to assume that equities will yield competitive returns in the future.¹³ Third, lack of political stability, lack of properly trained government staff with the right experience and expertise, the absence of an efficient governmental organization capable of undertaking this new task advises against a centralized approach. Moreover, the lack of an adequate incentive and information system that would motivate civil servants to resist political pressure suggest that a central agency would not have been capable of overseeing the program effectively. Fourth, by the time the problems of the banking system were first addressed—three years after the transformation of the Polish economy had begun—bank portfolios included both bad loans made under the system of central planning and bad loans made also to private firms during the transition. A centralized approach is more easily justified at the beginning of the transition, when all of the bad loans represent legacies of the previous system. Once the transition has begun, and bank portfolios include bad loans to the private sector, a decentralized approach, under which banks deal with their customers individually is more appropriate¹⁴ (Belka 1994). Fifth, banks in Poland lacked experience and skills and their portfolio situation partially reflected past poor decisions. A centralized solution would not address the main cause of the problem and only a decentralized approach would force

distorted management incentives—through liquidation or transfer of control to a government agency could therefore destroy the surplus value of the firm (van Wijnbergen 1993c). In theory, bankruptcy regulations allow for some restructuring as an alternative to liquidation; in practice, such outcomes rarely happen and liquidation is the most likely outcome.

12 *It should be noted that some of the alternative proposals that were considered in Poland provided for general debt forgiveness. The fiscal cost of some of these programs would have been enormous and would have jeopardized the return to a stable macroeconomic environment.*

13 *This advantage, which is strong in market economies, might be mitigated in Poland and other transition economies where the information system is weaker and informative asymmetries more severe.*

14 *This presumes that the banks have a commercial orientation, a strong internal auditing functions and governance mechanisms, and a supervisory agency able to monitor the quality of the loan portfolios.*

the banks to take responsibility for their credit decisions, as well as have an important learning effect.

Finally, and most important, the decentralized approach was based on better incentives. Under a centralized approach the government agency responsible for the collection and resolution of bad loans would face no incentives to succeed, since accomplishing its objectives would lead to its abolishment. The EBRP was designed to ensure that all participants had the right incentives. To stimulate prudent behavior early in the process (during the summer of 1992) the government sent SOEs a “no bail-out” message, forcing a change in expectations and behavior of enterprise managers and banks, with banks becoming increasingly reluctant to finance loss-makers. Banks were capitalized to a level that would allow adequate provisioning while leaving the bad debts on their books. Because the amount of recapitalization was not linked to the collection of bad debts, but it was based on the 1991 audits, banks had a strong incentive to recover their bad debts.

A potential problem of leaving the bad debts on the banks' books was that because the relationship between the banks and the debtors were not severed, banks may have continued to lend to enterprises not servicing their debts creating new bad debts. To prevent banks from continuing to lend to enterprises that did not service their debts, the 1993 law banned new lending to bad debtors (exceptions were allowed where a conciliation agreement was reached between the debtor and the bank). In addition, banks were required to provision for past due loans by the end of 1993 and set up debt work-out units that either sold or restructured substandard loans within a limited period of time.

Bank management and employees also faced the right incentives. Manager performance can be ensured by two main mechanisms: first, by the external market for corporate control which ensures effective monitoring and enforcement; and/or by an internal incentive structure that pushed managers in the right direction (i.e., profit maximization). Of course, in transition economies, monitoring is often ineffective, making the need for an appropriate incentive structure particularly strong. Creating incentives for bank managers is tricky, however. Sharing profits may not create the right incentives since short-term bank profitability can easily be manipulated by incorrect or illegal accounting procedures (such as shifting losses to the future through refinancing of economically nonviable enterprises, or under provisioning for non-performing loans) practices common when supervision is weak. Where capital markets are developed, a longer term incentive structure can be created by issuing a stock option exercisable at a future date. In Poland, management (and employees) have the right to buy a certain number of shares at half the market price if the enterprise is privatized. Such a system, which resembles a medium term stock option, encourages managers and staff to improve the bank's performance in the hope of accelerating the privatization of the bank and reaping the benefits of their cheaper shares. In addition to that, a credible privatization process pushes management to adopt a right behavior; in fact a private economy means a market for managers and thus reward for successful and skilled managers, be that inside or outside their present bank or enterprise. The law on bank-led enterprise restructuring also provided strong incentives for the enterprises involved in the conciliation agreements since, under the law, any concessions granted under the agreement would have been rescinded if the agreement were to be declared void. Finally, to insulate banks and

enterprises involved in the program from political pressure, politically sensitive enterprises were treated separately, and received subsidiary intervention from the government.

Notwithstanding all these positive features, the decentralized approach requires that certain conditions be met in order to be successful and has obviously also some shortcomings. First of all, to ensure the effectiveness of the incentives provided the final goal of bank privatization must be credible. Second, certain circumstances may render the decentralized approach more difficult to implement. As a matter of fact, MOF's monitoring activity might be more complex, given that all the banks involved in the program have to be monitored continuously (principal agent problems might be more severe).¹⁵ Consequently, cost savings through scale economies can be an argument in favor of a single, centralized work-out agency. Implementation of a decentralized approach requires also stronger coordination with other regulations, mainly tax and central bank regulations. Moreover, work out departments require people with the necessary skills in each bank. If banks skills are really scarce a central agency might ensure a more efficient utilization of scarce expertise. On the other hand, a government agency may attract professionals from the banking sector taking away from banks scarce skills. Third, another drawback of the decentralized approach, which could be particularly relevant in the case of Poland, is related to the size of the restructuring effort. If the scale and scope of the enterprise restructuring is such that it will have strong employment and other social consequences then the restructuring process might be very gradual and time-consuming. In such circumstances a linkage between banks and enterprises may absorb most of the bank resources. Finally, the choice of the approach is relevant for bank privatization as well. In fact, if the decentralized approach might facilitate privatization because of better incentives and skill development, although the bank portfolio evaluation might be more difficult and time-consuming since non-performing loans would still be within the bank.

4. The implementation of the program

The goal of the EBRP was to address the widespread financial distress in the bank-enterprise sectors. Consequently, problems of distressed enterprises that were able to meet their banking obligations (using other commercial credit or budgetary support) were not tackled.¹⁶ Even after excluding such enterprises however, the share of the debt under restructuring was large. As of the end of 1994, debt under restructuring was about 2.5 percent of GDP; 86 percent of the total debt was classified by banks as lost, 8 percent was classified as doubtful, and 6 percent was classified as substandard.¹⁷

15 Implementation can be also more complicated when enterprises have liabilities towards many banks in similar proportion: in this case the choice of which bank should be responsible for enterprise restructuring might become more difficult.

16 Information on such enterprises is not available. Given the importance of intraindustry financial relationship and budgetary liabilities in transition economies, support from these sources may have been significant.

17 Under Polish regulations, the loan portfolio is divided into four categories according to the debtor's delay in servicing and repaying its obligation. The four categories are: regular, substandard (loans that have not been serviced for up to three months), doubtful (loans that have not been serviced for up to six months, or for which the debtor has been forced to run down its own capital), and lost (loans that have not been serviced for more than six months or are owed by debtors in liquidation). The restructuring program aimed to deal only with the last two categories.

It should be noticed that the various Polish governments (1993-96) in charge of implementing the EBRP have had a different declared commitment to the successful implementation of the program. Moreover, collectively (for reasons which are beyond the objectives of this paper) they failed to take advantage of the “*window of opportunity*” offered by the EBRP to strengthen in the meantime the legal framework (e.g., revision of the bankruptcy law, the promulgation of a law on collateral and secured lending, among others) for the safer operation of financial intermediaries, as well as strengthening the commercial courts, so as to leave in place in a more permanent form a more efficient process and enforcement mechanism for the resolution of non-viable companies. This missed opportunity could prove to be costly in the future.¹⁸

The implementation of the EBRP also involved recapitalizing seven SOCBs and dealing with both viable and nonviable enterprises. The primary objective of the recapitalization of the banks was to augment their solvency ratios in order to prepare them for future privatization.¹⁹ Seven commercial banks received 15 year government restructuring bonds in 1993, and their managers became accountable for the profits and losses of their banks.²⁰

Among the banks that received restructuring bonds, debtor recovery activities were undertaken for 51.4 percent of the value of the total portfolio; activities aimed at the elimination of the debtors were undertaken for 37.7 percent of the portfolio. The rest of the portfolio was composed of units that repaid their liabilities or were reclassified under the first or the second group of credit risks. Table 1 provides additional information on the scope and type of restructuring initiated by the banks, distinguishing between the nine commercial banks and the rest of the sector.

18 On this point see Gray and Holle 1996b.

19 To encourage bank privatization, donor countries contributed up to US\$500 million to the Polish Banks' Privatization Fund (PBPF), which was created from grants originally offered by Western countries to support the convertibility of the zloty and the process of reform in Poland. Under an agreement between the Polish government and the PBPF, the restructuring bonds held by banks will be serviced by the PBPF fund if privatization of commercial banks occurs prior to the end of 1996. In view of the insufficient capacity of the capital market to absorb additional bank shares MOF is considering renegotiating the privatization schedule, and the PBPF benefits may be extended beyond the end of 1996.

21 The bonds had to be held for three years, and portions of these bonds were to be redeemed every six months, with redemption beginning 18 months after the date of issuance. Interest is paid twice a year and is equal to the arithmetic mean of the National Bank of Poland's monthly rediscount rate. Banks received annual interest income of 5 percent, with the remaining interest capitalized.

Table 1. Debt restructuring

<i>Restructuring</i>	<i>9 commercial banks</i>		<i>Other banks</i>		<i>Total</i>	
	<i>PLZ billions</i>	<i>%</i>	<i>PLZ billions</i>	<i>%</i>	<i>PLZ billions</i>	<i>%</i>
Total debt for restructuring	12,252.4	100.0	39,406.6	100.0	51,662.0	100.0
BCA	6,185.7	50.5	9,980.9	25.3	16,166.6	31.3
Court arrangement	532.8	4.3	2,189.2	5.6	2,722.0	5.3
Insolvency and liquidation	1,573.8	12.8	10,156.2	25.8	11,730.0	22.7
Sale of debts	197.2	1.6	7,577.1	19.2	7,774.3	15.0
Debt equity swaps	246.6	2.0	211.6	0.5	458.2	0.9
Debt repayment	100.5	0.8	267.2	0.7	367.7	0.7
Other forms of restructuring	3,516.3	28.7	9,225.7	23.4	12,742.0	24.7

December 1994

Source: National Bank of Poland

Three options were available to facilitate the recovery of debtors: BCAs, court settlement proceedings, and civil law settlements. BCAs have been the most frequently used tool for debtors considered capable of operating under competitive conditions. In many cases, terms established by a very small number of creditors (in some cases two or three creditors represented more than 50 percent of the total claims of the debtor) had to be accepted by all other creditors. Such a situation produced many objections from smaller creditors, who in some cases went to court to defend their rights. Despite the large number of objections, BCAs have been very successful, and none has yet been rejected by the courts.

The nine commercial banks accounted for about 24 percent of the total value of restructured credits, specialized banks accounted for 75 percent, and banks registered as joint-stock companies accounted for 1 percent. The commercial banks differed from the other banks in terms of debt restructuring strategy, restructuring most of their debts through BCAs, which covered 50 percent of all loans requiring restructuring. In the other banks, BCAs accounted for only 25 percent of restructured loans.

Several factors may account for the greater use of BCAs by commercial banks. First, the commercial banks began forming specialist teams in the work-out departments in the first quarter of 1992, whereas other state-owned banks did so only later. Second, given their inability to manage enterprise relationships, the specialized banks may have found it difficult to cope with conciliation proceedings. Third, the specialized banks were reluctant to acknowledge losses, and may not have had funds to provision for bad loans. Under such circumstances these banks preferred solutions that provided quicker—albeit possibly less effective—restructuring results, including sale of debt and filing for liquidation or insolvency of a debtor.

Overall the number of conciliation agreements was not high; in terms of value, however, a large part of the banks' portfolio was involved in the conciliation proceedings. According to a survey

carried out by the Gdansk Institute for Market Economics (1995), the main reasons cited by banks for rejecting enterprise proposals for entering into BCAs were the lack of realistic recovery programs (because of outdated products, poor management teams, or lack of prospects), and nonfulfillment of legal conditions. The use of BCAs for larger debts may reflect the fact that the agreements required significant inputs from specialized staff; that BCAs had to be negotiated with a large number of enterprise debtors, and involved the participation of many other creditors; and that expert staff to handle loan restructuring, collaborate with external advisors, and assess enterprise recovery programs was scarce. Last but not least, political pressures may be another reason to explain why BCAs were used for larger debtors.

The law allowed many different kinds of settlements between creditors and borrowers under the BCA, including partial reduction of debt (capital and interest), rescheduling of payments, and conversion of debt into shares. Initially the designers of the program considered debt-equity swaps as the core of the conciliation agreements and one of the main instruments to promote privatization. Conversion of debt into shares was viewed as a promising method for providing banks with the possibility of taking control over enterprises under restructuring through their exercise of corporate governance. However, in most cases banks chose not to engage in debt-equity swaps: as of the end of 1994, the value of commercial bank debt converted to equity was only 2 percent of their total debt under restructuring.

Why were debt-equity swaps not used more widely? First, tax regulations discouraged debt-equity swaps. Second, banks were often not ready to assume additional responsibilities for which they lacked trained staff. Third, banks may have feared increased social and political risk following their takeover of enterprise management (fear of the enterprise work force making direct claims against the bank were justified). Fourth, the Ministry of Privatization was required by law to approve debt-equity swaps, and the process was often very slow. Finally, clear evidence of ownership rights, such as land titles, was often lacking.

In the case of non-viable companies considered unable to compete in the new environment, banks could file a motion to declare the failure of the borrower or offer the borrower's liabilities in the secondary market²¹. In accordance with the law, banks had to sell bank receivables by the end of March 1994, unless they instituted a conciliation agreement or requested and obtained a court declaration of bankruptcy of the borrower.²² The designers of the program intended debt sales in the secondary market to be an important vehicle by which the loan portfolios of banks could be cleared. However, the obligation to sell debts and the tight deadline established by the law and incorrect incentives prevented the sale of debt playing a larger role within the EBRP. Reasons behind such failure include wrong fiscal incentives (the losses on debt sales were not deductible while other forms of debt restructuring were deductible from income for tax purposes), a limited financial infrastructure to create active and deep secondary markets, and impediments

21 For a in depth analysis of formal exit processes (including court conciliations, liquidation, bankruptcy and debt sales) and their main weaknesses see Gray and Holle (1996b).

22 Two exceptions were introduced by the MOF for two specialized banks: PKO BP and PGZ were allowed to sell their receivables by the end of September 1994 and the end of December 1995 respectively.

faced by debt purchasers (the latter faced severe problems in debt collection, and they could not use the purchased debt to pay for good and services from the debtor without his consent).

5. How well did the program perform

Given that many enterprise restructuring exercises are still under progress it might be premature to draw definitive conclusions on the impact of the whole EBRP on the Polish economy. Particularly on the enterprise side, EBRP's impact can be assessed only in the medium-term and the evidence currently available might be insufficient for a final assessment. With this caveat in mind, we provide some very preliminary evidence by looking separately at its impact on the banking and the enterprise sectors.

Effects on the banking sector

The restructuring program implemented by banks in 1993-95 significantly contributed to the economic recovery and growth of the Polish economy (table 2). The program directly affected nearly PLZ 50 trillion of bank debts, and the total effect of the program on enterprises—through restructuring of debts, BCAs and other mechanisms—was many times greater. Moreover, restoring the creditworthiness of some of the largest enterprises has had positive spill-over effects on a large number of medium-size and small firms. Moreover, and most important, it should be considered what would have happened to the Polish economy in the absence of the EBRP and bank recapitalization.

Table 2: Macroeconomic indicators

	1991	1992	1993	1994	1995*
Real output (% change per annum)	-12	-8	-3	4.0	7.0
Private sector share of GDP	42.1	47.1	51.9	52.2	58.9
Inflation	60.0	44.0	38.0	30.0	23.0
Broad money/GDP (%)	31.7	35.8	35.9	36.7	36.4
Total bank assets/GDP (%)	55.0	57.0	59.0	57.50	56.1
Foreign direct investment (US\$ millions)	117.0	284.0	580.0	542.0	22.77

* Preliminary data

Source: World Bank (MultiQuery Database)

Some positive prima facie evidence on the banking sector is available. Poland experienced no major financial crisis during the period under examination and the comprehensiveness of the EBRP clearly contributed to maintaining depositors' confidence in the banking system.

Table 3: Banking sector indicators (1995)

Countries	M2/GDP %	Currency/M2 %	Number of employees in the financial sector*
Bulgaria	67.0	14	44,038
Czech Republic	87.4	10	31,360
Hungary	41.0	26	46,775
Poland	36.4	26	159,000
Romania	26.6	30	134,900
Slovak Republic	69.0	13	19,964

* 1994

Source: The World Bank (Multi Query Database), and central statistical offices

In Poland the level of monetization and financial deepening is still relatively low in comparison to other European economies (table 3), but some signs of improvement occurred in the most recent years. The ratio of M2 to GDP has risen from 32.3 in 1991 to almost 37 in 1995. The number of employees in the financial sector (excluding the insurance sector) rose from 120 thousand in 1991, to 159 thousand in 1994. The ratio of bank credit to GDP went slightly down during the period 1991-94 reflecting the very conservative behavior of banks in granting new credit. However, more recent figures show a different picture with credit to the economy growing at 14 percent in real term in 1995. Credit allocation by economic sector also presents a positive development; the share of bank credit to the private sector increased from 29.7 percent in 1991 to 36.6 per cent in 1995 (table 4).

Table 4: Credit allocation by sector (in percentage of total credit)

	1991	1992	1993	1994	1995
Net credit to general government	33.2	43.3	47.5	49.3	42.7
Claims on non-government	66.8	56.7	52.5	50.7	57.3
Enterprises	64.3	54.0	48.9	46.6	51.6
State-owned	37.1	26.8	22.5	20.4	20.7
Private	27.1	27.2	26.4	26.2	30.8
Households	2.6	2.7	3.6	4.1	5.7
Private sector	29.7	29.9	30.0	30.2	36.6
Public sector	70.3	70.1	70.0	69.8	63.4

Source: NBP

Positive aspects can also be found looking at the performance of the banking sector. The range of financial services provided by banks and competition within the sector have increased significantly. Before the reform program banks were highly specialized without significant

overlap in their activities. Now, they compete in collecting deposits, granting loans and providing financial services to the economy. Besides, first rate international banks entered the Polish market fostering competition, especially for good corporate clients. Clear improvement in bank performance also occurred recently. According to the Central Statistical Office (GUS), in 1995, the banking sector's net profits totaled almost PLZ 2.8 billion. The bank net profits to cost ratio amounted to 9.4 percent²³ (four times greater than in industry). Many banks reported ROEs in the range of 35-45 percent versus an inflation rate of 23 percent in 1995.

In the most recent period and especially over the last year, there is some evidence that banks are pricing their loans and deposits in a more competitive manner. At the beginning of the reform negative real interest rates were a common feature in the Polish banking sector. For instance, in 1992 the real interest rate of a six-month time deposit denominated in zloty was negative (-5 percent), but its real rate was around 0 percent in 1996 (table 5). A similar trend can be observed for the prime lending rate, which was negative in 1992 (-6.3 percent) and it is now low but positive (1.4).

In the first years of reform bank interest rate spreads were quite high by any method of calculation. The OECD estimated an interest spread for the whole banking sector of 7 and 9 percentage points in 1992 and 1993, respectively (OECD 1994). The Polish Bankers' Association estimated even higher spreads: at the end of 1993 bank interest spread amounted to 12.3 percentage points (figure 4). However, the situation has improved significantly during the last two years with spreads declining gradually and steadily. In 1995, bank interest rate spreads amounted to few percentage points not very different from what can be observed in other countries with more developed banking systems.

Table 5: Interest rates

	1992	1993	1994	1995	1996*
1) Prime lending rate (1 year)	39.0	35.0	31.0	24.0	22.8
2) T-bills (1 year)	45.9	38.3	26.3	25.0	20.9
3) Zl. deposits (6-month) compounded	40.2	31.7	30.5	23.5	21.3
4) CPI (12-month)	45.3	36.9	33.2	28.1	21.4
5) Real prime rate (1 - 4)	-6.3	-1.9	-2.2	-4.1	1.4
6) Real T-bill (2 - 4)	0.6	1.4	-6.9	-3.1	-0.5
7) Real deposit rate (3 - 4)	-5.1	-5.2	-2.7	-4.6	-0.1
8) Bank spreads (1 - 3)	-1.2	3.3	0.5	0.5	1.5
9) Prime lending T-bill spread (1 - 2)	-6.9	-3.3	4.7	-1.0	1.9

Compounded interest rates, annual percentages. * March. Source:IMF.

23 The ratios of state-owned, private and cooperative banks were equal to 10.5, 9.5 and 5.4 percent respectively. Foreign banks' ratio was even higher (12.4 percent).

Figure 4. Bank interest rate differentials

Source: Polish Bankers' Association

Another indicator of success in solving the bad debt problem is the fact that SOCBs' recapitalization has been carried out only once in Poland and additional bank recapitalization do not seem likely in the near future.²⁴ Based on the whole banking system balance sheet, the situation of distressed enterprises is improving. The number of firms facing financial troubles has dropped recently. For the whole banking system the total bank claims on distressed enterprises are equal to 14.9 percent of total credits (November 1995). As a result of their recapitalization, the banks have coped with the stock of nonperforming loans and dealt successfully with the flow of new credits. With one significant exception, the recapitalization was successful. The 1993 law enabled banks to write off part of their irrecoverable debts and to reduce the share of irregular loans in their portfolios. At the same time, government bonds improved the banks financial situation to the point where the recapitalization was actually excessive if measured by standard bank capital adequacy measures. Ex ante recapitalization was set at a level to ensure that banks could reach capital adequacy ratios of 12 percent: ex post some banks surpassed that ratio. Higher values among the commercial banks reflect the very conservative attitude of the banks toward new lending (which led to a higher share of government paper in the banks' portfolio).

The program also introduced tighter bank regulations and more effective bank supervision, improved the banks' monitoring and credit granting procedures within the context of comprehensive institutional development programs (implemented with the assistance of Western twin banks),²⁵ and provided banks with tools with which to prevent the recurrence of the bad loan problem. The establishment of work out programs was essential in preventing the emergence of new bad debts through the improvement of credit procedures and risk management.

²⁴ This was not the case in other transition economies. For instance, in Bulgaria banks were recapitalized in 1993, but now two thirds of the Bulgarian banks are insolvent. Multiple bank recapitalizations have also taken place in Hungary.

²⁵ On this topic, see our forthcoming paper on the bank twinning experience in Poland.

The success of the recapitalization and reorganization of banks allowed Poland to move ahead with bank privatization. Although the original target of privatizing the nine commercial banks within a relatively short period of time was revealed to have been too ambitious, four of the nine banks have been privatized.

Effects on enterprises

The EBRP had two main channels to exercise a positive influence on the enterprise sector. The first channel was designed to directly affect firm performance through the restructuring programs which were part of the conciliation agreements. These programs aimed at improving the financial condition of debtors and promoting the implementation of internal changes within enterprises. These programs, often prepared for large enterprises by external consultants and financed by donors, provided the enterprise management with a complete diagnosis of the enterprise condition, and allowed management to work with experienced analysts and advisors to learn how to conduct analytical studies and prepare recovery programs that included forecasts of sales and costs, restructuring plans, establishment of sales and marketing units, and implementation of new production methods and technologies. The second channel was directed towards banks which were supposed to start to exercise enterprise governance, stop granting loans to non-viable enterprises and improve credit allocation.

However despite this positive framework that should have improved enterprise performance, the empirical evidence is not very clear and results are still mixed. Generally speaking, the program has been successful in selecting and keeping alive the best Polish enterprises while the worst were pushed toward exit. Pinto and van Wijnbergen (1995) found evidence corroborating the positive role of banks in exercising enterprise governance. Using econometric analysis and direct survey questions they support the view that after the reform, banks had future profitability in mind in granting new funds to the enterprise sector. Similarly, it has been shown that enterprises entering BCAs were on average more profitable and also had more employees than enterprises entering liquidation or bankruptcy (Gray and Holle 1996b). According to the Gdansk Institute of Market Economics (1996) some enterprises regained their development abilities and became robust borrowers from banks repaying their obligations according to the agreed timetable. In other cases, however, debt restructuring proved to be insufficient, and some enterprises failed to implement the recovery programs. Many enterprises that entered into BCAs received one time extraordinary gains as a result of debt forgiveness. Improvements in their financial results thus cannot be interpreted as proof of permanent improvement. There is also some evidence that some borrowers involved in the EBRP incurred significant increases in liabilities (Gray and Holle 1996a). The budget constraint imposed on enterprises by the restructuring program was relaxed by lax enforcement of taxes and social insurance contributions. In a situation in which firms can use tax and social security payments as alternative sources of finance, bank debt is replaced by government debt, and the impetus to restructure diminishes²⁶. In addition, some firms appear to have received new loans from other banks to pay off old debts of their main bank. Gray and Holle (1996a) also found that on average there was no improvement in firm profitability during

26 Pinto and van Wijnbergen (1995) stated that the damage caused by tax arrears through softening the budget constraint was in fact limited given that they could not exceed tax liabilities.

the first year after the conclusion of the BCAs. In the same enterprise sample, employment declined slowly and average wages rose; domestic sales increased slightly but exports did not increase.²⁷

The direct effect of the EBRP on the privatization of enterprises was weak. The program envisaged two main mechanisms for promoting privatization. The first mechanism, stipulated in section IV of the law, was based on a debt-equity swap; the second mechanism for facilitating privatization was linked to the bank conciliation proceedings. These two mechanisms have produced very different results. As of December 1994, no bank had taken advantage of the first mechanism possibly because of unclear and cumbersome procedures, fiscal disincentives, and difficulties imposed by the Ministry of Privatization. Privatization through conciliation agreements has been more successful. By December 1994 banks had used the BCAs to change ownership of 84 enterprises with debt-equity conversions used in 66 of the agreements. Some banks created investment funds to manage the restructured assets, others looked for strategic investors. Such investors, including two foreign investors, were found for only 8 enterprises. Moreover, in some cases following the implementation of agreements new owners were state-owned and therefore the real impact on privatization was even weaker. Overall, it appears that opportunities for privatization offered by the law have not been fully exploited, and that the quantitative relevance of the privatization has "so far had only a symbolic character" (Gdansk Institute for Market Economics 1995, p. 42).

As far as the impact of the program on the financial position of non-bank creditors is concerned, information is scarce. According to the law all creditors had to accept the terms of the BCAs. Nonbank creditors often questioned the terms of the agreements, arguing that their financial position would be hurt by the drastic reduction in the value of receivables. A very crude manner of assessing the financial position of economic agents is to look at payment holdups, for which some comprehensive statistics are published by GUS. In 1992 and 1993, holdups oscillated around 32 percent of total liabilities. By the end of 1994, that figure had declined to 27.9 percent, suggesting that the restructuring program had not induced additional payment holdups by damaging the creditors' solvency.

An area of concern within the enterprise sector regards the situation of those enterprises which were classified as special cases due to political and social considerations. No empirical evidence is available to assess the results of these restructuring programs run by a governmental agency (IDA). However, there is some evidence of significant interest rate subsidies granted and a non-transparent process of granting financial support.

The financial situation of small and medium-size enterprises (SMEs) is also of concern. The EBRP did not provide suitable instruments for SMEs. The threshold levels of debt to initiate a BCA were too high for most SMEs. SMEs were often excluded from the BCA program on the grounds that their financial condition was good. In fact, the lack of bank debt of most SMEs reflected their greater reliance on "inter-enterprise credit and tax arrears as external sources of finance to survive

27 In this study, performance measures of the enterprise sample (62 enterprises) are absolute indicators. They have not been compared with similar Polish enterprises which did not enter BCAs.

the worst periods of illiquidity during the transition" (Belka 1991). Moreover, BCAs were so costly and time consuming that banks applied them only in the case of large enterprises. Exclusion from the BCA program, the traditional shortage of credit for SMEs, inadequate record keeping of past performance, which makes bank assessment of viability difficult, unclear property rights over land or assets (which would be used as collateral) have all constrained SMEs' access to credit in Poland.

6. Concluding remarks and lessons from the Polish experience

The main objective of the EBRP was the institutional strengthening and privatization of banks and SOEs. Problems in the area of enterprise and bank restructuring were tackled through very innovative, pro tempore legislation which linked bank recapitalization to improvements in their operating procedures in order to increase efficiency and loan recovery. The approach stimulated the banks in playing a central role in enterprise restructuring and provided enterprises with new opportunities to succeed in their reorganization efforts. The main tool to implement such a program was the Law on Financial Restructuring of Enterprises and Banks.

All in all, the assessment of EBRP is positive. The decentralized approach in dealing with banks' bad loans represented a path-breaking solution and, apparently, it has been very effective in assisting the rapid recovery and transformation of the Polish economy. The whole program has been implemented without fraud or corruption (Gray and Holle 1996b), highly appreciated by the government and other participants, and has been increasingly emulated elsewhere.

Thanks to the program, many steps towards modernizing the Polish banking system have been taken and significant support from international donors has been mobilized. The structure of the banking sector resembles now that of a modern market economy. Some main regional banks have been privatized, the commercial banks participating in the program have a capital base more than adequate, problem loans are fully provisioned, workouts actively pursued, and most of management is considered progressive and market oriented. Competition within the banking system is increasing and the sector (with the exception of the specialized banks) seems relatively efficient and profitable. Interest rate spreads have declined and the menu of financial services has increased. Last but not least, the EBRP has contributed to provide banks, mainly through the experience of the work-out departments, with key banking skills to better implement their allocative and monitoring functions and a new awareness of the risks involved in the intermediation business.

On the enterprise side it is perhaps too early to assess the final results of the restructuring program. Some positive results are the central role for banks in enterprise governance, maintaining incentives to avoid unloading additional debts into the Government, resolving conflicts among creditors without triggering unnecessary liquidation, and avoiding excessive use of bankruptcy procedures and liquidation. However, it is not clear yet whether enterprises have been put on a permanently healthy and viable path or whether a second wave of bad loans could emerge in the near future, especially if the upward business cycle were to be reversed.

Poland's experience may provide lessons for other countries. The Polish program was quite successful because it was very comprehensive. It tackled at the same time the banking and the enterprise sector, dealing both with the bad debt stock problem and the associated flow problem. In addition, it made assistance related to the former contingent on concrete action with the latter and included the prospect of privatization or liquidation. As a matter of fact, Polish banks not only were recapitalized to get rid of previous bad loans, but were also equipped to improve their credit assessment and risk control systems. The lesson here is that solving the stock problem through bank recapitalization is necessary, but not sufficient. Rather, bank recapitalizations without any measures to improve bank skills and to provide sound incentives is likely to fail. The Polish experience seems to show that pursuing debt workouts and forcing banks to have proper loan-loss provisions, high capital asset ratios, strong governance and ultimate privatization in a competitive banking environment can do much to prevent banks from having future stock problems. The EBRP was also realistic in isolating "too important to fail" cases subjecting enterprises to special and (hopefully) temporary budgetary support giving political viability and transparency to the program.

The decentralized approach pioneered in Poland seems to have some advantages over the centralized one; however, its actual success requires bank recapitalizations to be carried out at the right time, namely, when all the other prerequisites to sustain responsible bank behavior are in force. The EBRP was carefully sequenced; bank recapitalization occurred at the right time when progress in other areas was quite advanced. In this respect, Poland made a concerted efforts in setting up a modern bank supervision function, adopted preliminary measures toward privatization and the Polish government had a strong commitment to structural adjustment. Work out units were put in place when management and ownership were really interested in changing practices within banks.

Finally, bank privatization is a complex issue which cannot be seen in isolation of the capacity of local investors and capital markets to absorb the new issues of bank shares. The Polish experience shows that the privatization of a relevant part of the banking sector takes years to accomplish. Therefore extensive bank privatization has to be considered an appropriate objective only in the medium run, but it must be absolutely credible to ensure the creation of a right incentive structure. To some extent enterprise privatization within the EBRP has not been fully successful so far. The privatization process of restructured enterprises proceeds at a much slower pace than anticipated and a few enterprises have been privatized as a direct result of the EBRP. The lesson here is that to speed up privatization, regulation has to minimize the number of public entities involved in the decision making process. Moreover, banks should be stimulated to intensify activities aimed at the conversion of receivables of restructured entities into shares first, and then sell them. In any case banks should be the main shareholders of their borrowers only during the transition. Finally, more needs to be done in understanding, enforcing harder budget constraints and living with the consequences (either through enterprise liquidation, downsizing, and privatization) for those enterprises under the Industrial Development Agency's purview.

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ANNEX: The Law of February 3, 1993 on Financial Restructuring of Enterprises and Banks²⁸

CHAPTER 1

GENERAL PROVISIONS

Article 1

1. The law regulates:

- 1) banking conciliatory proceedings,
- 2) public sale of banking receivable (claims),
- 3) acquisition of shares of sole shareholder Treasury companies for receivable,
- 4) transfer of resources to increase own funds of state owned banks and banks - joint stock companies in which the Treasury holds more than 50% of stock.

Article 2

The rights and obligations of a bank as determined in chapters 2 and 3 are exercised by every bank.

Article 3

The rights and obligations of a bank as determined in chapters 2 and 3 are also exercised by the Industrial Development Agency S. A. (Inc.)

Article 4

Whenever this act mentions:

- 1) companies - these should be understood to be joint stock companies and limited liability companies,
- 2) shares or stocks - these should be understood to be stocks in a joint stock company or shares in a limited liability company,
- 3) statutes - these should be understood to be charters of joint stock companies or agreements or deeds of association of limited liability companies,
- 4) net book value - this should be understood in case of a company the total of own capitals corrected by the financial result and in case of a state owned enterprise the total of own funds corrected by the financial results.

²⁸ *Unofficial, unedited translation*

CHAPTER 2

BANKING CONCILIATORY PROCEEDINGS

Article 5

1. On application of a debtor who has ceased to repay a debt to the bank, or will not be able to repay the debt in the future - the bank, with the reservation of article 7 and 8 and article 37, may institute banking conciliatory proceedings for the purpose of leading to a settlement between the debtor and the creditors.

Article 6

The banking conciliatory proceedings may pertain to:

- 1) exclusively a debtor which is a state enterprise, sole shareholder Treasury company or company whose shares being the property of the Treasury, state enterprises, and sole shareholder Treasury companies, constitute in total more than 50%.
 - 2) the Treasury Agricultural Property Agency covering in part its obligations taken over, in accordance with separate regulations on management of Treasury agricultural property, from liquidated state agrobusiness enterprises.
2. Should the Treasury Agricultural Property Agency be the debtor then subject to the banking conciliatory proceedings are receivable (claims) vis a vis individual, liquidated and taken over by the Agency state agrobusiness enterprises.

Article 7

1. The bank may institute conciliatory proceedings individually or in the name and upon consent of a group of banks, when

- 1) the receivable of the bank or a group of banks from the debtor are at least 10% of the general amount of debtor's liabilities, however the value of the bank's receivable shall not be less than one billion zł, or
 - 2) the receivable of the bank or a group of banks are not less than 20% of all debtor's liabilities.
2. If the Treasury's Agricultural Property Agency is the debtor then receivable mentioned in para. 1 are established on the basis of the protocol of transfer and receipt of assets, receivable and commitments of a liquidated agrobusiness enterprises, the protocol being made by the founding organ of such enterprise and the Agency.
3. The general amount of a debtor's commitments, mentioned in para. 1, is understood, reserving para. 4, to be the amount ensuring from the balance amount of a current balance sheet, made at the end of the quarter which precedes the day of filing the application, less:
- 1) capital funds - in case of a company
 - 2) own funds - in case of a state-owned enterprise.

Article 8

The bank appropriate to institute conciliatory proceedings is:

- 1) the bank whose value of receivable from the debtor is the highest from all banking receivable,
- 2) another bank which is a creditor, if the bank mentioned in point 1, has not instituted banking conciliatory proceedings within the time limit of 30 days as from the date of filing by the debtor application to institute proceedings, and in case defined in art 10 para. 1, within the time limit of 30 days as of presentation or supplementation by the debtor of a programme to improve management.

Article 9

1. The following should be attached by the debtor to the application to institute banking conciliatory proceedings:

- 1) conciliatory proposals, in particular such as refer to the debtor's management improvement, reserving para. 3 and 4,
- 2) balance sheet with a profit and loss account,
- 3) extract from the register,
- 4) list of creditors, including foreign ones, with first names, surnames or firms and addresses, as well as the indication of receivable and the deadlines for their payment secured by a collateral or mortgage,
- 5) list of granted guarantees,
- 6) list of executory titles against the debtor,
- 7) list of persons and firms liable vis a vis the debtor with indication of their liabilities and deadlines for their payment.
- 8) proposals for deductions according to principals mentioned in article 13.

2. The provisions of para. 1 shall be appropriately applied, if the subject to banking conciliatory proceedings are receivable mentioned in article 6, para. 2, however:

- 1) in the place of an extract from the register the debtor attaches the decision of the founding organ on the liquidation of a state agrobusiness enterprise,
- 2) data determined in point 2 and 4 - 7 relate to the liquidated enterprise.

3. If the debtor is state owned agrobusiness enterprise, then the conciliatory proposals taking into account the programme of developing the estate after the taking over by the Treasury Agricultural Property Agency, require the consent of the Agency.

4. If the debtor is the Treasury Agricultural Property Agency, then the conciliatory proposals take into account the programme of developing the estate of taken over from a liquidated state agrobusiness enterprise.

Article 10

1. The bank may condition the instituting or conducting of banking conciliatory proceedings on submission or supplementing of the program for repairing the management of the debtor or a programme of estate development, mentioned in article 9 para 3 and 4, assigning the latter for this activity a time limit not shorter than 30 days,
2. If the debt is a state-owned enterprise, the bank conditions instituting of conciliatory proceedings on submitting an application by the debtor to
 - 1) the Minister of Ownership Changes for the enterprise to be converted into a sole shareholder Treasury company in the procedure of the act of 13th July 1990 on privatization of state-owned enterprises (Dz. U No. 51 item 298, of 1991 No. 60, item 253 and No. 111, item 480) or
 - 2) the founding organ in order to contribute the enterprise or organized parts of estate of the enterprise to a company in the mode of article 37 para. 1 point 2 of the act on privatization of state owned enterprises,
3. The provisions of para. 2 do not apply to state owned enterprises who privatization requires consent of the Council of Ministers on the basis of separate provisions, unless the Council of Ministers gives consent to privatization. They do not apply to state agrobusiness enterprises either.

Article 11

1. Banking conciliatory proceedings, reserving article 12, cover all receivable, excluding the following receivable:
 - 1) from social insurance,
 - 2) from the employment relationship,
 - 3) from an agreement for a pension or an annuity,
 - 4) secured by a gage (lien), with the exception of gages established later than 30 days before lodging an application to institute banking conciliatory proceedings and to statutory liens within the meaning of the act of 19th December 1980 on tax obligations (Dz. U. No. 27 item 111, of 1982 No. 45, item 289, or 1984 No. 52, item 268, of 1985 No. 12, item 50, of 1988 No. 41, item 325, of 1989 No. 4, item 4, item 23, No. 33, item 176, No. 35, item 192 and No. 74, item 443, of 1990 No. 34, item 198, of 1991 No. 100, item 442 and No. 110, item 475 and of 1992 No. 21 item 86 and No. 53, item 251),
 - 5) secured by a mortgage, with the exception of mortgages established later than 30 days before placing an application to institute banking conciliatory proceedings and compulsory mortgages and statutory mortgages within the meaning of the banking law of 31st January 1989 (Dz. U of 1992 No. 72, item 359),
 - 6) stemming from the fact that the debtor is obliged in virtue of being a tax collector within the meaning of law of 26th July 1991 on personal income tax (Dz. U No. 80 item 350 and No. 100 item 442 and of 1992 No. 21, item 86) to collect advance payments for the personal income tax.

Article 12

1. Receivable secured by gage or mortgage excluded on the basis of Article 11 points 4 and 5 may be covered by the banking conciliatory proceedings only with the consent of the creditors.
2. If the receivable has not been embraced by a banking settlement because of there being no consent of the creditor as referred to in para. 1, after the settlement becomes legally valid the debtor may transfer upon the creditor, with the effect of complete satisfaction of the creditor as to receivable secured by mortgage or gage, the ownership of objects burdened with the gage or mortgage which have not been covered with the banking settlement.
3. Embracing under a settlement receivable secured by a gage or mortgage does not cause expiration of the gage or mortgage until the end of conciliatory proceedings in the mode as specified in article 35.

Article 13

In banking conciliatory proceedings, before the conclusion of a banking settlement, there takes place a deduction of liabilities and commitments of the debtor vis a vis the Treasury and budget units upon the principles as set in article 128 of the act on tax liabilities and mutual of the debt and creditors covered by the banking conciliatory proceedings - upon the principles provided in article 498 - 508 of the Civil Code.

Article 14

1. The bank announced the instituting of banking conciliatory proceedings in at least one daily with an all-Poland circulation and by placing announcements in the seat of the bank and its branches, and also in the seat of the debtor.
2. Banking conciliatory proceedings are considered instituted as of the first day of the press announcement mentioned in para. 1.
3. the bank notifies separately of institution of banking conciliatory proceedings:
 - 1) all creditors mentioned in article 9 point 4,
 - 2) appropriate tax bodies,
 - 3) Minister of Ownership Changes,
4. To the notification of creditors whose receivable are secured by a gage or a mortgage, the bank attaches a request for consent to bring their receivable under banking conciliatory proceedings. No response within 21 days from the date the notification is received signifies refusal to participate in conciliatory proceedings concerning a receivable covered by a gage or mortgage.

Article 15

The bank which directs the course of conciliatory proceedings, defines the detailed mode of procedure and the deadlines for carrying out actions embraced by the proceedings, and supervises the execution of the banking conciliation.

Article 16

1. Banking conciliation proceedings lead to a conclusion of a banking settlement which covers:
 - 1) commitment on the part of the debtor to undertake specific actions aimed at repairing his or her enterprise and in case the debtor is the Treasury Agricultural Property Agency to implement the programme of developing the estate remaining after the liquidated state agrobusiness enterprise,
 - 2) commitment on the part of the creditors to undertake actions for the purpose of facilitating implementation of the debtor's management improvement programme,
 - 3) definition of principles of converting debt into shares, if such conversion (swap) is provided in the settlement,
 - 4) definition of the mode of covering the costs incurred in connection with banking conciliatory proceedings; The Treasury is exempt from the duty of bearing the costs,
 - 5) definition of the mode of satisfaction of receivable covered by the banking settlement after the settlement's becoming effective.

2. The actions mentioned in para. 1 point 2 may consist in debt restructuring and making it easy for the debtor to raise new financial means, in particular in:
 - 1) setting off the terms of payments,
 - 2) lowering the interest on receivable,
 - 3) forbearing the account of interest within a specified time frame on the total or part of receivable,
 - 4) transitional capitalization of interest due,
 - 5) spreading of principal and interest installments over time,
 - 6) conversion of part of total receivable to shares,
 - 7) writing off part or total of receivable, including the interest.
 - 8) granting the debtor new loans, credits or credit guaranties.

3. The decisions in order to secure the execution of the banking settlement and control over its implementation may consist in:
 - 1) setting up of a Board of Creditors to control the execution of the provisions of a banking settlement; it shall include a representative of the Ministry of Finance, if Treasury receivables are covered by a banking settlement,
 - 2) transferring to an indicated creditor, for a specified time, the voting rights on shares, should creditors consider it necessary, through the establishment of an appropriate power of attorney.
 - 3) commitment of a shareholder of the company to dispose of shares and encumber shares with a right of lien on behalf of the creditors.

- 4) the rights of persons who are members of the Debtors Board mentioned in para. 3 point 1 concerning the receivable which they are entitled due to performing of such functions are defined in the Deed of Association.

Article 17

1. If the debtor is a state owned enterprise

- 1) The Minister of Ownership Changes shall transform the enterprise in a sole shareholder Treasury Company within the mode and upon principles of the provisions of the state owned enterprises privatization act, within 30 days from the day of signing the agreement at the latest,
- 2) The Minister of Ownership Changes shall express consent to contributing the enterprise or of organized parts of its property to a company within the mode of article 37 para 1 point 2 of the act on privatizing state owned enterprises and express consent to converting receivable into shares in the company according to principles mentioned in article 16 para. 1 point 3, within 30 days from signing the settlement.

2. The provisions of para. 1 do not apply, if:

- 1) the transformation of the enterprise within the mode and upon provisions of the state enterprises privatization act, or
- 2) liquidation of the enterprise within the mode as set in article 37 para. 1 point 2 of the law on state enterprises privatization act,

- is not a condition contained in the settlement.

3. The provisions of para. 1 do not apply to state owned enterprises whose privatization requires consent of the Council of Ministers on the basis of separate regulations, unless the Council of Ministers expresses consent to privatization. Neither do they apply to state agrobusiness enterprises.

4. As of the moment of transforming by the Minister of Ownership Changes a state owned enterprise into a sole shareholder Treasury Company or contributing the enterprise or organized parts of its property to a company in the mode of article 37 para. 1 point 2 of the state enterprise privatization act - this company shall become a party in the banking conciliatory proceedings as a debtor.

5. As of the day of taking a decision on liquidation of a state agrobusiness enterprise in order to transfer the assets of this enterprise to the Treasury Agricultural Property Agency - the Agency becomes part in the banking conciliatory proceedings.

Article 18

1. The banking settlement should take into account the interest of creditors on non-harming conditions.

2. The banking settlement may envisage the granting of privileged terms to creditors who have petty receivable.

Article 19

1. The tax organs shall make changes in tax liabilities of the debtor ensuring from the concluded banking settlement.

2. The Minister of Finance by way of an order shall set the mode of proceedings in which tax organs shall make changes in the tax liabilities of the debtor which ensue from the banking settlement concluded.

Article 20

1. The conclusion of a settlement shall take place in a case when a settlement defining the manner of executing all receivable embraced by the conciliatory proceedings is accepted by the debtor and creditors owning more than 50% of the receivable embraced by the proceedings including the bank conducting the banking conciliatory proceedings.

2. The settlement mentioned in para. 1 is binding for all creditors, reserving article 11 and article 12 para. 2.

3. A banking settlement should be concluded in writing on pain of invalidity.

4. A settlement embracing receivable of the Treasury shall be signed on behalf of the Treasury by the Minister of Finance or a person authorized by him.

5. A settlement concluded upon conditions set in article 17 para. 1 shall be signed on behalf of the Treasury the Minister of Ownership or a person authorized by him.

6. A representative of the Minister of Finance, mentioned in para. 14 may not sign the settlement only if the receivable of the Treasury have been treated in a manner harmful in relation to other receivable, reserving article 18 para. 2.

7. The regulations of the act on privatization of state-owned enterprises do not apply to disposing of and encumbering shares of the Treasury within the framework of the execution of a banking settlement.

Article 21

1. The bank informs publicly about concluding a banking settlement in the manner defined in Article 14 para. 1, indicating the place where the creditors can become familiar with its terms.

2. The bank separately and immediately notified on the conclusion of a banking settlement:

- 1) all creditors mentioned in article 9, point 4
- 2) appropriate tax organs,
- 3) Minister of Ownership Changes.,

Article 22

1. A creditor who has not signed the banking settlement and whose receivable have been embraced by the settlement, may file an objection against the settlement within 30 days from the publication, in accordance with article 21, of the information on concluding the banking settlement.
2. An objection together with justification shall be submitted through the mediation of a bank mentioned in article 15 in written form to the district court - department of economy, appropriate for the seat of the debtor.
3. Upon request of the court with which objection has been filed in accordance with article 2 the bank shall immediately transfer full documentation of banking conciliatory proceedings.

Article 23

1. In judicial proceedings, cases within the scope of banking conciliatory proceedings shall be examined on the basis of the regulations of volume two of the Code of Civil Procedure - non-litigious proceedings, with a consideration of the regulations of this chapter.
2. The applicant shall pay a fixed fee.
3. The Minister of Justice shall set by way of an order the amount of fee paid on the objection.

Article 24

1. The court shall dismiss the objection, if the concluded banking settlement does not breach the provisions of the law; otherwise, it shall repeal the banking settlement and discontinue conciliation proceedings.
2. The court ruling requires justification.
3. There lays no appeal against the court ruling.

Article 25

- A settlement is legally valid if within the time limit defined in Article 22 par. 1 no objection has been filed against the settlement, or if the court has ruled to dismiss the objection.
2. The bank announces the validation of the settlement in the manner defined in Article 14, par. 1.
 3. Following validation, the settlement is binding for all the creditors whose receivable have been embraced by the settlement.

Article 26

1. A banking settlement is a writ of execution in the understanding of the regulations of the Code of Civil Proceedings and within the meaning of the Act of 17th June 1966 on Executory

Proceedings in Administration (Dz. U. of 1991 No. 36, item 161 and of 1992 No. 20 item 78), reserving article 19.

2. Upon demand of a person entitled the bank shall issue an extract from the settlement with an assurance on its legitimacy collecting in consideration of such operation a fee in accordance with the table of chancellery fees in civil cases.

3. Each of those entitled on the grounds of the banking settlement, in case it is not satisfied by the debtor, may apply to the district court - department of economy appropriate for the seat of the debtor for issue of a feasibility clause to the writ of execution.

3. The provision of para 3 does not breach the regulations on executions.

Article 27

1. If debtor does not carry out the commitments ensuing from the banking settlement, the bank, on its own initiative or upon application of another creditor, mentioned in para. 2.

- 1) shall move to a regional court - economic court, appropriate for the seat of the debtor, for the dissolution of the banking settlement, or
- 2) shall satisfy out of own means the creditor harmed by the non-execution of the banking settlement by the debtor.

Article 28

The provisions of article 23 par. 2 and article 24 para 2 and 3 shall apply to court proceedings concerning the dissolution of a banking settlement.

Article 29

The court shall dismiss an application, if the debtor executes commitments ensuing from the banking settlement; otherwise the banking settlement shall be dissolved.

Article 30

On the dissolution of a banking settlement by the court the bank makes an announcement in the way determined in article 14, para. 1.

Article 31

1. A dissolution of the settlement by a court may take place not later than within three years from the date of its becoming legally valid.

2. In the period referred to in par 1, the running of the time limits of the commitments embraced by banking conciliatory proceedings is suspended.

Article 32

In the case of dissolution of the banking settlement by a court:

- 1) the debtor's actions carried out on the grounds of the settlement remains in force, and the paid out or executed sums are not subject to reimbursement,
- 2) the creditors retain the right to the part of the receivable existing before the conclusion of the settlement and not repaid by the debtor.
- 3) banking conciliatory proceedings cannot be instituted anew vis a vis the same debtor unless subject to banking conciliatory proceedings are to be receivable vis a vis a different state agrobusiness enterprise, liquidated and taken over by the Agency than the enterprise whose receivable have been covered by the banking settlement.

Article 33

If the debtor has already granted some creditors bigger benefits than envisaged in the settlement, every creditor as of 2 days from coming of this agreement into force may sue the debtor and creditor who has obtained undue benefit jointly and severally to pay the amount by which the receivable of the user has been diminished in the settlement. The creditor who has achieved undue benefit is liable exclusively up to the amount of such benefit.

Article 34

1. As of the day of instituting the conciliatory proceedings up to their termination, coming of the settlement into effect, repealing of the banking settlement by a court:
 - 1) conciliatory and bankruptcy proceedings under way shall be suspended,
 - 2) no repayment of receivable subject to banking conciliatory proceedings can be made,
 - 3) no execution of receivable subject to banking conciliatory proceedings can be instituted or further pursued against the debtor, execution proceedings instituted earlier are subject to suspension,
 - 4) no mortgages or gages can be established.
2. After the coming of the settlement into effect the suspended settlement, bankruptcy and executory proceedings with respect to receivable covered by the settlement shall be discontinued, and writs of execution issued during such proceedings shall be made ineffective.

Article 35

1. The bank shall discontinue banking conciliatory proceedings, if within the time limit of 4 months as from the instituting of banking conciliatory proceedings there is no conclusion of a banking settlement.
2. If the banking conciliatory proceedings have been instituted vis a vis a state-owned enterprise, the time limit mentioned in para. 1 is 6 months.
3. The bank announces the termination of banking conciliatory proceedings in the manner defined in Article 14 para. 1.

Article 36

1. Having ascertained that all liabilities following from the settlement have been executed the bank conducting banking conciliatory proceedings upon application of the debtor considers banking proceedings closed.
2. The termination of banking conciliatory proceedings is announced by the bank in the mode set in rt. 14 para. 1.

Article 37

Banking conciliatory proceedings cannot be instituted upon the lapse of 3 years after the coming into force of this act.

CHAPTER 3**PUBLIC SALE OF BANK RECEIVABLE****Article 39**

The matured banking receivable are disposed of:

- 1) by way of a bidding,
- 2) on the basis of a publicly announced offer,
- 3) as a result of negotiations entered into the basis of a public invitation.

Article 40

1. Concerning the intention of selling the matured receivable, the bank makes a public announcement in the mode as determined in article 14, para. 1.
2. Not later than 14 days before the public announcement, mentioned in para. 1, the bank notifies the following:
 - 1) the debtor,
 - 2) subjects who granted security for the repayment of the bank's receivable,
 - 3) if the debtor is a company in which shares are held by the Treasury - organ of state administration representing the Treasury.
 - 4) if the debtor is a state-owned enterprise - its founding body and the Minister of Ownership Changes.

The provisions of the Civil Code on the change of the creditor apply to the transfer of receivable, mentioned in article 40, with the following exceptions:

- 1) in no case the consent of the debtor is required,

- 2) transfer cannot be made for the sake of the debtor or entity associated with the debtor by the relationship of dependence or domination within the meaning of the Act of 22nd March 1991 on Public Trading in Securities and Trust Funds (Dz. U. No. 35, item 155 and No. 103, item 447).

Article 42

During the public sale of matured banking receivable no provisions of the banking law concerning the observance of the secrecy of turnovers and state of banking accounts are applied with respect to receivable put up for sale.

CHAPTER 4

THE PURCHASE OF SHARES OF SOLE SHAREHOLDER TREASURY COMPANIES FOR RECEIVABLES

Article 43

1. Creditors owning at least 30% of the matured commitments of a state-owned enterprise or a sole shareholder Treasury company may institute proceedings to exchanging the receivable for shares upon the principles defined in this chapter.
2. The condition for exchanging the receivable for shares is the commencement of the debtor's liability before the 30th of June 1992.
3. The condition referred to in para. 2 does not apply to receivable acquired by the procedure provided in chapter 3.

Article 44

In order to convert receivable into shares, the creditors mentioned in article 43 para. 1 shall submit to the enterprise or sole shareholder Treasury company and to the Minister of Ownership Changes, or, respectively, another state administration agency representing the Treasury in that company, an application containing a list of the mature receivable.

Article 45

1. If within one month from the date of filing the application mentioned in article 22 para. 1, the matured receivable included in the list are not satisfied, the Minister of Ownership Changes or another organ of state administration representing the Treasury in the company shall:
 - 1) publicly announce, in the procedure defined in Article 14 para. 1, of the intention of converting the receivable into shares, or
 - 2) submit to the Commission of Securities, through the mediation of a subject who runs a broker's company, an application for consent to introduce for public dealings shares of a sole shareholder Treasury company in order to convert receivable into shares.

2. If the debtor is a state-owned enterprise, before performing actions mentioned in para. 1., the minister of Ownership Changes shall conduct the transformation of the state-owned enterprise into a sole shareholder Treasury company.

Article 46

1. The public announcement mentioned in article 45 para. 1 point 1 has to additionally contain the balance sheet and the profit and loss account of the debtor, defined the manner and time limit of purchasing the shares not longer than 3 months from the lapse of the term mentioned in article 45 para. 1 as well as invitation to all creditors to purchase shares.

2. The Minister of Ownership Changes, or another state administration body which is the representative of the Treasury in the company, draws up a list of creditors who have expressed readiness to convert their receivable into shares and performs a conversion of the debt into shares of such company.

Article 47

1. Application mentioned in article 45 para. 1, point 2, should contain:

- 1) name (of the firm) and the seat of the issuer,
- 2) basic particulars on the issue relating the kind of issued paper, size and value of issue, intended time of launching shares for dealings.

2. To the application there should be attached an extract of the statutes, information on members of the company board and verified balance sheet and profit and loss account for the period ending no earlier than six months before the day of filing the application.

3. In case the conditions as determined in para. 1 and 2 are met the Commission of Securities expresses consent, mentioned in article 45 para. 1 point 2, within the time-frame of 14 days from the date of filing the application.

4. Having obtained the consent of the Commission of Securities the Minister of Ownership Changes or other organ of state administration representing the Treasury announces, in the mode determined in article 14 para. 1, the intention of converting receivable into shares.

5. The public announcement, mentioned in para. 4, should additionally contain a verified balance sheet, and a profit and loss account of the debtor, define the mode and time-limit of purchasing shares and the time-limit for submitting proposals of converting receivable into shares, not longer though than 3 months from the lapse of the term mentioned in article 45, para. 1.

Article 48

1. The provisions of Article 5 of the State Enterprises Privatization Act do not apply to a conversion of a state-owned enterprise into a sole shareholder Treasury company which is mentioned in Article 45, para 2.

2. The provisions of article 29 of the state enterprises privatization act do not apply to instances of purchasing shares for receivable.

Article 49

From the moment of converting the receivable into shares, the liability of the debtor relating to such receivable expires.

Article 50

1. When converting receivable into shares, if the parties do not establish the terms of converting the receivable to shares within the time-limit of 30 days from submitting the proposals of such converting receivable into shares, as set in article 46 par 1 and in article 47 para. 5, the owner of the receivable is entitled to file a claim, reserving article 51 para. 1, to the Treasury, as the owner of the shares, to convert the receivable into shares in accordance with the following principles:

- 1) if the net book value of the company is not negative, the creditor in exchange for a receivable takes over the share in the company capital in the proportion equal to the quotient of the receivable value into the book assets of the company, less the debts of the company, which have not been converted to shares.
- 2) if the net book value of the enterprise is negative, the receivable is subject to conversion into shares in part of the capital of the company in the proportion equal to the quotient of the value of the receivable into the total value of the company's commitments on the day of making out the balance sheet.

2. The net book value of the company is established on the basis of:

- 1) the balance sheet drawn up by the company and verified by a certified accountant, by the end of a month following the month in which the application was submitted,
- 2) the opening balance of the sole shareholder Treasury company in the case defined in article 45, para. 2.

3. The buyer of the shares may, at his own cost, entrust the establishment of the net book value of the company to persons authorized to investigate balance sheets and selected by himself.

4. The provision of para. 1 do not exclude the limitations in the trading in shares reserved in other laws.

Article 51

1. The conversion of receivable into shares cannot breach the rights to purchase the debtor's shares on preferential terms upon the procedure defined by the state owned enterprises privatization act - pending the completion of the procedure of making the shares available to the employees.

2. The provisions of the statutes of sole shareholder Treasurer companies concluded after this law comes into focus and limiting trading in shares are regarded as not reserved, within the scope defined by this act.

CHAPTER 5

TRANSFER OF RESOURCES IN ORDER TO INCREASE OWNER FUNDS IN STATE BANKS

Article 52

1. The Minister of Finance shall transfer on behalf of the Treasury to state-owned banks and banks in which the Treasury has more 50% of stock or shares, Treasury bonds issued to this purpose on the basis of a separate authorization, or monetary means in order to increase own funds and bank reserves.

2. Means mentioned in para. 1 shall be transferred to a bank which meets the following conditions:

- 1) has verified financial statement containing the analysis of the quality of the credit portfolio of the bank, conducted by an entity with experience in this respect,
- 2) has singled out creditors with inferior value,
- 3) has created a separate organizational structure to manage the credits mentioned in point 2
- 4) has submitted a plan for the restructuring of credit portfolios mentioned in point 2.

Article 53

1. Banks which will receive means in the mode defined in article 54 cannot grant credits and guarantees to debtors whose debts have been singled out in accordance with article 52 para. 2 point 2 except the case when the supply of new means ensues from the provisions of a banking settlement or when the debtor is the Treasury Agricultural Property Agency.

2. The Minister of Finance shall define by way of an order the term in which the banks mentioned in para. 1 are obligated to sell unsatisfied receivable from debtors whose credits have been singled out in accordance with article 52 para. 2 point 2, reserving para. 3.

3. The obligation set in para. 2 does not relate to cases in which:

- 1) an settlement or conciliation has been concluded with the debtor
- 2) the debtor has been put into receivership,
- 3) vis a vis the debtor liquidation proceedings have been instituted in the mode of article 37, para. 2 of the State Enterprises Privatization Act, or of article 18a of the Act of 25th September 1981 on State Enterprises Act (Dz. U of 1991 No 18, item 80, No 75, item 329, No 101, item 444 and No 107 item 464),
- 4) for a period not shorter than 3 months the debtor shall in full and regularly repay the credit,
- 5) the debtor is the Treasury Agricultural Property Agency or a state agrobusiness enterprise.

Article 54

The Minister of Finance shall set, by way of an order:

- 1) banks to which Treasury bonds and monetary means shall be transferred,
- 2) distribution of the amount allocated in the budget law to increase own funds and bank reserves among banks mentioned in point 1.

CHAPTER 6**AMENDMENTS IN BINDING REGULATIONS, FINAL PROVISIONS****Article 55**

In the Act of 25 September 1981 on State-owned Enterprises (J. of Laws 1991 No. 18, item 80, No. 75, item 329, No. 101, item 444 and No. 107, item 464) the following changes are made.

- 1) in Article 46 para 3, the second sentence is added worded as follows: "In the case of liquidation of a state-owned enterprise the sale of fixed assets can also be carried out on the basis of a public announced offer, or as a result of negotiations undertaken on the basis of a public invitation".
- 2) in Article 48 the full stop is replaced with a comma and the following words are added: "reserving Article 18 para. 1."

Article 56

In the Act of 31 January 1989 on the Financial Management of State-owned Enterprises (J. of Laws of 1992 No. 6, item 27) the following changes are made:

- 1) in Article 4:
 - a) para. 4a is added worded as follows:

"4a. An enterprise receiving fixed assets in the situation referred to in para. 9 increases its founding capital by the value equal to the sum by which the transferring enterprise decreases the founding capital."
 - b) para. 6 and 7 are now worded as follows:

"6. Reduction of the founding capital in the cases envisaged in para. 3, 5, 9 and 10 takes place only in the situation when the transferred property in the form of fixed assets or acquired buildings and premises were the basis for establishing this fund."

"7. The sum of reduction of the founding capital in the increases envisaged in para. 3, 5, 9 and 10 is established by multiplying the value of transferred fixed assets or acquired buildings and premises by the coefficient of the proportion of the founding capital in the total value of the founding capital and the enterprise's fund according to the state on 1 January (following reassessment) of the year in which this property has been gratuitously transferred or acquired."
 - c) para. 9 and 10 are added worded as follows:

"9. The founding capital is decreased in case of making a donation, in accordance with Article 46a of the State Enterprises Act (Dz. U. of 1991 No. 18 item 80 No. 75 item 329 No. 101, item 444 and No. 1107 item 464), of buildings and installations in possession and technical infrastructure in the form of machines, installations, gas and power networks, water supply and sewage networks, district heating and telecommunications network to another state-owned enterprise on the condition that this enterprise take over an appropriate part of the founding fund, determined in accordance with the principles given in para. 6 and 7".

"10. If an enterprise makes a donation, in accordance with Article 46a of the State Enterprises Act, to budgetary units or municipalities (municipality unions) of buildings and installations in which operate schools, hospital, clinics attached to work establishments, workers' hostels and technical infrastructure in the form of equipment, installations and networks: power and gas, water supply and sewage, district heating and telecommunications, such enterprise can reduce the founding capital in compliance with the principles defined in para. 6 and 7."

2) in Article 6 para. 2, pt 6 is added worded as follows:

"6. The amount of reduction of the value of property in the form of residential houses, nurseries and kindergartens of the work establishment and buildings serving the establishment's social-welfare activities, in connection with donation of the above fixed assets to other legal persons."

3) in Article 12: in para. 4 the words: until the time of the completion of the statutory economic activity, defined in the order on opening liquidation" are replaced with the words: until the day of opening liquidation, defined in the order on liquidation."

Article 57

The act enters into force upon the passage of 14 days from promulgation.

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