Resolution of Bad Enterprise Debt in Central and Eastern Europe: An Overview

Introduction

Resolution of bad enterprise debts (BED) is a core challenge for the new market economies of Central and Eastern Europe (CEE). The extent, relative importance and dynamics of the problem in its varying forms have changed over time and across countries over the past ten years. Nevertheless, BEDs have characterized the process of economic transition from its very beginning.

As the former socialist planning system and its necessary corollary, the mono-bank system were remodeled, the portfolios of commercial banks (either newly-created or transformed state-owned banks) were heavily overloaded with non-performing debt of state-owned enterprises (SOEs)[1]. Cleaning the portfolio of the commercial banks therefore was a priority concern from the outset of the privatization process. Action on a number of technical issues, such as *branch network management, risk analysis, product development, human resource management, information technology, marketing and training* helped address this concern in part, but the problem is not resolved.

The Many Dimensions of the Problem

Unfortunately, many Central and Eastern European policy makers were rather inexperienced politically and in terms of practical economic policy. The volume and the complexity of BED related issues surprised them, as did the revelation that the crisis of bad loans had not stopped in 1989/1990, as a natural consequence of the imposition of the market economy.

With the benefit of hindsight, several issues merit consideration here:

The collapse of the centrally planned system – both at the national and the regional level[2] – pushed the entire region into what has to be recognized as a depression instead of a recession. Although policy makers were aware of the recessionary danger emanating from the liquidation of loss making enterprises, many expected that the closure of firms with „negative value added" would actually result in growth of Gross Domestic Product (GDP). In other words, liberal policy makers assumed that since the planned economy was so inefficient, its liquidation would quickly foster economic growth.

1. Lack of comprehensive accounting and audit reforms and implementation of internationally comparable standards further complicated the resolution of BED. In many cases, International Accounting Standards (IAS) and International Standards of Auditing (ISA) would have provided a better snapshot of the financial situation of both banks and enterprises. In fact, the early 1990s saw a hectic wave of bank creation, as the flawed accounting system showed that operating banks in a rapidly changing economic environment is a highly profitable enterprise.

[1] Also, purchasers (new owners) of privatized enterprises also often assumed the debt of the purchased enterprise as part of the privatization deal.

[2] Reference is made here to Soviet-led regional cooperation arrangements, predominantly, though not exclusively, supervised by the Council of Mutual Economic Assistance (CMEA).

2. During the early years of transition (1989 - 1992), Western analysts and CEE policy makers interpreted BED only in a post-socialist context. It was only later, when it became a common knowledge that well established market economies, such as Finland, Norway, Sweden and the United States experienced similar problems.
3. For many years, policy makers did not give up the hope that state owned banks could assure good corporate governance and prudent banking behavior. They continued to assume that banks run by the "right" people could govern well. Continuous changes in governments have led to management and board changes at state-owned banks, and these changes have not always achieved the above-mentioned goal. Political influence still impacts the governance and management of state-owned banks.
4. Conversely, privatization and the creation of entirely new banks have not assured the complete disappearance of irresponsible bank lending. The private sector has not been immune from ineffective governance, poor management and problematic relationships. Privatization is no panacea against conflicts of interest. Initially, legislation did not adequately address this issue, and even now, although the legislation has been improved, regulatory authorities are most often stymied by a lack of resources (and in some cases political will) to enforce the law. Although a universal phenomenon, conflict of interest is particularly difficult to eradicate in post-socialist countries where many held a formal and low-paying job, but in reality live from the proceeds of a second job. Under the new circumstances, however, these second jobs generate totally different incentives. For example, bank board members or salaried bank employees can use their position to gain access to credit to finance a second, informal job or business.
5. By the mid 1990s, sentiments began to change among policy makers as the economic realities became clear. Hungary was the first country where the ruling political elite, (as well as many academics and an influential part of the media) accepted that the bulk of the commercial banks should be privatized *via* sale to foreign strategic investors. This was viewed as the only solution to the ongoing problems of recapitalizing state-owned banks, to break the vicious circle of moral hazard, generated by the bank rehabilitation process itself and to arrest endemic corruption. Between 1994 - 1997, Hungary sold all of its major commercial banks to large Western European banks. In turn, Czech Republic, Poland and later the Slovak Republic have followed the lead. Today, 60 - 80% of the banking sector in these countries is effectively foreign owned.

Beginning in 1992-1993, government sponsored bad debt schemes were implemented throughout the region. These programs, irrespective to the methods of their implementations, have proved to be extremely costly. Although final numbers for the whole region are not available yet, in most countries the equivalent of 3 - 6% of GDP had to be devoted to these programs. Two approaches were employed:

- **centralized schemes**
- **decentralized schemes**.

In the case of centralized schemes, a special financial institution was created with a clear mandate to collect bad loan portfolios from commercial banks and to enforce at least partial recovery of claims. These special financial institutions have operated under different names, such as "consolidation bank," "restructuring bank" or "bank hospital."

In the case of decentralized schemes, the government instructed commercial banks to establishing their own work-out units for a similar mandate. In both cases, the main idea was to separate the good portfolio from the bad portfolio. Using the language of time, governments wanted to have Chinese walls between the "good bank" and the "bad bank".

Czechoslovakia (prior to the Velvet Divorce), the former Yugoslavia (prior to its disintegration) and some of the Newly Independent States of the former Soviet Union (NIS) relied entirely on the centralized approach. Other countries, including Hungary, first tried to sort out BED problems through the centralized scheme, then eventually applied the decentralized approach.

The experiences of **centralized schemes** clearly suggest that the newly created, state-run, special-purpose entities can hardly be substitutes for commercial banks in this regard. The chances of a successful centralized workout unit proved to be slim in those countries where the government remains overburdened with other priorities emanating from nation-building, and economic reform (i.e. transition) is not the sole priority.

A **decentralized approach** can take advantage of the banks' superior knowledge of their customers. Within a decentralized strategy, there are two options.

The asset side approach There are two basic options for removing bad loans from the bank's accounts. One option is to remove the bad loans to a separate institution; the second option is that the bank retains the bad loans, but they are transferred to a special account where they are handled via a special contract between the bank and the owner of the claims represented in these loans.

The liability side approach This approach requires recapitalization of the bank to a level at which it is able to deal with BED. In other words, the bank accumulates adequate loan loss reserves. Of course, the capital increase raises governance questions: Who are the owners of the newly-issued shares or debt, and which role will they play in governance of the bank?

In practice, a mix of the two options has been orchestrated.

The Banking and Finance Assistance Center (BFAC)

From 1992 through 1996, the Banking and Finance Assistance Center (funded by the United States Agency for International Development [USAID]) organized several programs on the issue of BED in Central Europe.

Table 1

BFAC Conferences and seminars
on bad enterprise debts (BED) problems in Central Europe
1992-1996

1992 12	Budapest	Early Identification of Bad Loans
1993 07	Budapest	Regulation of Banks Exchanging Debt for Equity and Its Role in the Reorganization of Non-Bank Enterprises.
1994 06	Budapest	International Conference on Bad Enterprise Debt in Central and Eastern Europe

1996 02	Bratislava	Bad Loan Workout

The BED Problem in 1993

The following table provides a snapshot of BED in 1993:

Table 2

The BED problem in four CEE countries in 1993

	Bulgaria	Czech Republic	Hungary	Poland
Qualified loans/total loans	40-50	19-24	20-25	28
Qualified loans/GDP	28-35	14-18	6-7	6

Note: Further research is required to generate a similar table for 1999 or 2000.

Conclusions

Data from the Czech Republic and Hungary demonstrates that the decentralized approach in itself does not guarantee success. Simultaneously, banks require strong incentives and hard constraints to embark on the resolution of bad debt. If either of the two conditions is missing, there is a tendency to leave the problem unsolved and wait until the government writes off all the bed debt.

The Polish example suggests that in a typical transition environment, commercial banks pursue a rational strategy when they work seriously only with a relatively small fraction of large debtors. In other circumstances, they

- use the available state funds to write off the loans,
- sell them at a deep discount, or
- push the enterprises involved in bankruptcy and eventually liquidation.

The Polish scheme, named bank conciliatory procedure (BCP) is viewed as a relatively good example to handle the above mentioned contradictions. But, it turned out that the work-out process itself is also a hotbed of corruption, although proving this in court is difficult. Furthermore, determining the true value of the non-performing loan is also more complicated than frequently assumed. Thus it has become a rather lucrative business for risk-taking entrepreneurs to buy “not-very-bad” debts from commercial banks at close-to-zero price.

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