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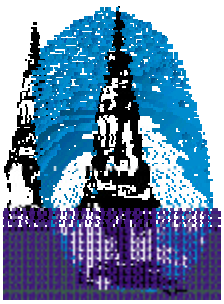

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Bankruptcy Procedures, Corporate Governance and Banks' Credit Policy in Croatia, Estonia and Poland

Tadeusz Kowalski
&
Evan Kraft
&
Andrew Mullineux
&
Vello Vensel
&
Clas Wihlborg

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Tadeusz Kowalski

Department of Economic Policy at the Poznan University of Economics

10 al. Niepodleglosci, 60-967 Poznan, Poland

Telephone: 48-61-8569584, fax: 48-61-8569565, e-mail: kowalski@novci1.ae.poznan.pl

Evan Kraft

Director of Research

The National Bank of Croatia

Trg hrvatskih velikana 3

10000 Zagreb Croatia

Telephone: 385-1-4564-858, fax: 385-1-4564-784, e-mail: evan.kraft@hnb.hr

Andrew Mullineux

Department of Economics at the University of Birmingham

Edgbaston Birmingham B15 2TT United Kingdom

Telephone: 0121-414-6642, fax: 0121-414-7377, e-mail: mullinaw@css.bham.ac.u

Vello Vensel

Department of Economics at Tallinn Technical University

101 Kopli Street, 11712 Tallinn, Estonia

Telephone: 372-6204058, fax: 372-6204051, e-mail: vvensel@tv.ttu.ee

Clas Wihlborg

Department of Finance at the Copenhagen Business School

3 Solbjerg Plads, DK-2000 Frederiksberg, Denmark

*Telephone 45-3815-3615, fax: 45-3815-3600, e-mail: **cw.fi@cbs.dk***

1. Introduction

A key component of a well functioning corporate governance system is the bankruptcy law and related insolvency procedures. Banks will not lend if they cannot retrieve their money from recalcitrant borrowers, and the costs and procedures for dealing with borrowers in distress will influence banks behavior towards borrowers. Many developing and emerging market economies have insolvency law "on the books", but few have procedures and courts that enforce the laws. If enforcement of debt contracts is weak while banks have effective governance the supply of credit tends to be severely curtailed. Alternatively, banking systems may lend based on criteria determi ned by relations or politics.

In this paper we evaluate the insolvency procedures in Croatia, Estonia, and Poland using a questionnaire that was sent to managers of foreign owned banks in the three countries. The managers responded to questions about their perceptions of formal and informal aspects of insolvency procedures, and of the impact on these procedures on the banks' credit policies. Foreign owned banks are used as respondents because managers of these banks have experience of insolvency procedures in the banks' home countries. Therefore they have a reference point when answering our questions.

Before presenting the perceptions of bankers we review the role of insolvency procedures in an economic growth and crises in Section 2. The variation in formal insolvency law across countries is described in Section 3, where insolvency law is also classified in different ways. Most often laws are classified as more or less creditor-or debtor oriented. A more interesting classification from an economic point of view is the extent to which it recognizes and enforces voluntarily entered contracts. The practical implementation of insolvency law and its contribution to restructuring in different countries is discussed in Section 4. Enforcement of law is identified as a particular weakness of insolvency regimes in most developing countries and many emerging market economies

We turn to the questions and responses in Section 5. Thereafter, in Section 6, we analyze which aspects of the insolvency procedures in the three countries seem to be most important for banks' credit policies. In Section 7 we present a few stylized facts about credit markets in the three counties as evidence of the impact of differences in insolvency procedures.

2. The Role of Insolvency law and Procedures[1]

"Bankruptcy is a collective procedure for the recovery of debts by creditors. It also protects individuals who have become overburdened by their debts." (Wood, 1995 Preface)

This quote summarizes well the role of bankruptcy law including laws for restructuring such as Chapter 11 in the U.S.A. There is a potential benefit to both creditors and debtors in bankruptcy. Creditors wish to recover debts to the extent possible in a speedy manner from a borrower who is unable to pay all creditors fully. From the borrower's point of view, bankruptcy should allow the speedy resolution of debts. Thereafter, the borrower can devote his or her human and other remaining resources to new ventures. The assets employed in the firm can similarly be reallocated to projects with positive value.

In Table 1, a distinction is made between "economic distress" and "financial distress." In "economic distress" the net present value of a firm's assets are negative and from a financial valuation point of view, the firm should be shut down in its present form. It is possible, however, that physical assets under different management would produce a positive net present value. If so, it would be efficient to auction or sell the firm as a "going concern" to new owners that would be able to improve management. Under "financial distress," the net present value of the assets is positive but the value of debts exceeds the present value of the cash flows generated by the assets. Thus, in financial distress a firm is insolvent but its assets produce a positive value from a social point of view. In this case, debt-reduction and rehabilitation, possibly in combination with more fundamental restructuring, such as change in control, would be efficient.

A firm may find itself in financial distress also because of liquidity constraints even if the present value of cash flows from assets exceeds the debts. This situation presumes that the financial system for one reason or another fails in its role of providing liquidity to solvent firms. The obvious remedy is rescheduling of debt, or liquidity infusion.

[1] This section is based on Wihlborg and Gangopadhyay (2001)

Insolvency procedures, should not only resolve a distress situation but the resolution should be accomplished at the lowest possible costs. Several studies show that direct and indirect bankruptcy costs in the USA are substantial. They vary across industries and depend on, for example, predictability and duration of procedures.[2]

Table 1. Types of distress and efficient action at the time of distress (ex post efficiency)

	Definition	Efficient action
Economic distress	The net present value of assets is negative under any management team	Piecemeal liquidation of assets
	The net present value of assets is positive under a different management team	Sale of assets as a "going concern" to enable a change of management
Financial distress	The present value of cash flows is positive but it is lower than the value of claims by non-shareholders	Debt reduction in combination with restructuring and/or ownership change, if value of assets thereby can be enhanced
	Liquidity-problem	Debt-rescheduling, Liquidity-enhancement

Insolvency procedures provide only one way to restructure an economy where assets need to be reallocated continuously in response to changes in preferences, technology and human skill. Mergers and acquisitions, internal restructuring within conglomerates, and voluntary closings of firms with associated asset sales offer alternatives in the restructuring process. Thus, insolvency procedures should be seen in the larger context of their contribution to restructuring.

The procedures can be the cause of a crisis if disincentives for bankruptcy in combination with a politically influenced banking system, and state support of banks and firms contribute to an accumulation of surviving, economically distressed firms. The disincentives for bankruptcy may be that proceedings are costly, and long drawn out with little likelihood for creditors to be paid in any case.

[2] Direct bankruptcy costs are, for example, lawyers' fees, while indirect costs may be caused by lost sales, or added costs of inputs in a distress-situation. See, for example, Altman (1984), Altman and Vanderhoof (1994) and Weiss (1997).

An existing crisis may be deepened and prolonged if financially distressed firms are not rehabilitated but are forced to shut down. Similarly, a crisis is deepened, if liquidity problems cause the shut-down of operations in a credit crunch. Wide-spread financial distress in a country may be caused by a severe macro-economic shock, large exchange rate changes, or increases in interest rates. We certainly observed this type of deepening of a crisis in the hard hit Asian economies, Indonesia, Korea, Malaysia, and Thailand (Hussain and Wihlborg, 1999)

There exists strong evidence that the lack of effective insolvency procedures can contribute to a banking-crisis, and the ability of banks to recover from a crisis. In a study by Caprio Jr and Klingebiel (1996) severe banking crises in 69 countries between 1980 and 1995 are recorded. Crises in 26 countries are studied in more detail with respect to their causes, and the resolution of crises. In a large share of the latter countries politically influenced lending practicies of banks were seen as a contributing cause of the crisis. An inefficient legal framework hindered the resolution of crises in many countries.[3]

It is easy to lay down the principle that if a firm's assets generate a positive net present value, then they should continue in operation even if the firm is in distress. The difficulty of implementing procedures leading to "ex post efficiency" as defined above is substantial, because of differences in availability of information among managers, shareholders and various creditors, and because inherent conflicts of interest imply that all information is not voluntarily disclosed. As a result, an independent body with enforcement powers, such as a court, is required in order to come to a conclusion on the issues of restructuring vs. liquidation, and of control. The valuation of assets at the time of distress is extremely difficult to arrive at, however. To obtain any approximation of value it may be necessary to offer the assets for sale in different configurations. Offering the assets for sale as a "going concern" or piecemeal implies that the alternative of rehabilitation including debt forgiveness with the present ownership is made possible. If the present owner can make the highest bid in spite of distress will there be restructuring without change of control. (Such informal restructuring is not uncommon as we note below.)

[3] Debt recovery was hampered by the legal system in the following heterogeneous group of countries outside Africa with recent banking crises: Indonesia, Thailand, Brazil, and Hungary. These observations indicate that a large number of countries with different legal traditions on all continents have insolvency procedures that contribute to or prolong economic crises.

One reason why an incumbent owner may value a firm higher than others is that he or she may have "invested" in or acquired firm-specific human capital (knowledge). Since this specific capital would be lost if the present owner would not be able to remain the owner after distress, he or she may value the firm as a going concern higher than others.

Not only the owner of a distressed firm may have invested in or acquired specific capital that would be lost if a firm were discontinued as a going concern. Many employees may have skills that would not provide any return if they want to work for other firms. Suppliers, customers, the surrounding community, the municipality and the state may also have strong interests in the continuation of the particular activity of a distressed firm.

Insolvency procedures affect economic incentives not only at the time of distress but also at the time various stakeholders enter contracts with a still healthy firm. The expected resolution of distress will therefore affect the incentives of various stakeholders to invest in firm-specific assets. Furthermore, the procedures affect the willingness of different groups of creditors to supply financing. Insolvency procedures that increase the likelihood of firm survival increase the incentives of various stakeholders to invest in firm-specific capital. The same procedures would reduce the expected return on financing the firm, if survival is accomplished at the expense of the lenders. As a result the costs of financing a healthy firm would increase. Uncertainty about procedures increases these costs further.

The issue of the ex ante efficient priority rule in bankruptcy remains unresolved even when a rather narrow range of specific assets is considered. What can be said is that ex ante efficiency is enhanced if:

1. Insolvency procedures are flexible enough to allow different types of resolutions for firms with different types of stakeholders.
2. Insolvency procedures are well defined ex ante. In other words, the rules for dealing with insolvency should not be subject to uncertainty.
3. Insolvency procedures allow speedy resolution of distress.

Viewing priority rules as one aspect of a firm's ex ante contracts with different stakeholders, these points indicate that, from an economic efficiency point of view, rules should allow the different stakeholders to obtain the types of contract they find suitable. We return to implications of this view below.

3. Orientations of Insolvency Procedures across countries

It is common to denote insolvency procedures as either creditor-oriented or debtor-oriented. These terms indicate whether the procedures tend to favor creditors or debtors in terms of claims on the distressed firm's assets, and in terms of control over these assets in and after legal proceedings for bankruptcy or restructuring. The existence of an easily accessible restructuring law generally favors debtors, since such a law—if it is mandatory-- implies that there is a constraint on the range of contractual solutions in distress situations. If incumbent owners are permitted to retain a stake and/or control after insolvency, then informal work-outs with a lesser stake to be retained by the incumbent owners are hindered. The degree to which restructuring law limits the range of informal contractual solutions depends on the ease of access to the restructuring procedures.

From an ex post economic efficiency point of view we also want to evaluate whether procedures are "survival"-or "shut-down" oriented quite independent of whether control changes hands or not. Survival of a firm is possible even if liquidation is mandatory under formal procedures, because an insolvent firm's assets can be sold as a "going concern". The assets can even be sold back to the original owners. Furthermore, creditors can agree on an informal work-out prior to bankruptcy with conditions for the owners. Thus, an evaluation of the survival-orientation of insolvency procedures requires that incentives for informal work-outs, and incentives for the sale of assets as a "going concern" are analyzed. These incentives are naturally strongly influenced by the design of formal insolvency law, its application and enforcement.

Table 2 is based on Wood's (1995) assessment of the degree of creditor or debtor orientation of formal procedures in different countries. Wood defines a creditor-oriented law as one that recognizes the claims of creditors to the greatest extent in insolvency. A debtor-oriented law allows debtors to retain a stake and/or control in insolvency although there is no equity left in the firm.

The table rates traditional British law as the most creditor-oriented, and current French law as the most debtor-oriented. The implementation of formal procedures for restructuring (administration) in 1985 and 1986 has made British law less creditor-oriented but it is still rated as marginally more creditor oriented than German, Dutch and Swedish law. Japanese and US laws are rated in the middle as more creditor-oriented than Italian, Spanish, and French law. Most developing countries base their

insolvency laws on the law of the former colonial power, while the former members of the communist block seem to have adopted an insolvency law akin to one of the Western European laws.

The main determinants of the creditor-orientation are listed in Table 3. Increasing the scope and efficiency of security allows more financing against collateral with greater probability for the secured creditors to keep the claim intact. On the other hand, the stronger the position of secured creditors, the less likely it is that unsecured creditors, employees, and the state will be paid in insolvency.

The existence of a rehabilitation statute or restructuring law reduces or weakens the position of creditors, because debtors are able to seek protection against some or all creditors, and it allows a search for a court-led solution with control and a remaining stake for the debtor. From creditors' point of view restructuring law may have the advantage that debtors have a stronger incentive to maximize the value of the assets even when distress can be foreseen. These incentives depend on the prospects for an informal work-out, however. It is argued below that a stronger position of creditors enhances the likelihood of a work-out.

If the law allows set-offs in insolvency, then some unsecured creditors have a de facto security in the form of a debt to the insolvent firm.

Recognition of ownership of assets in the possession of the debtor but not formally owned by the same is a controversial issue and ambiguous from the point of view of creditor-orientation. Clearly, if assets in a trust are deemed to belong to the estate of the insolvent firm it increases the funds available for creditors. On the other hand, recognition of ownership to assets in a trust can be seen as recognition of ex ante contractual relations, which is also the principle of recognition of security.

Whether the veil of incorporation and therefore limited liability of shareholders, and protection of directors against personal liability actually protects creditors or not can be debated depending on circumstances, but upholding the protection offered by the veil in insolvency can also be seen as recognition of ex ante contractual relations.

The upshot of this discussion is that the classification of creditor orientation as above amounts to the increased recognition of ex ante contractual relations after the filing for bankruptcy or restructuring rather than a clear-cut classification of the position of debtors and creditors.

Table 2: Creditor/Debtor Orientation of Corporate Insolvency Law

(Based on Wood (1995) The orientation refers to explicit law disregarding the practical implementation through the court system)

Scale: 1= Extremely pro-creditor 10= Extremely pro-debtor

1. Former British colonies except S. Africa, Zimbabwe
2. England, Australia, Ireland
3. Germany, Netherlands, Indonesia, Sweden, Switzerland, Poland
4. Scotland, Japan, Korea, New Zealand, Norway
5. United States, Canada except Quebec
6. S. Africa, Botswana, Zimbabwe (all Dutch-based); Austria, Denmark, Czech and Slovak Republics
7. Italy
8. Greece, Portugal, Spain, most Latin American countries (except Paraguay that protects security interests strongly)
9. Former French colonies, Egypt, Zaire; (Belgium)
10. France

No insolvency law: Liberia (many Arab countries)

Not classified: Russia, Belarus, Ukraine, Khazakstan

Insolvency laws vary across countries in terms of scope and efficiency of security. Table 3 includes a rating of the attitude to security expressed in some countries' laws. Countries are rated on a scale from very sympathetic to very hostile to security. Of particular interest here is the protection offered "floating charges", i.e. security against all existing and potential assets, and the position of employees and the state. Floating charges can be viewed as extending the scope of assets that can be offered as security to intangibles. Countries listed as very sympathetic to security

allow floating charges as security. Countries listed as sympathetic rank employees and the state below all senior creditors, while at least some senior creditors are ranked below employees and the state in "hostile" countries[4].

Wihlborg and Gangopadhyay (2001) show in more detail how different industrialized countries are ranked in the different dimensions of insolvency law listed in Table 3. Countries are ranked differently with respect to creditor orientation in different important dimensions. While the traditional English procedures and the French procedures are on either extreme in all dimensions, the German system is actually more creditor oriented than the English in two dimensions. Both German and Japanese laws protect title finance strongly, but contracts are not recognized as strongly "across the board "as in British law. For example, set-offs and trusts are recognized in British law. The scope of security is also wider in British law with the strong recognition of floating charges. These differences affect incentives of different creditors in informal work-outs.

Since one objective of insolvency law is to keep viable entities alive the role of rehabilitation statutes is particularly interesting. The US legal system is very debtor friendly in terms of prospects for rehabilitation under Ch.11, but relatively creditor friendly in other dimensions, and, therefore, in bankruptcy proceedings for distressed firms not seeking protection under Ch.11.

Even countries that are considered hostile to formal rehabilitation have some legal procedure for restructuring. Most common are "compositions" implying a moratorium on the payment of debts and the possibility of a negotiated restructuring of creditors' claims. These composition procedures are very rarely used, however, because of requirements for immediate payments of a share of non-secured creditors' claims (Austria, Brazil, Denmark, Italy, Norway, Sweden and others), or because the debtor must show that insolvency resulted from misfortune rather than mismanagement (Belgium, Luxembourg).

More debtor-friendly restructuring law has been implemented in recent decades in a number of countries. The French law of 1967 changed the orientation of

[4] In some "sympathetic" countries employees are protected by other means. For example, in Sweden there is a state supported wage guarantee for employees of bankrupt firms.

French law strongly. Chapter 11 of the US bankruptcy code was enacted in 1978. British "administration proceedings" have been possible since 1986. Australia

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Table 3. Determinants of high degree of credit orientation following Wood (1995)

1. Wide scope and efficiency on bankruptcy of security and title financing (retention of title, factoring, leasing)

Country attitudes to security:

Very sympathetic	Sympathetic	Hostile	Very hostile
English common law countries	Germany	Belgium	Austria
	Japan	Luxembourg	France
Sweden	Netherlands	Greece	Italy
Finland	Switzerland	Spain	
Norway	Scotland	Most Latin American countries	
	S. Africa		

2. Weak corporate rehabilitation statutes
3. Insolvency set-off enables reciprocal unsecured creditor to be paid ahead of other unsecured creditors
4. *Ownership of assets in the possession of debtor is recognized (e.g. trusts)
5. *Veil of incorporation and protection of directors against personal liability

*These determinants are ambiguous from creditors point of view (See text.)

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allowed formal restructuring in 1992, while Germany and Sweden have enacted restructuring laws in 1994 and 1996 but the latter two laws are not much different from already existing composition laws. Modern French law (redressement judiciaire and reglement amiable), and American law (Chapter 11) provide relatively easy access to restructuring procedures. The

courts will accept a debtor's application if there is some likelihood that the firm is a viable entity.

Restructuring laws differ in terms of their protection of various claims on the debtor. These differences reflect the objectives of the law. While British law is oriented towards upholding contracts, French law in particular explicitly gives the courts the role of keeping firms in operation, and preserving employment. The control over the firm in restructuring shifts to the courts or to a person assigned by the court to different degrees. In countries with mild restructuring laws, management certainly loses control. Under Ch. 11 in the U.S., the management retains control, under court supervision. In other countries the influence of management is up to the courts and depends on the court's objectives. In France in particular the courts' powers are used to protect employees and the role of the old management is subordinated to this objective.

The differences among restructuring laws reflect not only their objectives but, most likely, the different organizations of financial systems and the rules for banking. Kaiser (1994) observes that American banks are reluctant to get much involved in corporate decisions, because they may be held liable for bad advice (lender's liability). There are many alternative sources of financing in the American marketplace in particular, with the result that a corporation's financial structure is often complex with a large number of creditor groups with conflicting interests. A negotiated informal work-out involving debt-rescheduling or reduction can therefore be difficult to achieve (Baird 1997 a and b). There is always a risk that one creditor demands full, immediate repayment, thus preventing a negotiated settlement. Accordingly, the courts are able to bind dissenters in Ch. 11 proceedings.

Most continental European and Japanese financial markets are bank-oriented, and banks are deeply involved in corporate decision making. One bank tends to serve as the "house-bank" and main senior creditor of each corporation. The house-bank is well-informed about the economic situation of the firm, and it can initiate informal work-out negotiations. Therefore the banks determine the treatment of insolvent firms in the vast majority of insolvencies. Also in the UK banks tend to lead informal work-outs although the position of banks in corporate control is weaker than on the continent (see Franks and Sussman, 2000). British banks do not risk liability as American banks do, however.

Rehabilitation proceedings or restructurings have a low success rate in most countries, including France and the U.S. where the proceedings are relatively accessible. Kaiser (1994) presents date for the U.S.A., Germany, France and the U.K. In both the U.S. and France most firms filing for Ch. 11 or applying for restructuring end up being liquidated but the time it takes to get there is longer. The experience in France is that many of the firms being restructured -- often for reasons of preserving employment – return to insolvency after some time. In the U.S., the firms exiting from Ch. 11 seem to survive more often. However, Ch. 11 allows many insolvent firms to live for a year or two, only to end up being liquidated.

In order to evaluate whether restructuring law actually contributes to the survival of viable entities, or only allows economically distressed firms an extended life under legal protection, we have to compare effects of restructuring law with incentives of creditors to contribute to informal work-outs with or without the incumbent management.

4. The Practical Application of Insolvency Law

To what extent are financially distressed firms rehabilitated in informal work-outs, and to what extent are economically distressed firms allowed to survive under different insolvency regimes? In this section we look at this question and empirical evidence that may have a bearing on the efficiency of different insolvency law regimes.

Thorburn (2000) analyzes the results of 300 liquidation cases in Sweden between 1987 and 1991. She finds that in 75 percent of the cases the bankrupt firms survived as "going concerns". Sweden has a strongly creditor oriented law and allows floating charges like the UK. Restructuring law was and remains inaccessible. On the other hand the incidence of bankruptcy is very high in an international comparison. The procedure employed by the courts in bankruptcy is "cash auction" of the firms, meaning that the courts take over the insolvent firm and try to sell the whole entity to the highest bidder.

Stromberg (2000) argues that the Swedish cash auction system tends to lead to a sale of assets back to the original owner in cases when the bank benefits from this solution. This observation implies that the auction system under creditor-oriented law to a large extent accomplishes what restructuring laws are designed to accomplish.

Franks and Sussman (2000) present complementary evidence for Britain. They show in a study of three banks' handling of distressed firms that the banks have implemented elaborate informal rescue processes. The majority of distressed firms remain outside formal procedures, and the rate of liquidation does not seem particularly high, when banks remain in control of the insolvency procedure. Wood (1995) notes that the greatest disincentive for informal work-outs of distress situations is the existence of relatively debtor friendly restructuring law. The evidence for Sweden and the UK seem to confirm this observation**.** Furthermore, there is no evidence that the existence of strong restructuring law (France, U.S.) allows a greater survival rate for financially distressed but viable firms as compared to countries with no or ineffective restructuring laws (U.K., Germany, Sweden). The caveat to be noted here is that the evidence presented refers to periods with normal economic conditions.

The conclusion that may be drawn from the evidence presented is that the absence of restructuring law has not hindered the survival of viable firms in financial distress during normal times, and probably speeded up the shut-down of economically distressed firms. The anecdotal evidence from Sweden during a period of severe macroeconomic crisis 1991-93 including a banking crisis indicates that the Swedish informal system for restructuring did not function as well as during normal times, however. The willingness of banks to supply credit for survival was reduced, and there were few potential buyers with the means to buy distressed firms as "going concern" [5]

In spite of the evidence presented on the effectiveness of restructuring in the highly creditor oriented systems, the government in the UK is preparing to introduce legislation aimed at shifting the balance in favor of the (well behaved, but 'unlucky', entrepreneurs) as part of its drive to encourage 'entrepreneurism'. In the US, which has legislation that favors debtors much more than that of the UK, the government looks set to shift the balance back towards the creditors in an attempt to reduce moral hazard.

[5] An important question is whether a system with easier access to formal restructuring procedures could function better during macroeconomic crisis. Formal reorganization procedures may have the advantage of providing more time for alternative bidders to appear. The cost would be that the life of economically distressed firms could be prolonged as well. It is possible that the only effective remedy is to resolve a threatening banking crisis quickly.

The evidence presented so far refers to Europe and the USA. Turning to emerging market economies it is common that the discrepancy between formal law and actual procedures is large. There are three possible explanations for such a discrepancy. First, the credit allocation process of banks may be influenced by political factors, and specific groups with strong relations to a bank. Second, the legal process for dealing with insolvency according to the law may be ineffective, time consuming, and/or corrupt. Third, creditors and debtors may prefer informal procedures, perhaps because their value system differs from the one expressed in law. For example, insolvency procedures in Latin America are described in Rowat and Astigarraga (1999) as "woefully inadequate" in most countries of the region. The procedures are rigid and formalistic, they give judges too much arbitrary power to serve what they consider the "general interest", there is widespread cynicism about political influences overriding judgements, there is a powerful bias in favor of labor claimants, and corruption is rampant.

Turning to the former socialist countries in Eastern Europe many have implemented modern insolvency law but few have managed to enforce the laws successfully. Poland and Estonia seem to be the countries that have progressed the most in terms developing a functioning insolvency system based on law.[6] However, lack of capacity in the legal system is a problem in all the countries**.** Lack of expertise and tradition affect the time of proceedings take, as well as the ability of creditors to recover assets from the insolvent estate. Uncertain and ill-defined property rights have naturally been a hindrance for secured lending in Eastern Europe.

Djankov (1998) reports about Romania that "isolation programs" for large loss- making state enterprises have been implemented but the soft budget constraint imposed by banks have undermined these administrative restructuring procedures. Banking reform has not progressed far. Djankov questions the effectiveness of administrative restructuring procedures outside the court system on the grounds that such systems are more vulnerable to interferences by special interest groups.

Insolvency procedures in Russia are discussed in, for example, Gaddy and Ickes (1999a and b) and Freinkman and Starodubrovskaya (1995). There is a modern insolvency law but the procedures seem to be used for asset diversion of enormous

[6] See, for example, Coates and Mirsky (1995), Gray (1996) and (1997), and Montes-Negret and Papi (1996)

magnitudes through the activities of an "arbitration managers" appointed by a court to lead the insolvent entity after bankruptcy filing. Large resources of industrial groups are spent on influencing the choice of arbitration manager.[7] Black (2001) suggests much the same thing about Russia, arguing that the laws are in fact adequate but that enforcement is grossly inadequate.

As a point of reference for the study of bankers' perceptions below, we present indicators of creditor right protection in Croatia, Estonia, and Poland based on Pistor, Raiser, and Gelfer (2000). These authors have created indicators reflecting aspects of insolvency law. The indicators are similar to those in La Porta et al (1997) but more detailed. Table 4 shows four different "scores" for creditor protection in formal law, and three indicators of the "quality" of the legal system. The table footnotes shows the aspects of law that are reflected in the different scores. The 4 scores rank the three countries differently. It is therefore not obvious from this table which country has the strongest creditor rights. Poland seems to have weak protection in terms of Score 1 meaning that rehabilitation law is relatively accessible and debtor friendly. Croatia seems to have weak protection in terms of Score 3 reflecting the scope and effectiveness of security. In terms of Score 4 Estonia has the weakest protection in Table 4. This score pertains primarily to managers' liability for actions prior to bankruptcy.

We argued above that the most critical characteristics of law for evaluating creditor orientation are accessibility of rehabilitation law (Score 1), and the scope of security (Score 2). Adding these two scores Estonia would seems to offer the strongest protection for creditors in formal law.

Turning to the indicators of the quality of the legal system the differences among the countries are small. If any country has an edge (marginally) it would be Estonia being the strongest in terms of enforcement, equal to Poland in terms of Legal effectiveness and only slightly below Poland in terms of Rule of law. Croatia would be the country looking marginally weaker that the other two. This weakness is expected to contribute more to the debtor orientation of procedures in Croatia than in the other two countries.

[7] See Wihlborg and Gangopadhyay for an elaboration on this description.

Table 4: Creditor Rights and Enforcement indicators in 1998 based on Pistor, Raiser and Gelfer (2000)

	Creditor rights						
	Score 1 Max=4	Score 2 Max=5	Score 3 Max=3	Score 4 Max=3	Rule of Law Max=10	Legal Effectiveness Max=4	Enforcement Max=1
Croatia	4	5	1	2	7	3	.65
Estonia	4	4	3	1	8.5	4	.77
Poland	2.25	4.25	3	1.5	8.7	4	.70

Score 1: 1/0 for Restrictions for going into reorganization +
1/0 for No automatic stay on secured assets +
1/.75/.5/.25/0 for Secured assets priority +
1/0 for Management does not stay in charge.
Score 2: 2nd , 3rd, and 4th criteria under score 1 +
1/0 for Automatic trigger to file bankruptcy +
1/0 for Reorganization or liquidation plan requires creditors' consent
Score 3:1/0 for Establishing security interest in movable asset does not require transfer +
1/0 for Law requires register for security interests in movables +
1/0 for Security interest in land may be established
Score 4: 1/0 for Legal provision allows creditors to pierce the corporate veil +
1/0 for Management can be held liable for violating insolvency law +
1/.75/.5/.25 for Transactions preceding bankruptcy may be declared null and void.
Rule of Law from expert rating.
Legal Effectiveness from EBRD Survey of legal practitioners
Enforcement is proportion of firms in EBRD survey agreeing that "I am confident that the legal system will uphold any contract and property rights in business disputes"

Anecdotal evidence suggests that legal system weaknesses can be substituted for by private arrangements reducing the impact of ineffective laws on some banking activities. An example of this can be seen in the practices of Croatian banks regarding consumer loans. The banks generally force borrowers to have a co-debtor and two guarantors when signing the loan contract. If the borrower fails to repay, the co-debtor and guarantors are fully liable. The system usually functions without recourse to the courts, and overall levels of repayment (including the activation of the co-debtor and guarantor) remain extremely high (98-99%). (Galac 2002, Kraft 2000) Clearly, some

degree of rule of law must exist "in the background" to make banks' threats credible; but it seems that such business methods can be effective even with relative weak and inefficient legal practice.

Similarly, in a non-banking example, Frye (2001) finds that the courts are not important in protecting the property rights of small shopkeepers in Warsaw and Moscow. While two-thirds of Warsaw shopkeepers believe they could use the courts to sue local government if necessary, in general, they do not resort to this.

5. Perceptions of insolvency procedures in Croatia, Estonia and Poland

Murrell (2002) argues that in fact the overall development of formal institutions in transition countries is now quite high and in line with institutional development in other countries of similar GDP/capita. He suggests that much of the problem lies in enforcement of law. Ultimately, it may be less important whether the law is debtor or creditor oriented as long as there is enforcement of the law that exits. Without enforcement through the court system either banks ration credits or enforcement must be "internalized".[8]

In this section we describe how managers of foreign banks in several countries perceive the quality of insolvency and debt recovery procedures. The perceptions are obtained from our questionnaire. We are interested in discovering which dimensions of insolvency procedures are particularly important for credit policies, and monitoring efforts of banks. Although debtor-friendly legislation and legal practice seem to be widespread around the world, financial systems nonetheless function. Thus the interesting empirical question is not so much whether legal frameworks are debtor friendly (they usually are) or whether formal bankruptcy and foreclosure procedures are slow and costly (it almost goes without saying) but *the extent* to which legal frameworks are debtor friendly and just *how slow and costly* procedures are. Even more, it seems important to identify the impacts of specific weaknesses in the legal framework

8 Conglomerates—in particular those formed around a bank—may be seen as an organization that is able to internalize enforcement of debt-contracts.

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in environment. In particular, one would like to know which weaknesses in the legal framework prevent lending altogether, as opposed to weaknesses that can be compensated for by higher spreads.

In all three countries foreign banks play a very large, if not dominating, role in the banking systems. The questionnaire was sent to all foreign owned banks. Only in Estonia did we not receive answers from all the banks. Nevertheless, the two responding banks in Estonia constitute more than 50 percent of the Estonian banking sector in terms of assets.

I. Questions regarding overall impact of insolvency procedures.

The first question (I.a.) may be seen as an indicator of the degree to which banks ration credit, while the second question indicates whether banks charge a higher interest rate than in the home country as a result of weak insolvency procedures.

a. Inefficient debt recovery procedures make us reluctant to finance firms' investments, and the loan interest rate cannot compensate us for the risk we would take. (5 = very reluctant)

	Poland (10)	Croatia (9)	Estonia (2)
Average	3,3	2,3	2,5
Min	2	1	2
Max	5	4	3

Note: There is substantial variation in perceptions within each country. On average Polish banks are the most reluctant to lend. In the next question we observe that Polish banks also feel the strongest regarding the need to charge a high spread.

b. In comparison with the home country, and in accordance with my experience the interest rate spread in this host country is higher because of inefficient debt recovery procedures. (5 = Yes)

	Poland (8)	Croatia (9)	Estonia (2)
Average	3,4	3,0	3,5
Min	1	1	3
Max	5	5	4

II. Perceptions about aspects of procedures

1. *Describe the recovery process for security: (time, cost, predictable)*

a/ (time) (5 = very slow)

	Poland (11)	Croatia (9)	Estonia (2)
Average	4	4,8	3,5
Min	3	4	3
Max	5	5	4

b/ (cost) (5 = very costly)

	Poland (11)	Croatia (9)	Estonia (2)
Average	4	3,4	3
Min	3	2	3
Max	5	4	3

c/ (predictability) (5 = very arbitrary)

	Poland (11)	Croatia (9)	Estonia (2)
Average	3,6	4,0	3,5
Min	2	2	3
Max	5	5	4

2. *What is the value of collateral relative to the value of loans.*

Estonia 60%

3. *Describe the formal bankruptcy and rehabilitation procedures by answering the following questions:*

a) *Does bankruptcy law provide for strong protection of creditors' interests according to the letter of the law: (5 = not at all)*

	Poland (11)	Croatia (9)	Estonia (2)
Average	3,6	4,1	2,5
Min	3	1	2
Max	5	5	3

Note: There is difference of opinion about the letter of the law in Croatia in particular. On the average the formal procedures are considered the most debtor friendly in Croatia and the most creditor friendly in Estonia. The observation for Estonia is consistent with the indicators in Table 4 above.

b) Is the letter of law made more or less irrelevant by lack of enforcement in court? (5 = law is not enforced)

	Poland (11)	Croatia (9)	Estonia (2)
Average	2,2	4,1	2
Min	2	2	2
Max	5	5	2

Note: We observe again differences of opinion, and the weakest enforcement in Croatia. This observation is also consistent with the indicators in Table 4.

c) Are the courts unpredictable because of lack of knowledge, experience, training? (5 = lacking in these respects)

	Poland (11)	Croatia (9)	Estonia (2)
Average	2,1	3,8	3,5
Min	1	2	3
Max	5	5	4

Note: Polish courts are considered the most knowledgeable although the opinion varies substantially.

d) Are the courts unpredictable because of political influences and/or corruption? (5= strong influences/corruption)

	Poland (11)	Croatia (9)	Estonia (2)
Average	2,7	2,9	1,5
Min	1	1	1
Max	4	4	2

Note: Estonia seems relatively free from "influences" while some banks consider political influences strong in Croatia and Poland.

Transparency International's corruption index for the three countries on a scale of 10 (no corruption) is the following: Estonia, 5.6; Poland, 4.1; Croatia, 3.9.

e) The courts are unpredictable because of strong arbitrary powers of judges. (5=agree)

	Poland (11)	Croatia (9)	Estonia (2)
Average	2,8	3,1	3
Min	1	1	3
Max	5	4	3

Note: The three countries receive the same average score but the dispersion is high in Croatia and Poland.

f) Would you say that formal bankruptcy procedures are very time consuming? (5=very time consuming)

	Poland (11)	Croatia (9)	Estonia (2)
Average	4,3	4,8	4,5
Min	3	4	4
Max	5	5	5

Note: In all the countries the procedures are seen as time consuming.

g) As a foreign entity we cannot enforce credit contracts with the same effectiveness as domestically owned banks because the law is discriminatory. (5 = discriminatory)

	Poland (11)	Croatia (9)	Estonia (2)
Average	1,2	1,7	1,5
Min	1	1	1
Max	2	3	2

h) We cannot enforce credit contracts with the same effectiveness as domestically owned banks because we are discriminated against in court. (5= discriminatory)

	Poland (11)	Croatia (9)	Estonia (2)
Average	1,6	1,7	1,5
Min	1	1	1
Max	4	3	2

Note: Neither laws nor courts are perceived as discriminatory on the average, although a few banks in Croatia and Poland have different opinions.

5. There is a separate law for rehabilitation procedures in court or under administrative procedures

a) Estonia Yes (X) No ( )

Croatia Yes ( ) No (X)

b) Is it true that the formal procedures for rehabilitation are very seldom used, because debtors rarely qualify for the procedures. (5 = often)

	Poland (11)	Croatia	Estonia (1)
Average	2,2		2
Min	1		2
Max	5		2

Note: Although formal rehabilitation procedures exist in Poland and Estonia they do not seem easily accessible. Opinions vary in Poland, however. In Table 4 we observed that Poland has the relatively most debtor friendly rehabilitation law.

c) Is it correct that true that the formal rehabilitation procedures are very time consuming allowing insolvent debtors to continue operation? (5 = true)

	Poland (11)	Croatia	Estonia (1)
Average	3,7		2
Min	2		2
Max	5		2

d) Is it true that the formal rehabilitation procedures allow debtors to divert assets away from the insolvent estate? (5 = true)

	Poland (10)	Croatia	Estonia (1)
Average	3,6		4
Min	2		4
Max	5		4

e) Is it correct that once format rehabilitation procedures have been initiated security cannot be enforced and creditors position is weak? (5 = true)

	Poland (11)	Croatia	Estonia (1)
Average	3,4		3
Min	2		3
Max	4		3

Note: In Poland and Estonia where formal rehabilitation procedures exist they are perceived to weaken creditors position substantially. Correspondingly, the answers under 5b indicate that restrictive access to the procedures lead to infrequent use of the procedures. At least one Polish bank disagrees strongly with this assessment, however.

6) *Rehabilitation is handled informally by a bank much more frequently than formally under legal or administrative procedures.*

a) Estonia Yes (1) No (1)

b) Formal law and procedures are such that debtors easily agree to informal rehabilitation (5 = yes, debtors prefer informal procedures)

	Poland (10)	Croatia	Estonia (2)
Average	3,5		2
Min	2		2
Max	5		2

Note: Debtors do not seem to prefer informal procedures indicating that informal procedures are mostly used, because debtors lack access to formal rehabilitation.

c) As a creditor we often enter informal negotiations, because formal procedures offer no real and predictable alternative. (5=yes, formal procedures offer no real alternative)

	Poland (10)	Croatia	Estonia (2)
Average	3,8		3,5
Min	1		3
Max	5		4

Note: Creditors seem to avoid formal rehabilitation as we would expect after seeing the responses to the above questions.

As a summary assessment Estonia seems to be perceived to be the most creditor oriented in terms of formal procedures. This assessment is consistent with strong similarity between Estonian and Scandinavian bankruptcy law.

Enforcement is still not strong, however, although it seems stronger than in Poland and Croatia.

Polish law is strongly influenced by the relatively creditor oriented German law but even the formal law is not generally perceived as creditor oriented. On the average enforcement is perceived as weaker than in Estonia and a few Polish banks consider enforcement very weak and rehabilitation procedures as a device for creditors to delay payments and divert assets.

The Croatian formal law is perceived as the most debtor oriented in spite of the lack of formal rehabilitation procedures. The law is inspired by both Austrian and Italian law. Both these countries have relatively debtor oriented laws according to Table 2 above. The enforcement is also the weakest in Croatia according to the perceptions. There is arbitrariness in judgments and a perception of political influences on courts.

6. Perceptions of insolvency procedures and credit policy.

In this section we use the answers to questions I.a. and I.b. as indicators of credit policy of individual banks. In Question I.a. banks were asked whether they were reluctant to lend because interest rates cannot compensate for risk caused by weak bankruptcy procedures. In Question 1.b. banks were asked whether they charged a higher interest rate spread on loans in the host country than in the home country as a result of weak bankruptcy procedures.

As can be seen above the dispersion of perceptions among banks is substantial in the questions reflecting credit policy, as well as in questions about laws and their enforcement. We expect that the banks considering procedures relatively creditor oriented are the banks that are reluctant to lend unless they can raise the interest rate to compensate for risk.

In the following we study the correlations between Questions I.a. and I.b. on the one hand, and perceptions about different aspects of insolvency procedures on the other. Thereby we wish to discover which aspects of the insolvency procedures are particularly important for restricting credit or for raising the interest rate spread. Table 4 shows correlations for Polish and Estonian firms, while Table 5 shows the correlations for Croatian firms.

The correlations in Table 4 indicate that *banks' reluctance to lend* in Poland including two banks in Estonia is correlated particularly strongly with the perceptions that:

Formal laws offer weak protection of creditors interest,

Courts are subject to political influences and corruption,

Procedures are time-consuming,

Courts are discriminatory, and

Creditors view formal proceedings as preferrable to work-outs.

The bank's view that *the interest rate spread* is higher than in the home country is correlated with the view that:

Procedures to recover security are arbitrary,

Formal law offers weak protection of creditors' interest,

Enforcement is weak,

Courts are discriminatory,

Rehabilitation is fast, and

Creditors view formal proceedings as preferable to work-outs.

The characteristics that are correlated with reluctance to lend are largely the same as the characteristics that are correlated with the interest spread in Estonia and Poland. Only the correlation between *Rehabilitation is fast* and the interest spread is possibly surprising. However, fast rehabilitation may contribute to making formal rehabilitation attractive, and thereby weaken creditors' position.

Turning to Croatia there are no questions referring to rehabilitation procedures, since there is no formal procedure. Additional questions referring to banking supervision and regulation in Croatia are included in Table 5.

In Croatia, reluctance to lend is most strongly correlated with the following characteristics:

Arbitrary judge,
Bankruptcy time consuming (negative corr.),
Law offers weak protection

Costly recovery.

The interest spread is correlated most strongly with the following characteristics in Croatia:

Political influences and corruption of courts,
Courts' lack of expertise,
Law offers weak protection,
Costly recovery.

Both reluctance to lend and the interest spread are correlated with perceptions of weak protection in law, and costly recovery of security. Other perceived important characteristics in Croatia refer to the lack of a strong, independent court system. The correlation is negative between reluctance to lend and *bankruptcy time consuming*. The negative correlation is not expected but it may be explained by the low expectations of a positive outcome in court.

In the case of Croatia the correlation between the answers to I.a. ("we are reluctant to lend because of weak debt recovery procedures") and I.b.("interest rate spreads are higher because of inefficient insolvency procedures") is weakly negative. This result suggests that reluctance to lend and increasing the interest spread are seen as two rather distinct and incompatible responses by the Croatian respondents. Nevertheless, the two responses to weak insolvency procedures seem to be correlated with similar perceptions about characteristics of insolvency procedures.

The additional questions for Croatian bankers referring to supervision of banks indicate that specific demands of supervisors cause high interest rate spreads. The same specific demands are negatively correlated with reluctance to lend, however. More demands by Croatian supervisors are also negatively correlated with reluctance to lend, and positively correlated with the interest rate spread. These responses are surprising but could be explained if the demands by supervisors refer to encouragement of credit supply while allowing banks to compensate for risk by raising interest rates.

One could view the banks answering in this manner as willing to lend under the rather imperfect legal conditions in Croatia, but perhaps satisfied that

Croatia's higher interest spreads cover the costs imposed by inadequate legal conditions. This, however, does raise an interesting hypothetical question: if spreads fell sharply, perhaps due to intensified competition, and the legal system did not improve substantially, would the banks' perceptions change? In particular, would they become reluctant to lend, and even consider leaving Croatia? This is not at all an idle question, and should be taken quite seriously by the Croatian authorities. An additional possibility is that banks in Croatia will find themselves with relatively risky credit portfolios.

Although cross-country comparisons must be interpreted carefully, it is interesting to compare Croatia to Estonia and Poland. Which perceptions are the "show-stoppers" in the different countries, i.e. the factors that make banks reluctant to lend at all? In Croatia, the main show-stopper seems to be arbitrary judicial authority, while in Poland and Estonia combined the main show-stopper is discrimination against foreigners in court, followed by arbitrary judicial powers and corruption, and then debtor-friendly law combined with weak enforcement of creditors' rights. It can also be noted that Croatia's insolvency procedures actually are perceived more negatively than Poland and Estonia on characteristics that become "show-stoppers" in Poland and Estonia.

7. Stylized facts about credit policies in Croatia, Estonia and Poland.

The validity of the above observations about perceptions about insolvency procedures and credit policies could be tested if we had reliable data about banks' lending and interest rates on loans. Lacking such data we can ask what the differences in perceptions across countries may imply on the aggregate level for indicators of banks' and borrowers behavior. Strongly creditor oriented insolvency procedures are expected to reduce the degree of credit rationing by banks if they are subject to market discipline and governed according to shareholder wealth maximizing principles. Thus, the supply of credit at a given interest rate spread is expected to be relatively high under these conditions. The demand for credit would be lower under the same conditions if the banks impose hard budget constraints on borrowers. The supply side is expected to be binding to the extent that there is a degree of rationing.

Debtor oriented procedures would increase the demand for loans but the supply would adjust to the higher demand only if the government is expected to protect banks

from losses caused by non-performing loans. Thus, we cannot predict a relation between credit supply and insolvency procedures without knowledge about governments' policies with respect to protection of banks against credit losses.

Debtor oriented procedures are sustainable if either banks can compensate themselves for expected credit losses by asking for higher spreads, or if governments offer a degree of protection against losses. Creditor oriented procedures on the other hand are sustainable without government protection of banks.

A high share of non-performing loans year after year can be seen as an indication of debtor orientation of insolvency procedures. Recent World Bank data shows that Croatian banks' ratio of non-performing loans to assets is 15.5 percent. The corresponding figures for Poland and Estonia are 4,7 and 2 percent. EBRD (1999) shows that in relative terms these figures are representative since the mid 90s. This relative frequency of non-performing loans is consistent with the observed perception of relatively debtor oriented insolvency procedures in Croatia, and relatively creditor oriented procedures in Estonia.

We cannot observe directly, if the interest spreads in the three countries can explain these ratios, or if government protection play an important role in Croatia in particular. If government protection plays an important role we expect that the share of bank credit in the financing of non-government entities should be relatively high in Croatia. On the other hand, if government protection does not play a role in any of the countries we expect that Estonia should have the highest share of bank credit in the financing of firms, assuming that interest rate spreads cannot compensate completely for credit risk.

Fries and Taci (2002) show ratios of non-governmental sector credit to GDP in 1999. For Croatia, Poland and Estonia the ratios are 38.5, 28.8, and 35.8. The relatively high figure for Croatia is consistent with debtor orientation in combination with a greater degree of government protection than in Poland and Estonia. The higher ratio in Estonia relative to Poland is consistent with stronger creditor protection in Estonia.

Fries and Taci also calculate "market economy benchmarks" for the ratios of credit to GDP. The benchmarks are obtained from extrapolation based on a regression of the ratios in industrialized market economies on GNP/capita. The distances from the benchmarks are 8.4 for Croatia, 29.9 for Poland and 12.9 for Estonia. For all the countries the actual ratios are below the market economy benchmarks indicating a

degree of underdevelopment of the banking systems. The discussion here implies that the small distance from the benchmark for Croatia need not be an indication of less underdevelopment of the banking system but may be caused by debtor oriented insolvency procedures and a degree of government protection of banks. Similarly, the Estonian and Polish figures can be explained by differences in insolvency procedures.

Table 4. Correlations for Estonian (2) and Polish firms (11)

Parentheses refer to question number.	I.a Bank reluctant to lend	I.b Higher int.rate spread
slow recovery (1.a.)	0,30	0,20
costly recovery (1.b.)	0,30	-0,050
arbitrary recovery (1.c)	0,22	0,83
Law: weak protection (3.a)	0,51	0,51
Law: weak enforcement (3.b.)	0,34	0,72
Courts: lack of expertise (3.c.)	0,04	0
Courts: corruption (3.d.)	0,67	0,40
Courts: arbitrary judge (3.e.)	0,67	0,29
bankruptcy time consuming (3.f.)	0,53	0,11
Law: discriminatory (3.g.)	0,36	0,25
Court: discriminatory (3.h.)	0,85	0,51
Debtors rarely qualify for rehab.(5.b.)	0,035	-0,22
Rehab. time consuming (5.c.)	0,009	-0,51
Much diversion (5.d.)	-0,32	0,14
Creditors weak in rehab. (5.e.)	0,046	0,16
Debtors agree to work-outs (6.b.)	-0,048	-0,32
Creditors prefer work-outs (6.c.)	-0,58	-0,66
Bank reluctant to lend/i-rate does not compensate	1	0,36
Higher int.rate spread than home country , because of inefficient insolvence procedure	0,36	1

Table 5. Cross- firm Correlations for Croatia. (underlined questions were asked only in Croatia)

Parentheses refer to question numbers. Questions 5 and 6 do not apply, since Croatia does not have a rehabilitation law.	I.a. Bank reluctant	I.b. Higher int.rate spread
. slow recovery (1.a.)	-0,11	-0,20
costly recovery (1.b.)	0,31	0,36
arbitrary recovery (1.c.)	0,14	0,27
Law: weak protection (3.a.)	0,42	0,56
Law: weak enforcement (3.b.)	-0,32	-0,08
Courts: lack of expertise (3.c)	0,09	0,57
Courts: corruption (3.d.)	0,18	0,59+
Courts: arbitrary judge (3.e.)	0,64+	0,17
bankruptcy time consuming (3.f.)	-0,44	0,20
Law: discriminatory (3.g.)	0,29	0,00
Court: discriminatory (3.h.)	0,29	0,00
Bank supervisors often unprofessional	-0,07	0,00
Supervisors actions often arbitrary	0,05	-0,10
Croatian supervisors: more demands	-0,48	0,34
Croatian supervisors: specific demands	-.0.41	0,86*
FX controls interfere with business	-0,13	0,33
Bank reluctant to lend/i-rate does not compensate	1	-0,10
Higher int.rate spread than home country , because of inefficient insolvence procedure	-0,10	1

+ significant at 10% * significant at 5%

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