Can Banks Promote Enterprise Restructuring?: Evidence From a Polish Bank's Experience

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ABSTRACT

In this paper, we take a detailed look at one Polish bank's experiences with financial sector reforms focusing on a bank-led enterprise-restructuring plan that linked directly bank privatization and recapitalization to bad-debt workouts. Based on personal interviews and original statistical data, we evaluate the performance of Bank Depozytowo-Kredytowy (BDK) in promoting financial and operational restructuring of its clients. We found that BDK continued to provide soft lending to keep four old military-industrial companies afloat and actually increased its exposure to these companies during the program. The five success stories among BDK's clients were companies that had external agents other than the bank promoting and monitoring their operational restructuring. From our case study of BDK, we conclude that, while banks may play a role in financial restructuring of their clients, their ability to affect operational restructuring is quite limited. Moreover, state-owned banks are particularly vulnerable to incentive problems when dealing with large state-owned enterprises that may be too big or too political to fail.

Key words: Financial restructuring, Operational restructuring, Polish banking reform, Bank Conciliatory Procedures

SUMMARY

Unique among transition economies, Poland's financial sector development program linked directly bank privatization and recapitalization with enterprise restructuring. A new financial instrument for resolving bad debts, the bank conciliatory procedure (BCP), involved a lead bank, acting as an agent for all creditors, to design a financial restructuring plan and to arrange the enterprise's "revitalization" or business plan. Financial restructuring consisted of rescheduling total debt mainly by partial refinancing with a lower interest rate, partial cancellation, and swapping some debt for equity. The lead bank assumed responsibility for monitoring the financial restructuring contract with all creditors in return for recapitalization from the government. Once the bank is privatized, the security issued is serviced and redeemed from a fund established by international donors.

From the enterprise's perspective, old debts are rescheduled and written-down to allow the company to operate with a lower debt burden. The lead bank may lend new money to the clients in the BCP to finance restructuring activities designed to make the enterprise financially viable. The bank-led enterprise restructuring program was designed to force banks to confront actively their bad-loans problem, thus combating perceived creditor passivity, and to assist them in building the institutional capacity needed to carry out successful loan evaluation in the future. Supporters of the scheme argued that the

banks had both the information necessary to design the appropriate financial restructuring plan for their clients and the incentives to encourage their clients to restructure their operations to become viable in the new environment. One interim evaluation based on a sample of the participants (Gray and Holle, 1996) concluded that, although BCPs did reduce enterprise debt service and give companies breathing room, banks had limited power to enforce necessary operational restructuring. Although banks wrote down the debt of their large clients and were recapitalized by the government, these authors found little or no evidence or operational restructuring.

This paper takes a detailed look at one Polish bank's experience with BCP agreements. In 1994 when the program began, Bank Depozytowo-Kredytowy (BDK), headquartered in Lublin, was the smallest of the nine regional commercial banks in Poland. BDK is a particularly interesting case study because of its varied mix of industrial clients, its extensive use of BCPs, the large amount of its recapitalization, and the fact that it is now part of Poland’s largest banking group, the Pekao group holding over 20% of domestic banking assets. Our main contributions are twofold: first, we follow all of the BCP agreements made by BDK to completion whereas the literature has used interim information, and second, we provide a detailed account of BCPs from one bank’s experience based on bank data and interviews rather than on sample data.

BDK’s experience with the Polish bank-led enterprise-restructuring program illustrates the problems with relying on state-owned banks to be agents of change in transition economies. Three military-industrial clients accounted for over 70% of the old bad debt to BDK in the program. Financial restructuring consisted of BDK writing off 55.3% of this debt and swapping 36.2% of it for equity or new debt. As part of the BCP agreement, BDK extended new credit to these three clients in excess of 200% of their old bad debt. Although this new credit came with government guarantees, the exposure of BDK to these clients increased and no meaningful financial restructuring occurred. Even more significantly, the amount of new credit still outstanding at the end of 1997 to four old military-industrial companies exceeded the amount of recapitalization received by BDK. Operational restructuring was minimal and no one of these companies is poised to be economically viable. Rather, the size and importance of each to the regional labor market made it politically infeasible for the government to promote significant restructuring. Hence, BDK continued to provide soft lending to keep four old military-industrial companies afloat using recapitalization monies.

The five success stories among BDK’s clients in BCPs were companies that had external agents other than the bank promoting and monitoring their restructuring. Two were listed on the Warsaw Stock Exchange; two were involved with National Privatization Funds; and one had a strategic foreign owner. Hence, their successful operational restructuring can be attributed, at least partially, to these external agents.

The experiences of BDK indicate that state-owned banks can not be effective agents of change. First, the expertise necessary to design a proper business plan and to induce the necessary operational restructuring does not usually reside in banks. Second, state-owned banks will be influenced significantly by government policy and will find it impossible to resist soft lending for political reasons. As such, they will continue to be conduits of government subsidies that distort their portfolios because of decisions made on non-commercial terms. State-owned banks are particularly vulnerable to incentive problems when dealing with large state-owned enterprises that may be too big or too political to fail.

1. Introduction: Financial and Enterprise Restructuring

Poland's approach to financial sector development began in 1990s and is unique among transition economies. In consultation with the World Bank, the Polish government designed an integrated bank-led, enterprise-restructuring plan, which directly linked bank privatization and recapitalization with bad-debt workouts. The Act on Financial Restructuring of Enterprises and Banks was promulgated in March 1993 to supplement the court-based, Chapter 7 type bankruptcy and liquidation options under existing Polish privatization law with a new financial instrument for resolving bad debts, namely, the bank conciliatory procedure (BCP). In a BCP agreement, the lead bank acts as an agent for all creditors by designing a financial restructuring plan and by approving the enterprise's "revitalization" or business plan, which is intended to promote operational restructuring.

From the bank's perspective, financial restructuring consists of rescheduling total debt, both principal and accrued interest, using a combination of the following procedures:

- refinancing payment obligations with a lower interest rate,
- writing-down the face value of the loan (partial cancellation),
- swapping debt for equity, and
- infrequently, swapping old debt for new debt.

The bank assumes the responsibility that the client will meet the refinancing schedule with all creditors. In return, the bank is recapitalized using a special long-term government security that is serviced and redeemed from the Polish Bank Privatization Fund once the bank is privatized. Hence, the bank assumes responsibility for monitoring the financial restructuring contract with all creditors in return for recapitalization from the government.

From the enterprise's perspective, old debts that were not being serviced are rescheduled and written-down to allow the company to operate with a lower debt burden. Furthermore, the bank may lend new money to the clients involved in the BCP. In return, the enterprise is required to submit a business plan to the bank in which its strategies for becoming financially viable are described. Hence, these enterprises have access to new credit while they are repaying old bad debt, an option that was unavailable to them outside of the BCP. These new loans are granted by the division of the bank that was established to work out the bad loans so that the overall financial and operational situations of the clients participating in the program are monitored by this new division.

The bank-led enterprise restructuring program was designed to force banks to confront actively their bad-loans problem, thus combating perceived creditor passivity, and to assist them in building the institutional capacity needed to carry out successful loan evaluation in the future (Gray and Holle, 1996). The supporters of the scheme argued that the banks had both the information necessary to design the appropriate financial restructuring plan for their clients and the incentives to encourage their clients to restructure their operations to become viable in the new environment. Thus, these proponents identified the commercial banks as the appropriate agents of change to foster enterprise restructuring in the transition (Van Wijnbergen, 1997). Evaluation of the outcomes from the Polish program leads to a more critical conclusion. Gray and Holle (1996) claim that although BCPs did reduce enterprise debt service and, thus, give companies breathing room, banks had limited power to enforce necessary operational restructuring. From this perspective, banks wrote down the debt of their large clients and were recapitalized by the government in return but little or no enterprise restructuring was promoted.

This paper takes a detailed look at one Polish bank's experience with BCP agreements. Bank Depozytowo-Kredytowy (BDK), headquartered in Lublin, was the smallest of the nine regional commercial banks in Poland by total assets in 1994. BDK and six other regional banks that had not been privatized prior to 1993 participated in the bank-led restructuring and recapitalization program along with three national specialty banks, the two Polish savings banks and the umbrella agricultural bank. Although the smallest by assets, BDK received the second largest recapitalization payment and arranged the third highest number of BCPs among the seven eligible regional banks.

At the end of 1994, BDK's financial characteristics (e.g., deposit/credit ratio, size of irregular credit to total credit ratio, dedicated reserves, basic-capital-to-balance-sheet-total ratio, etc.,) were not significantly different from those of the other participating regional banks (see Table 2, p. 66 of Bonin and Leven, 1996). BDK's major industrial clients include companies in the auto and transportation industry, coal mining and steel plants, light industries and agricultural equipment and food processing. Some of these clients have been privatized since their BCPs were arranged; several to strategic investors, a few in the national investment fund (NIF) program, and others in IPOs. Some of the largest clients remain in state hands although participation in the program required that a firm be commercialized as a joint stock company wholly owned by the Treasury. BDK itself was privatized as part of the Pekao group, which is currently the largest bank in Poland with over 20% of domestic banking assets. BDK is a particularly interesting case study because of its varied mix of industrial clients, its extensive use of BCPs, the large amount of its recapitalization, and the fact that it is now part of Poland's largest banking group.

In the next section, we summarize the salient features of the restructuring program paying particular attention to the experience of all Polish banks with BCPs. This provides a background with which the experience of BDK can be compared. In section 3, we consider all of the BCP agreements arranged by BDK. After a brief history of BDK's client base, we take a detailed look at the conditions of financial restructuring in the BCP agreement and provide an account of the experiences with operational restructuring from interviews with BDK personnel. Section 4 concludes with an evaluation of BDK's experience in terms of the goals of the program and draws policy implications concerning the prospects of using banks as agents of change in a transition environment. Our main contributions are twofold: first, we follow all of the BCP agreements made by BDK to completion whereas the literature has used interim information, and second, we provide a detailed account of BCPs from one bank's experience based on bank data and interviews rather than on sample data.

2. The Polish Bank-Led Enterprise Restructuring Program

The Polish legislation covered 787 financially troubled firms that had loans classified as doubtful or loss at the end of 1991. For each of these clients, the lead bank was required to take some resolution action. Of these firms, 315 (or 40%) resumed payments on their debt in a timely fashion becoming good clients for whom no further action was necessary (Gray and Holle, 1997). By December 1996, 196 BCPs had been legalized, mainly with the largest borrowers of the involved banks. Although BCPs were arranged with only 41.5% of the 472 delinquent firms, the value of the old non-performing debt in BCPs amounted to over 60% of the total bad debt owed by these companies. Of the four other resolution options, i.e., court conciliation, sale of debt on secondary markets, liquidation, and bankruptcy, only bankruptcy accounted for more than 10% in value of bad debt remaining to be resolved.[1] Clearly, BCPs were the dominant instrument used by banks to deal with their clients with non-performing debt.

According to Gray and Holle (1996), the advantages for banks of using BCPs instead of other financial resolution options were:

- they were fast track procedures relative to court conciliation
- that the creditor priority rules were different from those in bankruptcy procedures as the Treasury lost its top priority,
- the lead bank could cram down changes if it represented creditors holding at least 50% of the value of the bad debt so that small creditors could not hold hostage an agreement, and
- the range of instruments was broadened to include debt/equity swaps to facilitate the eventual privatization of the company.

This final characteristic is clearly important as 128 of the 196 BCPs (or about 65%) involve debt for equity swaps (Blaszczyk et. al., 1999). An enterprise may apply for a BCP agreement to its leading bank creditor if that bank holds at least 20% of the firm's total debt, or 10% if the firm's total debt exceeds one billion zloty. The lead bank is responsible for monitoring the agreement and, as such, is liable for the losses of other creditors if the agreement is not completed on time or if the bank does not terminate the agreement when it is breached. Although it was originally anticipated that all BCPs would be completed by the end of 1996, BCPs could be finalized after December 1996 if negotiations between the bank and a client had already begun.

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[1] These numbers are calculated from Table 1 on p.26 of Gray and Holle (1997) adjusting for the number of BCPs arranged by the end of 1996.

From information in a World Bank sample of 62 Polish firms in the BCP program with nine commercial banks, Gray and Holle (1996) conclude that BCP's were initiated by firms with the intent of obtaining both a write down of existing debt and additional financing for working capital. Banks had been instructed to make no new loans to firms with non-performing debt so that, theoretically, such financing was unavailable outside of the program. In the authors' sample, banks identified as weak used debt/equity swaps significantly more than those identified as strong with the percentages being 70% and 20%, respectively, compared with 65% for the entire population. New bank credit was provided to 35% of the clients in BCPs by weak banks and to 28% of the clients in BCPs by strong banks, probably not a statistically significant difference. BDK is one three banks classified as weak by the authors.

Gray and Holle (1996) report that the firms involved in BCPs had positive average operating profitability in 1991/92 compared with substantially negative average profitability for enterprises resolved in other ways and that firms using the BCP option had the highest average number of employees of all groups. Hence, the selection process resulted in the choice of firms that were profitable, on average, before any restructuring and were relatively large bank clients. These authors assert that the restructuring plans presented by the enterprises were relatively unsophisticated and contained few tangible requirements for operational changes. For example, in their sample of firms, no business plan called for a change in enterprise management. From their data, Gray and Holle concluded that, the first two years of the program witnessed a slowdown in the rate of layoffs, a decline in average operating profitability, and little real privatization for the participating enterprises. Hence, they argue that BCPs provided breathing room for large enterprises to slow down the process of painful restructuring. In other words, the financial restructuring undertaken using the new debt-resolution instrument actually delayed the operational restructuring of these companies in Poland.

The Polish program fell victim to moral hazard in which enterprises that are too big to fail became linked more closely to weak commercial banks. These yet-to-be-privatized banks took equity stakes in their large clients and provided them with new loans while canceling old unpaid debt. Thus, the funds provided by international donors and used to recapitalize these banks were put at risk as exposure to some of these clients actually increased. Encouraging banks to take equity holdings in their clients leads to the well-known conflict of interest between the lending facility and the ownership objective, especially in periods of financial distress. Furthermore, it strengthens the ties between banks and their inherited troubled clients and puts a premium on the success of enterprise restructuring. The still state-owned commercial banks in Poland were not capable of handling this responsibility.

3. BDK's Experience with BCPs

3.1 Background on BDK and clients

Under socialism, the Lublin region was selected by Poland's central planners as a "heavy industry center" and designated as the Central Industrial Zone. Geography was an important factor in this selection. Planners sought to benefit from proximity to the Soviet market, which was expected to be Poland's primary heavy machinery import source and export destination. Historical factors also played a role. Foremost among them was the governance of that region of Poland for 150 years by Russia, Austria and Prussia. Throughout that period, the Lublin region was an economic backwater, relative to the Prussian and Austrian controlled areas. This heritage of underdevelopment was evident after the World War II, when the Lublin region had both an industrial infrastructure and a large agricultural labor force.

As part of the centrally planned economy, Lublin's Central Industrial Zone received a significant influx of state funds. Several key companies were created, often in the most underdeveloped parts of the region. To attract workers, the state provided housing and basic infrastructure. The selection of industries would, however, have a lasting impact on the economic health of the region. Consistent with the existing political climate, many heavy industrial companies specialized in military equipment according to a division of labor guided by the perceived needs of Warsaw Pact. As in the other centrally planned economies, many of the industrial plants constructed were local or regional monopolies.

The growth of these companies and their ancillary social programs, e.g., housing and childcare facilities, was financed by the state through government operated banks. In Lublin, the primary bank was BDK, which serviced such large, monopolistic companies as WSK Swidnik, FLT Krasnik, FSC Lublin, WSK Mielec, HSW and Mostostal Stalowa Wola. Much of the production from these heavy industry enterprises was geared towards military uses and for export to CMEA markets. Not surprisingly, these enterprises are the most difficult to restructure and reorient in the transition to the market economy. Burdened with aging machinery and obsolete technology, the enterprises in the Central Industrial Zone relied upon sales to the state and to Poland's CMEA partners on non-market terms. As those relationships unraveled, so too has the economic viability of these enterprises. The dominance of such clients in BDK's portfolio helps to explain why BDK received the second highest amount of recapitalization funds even though it is the smallest of the nine Polish commercial banks.

3.2 BDK's Experience with Financial Restructuring using BCPs

Prior to the 1993 enterprise-restructuring program, some of BDK's major clients were insolvent and faced with declining state subsidies. Although it was unable to improve the performance of these clients, BDK nonetheless continued to extend credits to them. Pursuant to the 1993 Act, BDK distinguished two classes of clients: large state enterprises with extensive debts and medium-sized insolvent companies. The bank focused on the large state enterprises because of their size and the extent of their debt. Of the available options, bankruptcy was ruled out because of the limited nature of secondary markets, the existence of company towns around several of the companies, and the potential viability of spin-offs ventures from mother companies. For these clients, BCPs were the preferred option from the bank's perspective.

According to the 1993 Act, creditors were required to prepare a list of debts subject to BCP agreements and submit it to the Ministry of Finance for approval. If the debts were not repaid within a month, the bank announced its intention to proceed with the BCP in a professional journal. One month after this announcement, the BCP agreement was to be signed. For the BCP agreement to be legalized, 50% of all creditors had to approve. Although creditors could hold up the agreement and even seek adjudication in court, most BCPs were legalized rapidly. The BCP agreement required the state enterprise to be commercialized, i.e., to become a joint stock company wholly owned at first by the Treasury, or to become a limited partnership prior to signing. The procedure was designed to be a fast-track resolution of the bad debt problem and to carry out the financial restructuring necessary to promote operational restructuring in a company with a more appropriate capital structure.

The most important decision for the lead bank was to determine the amount of old non-performing debt to forgive. The decree permitted only three years for completion of a BCP once it was finalized. After that period, the bank was held responsible for the entire old debt of the company with all of its creditors. This short time period made rescheduling the payment of old debt less attractive because banks feared that their debtors would not be able to meet such a tight repayment schedule. Hence, banks opted for substantial debt forgiveness. Although it was the lead bank in 28 BCPs, BDK held only 15% of total debtor liabilities for these companies. Therefore, BDK had strong incentives to complete its BCP agreements on time.

BDK arranged a total of 28 BCPs, of which 22 were legalized by the end of 1994 and targeted for completion by the end of 1997. BDK initiated BCPs with three other companies before the end of 1994 but these were legalized in 1995 only. Taken together with the 22 legalized by the end of 1994, these 25 companies constitute the core group for our analysis because our latest data are for the end of 1997.[2] By the end of 1997, 22 of these 25 BCPs were completed, 2 were cancelled, and one had a target completion date of June 1998.

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2 An extension to the Act allowed banks to initiate BCPs after 1994. BDK initiated agreements with three additional companies; one BCP was legalized in August 1996 and the other two were legalized during 1997. Of these three, one involved a large client, Polish Farm Meat Sp. z.o.o; this BCP accounted for 19.5% of the total liabilities to BDK in the entire program. The agreement with this company was not representative of the BCPs in the program as 60% of the old debt was cancelled and the other 40% was scheduled for repayment. BDK's share of this company's total liabilities in the program was a 57.4%, well above the average for other BCPs, and no new credit was extended in the agreement. The other two companies for whom BCPs were legalized after 1995 made up only 1.6% of the liabilities to BDK included in the program. Hence, excluding these three later arranged BCPs should not alter significantly our evaluation of BDK's experiences with BCPs.

In these 25 agreements, BDK cancelled 48.3% of its old debt to the clients, which is similar to the percentage of 54% found for the 62 BCPs in the World Bank sample (Gray and Holle, 1996). Accrued interest made up 42% of the total liabilities outstanding to BDK from these companies and almost all of this accrued interest (about 89%) was cancelled. Polish banks wrote off a high percentage of accrued interest in BCPs because other creditors had not accrued overdue interest and the Act stipulated that all creditors be treated equally in BCP agreements. BDK's resolution of the remaining old non-performing debt that was not forgiven used the following methods: (the first number reflects the amount of debt resolved by each respective method as a percent of non-cancelled debt and the number in parentheses reflects this measure as a percent of total liabilities to BDK in the BCP):

- rescheduled payments: 21.9% (10.9%)
- debt for debt swaps: 11.8% (6.1 %)
- debt for equity swaps: 67.1% (34.7%)

In the World Bank sample, banks swapped 32% of old debt for equity in BCPs so that BDK's practice is comparable in this respect to that of other banks. Numerically speaking, BDK used debt for equity swaps with 64% of its clients in BCPs and the same measure for all banks was 65% in the World Bank sample.

BDK extended new credit to over half of the firms participating in BCP agreements while only 30% of the firms in the World Bank sample received new credit. By the end of 1997, the total stock of new credit extended by BDK to clients in the program was 149.6.% of their old debt to BDK included in the program. Rather than reducing its exposure to this group of clients, BDK actually increased its total outstanding debt with them. The extension of new credit within the program focused on three large clients who account for 71.3% of all liabilities in the program to BDK. The three, with their main product lines in parentheses, are Swidnik (transportation equipment), Mielec (aircraft), and HSW (steel). By the end of 1997, BDK had loaned 196.1 million zloty, which accounts for 96.1% of all new credit extended and still outstanding, to these three. BDK's loan exposure to these clients increased with the new credit extended as new credit outstanding at the end of 1997 amounted to 201.5% of these company's old liabilities to BDK.

For new loans made to these three companies, BDK required state guarantees. Treasury guaranteed the loans to HSW while a state-funded credit agency, KUKE, guaranteed the loans to Swidnik and Mielec. The total outstanding credit, as of the end of December 1997, extended in the program to each of these companies in recorded in the table. Tracing the extension of new credit to each of these clients back to June 1996, we find that HSW had a relatively constant stock of around 60 million zloty while BDK's exposure to both Swidnik and Mielec increased substantially throughout this period. For Swidnik, credit outstanding as of June 1996 was 37.9 million zloty and this stock grew to 51.9 million zloty by the end of 1996. For Mielec, credit outstanding as of June 1996 was 24.8 million zloty and this stock grew to 39.9 million zloty by the end of 1996. By the end of 1997, the stock of outstanding credit extended within the BCP agreements to these three companies equaled 195.7 million zloty, an amount greater than the recapitalization funds of 179 million zloty received by BDK for its participation in the program. Through the credit facility available to companies in the BCP agreements, BDK loaned a sum in excess of the recapitalization funds received to three old heavy industrial companies, albeit with state guarantees attached to the loans.

These three companies accounted for a disproportionate amount of debt cancelled or swapped for new debt as their BCP agreements covered 81.6% of all debt cancelled and 75.7% of all debt for debt swaps but only 71.3% of the total liabilities to BDK in the program. In addition, they received almost all of the new credit extended and still outstanding at the end of 1997. The details of the BCP agreement for each client are found in the table. At the end of 1997, these three still held outstanding new credit equal to more than twice their old liabilities to BDK included in the BCP agreements. For these old heavy industrial companies, little in the way of financial restructuring appears to have been accomplished within the program. Since these three clients make up more than 70% of the debt in the program, their lack of financial restructuring is a significant negative evaluation of BDK's experience with BCPs.

Three other heavy industrial companies, Autosan (buses), Bogdanka (coal) and Dezamet (special military equipment), account for another 8% of the liabilities to BDK in the program. These three companies constitute a disproportionately high share of the debt for equity swaps (12.2%) and rescheduled payment (10%) but a disproportionately low share of debt cancelled (5.7%). Only Dezamet continued to hold new loans in the program at the end of 1997; the stock of outstanding new credit was 1.6 million zloty or over 100% of its old debt to BDK (see table). Bogdanka received no new credit in the program while Autosan had credit outstanding as of June 1996 equal to 3.2 million zloty, which was reduced to 1.98 million zloty by the end of 1996. By the end of 1997, the BCP with Autosan was completed so that any outstanding credit extended in the program was transferred to BDK's credit department on commercial terms. Therefore, the financial restructuring of Autosan and Bogdanka was successful. However, Dezamet still held new credit equal in value to the old liabilities to BDK worked out in the program so that its financial restructuring was ongoing.

Five of BDK's clients in the BCP program are involved with other outside agents. Mostostal (steel) and Lukbut (shoes) are listed on the Warsaw Stock Exchange (WSE). Zamoyska Fab. Mebli (Furniture) and Cmielow are attached to different National Investment Funds (NIF) within the mass privatization program. Fabryka Samochodow Lublin was taken over by a strategic foreign investor, Daewoo, and its entire debt to BDK was swapped for equity. By itself, this transaction accounted for 18.2% of all debt for equity swaps undertaken by BDK in the BCP program. Taken together, these five companies accounted for 10.2% of the total liabilities to BDK in BCP agreements, with Fabryka Samochodow Lublin accounting for 6.3% by itself. As a group, these companies constitute a disproportionately high share of the debt for equity swaps (22.2%) and rescheduled payment (13%) but a disproportionately low share of debt cancelled (2.1%), with Mostostal responsible for the entire amount.

The only one of these clients having new credit outstanding at the end of 1997 was Zamoyska Fab. Mebli, with a balance of 0.95 million zloty or 100% of its debt to BDK in the program (see table). The other company attached to a NIF, Cmielow, had all of its debt rescheduled in the BCP and received new credit while in the program, having credit outstanding as of June 1996 equal to 0.73 million zloty and 0.82 million zloty by the end of 1996. Arrangements were made with the NIF so that Cmielow met all scheduled repayments and paid back to BDK all new credit extended by the end of 1997. Mostostal also received new credit during the program with credit outstanding as of June 1996 equal to 1.5 million zloty, which was reduced to 1 million zloty by the end of 1996. By the end of 1997, the BCP with Mostostal was completed so that any outstanding credit extended in the program was transferred to BDK's credit department on commercial terms.

The financial restructuring of Cmielow, Lukbut, Mostostal and Fabryka Samochodow Lublin was successful. As a result, BDK holds equity stakes all but Cmielow. Since Lukbut and Mostostal are both traded on the WSE and Fabryka Samochodow Lublin is held by a strategic foreign investor, BDK has an available exit option in each case. Zamoyska Fab. Mebli is the only one of this group whose financial restructuring was not complete by the end of 1997. As a result of the BCP agreement, BDK holds an equity stake in this company and an outstanding balance of credit extended to this client within the program. EDA Ponialowa is the only company with whom a BCP agreement was not completed at the end of 1997.[3] Although the targeted date of completion was June 30, 1998, the client had made less than 20% of its scheduled repayments to BDK by the end of 1997. Clearly, this client was not successfully restructured at that time.

In 22 of the 25 BCPs, all financial transactions were complete by the end of 1997 and two others were cancelled prior to that time. However, the completion of a BCP agreement does not necessarily constitute successful financial restructuring of the company. Three old military-industrial companies were not restructured financially in any meaningful way. Another company that specializes in military equipment acquired more in new credit than the value of old debt. One client attached to a NIF held outstanding new credit equal to its old debt in the program. The only uncompleted but not cancelled BCP at the end of 1997 involved a company that was granted new credit in excess of six times its old debt and, even then, could not meet its payment schedule for rescheduled old debt. By company count, about one-third of the BCPs arranged by BDK did not result in successful financial restructuring. By value of old non-performing debt, about 75% was held by companies that were not financially restructured. Even more significantly, the total amount of new credit extended under the program and still outstanding at the end of 1997 to three old military-industrial companies exceeded the amount of recapitalization monies received by BDK by itself. Recapitalization monies

[3] While accounting for less than one-half on one percent of the liabilities to BDK in the program, this company held a substantial amount of new credit equal to 1.9% of the total outstanding new credit extended by BDK in the program. The BCP agreement swapped 40% of its old debt for equity and rescheduled 60%.

provided by international donors appear to have been funneled to three of BDK's old military-industrial clients as state-guaranteed new loans.

3.3 BDK's Experience with Operational Restructuring[4]

Financial restructuring within the program was intended to provide the foundation for the operational restructuring that would render the companies viable in the new market environment. Relieving the companies of a debt burden that had been accumulated in a non-market environment allowed them to achieve capital structures that were more appropriate for operation as an ongoing concern. The fundamental premise of the Polish program was that the banks had the necessary information about their clients both to arrange the proper financial structure and to promote the necessary operational restructuring to make these companies economically viable. By allowing the banks to take equity stakes in their clients through the BCP agreement, the program was designed to give the banks the leverage they needed to monitor the business plan that were required in the BCP agreements and that were intended to facilitate operational restructuring.

The Act required each bank to set up a special division, a department of restructuring, to arrange the workout of the bad loans, to develop the business plan with the client and to monitor the company's compliance with the agreement. The World Bank asserted that one objective of the program was to develop institutional capacity in Poland's financial sector by attracting new talent to the banks. The new department was envisioned as a training facility in which young, talented people would learn the requisite banking skills. The presumption was that there was insufficient human capital in Polish banking and that people's experience in this division would be sufficient to start them on successful careers in the financial sector.

Following this principle, BDK recruited the staff of its newly created Department of Restructuring from outside the bank. Lawyers, economists, engineers, and mathematicians were among the 14 people who usually worked in this department. By the summer of 1999, two thirds of these people had left BDK. Several of the people left after PeKaO SA took over BDK and introduced its own staff. Those who stayed tend to work as loan officers and are responsible for major institutional clients. However, these employees consider themselves to have been demoted. Furthermore, Lublin provides limited opportunities for people with financial expertise so that those who left were required to move to Warsaw to continue their careers. Hence, BDK's experience indicates that the objective of developing human capital and modern banking skills within the regional banks was not met.

To promote operational restructuring for each client involved in a BCP, the staff of the workout department prepared a detailed evaluation of the client's economic condition,

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[4] The information in this section is compiled from interviews that were conducted by Dr. Leven with bank personnel in Lublin during the summer of 1999.

including a market analysis, a production profile, and a revenue analysis. This evaluation provided the basis for a business plan that was required for each client by the BCP agreement. Similar to the experiences of other banks, BDK's staff focused on the following areas in the business plans:

- improving product quality and broadening the product range,
- upgrading information systems and improving management,
- reducing cost, especially by eliminating social assets, and
- increasing efficiency by modernization and the elimination of unnecessary or obsolete assets.

Each client was assigned to a member of BDK's restructuring division; on average each bank employee was responsible for 2 or 3 companies. To develop the business plans, BDK's staff relied greatly on outside resources; in particular, they used outside consultants and brain stormed with personnel from the other banks. A consulting group, BMF, which is part of a Swiss Bank, was used to assist in the preparation of the business plans. The group was praised highly for its expertise by a senior bank official at BDK.

The military-industrial companies engaged their own independent consultants to assist in the preparation of their business plans. However, the plans proposed by those consultants were of particularly poor quality and had to be revised significantly with BDK's involvement. Since business plans were difficult to adjust after the final BCP agreement was signed, their original content was particularly important. BDK's staff focused on the large companies and had little involvement with the small and medium sized companies in the program.

The resulting business plan usually required companies to sell off some portion of their assets, especially social assets. While sales of some assets clearly were necessary, many were based on poor economic analysis and a misunderstanding of the limited capacity of secondary markets. The biggest issue in the negotiation over the business plan involved the bank's attempt to convince a company to reduce its labor force. Rather than downsize in this way, many of the large clients preferred to spin off several different companies, some of which were subsequently sold. The formation of several independent companies from a mother company was often considered to be a protection against the bankruptcy of the larger unity. Hence, observing that large companies break into smaller units does not necessary indicate an economically efficient outcome. Furthermore, this break up of large companies into smaller independent companies makes tracking quantitative measures of restructuring over time difficult if not impossible. Hence, we rely on examples to provide evidence of the extent of operational restructuring achieved by BDK's clients within the program.

Before turning to the largest clients, we consider the five companies that were involved with other outside agents. These clients are Mostostal and Lukbut; both currently listed on the WSE, Zamoyska Fab. Mebli and Cmielow, each of which is attached to a NIF, and Fabryka Samochodow Lublin, taken over by Daewoo. BDK played no meaningful role in the operational restructuring of the last enterprise but it does hold an equity stake in the new company that was created by the strategic foreign investor. From Mostostal (steel), five satellite companies were spun off; the core company is listed on the WSE. New investment, financed partially by new credit from BDK, has allowed the company to expand its markets. In addition, restructuring has involved cutting overall costs and reducing labor costs. Hence, Mostostal has made significant strides in operational restructuring.

Zamoyska Fab. Mebli (furniture) actively sold social assets, including a medical clinic and company housing, and is now leasing real estate and housing. The company is targeting Western markets for its product. Lukbut (shoes) has also been actively restructuring and reorienting its sales to Western markets away from its traditional Russian markets. The company has sold its real estate assets, concentrated management and production decisions in one center, improved its production processes by reducing line time, improved its product design, and introduced new distribution centers and a flexible pricing policy. By reorienting their products for Western markets, these two companies are well along the route to successful operational restructuring. The fifth company, Cmielow (porcelain), with the assistance of Ernst and Young, has restructured management procedures, modernized its distribution system, and cut costs. All five of these companies have had outside agents involved in their restructuring and monitoring their performance. Hence, their successful operational restructuring can be attributed, at least partially, to these external agents and BDK has benefited from their input.

The companies for which BDK is the primary, or only, agent of change include Autosan, Swidnik, Mielec, HSW, and Dezamet. HSW (steel) was considered initially by BDK's staff to be one of its two most difficult clients to restructure. The business plan involved the sale of part of the company and the formation of a holding company for several independent companies. Although one of these spin-offs is near bankruptcy today, the others are doing very well. Mielec (aircraft) was considered initially to be the second most difficult client to restructure by BDK's staff. As part of its business plan, a holding company was established consisting of 26 new independent companies. Employment cuts and assets sales have occurred in these companies. Swidnik (transportation equipment) also formed several autonomous companies as part of its restructuring program. The mother company sold company housing, converted some of its real estate to municipal assets and sold other assets. Autosan (buses) was reconstituted as four independent companies after having liquidated some redundant assets. The mother company reduced inventories, cut employment, and introduced a new standard accounting system. Since these four companies engaged in significant organizational restructuring using holding companies to create autonomous units, the extent of actual operational restructuring is difficult to determine.

Dezamet (special military equipment) was also considered to be one of the most problematic companies to restructure by BDK's staff. This company's business plan required it to transfer some of its labor force to the fire company, to sell most of its special equipment on secondary markets, and to sell some of its real estate to the municipal government. Although BDK recovered some of its money from these sales, the bank's staff considers the company's business prospects to be poor. In 1997, Dezamet made substantial losses. Clearly, this company is not very far along with operational restructuring and is not yet economically viable.

BDK's financial involvement with four military-industrial companies; Swidnik, Mielec, HSW, and Dezamet, was increased in the BCP program. These four companies have not progressed very far in operational restructuring and are not yet economically viable. The reasons given by bank personnel for why restructuring these enterprises proved to be so difficult include:

- lack of a competitive products,
- inability to function in a competitive environment,
- objectives other than profit maximization,
- high interest payments,
- high social benefits,
- bad structure of their debt, i.e. short term debt with long production cycle, and
- the depletion of the state's "war reserves,"

The scorecard on operational restructuring is not significantly different from our evaluation of financial restructuring. Five companies involved with outside agents have made significant progress in operational restructuring and are now viable independent companies. Three old military-industrial companies and a bus company have each split up into autonomous business entities under the umbrella of a holding company but engaged in very little real operational restructuring. Not only does BDK hold equity stakes in all four companies as a result of the BCP agreements but it increased its loan exposure to the three military-industrial companies during the program. The economic viability of these companies is in doubt. A fifth company selling specialized military equipment has also not undergone significant operational restructuring and is not economically viable. Nonetheless, BDK still remains highly exposed to it financially with substantial new credit extended and an equity stake from the BCP agreement. The very clients for whom financial restructuring was unsuccessful tend to be the ones that undertook little if any meaningful operational restructuring. By contrast, companies that were involved with other agents of change were successfully restructured on both scores.

4. Conclusion: State-Owned Banks as Agents of Change

The designers of the Polish program identified state-owned banks as the appropriate agents of change based on the information that they held on their clients and the hope that bank recapitalization would provide the proper incentives. Evaluations of the Polish banks' experiences with the program indicate that the BCP agreements were not effective instruments to promote enterprise restructuring. Some identify the lack of supporting legal and economic instruments that would induce creditors to participate actively in operational restructuring and the lack of a mechanism that links bank recapitalization to successful enterprise restructuring. The evidence indicates that banks forgave a significant amount of old debt in the BCP agreements and they were poor monitors of the implementation of the business plans that were required in the BCPs.

Could policy design problems be responsible for a negative evaluation of the Polish program? Certainly, the three-year time constraint during which the BCP was to be completed or the bank would be held responsible for the liabilities to all creditors did not provide ample time for the meaningful operational restructuring of some large problem clients. The human capital constraint did not seem to be significant at BDK as the staff of the new workout division relied on outside consultants and a network of personnel in such departments of other banks when necessary. However, the program did not achieve its modest objective of providing an entry for new, young talented people into regional banking. Most of the newly hired people at BDK have left the bank and the Lublin area. The pertinent question is: can state-owned banks be relied upon to be agents of change for their old state-owned enterprise clients?

Banking is a relational activity, by definition, so that the interests of the bank and its clients become intertwined. State-owned banks have their own governance problems and are themselves in need of operational restructuring. In many transition economies, the state has substituted loans made by state-owned banks for direct subsidies to state-owned enterprises as a means of reducing the financing requirement of the fiscal budget. These quasi-fiscal transactions have maintained the soft budget relationship between the government and state-owned enterprises by using the banks as instruments. Hence, the lack of political will to face the implications of restructuring the old heavy industrial dinosaurs leads the government to incur contingent liabilities by guaranteeing loans made by the state-owned banks.

BDK's experience with the Polish bank-led enterprise-restructuring program illustrates these points well. Three military-industrial clients in the region accounted for over 70% of the old bad debt to BDK in the program. Financial restructuring consisted of BDK writing off 55.3% of this debt and swapping 36.2% of it for equity or new debt. During the period in which the BCP agreement was in force, BDK extended new credit to these three clients in excess of 200% of their old bad debt. Although this new credit came with government guarantees, the exposure of BDK to these clients increased, no meaningful financial restructuring occurred and, in each case, independent new companies were split off from the mother company under the umbrella of a holding company. Operational restructuring by these three was minimal and no one of them is poised to be economically viable. Rather, the size and importance of each to the regional labor market made it politically infeasible for the government to promote significant restructuring.

Another company that specializes in military equipment acquired more in new credit than the value of its old bad debt to BDK. Together, these four clients held 97% of all outstanding new credit extended by BDK in the program at the end of 1997. Even more significantly, the total amount of new credit extended under the program and still outstanding at the end of 1997 to these four old military-industrial companies exceeded the amount of recapitalization received by BDK. Hence, BDK continued to provide soft lending to keep four old military-industrial companies afloat thanks to recapitalization monies made available by international donors.

The success stories among BDK's clients, on both financial and operational terms, were companies that had external agents other than the bank promoting and monitoring their restructuring. Hence, the experiences of one Polish bank corroborate the general principle that state-owned banks can not be effective agents of change. First, the expertise necessary to design a proper business plan and to induce the necessary operational restructuring does not usually reside in banks. Second, state-owned banks will be influenced significantly by government policy and will find it impossible to resist soft lending for political reasons. As such, they will continue to be conduits of government subsidies that distort their portfolios because of decisions made on non-commercial terms. State-owned banks are particularly vulnerable to incentive problems when dealing with large state-owned enterprises that may be too big or too political to fail. Quis custodiet ipsos custodes is the appropriate question to ask of state-owned banks before designating them as agents of change in any transition economy.

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Table 1

BDK's Major Clients in the Program

	HSW	Milelec	Swidnik	Autosan	Bogdanka	Mostostal	Lukbut	Dezamet	Zamoyska Fabryka
Total debt in BCP, of which	54.3	28.8	14.2	4.5	4.9	2.8	1.2	1.5	0.95
principal	33.7	3.3	10.5	2.5	4.9	2.0	1.18	1.3	0.95
interest	20.7	25.5	3.7	2.0		0.8	0.02	0.2	0
Cancelled %	50.0	79.9	26.1	28.9	40.8	50.0		25.0	
Repayment %	10.9	8.0	0	15.6	8.2	21.4	50.0	25.0	50.0
D/E swap %	39.0	12.2	29.6	55.6	51.0	28.6	50.0	50.0	50.0
D/D swap %			44.4						
New credit End of 1997 as% of debt*	57.4 106.4	85.78 297.9	52.49 369.7	1.98* N	0 0	1.0* N	0 0	1.55 103.3	0.95 100
BDK's debt as a % of total	18.5	15.4	24.9	20.7	3.3	16.0	17.9	13.7	25.5

Notes:

1. Value is in millions of new zloty
2. * indicates as of 12/1996