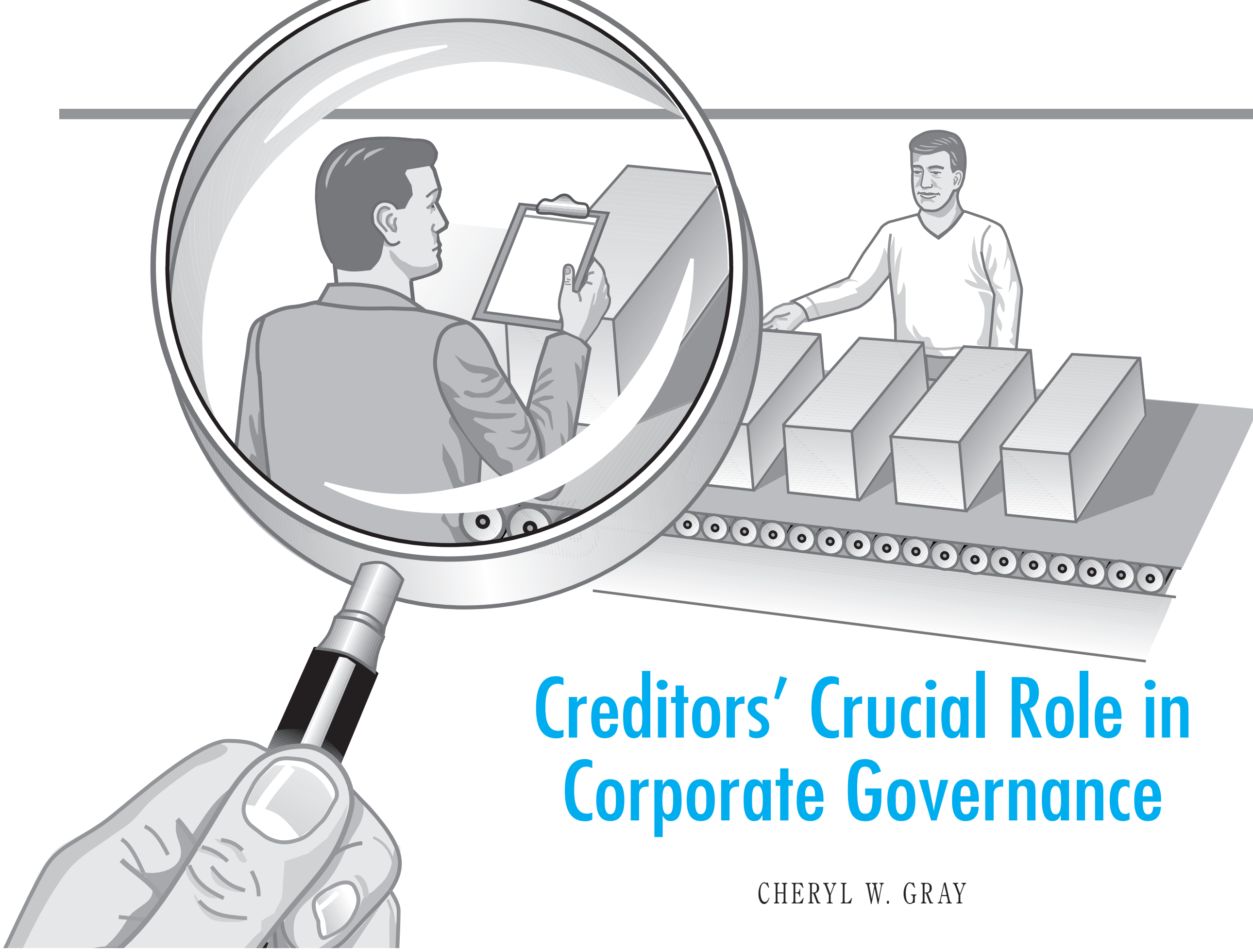

Creditors' Crucial Role in Corporate Governance

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Effective debt monitoring and collection play a crucial role in corporate governance in market economies and require adequate information, creditor incentives, and an appropriate legal framework.

BOTH FINANCIAL sector reform and private sector development have received considerable attention in developing and transition economies in recent years. But the critical nexus between banks and firms—not only for financing but also for efficiency and ultimate survival—has been underemphasized. Banks and other creditors have an extremely important role to play in fostering efficiency in medium and large private or state-owned firms. Creditors, in turn, rely for their survival on debt repayment by their borrowers. Without dependable debt collection, no amount of supervision or competition can make banks run efficiently.

Debt appears to be slowly emerging as a device for exerting control over medium and large enterprises in some transition economies. The powers and incentives of creditors in these countries are still weak, however, compared with their counterparts in more mature market economies. Strong creditors are as critical to the efficient functioning of enterprises as are strong owners. External financing for private firms comes essentially from two sources: debt and equity. While control by equity holders is appropriate in profitable times (when entrepreneurial risk taking is needed), creditor monitoring and control become binding in times of financial distress, particularly when tight controls on spending and investment are needed. Indeed, foreclosure and bankruptcy laws typically shift control of firms to creditors at such times. Thus, the development of effective creditor controls is a crucial element in successful economic transition.

The requirements for good control, or "corporate governance," by owners have been extensively analyzed. The legal and institutional requirements for effective debt monitoring have not been as thoroughly analyzed but are no less important. Like equity holders, creditors can monitor firms either actively or passively. The active mode involves hands-on evaluation of a firm's operations, investment decisions, and capacity and willingness to repay. The passive mode depends on collateral for security. To the extent analysis is carried out before a lending decision is made, the value of the firm's collateral is what is analyzed rather than the operations of the firm.

There are three crucial underpinnings to creditor monitoring and control in market economies: adequate information, market-oriented creditor incentives, and an appropriate legal framework for debt collection. The experiences of Hungary and Poland in the first half of the 1990s provide fascinating lessons about how—and how not—to strengthen creditors as agents of governance and restructuring for medium and

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large enterprises. Although this article focuses on these two countries, their problems have much in common with those faced not only by other countries in Eastern Europe but also by many developing countries in Africa, Asia, and Latin America.

Information

The first requirement is information. Lenders need information on the creditworthiness of potential borrowers, and depositors and bank supervisors need information on bank portfolios. While this may seem obvious, the constraints imposed by the poor quality and asymmetric distribution of information in developing and transition economies should not be underestimated. Inadequate financial and cost accounting can hide the true value of firms' assets, and dramatic changes in the structure of input prices, demand, competition, and distribution channels reduce the value of prior information. Reputation, the basis for much lending in stable market economies, is less binding, owing to the phenomenal pace of change. In sum, every firm currently operating in a transition economy is to some extent a new firm, even if it has been operating for 50 years.

Even if information on firms is available from potential borrowers, bank employees are often not trained in techniques of market analysis and loan appraisal, and thus have difficulty using that information. Similarly, bank supervisors often lack not only the technical ability but also the political will to carry out tough supervision. Furthermore, the "watchdog" professions—including accounting, law, securities, and credit rating services—are still in their infancy, making it difficult for outside investors to monitor firms and prevent fraud or misuse of their investments.

When information asymmetries are significant, adverse selection may make it costly, if not impossible, for outside investors to fund the growth of a firm with either debt or equity. If formal lending occurs, it will typically be based on collateral (or perhaps reputation) rather than on active monitoring of the firm's operations.

Creditor incentives

The second requirement for debt to serve a control function is the existence of appropriate market-based incentives for creditors, whether banks, trade creditors, or government.

Bank credits. Banks should play a pivotal role among creditors in maintaining borrower discipline and financing new activities. By 1992, many of the state-owned commercial banks in Hungary and Poland were in serious financial difficulty when evaluated using internationally accepted accounting principles. This difficulty was the result of several factors, including bad loans inherited from the socialist era, transition-induced defaults on existing loans, and defaults on new loans extended after the onset of relative price reform.

Both countries moved to reinvigorate existing banks through recapitalization. On the one hand, a one-time recapitalization early in the transition process may be necessary (but not sufficient) to establish viable institutions, given the undercapitalized state of most commercial banks when they were initially created. Undercapitalized banks cannot operate for long without government support and may face perverse incentives to continue distress lending and engage in ever riskier behavior to avoid bankruptcy. On the other hand, growing experience from around the world shows that recapitalization is risky, particularly if undertaken repeatedly.

> ***"Banks and other creditors have an extremely important role to play in fostering efficiency in medium and large private or state-owned firms."***

Until mid-1994, Hungary's efforts to reform its banks paid little attention to the dangers of recapitalization. Hungarian banks were effectively recapitalized four times during 1991–94. Yet little else was done to create strong incentives for bank restructuring. No independent, in-depth portfolio audits were undertaken. Performance-oriented management contracts were not implemented, nor were bank managers given strong and clear incentives to increase the value of the banks they managed. The government did not formulate a clear plan for privatizing state banks, although two of them undertook privatization programs largely on their own initiative. Most observers agree that banking supervision was weak.

Poland, after a rocky start, made stronger efforts than Hungary in the four years ending in mid-1994 to deal with the perverse incentives faced by the managers of a group of state-owned banks. Like Hungary, it opted to recapitalize its commercial state banks, but, unlike Hungary, it carried out only one round of recapitalization. Furthermore, this recapitalization was embedded in a much larger program, the Enterprise and Bank Restructuring Program (EBRP), designed to change incentives and promote privatization. Among other actions, it prohibited new lending to problem borrowers and required banks to set up workout departments and take actions to resolve those loans that had been classified as nonperforming at the end of 1991. It also required banks to undergo repeated, in-depth portfolio audits by outside auditors. The program was made credible by the strong and consistent leadership of the Polish Ministry of Finance from 1990 through early 1994.

In sum, during 1991–94, Poland's banking reforms were far more comprehensive than Hungary's. Because the Polish reforms forced greater transparency and were tougher and more credible, they were more successful in slowing any further deterioration of the state-owned commercial banks and—most important for this discussion—in strengthening banks' resolve to pursue debt collection vigorously.

Trade credit. Suppliers were also weak creditors in the early years of transition. In 1993 and 1994, a significant portion of the debt to trade creditors in Hungary and Poland consisted of overdue payables, many of which had resulted from the transition-induced demand and liquidity shocks of 1991 and 1992. This stock of interenterprise arrears undercut discipline, owing to the fear of "domino" bankruptcies occurring if any creditor attempted to collect debts. Yet the incentives of trade creditors to monitor debtors are growing steadily stronger as the private sector continues to grow. Trade creditors, particularly privately owned ones subject to their own hard budget constraints, have increasingly prevented the emergence of new overdue receivables by requiring payment in advance—that is, before they ship goods to problem firms.

Government credit. Debt owed to the government—including arrears to the tax office, the social security service, and the customs office—became a substantial portion of the debt on the books of problem firms in Hungary and Poland in the early 1990s. Yet these agencies were weak creditors, not known for active law enforcement and collection of arrears. In contrast, their legacy from the years before 1990 was one of pervasive bargaining and redistribution from profitable firms to loss-making ones. Habits are not easy to change overnight, and tax and social security arrears continue to be a major source of "financing" for firms in financial distress. There is, however, some evidence that budget pressures are beginning to make government creditors more vigilant in both countries.

Debt collection

The third requirement for creditor monitoring and control in a market economy is an appropriate legal framework and effective procedures for debt collection. Without an effective system of debt collection, debtors lose repayment discipline, the flow of credit is constrained, and creditors may be forced to turn to the state to cover their losses if they are to survive. In informal credit markets, the effectiveness of debt collection depends on nonlegal or extralegal sanctions—such as the threat of a debtor's ostracism by the business community or, in extreme cases, self-help (sometimes violent) on the part of creditors or their agents. Formal credit markets depend more on legal procedures involving collateral (secured lending), workouts (creditor-mandated reorganization of the debtor firm), and bankruptcy (liquidation). Well-designed and implemented rules facilitate rapid and low-cost debt recovery in cases of default, thereby lowering the risks of lending and increasing the availability of credit (particularly bank credit) to potential borrowers. Poorly designed and implemented rules make lending more costly and stifle the flow of credit. The recent experiences of Hungary and Poland provide interesting illustrations of both flaws in the debt-collection processes and attempts to address them.

Collateral. In the early 1990s, Hungarian and Polish laws on collateral dated from the prewar period and failed to provide an adequate foundation for a strong financial system. First, the definition of property that could be used as collateral was narrow, and movable property had to be in the possession of the lender (thereby making it useless to the debtor firm) to serve as security. Second, there was essentially no way to register liens on movable property in either country; it was common for several liens to be secured by the same property, and banks often took liens on property worth much more than the value of the corresponding loans. Third, priorities among creditors favored the government over secured creditors. In Poland, for example, the government had an automatic lien (whether or not formalized in any way) over all property of any party in arrears to it for taxes, social security payments, or customs duties. Fourth, executing liens was extremely difficult and time-consuming, requiring a court decision and then action by a bailiff (to whom a large fee had to be paid up front). Finally, even if a creditor succeeded in executing a lien, it was often difficult to sell the collateral and thus collect on the loan. For residential properties on which the mortgagors had defaulted, for example, it was virtually impossible to evict tenants and sell the properties unencumbered by tenants' liens.

Poland provides the first test case in comprehensive collateral law reform. In late 1996, it adopted a new and modern collateral law that reforms creditor priority rules, provides for a central registry for liens on movable property, and simplifies foreclosure procedures. Hungary has also recently taken steps to improve its collateral system.

Debt workouts. A second critical component of the legal framework for debt collection is the procedure for informal workouts and formal reorganizations, the mechanisms a problem debtor may use in an effort to negotiate a reduction in its immediate debt-service costs in order to stay in business. In return for agreeing to such procedures, creditors may insist on partial debt payments and/or on fundamental changes in the firm's size or functioning in order to increase the creditors' chances of recouping the remaining debt. From a public policy perspective, these procedures are intended to promote reorganization of firms whose value as going concerns (after their reorganization) exceeds their liquidation value. Firms seeking reorganization may, for example, have assets, such as specialized machinery or unique trademarks, that have little value in alternative settings.

Since 1991, both Poland and Hungary have taken far-reaching steps to adopt market-based workout processes. Poland had both a judicial procedure and an extrajudicial one. Judicial debt workouts occur under the law on "arrangement proceedings," whose main disadvantage is its inflexibility. To overcome its deficiencies, Poland adopted a new temporary procedure for working out bad loans—the bank conciliation agreement—as part of the 1993 EBRP. Under this procedure, which could be used until February 1996, power shifted from the courts and the borrowers to the banks. Banks were empowered to negotiate, and required to monitor, workout agreements on behalf of all creditors, providing they received approval of creditors representing more than 50 percent of the value of a defaulting borrower's outstanding debt. The conciliation process was used quite extensively, along with other options for handling problem debts. This temporary process has expired, but the shortcomings of Poland's permanent judicial process have not yet been addressed.

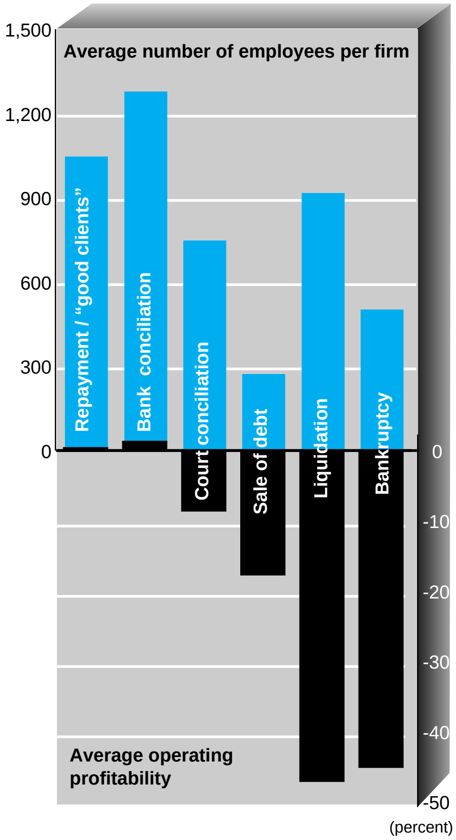
In 1991, the Hungarian parliament adopted a tough new bankruptcy/liquidation law, which took effect on January 1, 1992. It required managers of firms with any arrears of 90 days or more to file for reorganization or liquidation. On their face, the reorganization provisions of the law are similar to those of bankruptcy laws in advanced market economies, including Chapter 11 of the US Bankruptcy Code. Managers of a bankrupt firm retain their jobs after filing and have the first opportunity to present a reorganization plan. Creditors may then vote on the managers' plan and present alternative plans. If an agreement cannot be reached between a firm and its creditors, the procedure reverts to liquidation. From the first filing until the final agreement is reached, the courts have relatively little substantive involvement.

The 1991 law led to a wave of filings for both reorganization and liquidation. Some 5,000 reorganization cases and 17,000 liquidation cases were filed during 1992 and 1993. The law was widely criticized as overly ambitious, and amendments made in September 1993 removed both the filing requirement (the "stick") and the debtor firm's assured protection from creditors (the "carrot"). The number of reorganization filings under the bankruptcy law declined dramatically in 1994.

Liquidation. Liquidation is the final stage of the debt-collection process. Creditors' control rights over defaulting debtor firms derive ultimately from the former's power to force liquidation, yet in many transition economies the laws governing liquidation give little power to creditors.

In Poland, the liquidation of financially distressed firms may occur under the 1934 bankruptcy law or under Article 19 of the law on state enterprises (a legacy of socialism). Creditors or the debtor may file for bankruptcy or liquidation, and the laws provide standard rules for appointing liquidators, winding up estates, and satisfying claims in order of priority. But the priority list for creditors discourages active creditor involvement by favoring almost everyone else. If the government and procedural costs do not consume the debtor's

Characteristics of Polish firms, by resolution path, 1991/92



Source: Cheryl Gray and Arnold Holle, 1996, "Bank-led restructuring in Poland: The conciliation process in action," *Economics of Transition*, Fall, pp. 349–70.

entire estate, employees' claims may well do so.

In addition, the law provides few means for a receiver or judge to void fraudulent transactions made by a debtor firm's managers or owners, at the expense of creditors, prior to filing. Such transactions are thought to be common, and Poland's legal system must find a way to identify and punish them if the bankruptcy process (or, indeed, any debt-collection process) is to be credible. Although only companies that are still solvent are legally eligible for state enterprise liquidation, many companies in liquidation are actually insolvent. In practice, creditors recover even less under Article 19 liquidations than under bankruptcy proceedings.

In Hungary, liquidation procedures are contained in the same law as the reorganization process already discussed. As in Poland, the process is a fairly standard one, at least on paper. Either creditors or the debtor petition for liquidation, a liquidator is appointed, a list of assets is drawn up, and the assets are then supposedly sold to satisfy claims in the order of creditor priority. While the Hungarian law does not include the counterproductive priority rules incorporated in the Polish law, the compensation formula for liquidators leads them to keep firms in operation for as long as possible and to act more as restructurers and privatizers than as agents of creditors. Furthermore, the process is thought to offer many opportunities for fraud, both by managers (who may remove valuable assets before filing for liquidation) and by liquidators (who may find many ways to profit from their near-monopoly control over the process). In Hungary, the problem is not so much the existing legal framework as the difficulty of administering it properly in an environment characterized by poor information, little accountability, and confused incentives.

Debt's emerging role

Surveys of Polish firms involved in the EBRP and Hungarian firms involved in bankruptcy show that the outcomes of these processes have been mixed (see references). The EBRP forced Polish banks to confront their problems, and both countries' processes furthered the difficult task of weeding out and closing unviable firms and helped build institutional capacity in banks (Poland) and in courts and the trustee profession (Hungary). Loans were written down in both cases without creating an environment of general debt forgiveness. Better-off firms entered reorganization, while weaker ones tended to go into liquidation. Size also mattered, particularly in Poland (see chart). Larger firms were more likely to enter reorganization regardless of their profitability. This should not be surprising, since these firms are politically more difficult to close.

The workout and liquidation processes did not, however, impose strong restructuring mandates on problem debtors or efficiently close insolvent firms. The first two years of implementation of the bank conciliation agreements in Poland, for example, saw a slowdown (over earlier years) in the rate of layoffs, a decline in average operating profitability, and very little real privatization. In both Poland and Hungary, liquidations have been slow and have returned very little to creditors. Continued reforms of laws, court procedures, and creditor incentives are needed to build strong banks and effective legal processes that allow debt to serve as a device to exert control over firms in times of financial distress.

Conclusion

The facts regarding firm financing, bank incentives, and the mechanisms for debt collection may differ from one country or continent to another. Some underlying themes are constants, however, and apply as much to Africa, Asia, and Latin America as to Central Europe. First, strong, market-oriented creditors are good for an economy. They can afford to provide financing to a wide range of clients at reasonable rates and play an important role in corporate governance, particularly in the restructuring of firms in financial distress. Second, creditors must have strong legal rights under contract, collateral, workout, and bankruptcy laws if they are to play this governance role. Giving them those rights may require extensive legal reform in some developing and transition economies. Third, creditors must also have information on their borrowers if they are to play this role. Credit information or credit-rating services can be extremely valuable in facilitating firms' access to financing, and governments should encourage their formation and growth. Accounting services, chambers of commerce, the business press, and other parts of civil society also provide much-needed information in well-functioning market economies. Finally, creditors must have strong incentives to ensure that debts are repaid, and this means they must depend on the market to survive. This implies competitive markets, financial discipline, predominantly private ownership, and a true risk of failure for both banks and firms. F&D

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