RESTRUCTURING OF A BAD DEBT PORTFOLIO IN A COMMERCIAL BANK IN THE MIDST OF AN ECONOMIC TRANSITION PERIOD

Case study: Powszechny Bank Gospodarczy w Łodzi

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1. Introduction

Powszechny Bank Gospodarczy S.A. w Łodzi is one of the commercial banks that were hived off from the National Bank of Poland as a result of the reform of the Polish banking system that occurred in 1989. Out of the total of nine banks thus established, three institutions - Wielkopolski Bank Kredytowy S.A., Bank Śląski S.A. and Bank Handlowo-Przemysłowy S.A. - have been privatised to date. Powszechny Bank Gospodarczy S.A. is still a single shareholder joint stock company owned by the State Treasury. In terms of asset size it ranks among the major commercial banks in Poland. It is a regional bank, whose principal territory of operations is confined to the Central Poland region, although a network of its branches guarantees the bank nation-wide coverage.

The period of systemic transformation has exerted a direct influence over current activity and the development strategy of the bank. The loan portfolio is characterised by a large share of loans advanced to finance central government investment projects, which are fully guaranteed by the State Treasury. Similarly as in other commercial banks, “bad debts” in PBG S.A. became a threat to its solvency. At the trough of the critical period the share of problem loans (“bad debts”) in the loan portfolio, excluding loans granted to finance central government projects reached 39.9%. Recapitalisation, corporate recovery and restructuring activity became a prerequisite for the bank’s survival and existence of prospects for future development.

Under the government's bank and enterprise financial restructuring programme PBG S.A. was recapitalised with the amount of PLZ 1,256,390 million, and completed far reaching restructuring of the “bad debt” portfolio, introduced new credit and banking risk assessment procedures, as well as implemented a new system for monitoring of borrowers’ current situation. It completed a comprehensive restructuring programme and developed a strategic development plan.

Recapitalisation of the bank was conditional on pursuing loan portfolio restructuring activity, which was regulated by a special parliamentary bill - Enterprise and Bank Financial Restructuring Act, which was adopted by Parliament in February 1993.

The implementation of the provisions of the Act vis a vis PBG S.A required that the bank take a pro-active approach in the process of bad debt portfolio restructuring and adopt a special stance vis a vis borrowers - bad debtors.

The present study presents the context of the enterprises and banks financial restructuring programme in Poland and its implementation in PBG S.A. The strategy of “bad debt” restructuring shown in this study stems from the macroeconomic climate in Poland at the beginning of the 1990s, existing legal environment and from the extent to which the bank completed the process of adjustments to the market economy. The method tackled here does not offer any universal concept of bad debt portfolio restructuring in a commercial bank.

All the opinions and views presented here are those of the author.

2. Reasons for emergence of bad debts in the banking sector.

At the beginning of the 1990s the following factors had a critical impact on developments in the Polish banking sector:

- reform of the banking system which commenced in 1989;
- radical market oriented reforms in the Polish economy (the Balcerowicz Plan).

The emergence and rapid increase in the size of bad debts accompanied the systemic transformation processes underway in Poland. The main causes of the surge of bad debts in the banking sector in Poland - which are defined here as doubtful and loss loans[1] - are a result of both internal developments in the banking system and of the external economic environment.
The external causes of the emergence of ”bad debts” are principally identified as the following:

Macroeconomic

- collapse of the command economy;
- radical programme (”shock therapy”) implemented to quench inflation and liberalise the country’s economy;
- collapse of traditional export markets as a result of the secession of former Soviet Union republics and accompanying economic crisis in the economies of the former COMECON countries;

Legal and systemic maladjustment and bottlenecks in the mechanism of market allocation of resources

- poor efficiency of bankruptcy and liquidation proceedings as means to eliminate inefficient entities from the market;
- poor efficiency of insolvency proceedings stemming from a lack of appropriate legal regulations and bottlenecks in the existing legal framework;
- lack of appropriate credit controls and receivables monitoring by enterprises which led to the uncontrolled growth in past-due receivables and thereby threatening the enterprises’ viability;
- loopholes and inadequacies of the law pertaining to business activity e.g.(lack of criminal liability for deliberate actions causing bankruptcy and vaguely defined liability of a debtor acting to the detriment of a creditor);
- questionable value of collateral for advances granted owing to the following factors:

  1. existence of undisclosed pledges and legal mortgages;
  2. lack of central database of bank pledges;
  3. low liquidity and realisable market value of legal collateral of loans;
  4. inefficacy of execution proceedings.

[1]Doubtful and loss debts, classified in accordance with international accounting standards and with the regulations of the president of the NBP nr 19/92 and 13/94.

External factors constitute a general background to the emergence of bad debts. Their existence to a considerable extent stems from the collapse of the centrally planned economy and accompanying economic recession. They are a result of an inefficient and inappropriate legal framework for the business community which is a descendant of the socialist period. The inadequacy of the legal system in the context of the needs posed by a market economy led to the preservation of economic inefficiencies and hindered the structural turnaround necessary to create an environment conducive to economic growth. "Bad debts" are also a cost incurred by the economy in its transitional phase. Radical market oriented reforms, necessary to stop negative tendencies in the economy, were a shock treatment and led to the commencement of business activity in a new economic environment. Many businesses, especially large state-owned enterprises, had considerable difficulties adjusting to the workings of the market economy, and their problems were further exacerbated by the urgent need to undergo far reaching restructuring to answer the demands of the market. As a consequence, the indebtedness of enterprises vis a vis all kinds of creditors soared. Much of that debt capital soon became "bad debts". The worsening of the financial standing of enterprises (clients of banks) emerges as a crucial external factor responsible for the emergence of bad debts and hence merits a special treatment. Generally speaking, the causes of crisis and threats to the very economic existence of many service and manufacturing businesses that occurred during the period of transition from the command economy to a free market system, are akin to the external causes of the emergence of bad debts in the banking sector outlined above. Additionally, insofar as the external relations of business entities are concerned, the following can be identified as the origin of the loss of liquidity and impending bankruptcy:

- unstable and insecure economic environment;
- high inflation
  - increase in financing costs;
  - increase in prices of materials and components;
- demand fell as prices were increased to reflect true market values thereby necessitating the need for structural changes in the areas of business organisation, technologies and product ranges;
- the breaking of traditional economic relations within supply and distribution chains brought about by demonopolisation;
- loss of Eastern markets and difficulties in selling surpluses in the domestic market accompanied by contemporaneous lack of capability to swiftly change the product mix and adjust it to the quality standards demanded by Western markets.

The worsening of the financial situation of enterprises (clients of banks) resulting in loss of liquidity and creditworthiness at the end of the day were a direct reason for emergence of bad loans in the assets of a commercial bank. The financial crisis of the enterprises, in the majority of cases, originated within the businesses, and the following may be identified as internal factors producing crisis situations:

Unskilled enterprise management:

- incompetent enterprise management
- lack of business management skills in a market environment;
- lack of current and strategic planning of business activity;

- lack of rudimentary skills in the area of financial management;
- lack of management accounting systems and management information systems.

Financial constraints and barriers to the activity of businesses:
- sharp increase in financial costs (interest expense on loans and other financial obligations);
- lack of skills in the areas of financial analysis and management;
- lack of cash flow planning, which given the unstable conditions of business activity leads to sudden and unexpected liquidity squeezes;
- accounting systems not able to produce a fair assessment of the current situation of a business;
- uncontrolled surge in the days receivable ratio and a sharp increase in the size of past due receivables.

Business operations:
- inefficient organisation of labour;
- low labour productivity;
- low utilisation of production capacity;
- lack of adequate cost and product quality control systems;
- plant over manning.

Structural maladjustment:
- organisational and functional structure of the enterprises designed so as to accommodate the old centralised allocation system and defined within the limits of curtailed economic independence of economic units;
- wrong employment structure ;
- product mix and quality not geared to accommodate changing demand patterns;
- low technological and product innovativeness;
- high proportion of ”surplus assets” (social infrastructure, non-production assets, unutilised production assets).

Constraints in the supply and sales functions:
- lack of basic marketing skills;
- failure to react to stagnating demand and changes in demand patterns;
- unsuitable organisation of the sales function in enterprises which, given the liquidation of the old monopolised distribution channels, is the principal barrier to sustaining and thereafter increasing sales volumes.

Contemporaneous impact of many of the above listed factors resulted in permanent liquidity squeezes in enterprises. In a fully-fledged market economy loss of financial liquidity endangers further existence of a business. The Polish situation is peculiar in this respect, as enterprises could for a number of years in a row, which is a long period of time, finance their shortages of financial resources by increasing their liabilities vis a vis creditors. Initially they kept on inflating their indebtedness vis a vis banks, and afterwards went on increasing their liabilities to the State Treasury and business suppliers, and the State Treasury turned out to be the most lenient creditor they had.

The transformation period also revealed many structural and operating maladjustments of financial institutions to functioning in a market economy. It had an influence on deterioration of the loan portfolio inherited from the socialist past, as well as manifested itself in a high and growing share of „bad debts" in the portfolio of loans granted in the transformation period.[2]

The principal internal reasons that spurred the emergence, persistence and increase in "bad debts" in the banking sector were as follows:

- loan procedures, especially assessment of credit risk, not geared to accommodate the requirements of a market economy, especially to an economy in transition;
- lack of a satisfactory system of ongoing monitoring of loan portfolio quality and off-balance sheet liabilities;
- lack of mature concept relating to credit policy, which acutely exposed banks in the period of transforming the economy into a market-driven one and the companion structural economic crisis;
- imperfect system of monitoring the current situation of borrowers in view of banking risk assessment, which should have performed the role of an early warning system;
- lack of qualified personnel equipped to deal with areas of credit risk, loan administration and management, as well as the absence of loan restructuring and insolvency functions within banks;
- imperfect prudential regulations in the banking sector, which gave banks an opportunity not to disclose the size of distressed assets;
- absence of firm action vis a vis unreliable borrowers, often unwarranted waiting for the borrower's situation to improve, plus the practice of extending new loans to enable settlement of previously taken on debts or agreeing to rescheduling of payments.

The identification of distressed assets and off-balance sheet liabilities depends on the efficient operation of the system responsible for ongoing assessment of banking risk inherent in the assets and off-balance sheet liabilities of the bank. The system of permanent monitoring of loan portfolio quality and off-balance sheet liabilities acts as an early warning system and constitutes the foundations of the bank's security. The commercial banks hived off from the National Bank of Poland in 1989 took over selected assets and liabilities from the central bank, inclusive of a loan portfolio whose shape was defined in the command economy period. The operations of a commercial bank in a command economy differ substantially from the operational principles of its counterpart active in a market economy. These differences are especially important in terms of credit activity. Loan administration procedures and the operational principles of a bank functioning in a command economy are geared to allocate limited financial resources with beneficiaries being selected according to vaguely defined principles (inter alia political considerations). The assessment of a customer's creditworthiness and the loan application is carried out on the basis of distorted prices of resources and products and takes into account erroneously evaluated demand-supply relations. In the end the pivotal criterion of allocation is that of political imperative, manifested in credit decisions of the bank, which are in essence administrative and clerical. Credit risk -

[2]"Bad debts" in the banking sector are largely the legacy of the command economy era, nevertheless a significant part of them arose as a result of imprudent credit policies pursued at the beginning of the 1990s. It seems that commercial banks gave in to political pressures advocating support for the private sector, and given the lack of appropriate experience and skills they made many mistakes, both in the area of borrowers' creditworthiness assessment and evaluation of credit risk connected with investment projects they financed.

understood as a risk of recovery of funds advanced - under this system is an abstract notion without any direct reflection in economic practice. The reform of the banking system - commenced in 1989 - and especially the accelerated drive towards a market-driven economy in Poland, uncovered that the manner in which the commercial banks function was ill adjusted to meet the demands of a competitive economy. Emergence of ”bad debts” in the banking sector stems from this maladjustment and is a price borne in relation to systemic transformation.

The internal causes of the emergence of bad debts in commercial banks are explainable to the extent of their being a legacy of the past, underdevelopment of rudimentary banking techniques and lack of skills gained in their practical application. They become an inexcusable negligence if their causes are not removed as a result of a financial restructuring and recovery of the quality of loan portfolio. The identification and analysis of reasons for emergence of bad loans in portfolios of banks should lead to:

- establishment of an efficient system of bank assets classification and design of a system for monitoring borrowers that meets the prerequisites of an early warning system;
- identification of mistakes and deviations from the proper course of action that occurred in the past;
- design of a restructuring process;
- creation of an effective system of banking risk assessment drawing on the experience gathered during restructuring of ”bad debts”;

The reasons for emergence of problem loans in the banking sector presented here do not constitute a finite set of issues. The analysis of the importance of individual factors that would define their impact on engendering bad debts in the banking sector was not carried out. This was mainly based on the premise that the importance of factors differs among individual banks. Origins of bad debts in the banking sector outlined above reflect the author’s opinions, which draw on experience gathered during restructuring a portfolio of problem loans carried out in one of the major Polish banks.

3. Programme of financial restructuring of enterprises and banks

3.1. General background

The implementation of the economic transformation programme underway since the beginning of 1990 turned out to be a very difficult test in respect of efficiency and ability to adjust to the demands of the market economy to which most of the state enterprises were put. The period uncovered a blatant truth about their adaptive potential, efficiency of business activity and ability to compete in the domestic and foreign markets. It turned out that a significant majority of state enterprises cannot survive competitive pressure posed by private domestic and foreign manufacturers, their reactions to market signals are weak, and that they are not capable of working out and implementing radical restructuring programmes, and in many cases they are loss making businesses. The sector of state owned enterprises languished in a structural crisis exacerbated by negative changes in the Polish economic environment. Increase in the amount of liabilities to the extent of the permanent loss of liquidity and threats to the existence of individual enterprises were one of the symptoms of this crisis[3]. Excessive indebtedness vis a vis all kinds of creditors quickly became bad debts:

- trade creditors;
- The State Treasury and the National Insurance (ZUS)
- financial institutions

[3]Dąbrowski,J.M.; Fedorowicz,M.; Levatas,A.: "State owned enterprises - The second year of economic transformations", Institute of Market Economy Studies, Warsaw - Gdańsk, 1992, p.15 et al.

Figure 1.

Indebtedness of state-owned enterprises

Enterprises employing:

over 50 staff in mining, coal mining and in manufacturing,

over 20 staff in other categories

	1990	1991	1992	1993	I-XI 1994
A. To the State Treasury	21,490,400	24,912,382	83,835,311	127,040,204	126,755,990
in constant prices of 1990	**21,490,400**	**15,570,239**	**36,450,135**	**40,330,223**	**30,220,687**
growth in % in comparison to the previous period		**- 27.5**	**+134**	**+10.6**	**-22.6**
of which:	21,490,400	24,912,382	66,695,369	93,434,453	84,877,828 **
- amounts due to the State Budget	- *	- *	17,139,942	33,605,751	41,878,162
- amounts due to National Insurance (ZUS)					
B. Trade creditors (total)	114,563,765	124,275,197	231,324,498	273,447,707	288,535,893
in constant prices of 1990	**114,563,765**	**77,671,998**	**100,575,869**	**86,808,796**	**71,067,953**
growth in % in comparison to the previous period		**-32.2**	**+29.5**	**-13.7**	**-18.1**
of which:	110,302,.228	122,500,427	227,188,199	270,188,566	288,535,893
- suppliers	4,261,.537	1,774,770	3,136,299	3,259,141	- *
- bills of exchange payable					
C. Financial institutions (loans and advances)	81,999,662	97,532,229	203,504,968	274,322,367	305,963,722
in constant prices of 1990	**81,999,669**	**60,957,643**	**88,480,421**	**87,086,466**	**75,360,523**
growth in % in comparison to the previous period		**-25.7**	**+45.2**	**-1.6**	**-13.5**
of which:	39,099,521	52,829,121	116,741,681	167,061,411	- *
- long term bank loans and advances	41,936,202	38,926,215	73,754,271	90,864,414	- ***
- other loans and advances					

Notes:

* no data available in the report

** Amounts to the budget (current)

*** Short term loans and advances

**** Price growth rate for consumer goods (1991 - 60%; 1992 - 44%; 1993 - 37%; 1994 - 29%)

Source: Central Statistical Office Data

Figure 2.

Indebtedness of state-owned enterprises

Enterprises employing from 5 staff to:

50 staff in mining, coal mining and in manufacturing,

20 staff in other categories

	1990	1991	1992	1993
A. To the State Treasury	754,176	16.310,770	4,116,124	6,187,133
in constant prices of 1990	**754,176**	**10,194,231**	**1,789,619**	**1,964,169**
growth in % in comparison to the previous period		**1,251.7%**	**- 82.4**	**+ 9.8**
of which:	754,176	16,310,770	3,282,202	5,144,258
- amounts due to the State Budget	- *	- *	833,922	1,042,875
- amounts due to National Insurance (ZUS)				
B. Trade creditors (total)	5,214,099	56,637,744	24,779,740	33,015,795
in constant prices of 1990	**5,214,099**	**35,398,590**	**10,773,800**	**10,481,205**
growth in % in comparison to the previous period		**579%**	**- 69.6**	**- 2.7**
of which:	5,118,591	55,885,077	24,271,502	31,322,487
- suppliers	95,508	752,667	508,238	1,693,308
- bills of exchange payable				
C. Financial institutions (loans and advances)	3,740,383	41,916,168	17,614,853	27,038,769
in constant prices of 1990	**3,740,383**	**26,197,605**	**7,658,632**	**8,583,736**
growth in % in comparison to the previous period		**+ 600.4**	**- 70.8%**	**+ 12.1%**
of which:	2,297,121	20,892,900	12,125,815	19,664,263
- long term bank loans and advances	1,215,672	18,021,357	3,989,382	5,017,721
- other loans and advances				

Notes:

* no data available in the report

** This group of entities was not obliged to file F-01 statistical statements between January and September 1994

*** Price growth rate for consumer goods (1991 - 60%; 1992 - 44%; 1993 - 37%; 1994 - 29%)

Source: Central Statistical Office Data

The burden of indebtedness snowballing over time posed a threat that the economic system, manufacturing and financial sectors and the State Budget would be immobilised. Ineffectiveness of traditional mechanisms of eliminating permanently ineffective entities from the market produced a direct threat to the security of business operations. The indebtedness of medium sized and large enterprises vis a vis major creditor groups snowballed in the period 1991-1992 as follows(fixed prices):

- to State Treasury by 134%
- to suppliers by 29.5%
- to financial institutions by 45.2%.

Data relating to enterprise indebtedness derived from statutory financial reports are under stated, as they do not include most of interest on overdue debts owed to suppliers nor penalty interest accrued on delinquent loans and advances.[4]

Indebtedness of small enterprises displays different growth patterns. Enterprises which did not have inventory and reserves incurred debts earlier than others and their indebtedness soared rapidly. The trend reversed equally rapidly in 1992, when debts owed to all classes of creditors went down to rise again.

The initial phase of the transformation period of the Polish economy - between 1990 and 1991 - revealed that the extent to which state owned enterprise were not adjusted to cope with a fast changing economic environment posed a threat to the existence of the vast majority of them. Survival of many enterprises, including those having potential for restructuring and market prospects, depended on the government adopting a package of institutional supportive action. This situation occurred contemporaneously with the emergence of the first serious indicators of the financial system crisis. The increase in the size of default indebtedness of enterprises was reflected in the growing share of doubtful and loss loans in the portfolios of commercial banks. Initially the deterioration of loans advanced by the banking sector was not fully realised by the banks themselves. Diagnostic studies of the financial position of the nine commercial banks - where principal emphasis was placed on the examination of loan portfolio quality - commissioned with independent auditors by the Ministry of Finance and conducted in 1990 and 1991, confirmed the existence of problem loans in the portfolio and the increase in the share of problem loans over time. The increase in the share of loans - classified in the two lowest categories - doubtful and loss loans - ranged between 9% and 20% in June 1990 and 24% - 68% in June 1991. The creation of mandatory provisions for problem loans was beyond the means of those banks, with the exception of Bank Śląski S.A. and Wielkopolski Bank Kredytowy S.A.. Capital adequacy ratios - calculated in accordance with internationally acknowledged standards - in some cases were significantly below the acceptable safety level i.e. 8%. Diagnostic studies carried out in 1992 and 1993 for Bank Polska Kasa Opieki S.A., PEKAO S.A., Bank Gospodarki Żywnościowej and Polska Kasa Oszczędności BP rendered equally disconcerting results. The analysis of the current situation of banks and forecasts relating to future developments in this respect showed that restoring safe solvency ratios for those banks would in the short term perspective require their owner - the Ministry

[4]Actual indebtedness of enterprises in the midst of crisis is significantly higher, even by several dozen percent, than reported in financial statements (Cf. Fig. 14 and 15)

of Finance - to provide substantial capital injections. Financial restructuring of commercial banks required that urgent action be taken in respect of bad debt portfolio restructuring, implementation of mechanisms preventing emergence of such debts, while simultaneously ensuring that costs of such operations would be covered.

The general factors outlined above compounded to necessitate a vital need to force acceleration of and support for restructuring processes in state owned enterprises, enterprises where the State Treasury was a majority shareholder and in commercial banks which were their creditors[5]. The programme of financial restructuring of enterprises and banks, adopted by the government in 1992, assumed that the solution to the problem required the intervention of the state, and called for decisions and an institutional action package. It should be stressed that the following entities were anticipated be the main beneficiaries and agents of change in the programme:

- state-owned enterprises, single shareholder joint stock companies of the State Treasury and companies formed pursuant to the commercial code, where the State Treasury, state-owned enterprises and single shareholder joint stock companies of the State Treasury in aggregate hold more than 50% of the shares,
- commercial banks - single shareholder joint stock companies of the State Treasury and state owned banks being recapitalised.

The role of banks in the programme of restructuring of enterprises and banks stemmed from the inherent logic driving the plan. The price that the banks had to pay for recapitalisation was their active stance taken in the process of restructuring of enterprises, which were their debtors. The financial sector was obliged to force enterprises to embark on action aiming to recover their viability, or to take steps leading to their liquidation or bankruptcy. It was assumed that banks would be taking decisions about the course of action to be adopted based on rational criteria of allocation.

3.2. The goals and instruments of the Act on Financial Restructuring of Enterprises and Banks

In order to ensure effective completion of the programme of restructuring of enterprises and banks a special law - lex specialis - was enacted for the period of transformation, whose provisions contain hitherto unprecedented solutions in the realm of bankruptcy and arrangement proceedings and civil law. The Financial Restructuring of Enterprises and Banks Act , in line with the goals its creators had in mind, aims to:

- create development prospects for commercially effective enterprises, which are capable of working out a viable strategy of operation in a competitive environment;
- eliminate entities which do not stand a chance of further independent functioning;
- recover the loan portfolio of banks.

The Act is one of the most important elements of the programme of financial restructuring of enterprises and banks which the government adopted. The pre-eminent goal of the

[5]Kawalec, S.: "Polish methods of bad debt restructuring" in PBR - CASE Procedings Papers, nr. 12. Warsaw 1994.

programme is to simultaneously prepare banks and enterprises with viable market prospects for privatisation.[6]

The realisation of the above outlined goals is aided by new instruments of financial restructuring introduced by virtue of the Act, i.e.:

1. bank conciliatory proceedings
2. disposal of bank debt carried out according to simplified procedures
3. conversion of mature debt of state owned enterprises and of single shareholder joint stock companies of the State Treasury into an equity interest in them.

Ensuring a pro-active approach by banks in the restructuring process is of key importance in achieving the success of the operation. Recapitalisation of selected commercial banks, first carried out for seven commercial banks, and then for BGŻ, PEKAO S.A. and PKO BP took into account the cost - determined in advance - of restructuring of a bad debt portfolio, as of 31 December 1991 and 30 September 1992 respectively, assuming the target capital adequacy ration of 12% after recapitalisation.

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[6]Groszek,M.;Jaszczyński,D.; Klimkiewicz,E.; Krawczyk.M.; Urbaniak.J.: "Financial Restructuring of Enterprises and Banks"; Warsaw 1993, p.12.

Figure 2

Recapitalisation funds made available to banks under the Act on Financial Restructuring of Enterprises and Banks

Note: All figures in PLZ billion

BANKS	Equity	Provisions for losses on substandard loans		Recapitalisation amount	Capital adequacy ratio	
	1992 r.	**1993 r.**	**1992 r.**	**1993 r.**	**1993 r.**	**1992 r.**
Bank Depozytowo-Kredytowy w Lublinie S.A.	638.4	1 354.6	303.5	1 790.21	27.7%	3.2%
Bank Gdański w Gdańsku S.A.	1 135.0	1 261.0	703.0	1 609.59	34.3%	22.1%
Bank Przemysłowo-Handlowy S.A. w Krakowie	1 258.5	1 770.0	727.0	1 598.43	17.9%	11.2%
Bank Zachodni we Wrocławiu S.A.	1 327.0	1 688.0	655.0	1 445.06	22.7%	5.3%
Pomorski Bank Kredytowy S.A. w Szczecinie	1 485.0	2 793.0	1 219.0	1 363.67	19.5%	9.5%
Powszechny Bank Gospodarczy S.A. w Łodzi	686.0	1 320.0	238.0	1 256.39	18.9%	3.5%
Powszechny Bank Kredytowy S.A. w Warszawie	1 394.0	2 873.0	924.0	1 936.65	23.6%	5.8%

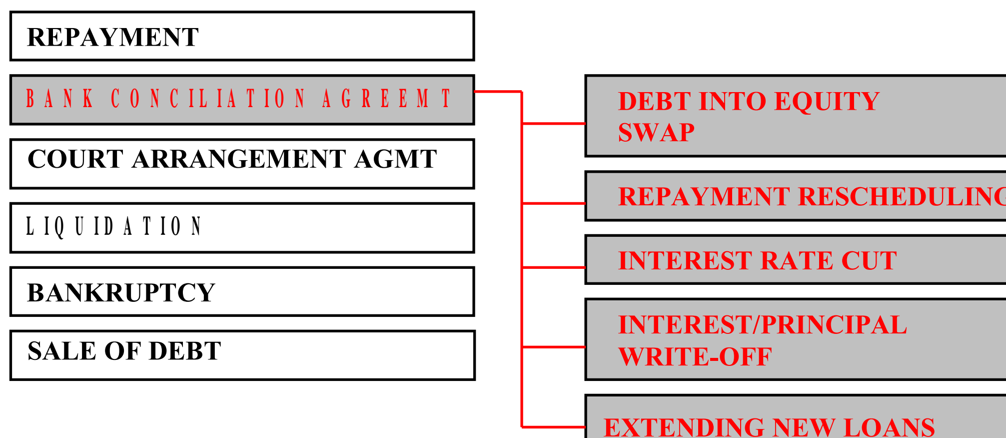
Sources:

1. Regulation of the Minister of Finance of 27 July 1993 (Journal of Laws, Issue 69, item. 332)
2. Ranking of banks ’94, Gazeta Bankowa (4 July 1994 r.)

Banks recapitalised pursuant to the provisions of the Act on Financial Restructuring of Enterprises and Banks were obliged to embark on restructuring activities, for which deadlines were set. Provisions of the Act in this respect are injunctive - Article 53, item 3 of the Act lists action to be taken and provides for strict deadlines for individual steps, which banks are obliged to take vis a vis debtors, whose liabilities to the bank were graded as substandard loans and were a basis for Recapitalisation.

Figure 4

Path of financial restructuring of bad debt portfolio.



Bank conciliatory proceedings are the principal instrument of restructuring as provided for in the Act on Financial Restructuring of Enterprises and Banks. Its framework is based on the institution of court voluntary arrangement as provided for by the Arrangement Proceedings Act of 1934, the essential difference being that proceedings are initiated and verified by the bank, and the conclusion of the proceedings is conditional on the agreement of more than 50% of valid votes cast by creditors subject to the agreement. It is very important that amounts owed to the State Treasury are treated on an equal footing with other debts, while in bankruptcy and arrangement proceedings the State Treasury is a privileged creditor, taking precedence over trade and bank creditors. In justified cases it allows for achievement of substantial debt write-offs for enterprises undergoing a crisis according to the rules involving no detriment to any of the creditors, at the same time ensuring that only a low number of votes need to be cast to accept the result of proceedings. The role of the bank merits emphasis, as it is responsible for:

- initiation of bank conciliatory proceedings at its sole discretion;
- management of the proceedings and verification;
- supervision over the execution of the obligations under the proceedings;
- in justified cases, for filing a petition with a court to set aside the bank conciliatory proceedings

Sales of debt is a voluntary restructuring option available for the bank to pursue at its discretion, although it may be forced on the banking institution if before the set deadline the bank did not restructure the loan being subject to recapitalisation. The Financial Restructuring of Enterprises and Banks Act - as provided for in Article 53, item 2 - obliges the bank to sell delinquent debt. The obligation does not relate to banks which before 31

March 1994 completed the financial restructuring in another manner. Only the banks recapitalised by the Ministry of Finance pursuant to the provisions of the Act are subject to the aforesaid obligation. The issue of bank debt sale is regulated by Section 3 of the Act. It defines the manner and principles of mature bank debt sale. The provisions of the Act in this respect are a special regulation overriding generally applicable provisions of the Civil Code. To the public sale of bank debt, provisions of the Banking Law Act in respect of bank secrecy exercised in relation to the confidentiality of turnover in customers' accounts and account balances do not apply provided that the debt is earmarked for sale (Article 42). It is a special provision, overriding the stipulations of the Banking Law Act, and allows for disclosure of the information about the debt to the extent that is deemed necessary to define the subject of the contract of sale.

Debt to equity swap may be carried out according to a special path as provided for by the Act or may be executed within the framework of bank conciliatory proceedings. The aforesaid special path provides for the right of an entity holding at least 30% of mature debt owing by a state-owned enterprise or single shareholder joint stock company of the State Treasury to swap the debt into equity in the manner defined by the Act. The prerequisite being that the debtor's obligation was contracted before 30 June 1992 or the said debt is purchased from the banks in the manner defined in the Act. The instrument offers the possibility to complete debt reduction and privatise the enterprise at the same time.

Banks subject to recapitalisation were obliged to refrain from providing loan capital to finance new needs of delinquent debtors, which as a result renders cost cuts, asset disposals, reduction in days receivable ratio and increasing amounts owed to non-financial institutions (especially the State Budget and National Insurance) the only way to finance an increase in working capital. In order to boost efficiency of the restructuring action, banks - upon demand of the Ministry of Finance - created loan workout departments, whose directors would on management boards of their Banks. The underlying purpose of this action was to separate management and restructuring of bad loan portfolios from regular loan management and administration, and thereby increase the influence of people overseeing the restructuring over the flow of restructuring processes and utilise their experience to improve the standards of credit risk management in the entire bank.

4. Stance of a commercial bank vis a vis enterprises bad debts in the transformation period.

Commercial banks are one of the key institutions being agents of change in the transformation of the Polish economy. Their special role relates to initiation of adjustment processes in the economy and exerting pressure on the economy to force it to meet the demands of a market-driven system and international competition. This action package stems from the role allocated to banks under the programme of restructuring of banks and enterprises, as well as from the desire to attain operational and strategic goals of a commercial bank, being:

- ensuring the security of liabilities and assets, especially that of loans and deposits;
- adjusting the level and scope of services provided to meet increasingly diversified demands of the market;
- financial restructuring of the bad debt portfolio in order to secure competitiveness in domestic and foreign financial markets;
- securing a stable customer base comprising small, medium-sized and large economic entities as well as private individuals and households.

The way a bank tackles an enterprise in crisis has a significant impact on the latter's current operations and survival prospects. It is of particular importance to enterprises in whose debt portfolio amounts owed to financial institutions constitute a significant portion. The decision of the bank in relation to the action strategy adopted vis a vis a given enterprise is of strategic importance to other creditors. In the event that indicators of a crisis in the enterprise and threats to loan repayment make themselves felt the bank has to follow one of the three courses of action specified below:

A. Waiting
B. Confrontation
C. Support

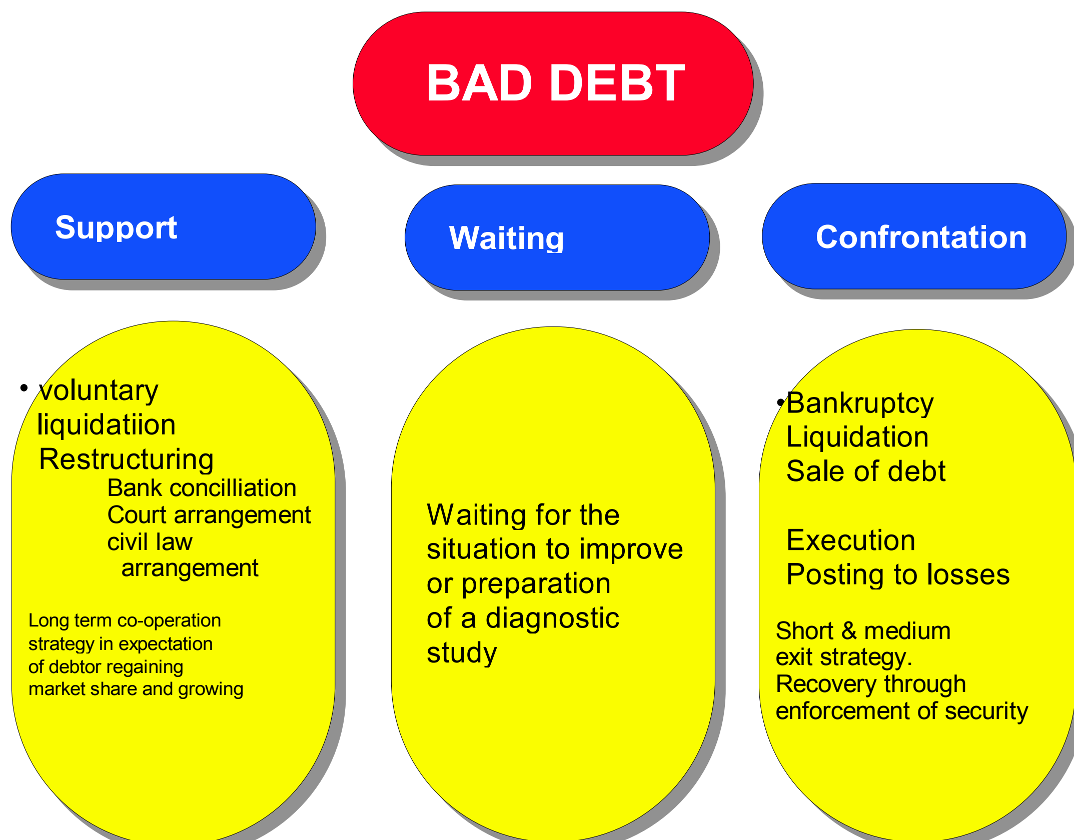
Waiting - is the period needed to observe the development of the situation and improvements in the current situation or to produce a diagnostic report, permitting direct action to be taken vis a vis the enterprise. In the event that the enterprise cannot manage to overcome the crisis drawing on its own resources the bank is forced to adopt a stance on the matter and take adequate action.

Confrontation - results in terminating the loan agreement accompanied by contemporaneous initiation of insolvency proceedings aiming at recovery of all debt or part of it, with special emphasis being placed on legal collateral for the loan.

Supportive action - includes all action undertaken by the bank to which a borrower is entitled by virtue of the risk taken on and costs incurred owing to their critical condition and impending threat to the recovery of the bank's assets. The bank's decision to undertake action aimed at supporting the enterprise endeavours to overcome the crisis must take into account the impact such decisions will have on the attainment of the principal goals of the bank: profitability, credibility and liquidity.

Figure 5

Approaches of the bank to enterprises in crisis



A financial and operational crisis in an enterprise consists of the emergence of difficulties posing threats to the prospects of the enterprise in the foreseeable future, and the removal of which is beyond the scope of ordinary management techniques and calls for external assistance. The survival of an enterprise in such circumstances depends on the success of restructuring and the co-operation of creditors. Restructuring is the coherent sum of actions aimed at ensuring the survival of the enterprise through preserving the core areas of the enterprise's business activity and revamping them in such a manner so as to achieve a sustainable restoration of liquidity and profitability. The form and scope of supportive action extended towards the enterprise by the bank is an outcome of analysis of the bank's own interests given the impending dangers to the enterprise's survival and the threat of losing part or the whole of its exposure and costs and risks related to the restructuring. A number of methods that the bank can use to support an enterprise in crisis may be identified. The principal being:

A. Avoiding losses of loans advanced:

- expected costs of financial restructuring are lower than forecast losses to be incurred should the execution proceedings on legal security be initiated or in the event that liquidation or bankruptcy options are chosen;

- future income of the bank resulting from continuing the co-operation with the client will offset currently incurred losses and costs of restructuring borne by the bank;
- spreading losses over time in order to avoid their cumulated impact on the income statement, the bank's credibility and its corporate image.

B. Awaiting future income generated through maintaining business relations with the client:

- in the event that restructuring proves to be successful, services extended to the customer and providing funds to meet his working capital needs and investment project related needs are sources of revenue for the bank;
- the bank may rely on the customer's loyalty by virtue of the help it offered in ”difficult times”;
- familiarity with the customer permits rational credit risk assessment for future operations;

C. The bank as a shareholder in an enterprise in the crisis period may directly influence the choice of operating restructuring concepts and have a say in their completion.

Enterprises languishing in crisis that merit external support expect the banks to provide wider ranging assistance than from other entities. While a bank traditionally approaches each loan restructuring exercise with utmost care verging on distancing from methods of support which go beyond routine changes of terms and conditions of repayment.

5. Restructuring of a bad debt portfolio in a commercial bank as a mechanism of capital allocation in the process of economic systemic transformation and far reaching structural changes.

Case study: Powszechny Bank Gospodarczy S.A. w Łodzi

5.1. Criteria of bad debt portfolio restructuring method selection

The principal criterion the banks consider while deciding on the choice of course of action in restructuring of a bad debt is that of maximising returns in assets employed, given existing risk factors and the time needed to recover funds. The logic underlying this criterion is obvious, yet its practical application is very difficult and requires detailed study of the bank's financial and asset position, as well as of the current situation of the enterprise, origins of the crisis and possibilities of combating it.

The time factor is predominant in respect of the choice of one of the courses of action set out below:

- short term exit strategy (up to 1 year) - repayment of the loan affected through a third party bank taking over the financing of the enterprise, sale of the company or its assets, debt disposal, initiation of bankruptcy proceedings;
- medium term controlled exit strategy - schedule of implementation of short term strategies spread over up to a three year period;
- long term restructuring strategy - support given to operating restructuring approved by creditors carried out within the framework of financial restructuring, ensuring adequate capital structure to embark on corrective action and provide for the development of the enterprise.

In order to decide on the best course of action, it is necessary that sophisticated company and asset valuation, economic and financial, organisational, management and market analysis techniques are used. In the period of transformation the completion of such analyses is far more difficult, and their result less reliable, than in the case of fully-fledged market-driven economies. Besides, the assessment of many kinds of risk encountered in various restructuring options for a bad debt does not lend itself to quantification, which further complicates the choice of the desired course of action and requires participation of experienced loan professionals. In order to define a restructuring strategy the following elements are indispensable:

- Completion of a diagnostic study, containing financial, accounting and legal audit of the company's operations, leading to identification of the main reasons for problems and ways of resolving them;
- Analysis of the legal and litigation position of the bank and of action that may be taken vis a vis the enterprise;
- Ensuring control of the bank over the current operations of the enterprise in order to safeguard against any action undertaken to the detriment of the creditors and to counteract any depreciation in the economic situation of the enterprise;

- Ensuring short-term stabilisation for the period of time necessary to carry out full diagnosis of current situation and work out action scenarios, which will provide means for the enterprise to survive until the completion of financial restructuring;
- Securing co-operation with creditors, which will allow for a standstill agreement to continue and avoid aggressive insolvency action destabilising the financial and legal position of the enterprise;
- Presentation of a business plan by enterprise management accompanied by suggestions of methods to combat the crisis;
- Completing an assessment of the operating prospects of the enterprise, taking into account the main available restructuring options that meet the bank's requirements;
- Assessing the expected recovery rate for the bank's exposure for each restructuring scenario, including determination of the risk/reward ratio.

The choice of a restructuring scenario also depends on external factors.

The acceptance of the conditions of the restructuring process by the creditors deciding to conclude a restructuring agreement or those having an influence over the implementation of the agreement and the functioning of the enterprise may be pivotal in terms of determining which option should be chosen. Therefore agreeing on the mode of co-operation with all major creditors and taking heed of their interests in the restructuring scenario preferred by the bank is an essential prerequisite to completing a restructuring. Finally, the banks preferred restructuring scenario should be a compromise reconciling two contradictory interests: that of the debtor and that of the creditors. Any restructuring proposal which is not accepted by all major parties to the restructuring event is not a solution to the problem, even if it is correct from the technical point of view.[7]

5.2. The bad debt portfolio of Powszechny Bank Gospodarczy S.A. w Łodzi

Identification of distressed assets at the right time is the foundation for embarking on restructuring. The likelihood of achieving a successful restructuring is inversely proportional to a delay that occurs in the bank's identification of the threat to repayment of the loan.[8] In order to assess banking risk a bank conducts periodical reviews of all debts and off-balance sheet liabilities. Applied accounting standards, external prudential regulations of the central bank supervisory authorities as well as internal principles of grading debts and off-balance sheet liabilities in terms of the banking risk involved have a bearing on the amounts of doubtful debts disclosed by banks. All of the above mentioned factors, determining the amounts of distressed debts disclosed in bank's statutory accounts in Poland at the beginning of the 1990s were applied in a quite lax manner and varied from internationally acknowledged standards in this respect, which lead to a distorted picture of loan portfolio quality in commercial banks. Therefore one needs to approach historical data relating to volume patterns in the development of problem debt portfolios with a certain degree of caution.[9] One may presume that a significant portion of the growth in the volume

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[7] Chatterji S., Gieryński P., Hedges P. *Financial restructuring of enterprises - arriving at a solution*, published in Bank Issue 1, 1995

[8] Luethy, M. *Unternehmenskrisen und Restrukturierungen*, Bern 1987, p. 207

[9] Debts in commercial banks were graded according to the rules set out in the Directive of National Bank of Poland of 10 August 1990. Only the Regulation by the President of the National Bank of Poland - no. 19/1992 of 18 November 1992 with subsequent amendments introduces assessment citeria in the area of debt evaluation and creation of special purpose reserves, which are more stringent and brought in line with internationally

of problem debts by far stems from the application of a more rigorous evaluation methodology.

The problem debt portfolio in PBG S.A. as of 31 December 1991

The problem debt portfolio as at 31 December 1991, was the basis for calculating the amount of recapitalisation funds under the Financial Restructuring of Enterprises and Banks Act and constitutes the so called portfolio of separated out loans, whose restructuring should have been completed before 31 March 1994. [10]
The recapitalisation needs of banks under the Financial Restructuring of Enterprises and Banks Act (Article 52, subparagraph 2, item 2) are defined as loans which were classified into ”doubtful” and ”loss” categories on the basis of criteria used by auditors during audit of a loan portfolio sample.

A diagnostic study on the quality of the loan portfolio in PBG S.A. commissioned by the Ministry of Finance and conducted by Ernst & Young covered 48% of the loan portfolio and 65% of off-balance sheet liabilities (by value). The remaining part of the portfolio was classified by the bank according to rules that did not meet International Accounting Standards. The problem loan portfolio being the basis for recapitalisation of PBG S.A. in Łódź was set aside, as the sum total of:

a) all loans graded and classified into Group IV (doubtful) and Group V (loss) by the auditor examining the quality of the loan portfolio;
b) all loans which according to internal evaluation criteria were classified as those granted to borrowers who lost creditworthiness.

It is assumed, that advances granted to borrowers who lost creditworthiness were roughly equal to those that the auditors included in ”doubtful” and ”loss” categories.

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acknowledged standards.

[10] Banks were obliged to restructure all separated out loans within 12 months from the date of the promulgation of the Act.

Figure 6

Problem loan portfolio in PBG S.A. in Łódź . (in current prices - millions PLZ).

Category	1991		1992		1993		1994	
	Number	Value capital interest guarantees	Number	Value capital interest guarantees	Number	Value capital interest guarantees	Number	Value capital interest guarantees
Separated out problem loans	666	1,301,827	627	1,213,834	417	1,241,264	59	291,818
DRS base Branches of the Bank	120 546	1,146,272 155,555	81 546	1,058,279 155,555	67 350	1,092,655 148,609	59	291,818
Distressed debts			1376	2,384,977	1,703	3,322,408	1,036	2,475,663
Bad debts			899	1,365,816	1,107	2,409,096	655	1,990,280
Provisions		220,055		238,291		1,632,598		1,490,751

1. distressed debts as of 31 December 1991 were set aside as a result of the loan portfolio quality review carried out by an independent auditor and comprise, as provided for by the internationally acknowledged standards, loans graded as „doubtful" and „loss" .
2. distressed debt /from January 1993/ comprise loans and off-balance sheet liabilities classified as substandard (Group II), doubtful (Group III) and loss (Group IV) as set out in the Regulation No. 19/92 by the President of the NBP.
3. problem loans cover loans and off-balance sheet liabilities classified in the two lowest categories - doubtful and loss - according to current grading criteria
4. value of capital, interest and guarantees in 1994 takes into account debt into equity swaps and write-offs under bank conciliatory proceedings as well as write-offs stipulated in court arrangement proceedings and in civil and legal voluntary arrangements conducted according to the principles of court arrangement proceedings.

The portfolio of separated out loans managed by the Loan Workout Department at HQ contained 120 entities (state-owned and co-operative enterprises with total PBG S.A. exposure of PLZ 1,446,272 million (before currency redenomination) - of which 65% was debt principal, 20% interest and 12% guarantees extended by the bank).

Figure 7 below shows loans granted by PBG S.A. comprising the portfolio directly supervised by Head Office broken down according to amounts of advances extended - as of 31 December 1991.

Figure 7

Exposure ranges (PLZ million)	**Number of businesses**	**PBG S.A. exposure**	**share in %**	
			number	**exposure**
0 -5 000	74	85,816.0	61.67%	7.49%
5 000 - 20 000	33	363,824.0	27.5%	31.74%
20 000 - 50 000	7	216,067.0	5.83%	18.85%
50 000 - 100 000	5	356,045.0	4.17%	31.06%
over 100 000	1	124,520.0	0.83%	10.86%
Total	*120*	*1,146,272.0*	*100%*	*100%*

As of 31 December 1991r. most loans in the portfolio were within the PLZ 5,000 to PLZ 20,000 billion (before currency redenomination). PBG S.A. exposure in this category amounted to PLZ 363,824.0 million, which constituted 31.74% of total PBG S.A. exposure in the separated loan portfolio. The exposure range of PLZ 50 to 100 million was second in terms of volume - it covered 5 economic entities - whose share in the portfolio of bad debts amounted to 31.06%.

Figure 8

Separated out problem loan portfolio broken down by borrowers' industry profile

Industry	Number of units	Value of exposure	% of portfolio	
			number	value
electrical and machine engineering	29	432,237	24.165%	37.70%
light	49	403,405	40.8%	35.19%
chemical	3	83,340	2.50%	7.27%
distributive trades and catering	20	72,062	16.66%	6.28%
general manufacturing	2	6,972	1.66%	0.60%
food processing	2	125,213	1.66%	10.92%
mineral wood and paper	8	3,555	6.66%	0.03%
construction	3	2,844	2.50%	0.24%
transport and communication	2	376	1.66%	0.03%
Other branches	2	16,268	1.66%	1.41%
Total	120	1146272	100%	100%

The major share of light and electrical and machine engineering industry units stems from the fact that PBG S.A. took over a loan portfolio from branches of the National Bank of Poland, with each branch specialising in lending to specific industries, as well as from the fact that these industries dominate in the operating area of the bank. Restructuring of the problem loan portfolio was also additionally complicated by a high share of sunset industries in the portfolio. The structural crises the cotton, wool, leather, electrical and machine engineering industries grapple with had a particularly acute impact on the worsening of PBG S.A.'s loan portfolio.

The problem loan portfolio - which constituted the basis for recapitalisation - also included a group of small loans extended to private businesses and individuals. The group included 546 entities, whose total indebtedness was PLZ 155,555 billion as of 31 March 1992.

Figure 9

Problem loan portfolio - loans advanced to private enterprises and individuals - the basis for recapitalisation

Loan principal range	Number of units	Capital	% share	
			Quantity	Capital
PLZ 0-100 mln	352	7,099	64.47%	6.16%
PLZ 100-500 mln	123	17,846	22.53%	15.49%
PLZ 500-1000 mln	30	47,815	5.49%	41.49%
PLZ 1000-5000 mln	36	18,721	6.59%	16.25%
over PLZ 5000 mln	5	23,751	0.92%	20.61%
TOTAL	**546**	**115,231**	**100.00%**	**100.00%**

Small loans (up to PLZ 500 million) prevailed in this group of bad debts and such loans accounted for 87% of the category total. In terms of value medium-sized loans (PLZ 500 - 5,000 million) prevailed, their share in the category total being 57.74%.

Figure 10

(PLZ millions)	Number of entities	Exposure		Guarantee	Total
		principal	interest		
State-owned enterprises, State Treasury companies, companies	120	782,364	226,202	137,706	1,146,272
Private businesses and individuals	546	115,231	40,324		155,555
Total	666	897,595	266,526	137,706	1,301,827

The loan portfolio that was the basis for recapitalisation of PBG S.A. in Łódź included 666 enterprises, whose indebtedness amounted to PLZ 1,301,827 million. The portfolio of earmarked loans - subject to exclusive management of the Loan Workout Department - encompassed 120 enterprises with indebtedness totalling PLZ 1,146,272 million - as of 31 December 1991 - which translates into 88% of the problem loan portfolio subject to recapitalisation.

5.3. Bad debt portfolio restructuring strategy adopted by PBG S.A.

The process of choosing the strategy directions and elaborating the concept of the earmarked problem loan portfolio was influenced by a number of factors. The pre-eminent factors were:

- availability of expertise and quality of internal human resources;
- existing and expected scope of co-operation with associates in the restructuring process such as:
  - debtors

- other creditors, including major creditor categories: trade creditors, the State Treasury, other financial institutions;
- government and public institutions (Ministry of Finance, Ministry of Privatisation, Tax Offices, economic courts, ownership supervisory bodies in enterprises);

♦ availability of financial restructuring instruments, given:

- economic environment;
- legal and systemic framework;
- level of special provisions in banks and sources of funds to establish them;
- development strategy of a bank

The creation of adequate organisational and technical support structure as well as of accompanying procedures in the bank preceded restructuring activities, as the bank had neither expertise, nor skills and experience in this area. In March 1992, before the programme of bank and enterprise restructuring became legally binding, Powszechny Bank Gospodarczy established a Loan Workout Desk (later transformed into a department) - a special organisational unit dealing with the earmarked problem loan portfolio. As of 1 January 1993 the Director of the Loan Workout Department was invited to sit on the Management Board of the Bank and was entrusted with responsibilities for restructuring of the ”bad debt” portfolio. Staffing in the department grew accordingly in 1993 from 11 to 22 officers recruited from experienced banking professionals and experienced individuals from outside the banking sector, having appropriate skills in the areas of financial and company analysis, management, marketing and ownership transformations. To the team were added restructuring experts sourced from the Special Situations Department of National Westminster Bank, Nat West Markets and Nomura Bank International. Another UK expert was appointed marketing advisor for the restructured enterprises. Employment contracts for foreign nationals working with the Loan Workout Department PBG S.A. were arranged with the assistance of The Know How Fund For Poland, which fully funded their stay in Poland. In the process of ”bad debt” portfolio restructuring the bank also drew on the assistance provided by external advisors - Warsaw Consulting Group and Boston Consulting Group, which was made available to the bank under the EC PHARE programme. Employees of the Loan Workout Department acquired necessary skills while working with high-profile specialists as well as completing an intensive training programme. Simultaneously with restructuring activities the staff completed custom designed training sessions which were usually held at the weekends, and the average time spent on training by each employee in 1993 was 258 hours.

The co-operation in the area of ”bad debt” restructuring with external institutions was of substantial importance to the decisions the bank took in terms of the course of action to be adopted. In this respect the most important were relations and possibilities of co-operation with creditors, debtors, government bodies, including the Ministry of Finance and the Ministry of Privatisation, Tax Offices, other central and local government bodies as well as with economic courts. Lack of binding arrangements between the Ministry of Finance - the owner of the bank implementing the provisions of the Act and the Ministry of Privatisation - responsible for overseeing the transformation processes in enterprises covered by the provisions of the Act had a negative impact on the work in the area of completing a part of

the responsibilities and provisions resulting from concluding a bank conciliatory agreement.[11] It especially concerns the process of ownership transformations afoot in state-owned enterprises and debt into equity swaps. Bottlenecks in economic courts are widely known, as it was one of the reasons for including bank conciliatory agreement procedures in the Act instead of resorting to the mechanism of court arrangement proceedings, yet the incapacity of the courts constituted a serious obstacle in applying liquidation paths in a limited time frame. In many cases the long time elapsing before the court pronounces its verdict in the event that the bank conciliatory agreement is appealed can threaten the bankruptcy of the enterprise to be restructured. Expected difficulties in liaison and co-operation with external institutions excluded the possibility of adopting some of the restructuring scenarios.

The choice of the restructuring strategy - from the point of view of the bank - must take into consideration the economic environment, legal conditions, size and sources of special purpose provisions and the general strategy pursued by the bank.

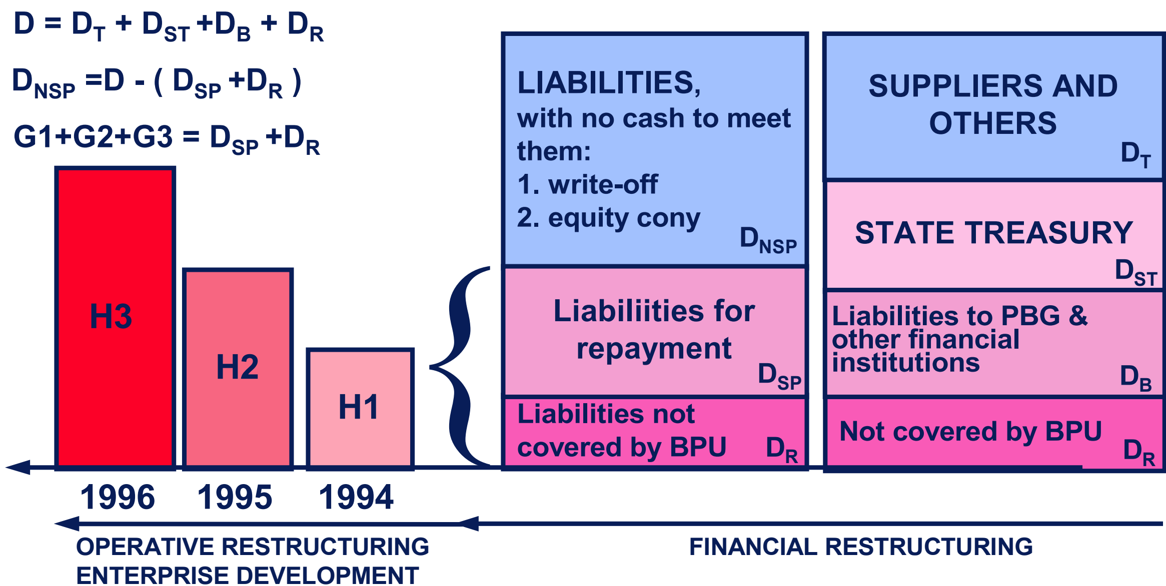
The size of the enterprise and its significance in the economy of a given region, as well as social issues, cannot be neglected when designing a restructuring strategy. The „too big to fail" principle is also applied to large state-owned enterprises that are ill-adjusted in terms of their structure to the requirements of the market-driven economy. In such cases the role of the bank is doubly difficult, as on one hand the bank is seeking a solution that is optimum in terms of the market needs, and on the other a workable solution - capable of being realised - usually involves a compromise bearing in mind of social and economic considerations.

Financial restructuring of the earmarked loan portfolio was subject to a number of significant constraints, which had a material impact on the choice of strategies and instruments applied. The most important of them being:

- deadline for completion of restructuring projects (31 March 1994)
- possibility of terminating a bank conciliatory agreement within three years from its coming into force;
- prudential regulations of the NBP in the area of establishing special purpose reserves;
- tax regulations pertaining to the possibility of treating costs borne on creation of special purpose reserves and costs/losses related to restructuring as tax deductibles or revenue earning costs.

[11] Pwałowicz,L.: "Evaluation of bank and enterprise restructuring programme" reference prepared for the session of the ownership transformation committe affiliated to the council of ministers, Warsaw 16 February 1995.

Figure 11



Financial engineering applied in restructuring exercises was based on cash flow projections for the period extending three years into the future from the day a bank conciliatory agreement comes into force. It results from the responsibility of the bank - as provided for by the Act - for repayment of debt regulated by the agreement within three years from the legal validation of the bank conciliatory agreement. Hence the time frame of bank conciliatory agreements is relatively short and in most cases is limited to three years. Debt subject to repayment under a bank conciliatory agreement is not interest bearing in cases where the agreement covers also tax liabilities. Lack of possibility of charging and collecting interest on the amounts subject to restructuring is also regulated by the provisions of the Tax Liabilities Act. In order to preserve the principle of not acting to the detriment of any parties involved, a bank conciliatory agreement may not provide for interest being charged on the amount subject to repayment during the period of agreement implementation.[12] Financial projections constituting a crucial element of the enterprise recovery programme show the enterprise's ability to generate operating surplus in a defined time frame. The size of this surplus in individual years limits the entity's ability to meet its payment obligations, including those related to the servicing of debt subject to restructuring. Therefore financial restructuring consists in matching the requirements related to servicing of overdue liabilities to financial capabilities of the debtor, assuming that the recovery programme accepted by the creditors was implemented. The experience of restructuring exercises conducted by the Loan Workout Department of PBG S.A. shows that financial restructuring of an enterprise (concerning mainly state-owned enterprises, yet to a certain extent also including private businesses) as a rule involved the need for very sizeable principal and interest write-offs. The need to write off part of indebtedness is a prerequisite for a debtor to recover current financial liquidity and the ability to meet payment obligations in the future. Debt into equity swaps has a similar impact on financial

[12]Letter of Ministry of Finance, Banking System and Financial Institutions Department ref nr. BS/987/94.

projections as a debt write-off. In such a case a debt into equity swap transaction may be viewed as an alternative to a corresponding debt write-off.

Existing tax regulations, especially those in the area of corporate income taxes, have a material impact on the selection of available financial restructuring instruments. Differences in terms of qualifying restructuring costs as revenue earning costs being tax deductible for income tax purposes results in the underprivileged status of debt sale, civil law arrangement agreements and the charging to losses without write-off when compared with bank conciliatory proceedings, court arrangement proceedings, bankruptcy and liquidation in terms of direct effectiveness of the instruments enumerated here. By way of an example, a loss incurred as a result of a financial restructuring agreement based on the provisions of the civil code is not eligible to be treated as a tax deductible item, while the same loss resultant from a court arrangement agreement or from bank conciliatory proceedings is a tax deductible. The impact of such operations on the income statement of a bank is obvious. Profit after tax in case of a civil law based agreement is 45% of the written-off amount lower than profit after tax in the event that the same amount is written-off under a court arrangement agreement or a bank conciliatory agreement.

Similar problems stem from tax regulations pertaining to establishing provisions for bad debts.

To date the basic restructuring path in the Loan Workout Department of PBG S.A. has been a bank conciliatory agreement. It results from the fact that it is the most effective method of radical debt write-offs for enterprises in order to restore their liquidity and creditworthiness, and primarily in terms of creating a conducive environment for far-reaching non-financial restructuring. It is a special financial restructuring instrument designed to resolve the problem of bad debts, which arose as a result of the system transformation and structural crises. This restructuring method met the requirements of the government spelled out in the programme of financial restructuring of enterprises and banks, as well as suiting the restructured enterprises and matched the restructuring strategy pursued by the bank. It may serve as an example of the positive impact on the economic environment and of an active role that a bank plays in the region in which it operates, which considerably exceeds the traditional functions of a commercial bank. On the other hand, given uncertainty and mounting competition in the financial markets, adoption of a bank conciliatory agreement constitutes an effective method of securing a stable customer base. Enterprises which concluded bank conciliatory agreements with PBG S.A. in many cases play a major role in their region of operations. Their fall heralds social and economic decline for those regions. Those enterprises were a primary source of income for some of the bank branches, not only in terms of interest income but also related to keeping the current accounts of those entities and related economic subjects. Survival of those enterprises had a direct impact on the operating performance of bank branches and at the end of the day may determine their existence.

The general strategy of the bank's activities may influence the choice of a restructuring strategy. Commercial banks not involved in investment banking are not eager to embark on debt into equity swaps. The restructuring strategy for the problem loan portfolio in Powszechny Bank Gospodarczy S.A. takes into account functional development of the institution aimed at playing the role of a universal bank, as well as providing for the creation of a subsidiary organisation specialising in investment banking. The realisation of

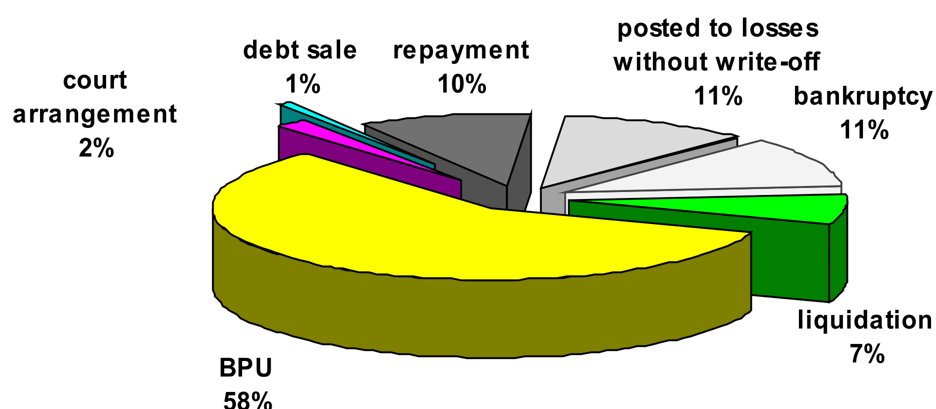
the financial restructuring programme for enterprises and banks therefore became a starting point for investment banking activity, and offers scope for acquiring necessary experience and learning by doing.

5.4. Course of action taken vis a vis enterprises - bad debtors

Restructuring of the problem loan portfolio subject to recapitalisation of PBG S.A. took advantage of all the available paths. All decisions and activities related to restructuring taken were based on the principle of maximising return or minimising losses of the bank's exposure. Much care was taken on the work on the core portfolio and the process was finished as planned before 31 March 1994, and in cases where bank conciliatory agreements were adopted work lasted until 30 April 1994.

Figure 12

Methods applied to restructuring of PBG S.A. problem loan portfolio subject to recapitalisation-broken down in terms of value as at 30.4.94



In terms of value bank conciliatory agreements have an overwhelming share in the restructuring of the bad debt portfolio. It was the most important and at the same time most time consuming restructuring path. The range of responsibilities and duties of the bank was incomparable to any of the other restructuring methods. In terms of value of loans involved, bankruptcy and posting to losses without write-offs were the second most commonly used instrument. Posting to losses without a write-off is a result of a consistent practical application of a solution available under traditional procedures, which is costly to the bank at the moment of application, but enables recovery of debt in the 5 to 10 year period thereafter. Off-balance records of bad debts allows production of a "cleaned" balance sheet. As a restructuring tool, bankruptcy ranks as second in terms of frequency of applications, but its share is still relatively small. It stems from procedural difficulties connected with this option referred to beforehand. Total repayments effected during the work on the project reached 10% of the bad debt portfolio of PBG S.A. Least important in terms of bad debt portfolio restructuring are court arrangement proceedings (2%) and sale of debt (1%).

When broken down by restructuring methodology applied to number of enterprises a totally different picture of the portfolio emerges.

Figure 13

Restructuring paths for bad debt portfolio in PBG S.A. - in terms of number of enterprises - as of 30 April 1994.

Restructuring path	Number of units	Share in %
Bank conciliatory proceedings	25	3.75%
Court arrangement proceedings	5	0.75%
Bankruptcy and liquidation	35	5.26%
Sale	4	0.6%
Posting to losses without a write-off	339	50.9%
Recovery of debt	258	38.74%
Total	666	100%

Number of loans posted to losses dominated the total of restructuring operations undertaken with entities from the separated bad debt portfolio that constituted the recapitalisation base for the bank. This restructuring method was primarily applied to private businesses and individuals, whose average indebtedness was relatively small. Full recovery of debt through restructuring work occurred in 258 cases, which was equivalent to 38.74% of loans by value. The small number of entities involved in bank conciliatory proceedings is inverse to the value ratio. It stems from the fact that this method was applied to the biggest bad debts, where potential losses could have had the most negative impact on the bank.

5.4.1. Recovery

Some of the enterprises included in the separated problem loan portfolio repaid their loans in full within the period stipulated by the Act i.e. before 31 March 1994. In cases of debt where repayment was endangered, the most advantageous option was to liquidate the bank's exposure by total recovery of the funds, both in terms of principal and interest. Full repayment is the most desired effect of restructuring. In those cases it was a result of operational restructuring and of an upturn in the economic situation of the enterprises. In addition as much is owed to the skilful liaison of the bank with the customer.

The number of enterprises which repaid their debt in full actually exceeded projected figures. 258 enterprises from the separated loan portfolio managed by the Loan Workout Department fully repaid their debt totalling PLZ 136,371 million which is 10% of the value of the separated loan portfolio.

5.4.2. Court arrangement proceedings

Loans by Powszechny Bank Gospodarczy S.A are subject to court arrangement proceedings in the case of three enterprises from the separated loan portfolio. The

amount of debt involved is PLZ 24,954 million. The bank - as a privileged creditor - frequently having adequate legal collateral or a guarantee for a loan in Polish circumstances as a rule does not get involved in court arrangement proceedings, and the State Treasury adopts the same stance. If the strategy of active support for the debtor is adopted, privileged creditors conclude separate restructuring agreements, whose conditions in practice are similar or identical to those available through court arrangement proceedings. In two cases PBG S.A. concluded a civil law agreement based on court arrangement proceedings conditions. Bank debt restructured through court arrangement proceedings and civil law agreements totalled 6% of the separated problem loan portfolio.

5.4.3. Bank conciliatory proceedings

Bank conciliatory proceedings are initiated and managed by a bank acting alone or on behalf of a group of banks, when:

1. debts owing to a bank or a group of banks constitute at least 10% of total indebtedness of the debtor, provided that bank debt amounts to at least PLZ 1,000,000,000 or

2. debts owing to a bank or a group of banks constitute at least 20% of total indebtedness of the debtor. The application to initiate bank conciliatory proceedings must include a number of documents provided for by the Act, the most significant one being a recovery programme for the debtor's business. Presentation of a viable recovery programme is a prerequisite for initiation of bank conciliatory proceedings. A bank initiating the proceedings is guided by its assessment of debtor's ability to adjust to market competition and regain the sustainable ability to meet payment obligations. The initiation of bank conciliatory proceedings is an expression of the bank's acceptance of the presented corporate recovery programme and the conditions of the agreement. The bank may decide to refuse to initiate proceedings at its sole discretion and such a decision is not subject to court appeal.

PBG S.A. concluded bank conciliatory agreements with 25 enterprises from the separated out bad debt portfolio. Under the agreements a total of PLZ 5,995 billion of enterprises' liabilities were restructured. Debt not covered by the agreements amounted to PLZ 1,054 billion and primarily consisted of the amount owed to ZUS and personal income tax payments deducted at source by the enterprises. (See Appendix 1).

The following were covered by bank conciliatory agreements:

principal liabilities	PLZ 3,358 billion
interest	PLZ 2,637 billion

Bank conciliatory proceedings were the restructuring method that covered the largest share of the bad debt portfolio as regards to the amount involved. It was a result of the strategy adopted by the Loan Workout Department at PBG S.A., which treated bank conciliatory proceedings as a instrument for supporting enterprises which were capable of survival and in position to present and implement a credible corporate recovery programme. Bank conciliatory proceedings were the main restructuring path applied to

the separated out bad debt portfolio of PBG S.A. It originates from the fact, that this method was the most effective way of radical debt write offs for enterprises in order to restore their liquidity and creditworthiness, and was especially conducive to the creation of conditions enabling realisation of a comprehensive operational restructuring. Besides, as it was mentioned earlier, along with total debt recovery bank conciliatory proceedings were the most advantageous option from the point of view of the bank's interests.

Enterprise financial restructuring through bank conciliatory proceedings

The financial situation of enterprises that filed applications to initiate bank conciliatory proceedings was in many cases utterly disastrous. The aggregated balance sheets of the enterprises from the separated bad debt portfolio with which PBG S.A. concluded bank conciliation agreements shows the degree of their financial crisis(see Appendix 2). 25 enterprises in the core portfolio, which PBG S.A. decided to support through instigation of bank conciliatory proceedings at the end of 1993 made net loss of PLZ (1,622,913) million in the aggregate, while their pooled shareholders' equity was PLZ 2,159,632 million. Financial position ratios for these enterprises are not at the level provided for by any financial analysis textbook. When applying all assessment criteria available those businesses should have gone bankrupt a long time ago. (Figure 14). Only radical financial restructuring, verging on total debt reduction would be capable of bringing the basic financial position ratios to a near normal level. To that end creditors had to incur huge costs. Yet had those enterprises gone bankrupt no creditors apart from the State Treasury would have recovered their exposure.

Figure 14

Principal aggregated balance sheet indicators for the separated portfolio enterprises, with which PBG S.A. concluded bank conciliation agreements

I. Long term stability

	pre-BPU	post-BPU
- Net assets (total assets - loans - other liabilities	621,395 mln zł	6,184,917 mln zł
- Equity capital to fixed assets (equity capital/ fixed assets)	0.37	0.82
- Equity capital to total assets (equity capital/ total assets)	0.22	0.49

II. Short term stability

	pre-BPU	post-BPU
- Current ratio (current assets / current liabilities	0.42	1.71
- Quick ratio (current assets - stocks / current liabilities)	0.25	1.02
- Working capital (current assets - current liabilities)	-3,294,366 mln zł	1,001,447 mln zł

III. Debt ratios

	pre-BPU	post-BPU
- Total indebtedness (total liabilities / total assets	0.91	0.22

- Indebtedness to shareholders equity (total liabilities/shareholders' equity)	2.99	0.45

Financial restructuring of enterprises under bank conciliatory agreements concluded with the participation of PBG S.A. utilises all available instruments.
Owing to the strategy adopted by PBG S.A. the most important of them are:

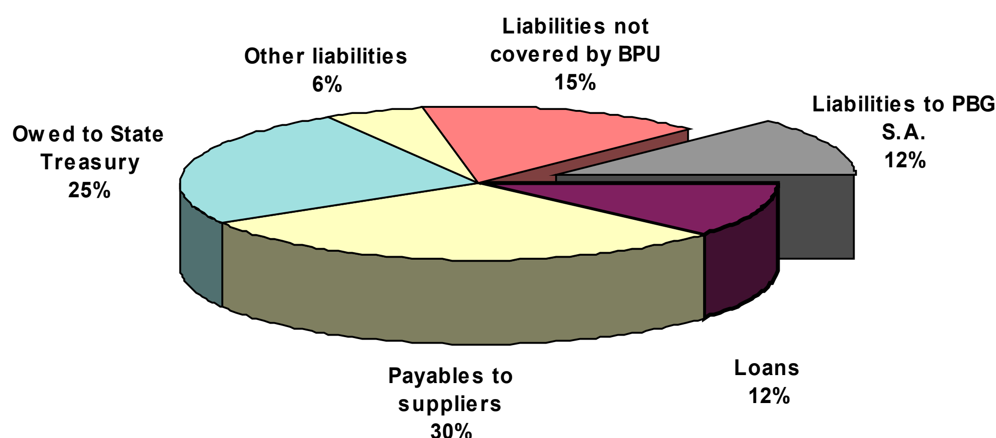
- interest/principal write-off
- debt into equity swap
- rescheduling of repayments
- interest rate cuts

As a rule financial restructuring is a combination of the instruments presented above.

The amount of liabilities covered by bank conciliatory agreements was much bigger than that shown in balance sheets. It stemmed from the fact that most interest on overdue loans and trade payables was not entered into accounts. The list of debts subject to restructuring was carefully collated according to a special procedure.

Figure 15

Total liabilities of separated out loan portfolio enterprises with which PBG.S.A concluded bank conciliation agreements before 30 April 1994



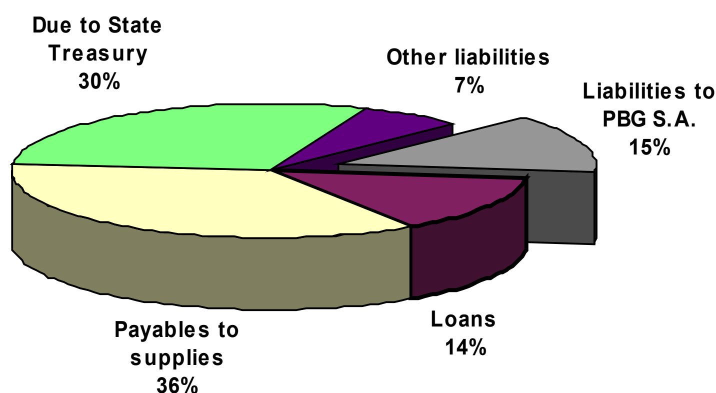
The structure of the enterprises' liabilities shows that in terms of value trade debtors had the largest share, being 27% of total liabilities at the day of bank conciliatory proceedings initiation. Loans and advances from PBG S.A. and other financial and non-financial institutions constituted 27% of all liabilities, while the amount owed to the State Treasury accounted for 25% of the total. The share of the amounts owed to the State Treasury in the liabilities covered by bank conciliation agreements varied considerably in individual cases, and in a number of instances reached 60%. The

average share of liabilities not covered by the conciliatory agreements was 15%. The structure of liabilities is a reflection of the strategies that enterprises undergoing structural crisis in the period of transformation adopted in taking on debt. Enterprises met their payment obligations by basing their decisions in this respect on their internal hierarchy of importance and not on maturity of debt[13]. Another criterion that shaped the decisions that enterprises made in respect of allocation of their meagre resources was that of the expected reaction of the debtor involved. Hence, bearing in mind the lack of firm steps taken by the State Treasury, the amount owed to the treasury grew, though in the event of execution proceedings the State Treasury is a privileged creditor. The firmer stance taken by banks and the high cost of credit resulted in the decreasing share of bank debt in the liabilities of state-owned enterprises.

The structure of debt covered by bank conciliatory agreements is extremely important in achieving the final success of restructuring. A bank conciliatory agreement is concluded when the agreement proposal is accepted by the debtor and creditors representing at least 50% of the sum total of indebtedness covered by the bank conciliatory proceedings.[14]

Figure 16

Structure of liabilities covered by bank conciliatory agreements concluded before 30 April 1994



The State Treasury was a passive participant in the conciliatory proceedings and in all cases was obliged to vote in favour of the conclusion of the agreement, in the event that the amounts due to the Treasury were not treated in a detrimental manner. PBG S.A.'s average exposure gave it the right to 15% of the votes. In some cases for the agreement to be concluded it was sufficient to secure the additional support of other banks or financial institutions (e.g. The Agency for Industrial Development) participating in the bank conciliatory proceedings. Nevertheless in most cases the conclusion of the bank conciliatory agreements was conditional on the support of trade debtors and on necessary reassurances in terms of implementation of the corporate recovery

[13]Financial restructuring of enterprises and banks; L. Pawłowicz et al. , Gdańsk 1994, p. 39
[14]Financial Restructuring of Banks and Enterprises Act, Article 20, item. 1

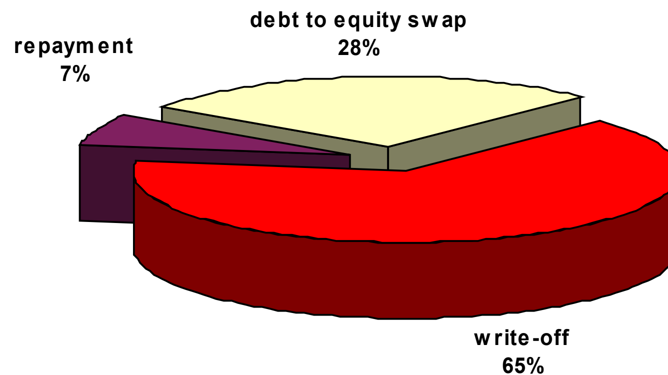
programme. The experience of restructuring work carried out in the Loan Workout Department of PBG S.A. shows that financial restructuring as a rule involves substantial write-offs. The need to write-off a part of the liabilities is a prerequisite for the debtor to recover current financial liquidity and his ability to meet payment obligations in the future. The choice of financial restructuring instruments depends on a number of factors:

- possibility of achieving financial restructuring;
- impact on the financial outcome of a given restructuring exercise;
- influence on the balance sheet and income statement of the bank;
- impact on balance sheets and income statements of other creditors taking part in the restructuring exercise;
- possibility of exercising effective supervision over the implementation of the conditions stipulated in the restructuring agreement;
- prospects of sale of shares acquired as a result of debt into equity swap;
- financial benefits to be derived from holding equity interests in enterprises;
- other benefits accrued from shareholdings in enterprises.

The possibility of completing a restructuring exercise as manifested by the acceptance of restructuring conditions by the creditors considering entering into a bank conciliatory agreement or by those having a say in implementation of the agreement and the functioning of the enterprise may shape the choice of a restructuring option. Under a bank conciliatory agreement it is easier to secure acceptance of the agreement conditions from trade creditors, as an agreement of this kind instead of providing for substantial debt write-offs stipulates debt into equity swaps. In the case of a bank conciliatory agreement concluded with state-owned enterprises a result is that of a change in ownership with some elements of privatisation in the instances where some of the creditors swapping their debt into equity interests are privately owned businesses. Ownership supervision may significantly facilitate the fulfilment of the bank's obligation to supervise the implementation of the agreement stipulated by the Act.

Figure 17

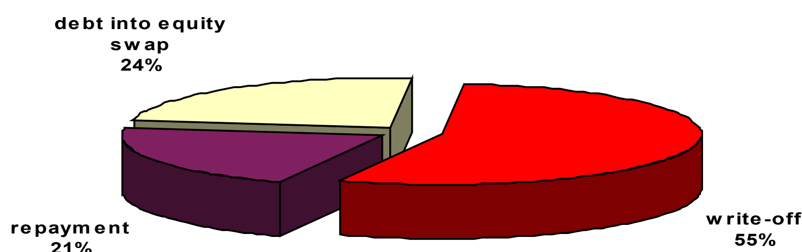
Financial restructuring of enterprises utilising the bank conciliatory proceedings mechanism



The structure of financial restructuring of the separated out problem loan portfolio being restructured by way of bank conciliatory proceedings shows the magnitude of debt write-offs necessary for the debtors to recover their liquidity. At the same time it is a proof of the bank's dedication to restructure its problem loan portfolio and play an active role in enterprise restructuring. In the bank conciliatory agreements that PBG S.A. concluded the effect of debt reduction, understood as the sum of write-offs and debt into equity swaps, was 93% of debt covered by the bank conciliatory agreements. Taking into account liabilities that are not handled by the bank conciliatory agreements the enterprises had to repay 21% of the entire indebtedness as reported on the day the agreements were concluded. As a result financial restructuring reduced total indebtedness by 79%.

Figure 18

Financial restructuring of enterprises under bank conciliatory agreements inclusive of liabilities not covered by the agreement (as of 30 April 1994)



In line with the expectations that the creators of the plan of financial restructuring of banks and enterprises had, bank conciliatory agreements emerged as the most important restructuring path in the implementation of the programme. PBG S.A. applied this restructuring tool to the biggest bad debts, previously extended to medium-sized and large state-owned enterprises and single shareholder joint stock companies of the State Treasury. The primary goal of the operation was to strengthen the portfolio of bad debts, with simultaneous financial restructuring of the enterprises, which was to constitute the basis for implementation of corporate recovery programmes and operational restructuring. As a result of this process the enterprises were envisaged to recover financial liquidity and a competitive edge in the market place. A bank expects to recover part of its exposure and maintain its business relationship with the customer, which in the future may generate income far exceeding the costs incurred during the restructuring exercise.

5.4.4. Exit through confrontation

A controlled exit strategy may be implemented in the short and medium term. In most cases adopting this strategy results from the bank's negative evaluation of the customer, both in terms of the business relationship to date and co-operation prospects in the future. The assessment of the bank's negotiation position has a material impact on the choice of the restructuring path , as does the kind of legal security and how privileged it is vis a vis other creditors.

Deadlines set for the completion of the financial restructuring programme for enterprises and banks prompted the adoption of exit strategies in all the cases where loan exposure was relatively small, and the customer's importance in the hierarchy of the bank's interests was relatively small, while the risk and costs connected with restructuring were high, and the time needed to complete the process was considerable. Exit strategies were usually accompanied by confrontation with the customer and termination of the business relationship was expected to occur in the future. In such a

case the bank had a few courses of action available. The most important of them were: enforcement of security, bankruptcy and liquidation, sale of debt and posting to losses without a write-off.

5.4.4.1 Bankruptcy in the process of insolvency and liquidation.

Insolvency

The legal basis of insolvency proceedings is set out in the Regulation by the President of the Republic of Poland of 24 October 1934.

Proceedings leading to the declaration of bankruptcy are court proceedings. Both the debtor himself and each of the creditors may file for bankruptcy. The Court declares bankrupt each entity which has stopped repaying its debts.

In case of companies and judicial persons bankruptcy will also be adjudicated if the bankrupt's estate is not sufficient to meet the repayment of debt.

In accordance with the above, solutions involving bankruptcy should be applied in cases where there are no indicators that the enterprise will overcome the crisis by way of designing and implementing a corporate recovery programme.

Liquidation.

Liquidation as a fait accompli meeting the stipulations of the Restructuring Act, Article 53, item 3 concerns the winding up of state-owned enterprises, co-operatives and commercial law companies.

The conditions set out in the Restructuring Act are fulfilled in cases where an entity is liquidated with a view to subsequent privatisation - pursuant to Article 37, item 2 of the Act[15] as well as by liquidation resulting from economic considerations as stipulated in State Enterprises Act. [16]

The decision about liquidating an enterprise in order to privatise it is taken by the founding organ and is subject to agreement by the Ministry of Privatisation. The aim and basis of liquidation in this manner is to bring in part or the whole of the enterprise as an in-kind contribution to a single shareholder joint stock company of the State Treasury. Decision about liquidation of an enterprise pursuant to the State Enterprises Act is taken by the founding organ on its own initiative or upon a motion submitted by the workers' council of the enterprise.

The basis for a decision to liquidate an enterprise in such a manner stems from economic considerations, enumerated in Article 19 of the State Enterprises Act, i.e.:

- lack of profits to pay mandatory dividend;

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[15] The Journal of Laws, Issue 51, with subseqent amendments.

[16] The Journal of Laws, Issue 18, item 80-, with subseqent amendments.

- loss making activity of an enterprise, which was exempted from the mandatory dividend;
- a legally binding injunction was issued prohibiting the enterprise from continuing business activity in all areas of its statutory business lines;
- when such a motion is filed by the management administration;
- when over half of the company's assets is in the form of equity interests in other businesses or if the assets were made available to another party on the basis of civil law contracts.

In case of co-operatives and commercial law companies, liquidation is effected pursuant to the respective provisions of the Co-operatives Act and the Commercial Code.

Liquidation defined as meeting the conditions stipulated in Article 53, item 3 of the Restructuring Act initially was not a binding interpretation. At the beginning the Ministry of Finance directives set out in Article 53, item 3 were only applicable to the liquidation of state-owned enterprises. The interpretation of this stipulation was amended as a result of a motion submitted by banks participating in the programme of financial restructuring of banks and enterprises[17]. Therefore classification of some of the entities in the primary portfolio into individual restructuring paths was also changed. It concerns co-operatives being wound down, which before the interpretation was changed had been earmarked for public sale of debt. Yet as discussed earlier, basing the choice on the premise that liquidation solutions meet the interests of the Bank to a higher extent, it was decided to change the restructuring path.

As of 31 March 1994, 30 entities from the primary loan portfolio were either declared bankrupt or being liquidated. Their aggregate debt owing to the Bank was PLZ 232,932 million. The above figure includes co-operatives in liquidation, on the basis of the interpretation of the Ministry Finance quoted beforehand.

5.4.4.2. Public sale of debt

The creators of the programme of financial restructuring of enterprises and banks envisaged the public sale of debt to be one of the main restructuring paths for bad debt portfolios of recapitalised commercial banks. It was meant to make purchase of debt available to other economic entities for them to convert the debt into equity interests according to a special procedure provided for by the Act. This option was to be a smooth method for banks to clean their bad debt portfolio. The practice of bad debt portfolio restructuring in PBG S.A. did not confirm those expectations. Sale of debt is an uncompetitive instrument because of tax considerations when compared with execution and court arrangement proceedings, bank conciliatory proceedings, bankruptcy and liquidation.[18] The losses resulting from sales of debt below the value of primary debt (principal) are not eligible for a tax deduction, while the application of other restructuring instruments provides for tax savings and thereby leads to a better financial result of the restructuring exercise as reflected in the income statement of the

[17] The letter of the Minister of Finance of 4 March 1994, ref. no. BS/KK/919/94

[18] Wierzba R. "Taxation aspects of the process of enterprise and bank restructuring in Poland", Gdańsk Academy of Banking, Gdańsk 1995

bank. Additional constraint was imposed by the lack of developed infrastructure for a market for debt[19]. Therefore utilisation of public sale of debt as a restructuring path was limited in the entire banking system. In many cases in Poland public sale of debt may have lead to the debtor being relieved of his indebtedness by arranging for related "dummy" investors to purchase their debt. Such action countervenes the law, yet was quite commonly used, especially in relation to debt taken on by private individuals and small private businesses. [20]

In the restructuring exercise completed by PBG S.A. sale of debt was of marginal importance. During restructuring of the separated out bad debt portfolio only four debts totalling PLZ 9,507 million were sold. The recovered amount constituted 27.20% of principal and 5.9% of total debt. Sale of debt was treated as an avenue of last resort, when other restructuring options could not be applied or proved to be unsuccessful.

5.4.4.3. Posting to losses without a write-off

The Restructuring of Banks and Enterprises Act is an incidental parliamentary bill, a special procedure which is limited to a defined time frame and a selected group of entities. Equity at law and rationalisation of expectations for the future are an important element in proper shaping of relationships in the business environment. The forced sale of debt, especially small loans taken on by private individuals, constitutes a threat to the stability of the business environment. In cases of irrecoverable debts from private individuals and small companies, a better solution from the point of view of a commercial bank's security and reputation is that of posting these debts to losses without a write-off. It enables removal of doubtful and loss debts from the assets of a commercial bank and at the same time provides scope for recovery of the said debt within the period from 5 to 10 years. As part of the restructuring of the debt portfolio was subject to recapitalisation, PBG S.A. decided to post to losses all irrecoverable loans granted to private individuals and small private businesses without a write-off provided that such debt met one of the criteria specified below:

1. debts in relation to which insolvency proceedings were finished by way of a court ruling to cease insolvency proceedings.
2. debts difficult to recover i.e. execution takes more than two years.
3. debt taken on by an enterprise involved in a prolonged winding up or bankruptcy proceedings.

[19]"We are building a market for debt" Polish Business Offers, p.2. Material prepared for a PBR-CASE seminar titled "Financial restructuring of enterprises and of bad debt portfolios in commercial banks" Warsaw, 12 January 1995.

[20]Piętka "Trading in bank debt" p. 10. Material prepared for a PBR-CASE seminar titled "Financial restructuring of enterprises and of bad debt portfolios in commercial banks" Warsaw, 12 January 1995.

Figure 19

Ownership and value structure of debts posted to losses without a write-off

Ownership form	Number of entities	Principal	% of value	% of number
State-owned	6	12,121	13.5%	1.8%
Private	333	77,195	86.5%	98.2%
Total	339	89,316	100.0%	100.0%

339 debts totalling PLZ 155,555 billion as of 31 March 1994 were posted to losses. The ownership and value structure of debts posted to losses without a write-off shows that most of them are small loans granted to private individuals.

5.5. Financial restructuring of a bad debt portfolio of a commercial bank as a privatisation path for enterprises

The realisation of the programme of financial restructuring for banks and enterprises was to constitute another privatisation avenue. To that end the Act provides for a special procedure of purchasing shares of single shareholder joint stock companies of the State Treasury in exchange for their debt.[21] Bank conciliatory proceedings are another special instrument of enterprise financial restructuring introduced by the Act, which provided for swapping debt into equity[22]. Swapping debt for equity as stipulated in the Act is especially targeted at creditors who are non-financial institutions or at strategic investors interested in taking over an enterprise for debt available on the market for debts. This restructuring path in practice did not find the application it was intended for. To date no enterprise has been taken over in exchange for its debts according to a special procedure regulating purchase of shares for mature debt. Debt into equity swaps found a wider application - yet different from the expected one - in financial restructuring through bank conciliatory proceedings. In January 1995, debt to equity transactions occurred in 28 bank conciliatory agreements, of which 19 were realised by Powszechny Bank Gospodarczy w Łodzi.[23]

The restructuring strategy applied to the separated out portfolio of bad debt in PBG S.A. from the very outset contained an assumption that one of the pivotal principles underlying each restructuring exercise is that of limiting the negative financial effects of restructuring on creditors. Therefore in order to attain the planned debt reduction effect in all justified cases the mechanism of converting debt into equity was used. Such a course of action was meant to:

- maximise the financial benefits for PBG S.A. derived from restructuring of the loan portfolio;
- minimise costs of financial restructuring borne by all creditors, assuming that acquisition of an equity interest offers a chance of real settlement of some of the claims in the future provided that the non-financial restructuring exercise is successful;

[21] Financial Restructuring of Enterprises and Banks Act, Section 4, articles 43-51.

[22] Financial Restructuring of Enterprises and Banks Act,Article 16, sub-paragraph 2.

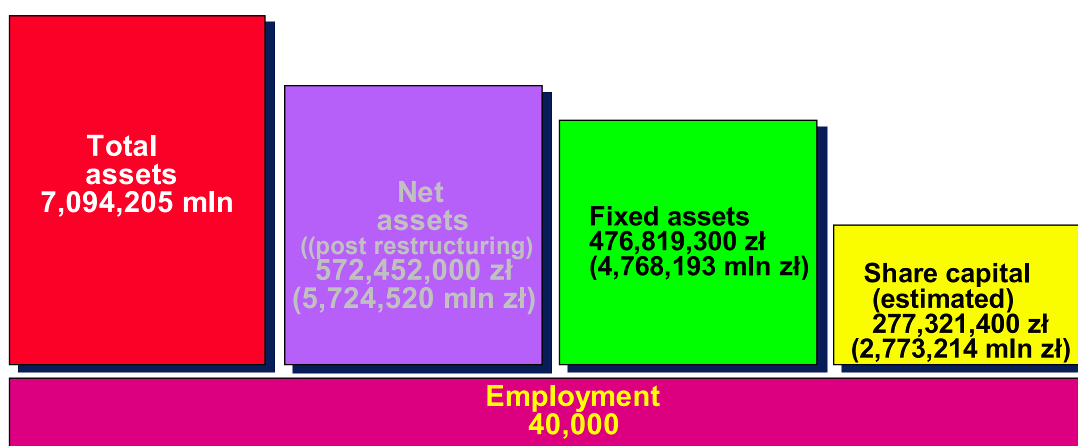
[23] Pawłowicz L. “Evaluation of the enterprise and bank restructuring programme” Material prepared for the meeting of the Commission of Ownership Transformations affiliated to the Council of Ministers of the Republic of Poland, Warsaw, 16 February 1995

- change the ownership structure of state-owned enterprises in order to boost economic efficiency;
- ensure more control over the process of operational restructuring for creditors acquiring ownership supervision;
- start operations in specialised investment banking activity in PBG S.A.

The concept underlying the restructuring strategy of the problem debt portfolio in PBG S.A. envisaged privatisation to be a prerequisite for the debtors to recover sustainable profitability and have development prospects. Privatisation supports implementation of corporate recovery programmes. In cases where radical operational restructuring is necessary privatisation is crucial to the success of the exercise. Therefore the bank consistently insists on having all state-owned enterprises concluding bank conciliatory agreements transformed into limited or joint stock companies. It is the first step on the way to privatisation, which makes it possible to eliminate some of the inherent drawbacks of a state-owned enterprise, including unmanageable division of powers among the management board, workers' council and the trade unions. A debt into equity swap under bank conciliatory proceedings leads to privatisation achievable pro rata to the share of private creditors converting their debt into equity in all debt subject to the agreement. Even if privatisation thus achieved is only partial, and somehow forced on the parties involved, it still constitutes another step taken on the way to privatisation involving a strategic investor. The main consideration that drives the bank in taking the debt into equity option is that of an increase in the expected recovery of its exposed assets, when shares acquired for debt - instead of writing the latter off - gain a real value as a result of the operational restructuring process. Owners' supervision increases the likelihood of full implementation of the corporate recovery programme, which is the basis for enterprise's survival and increase in value. Three debt into equity swaps - out of the total of nineteen - were realised in order to involve a strategic investor in purchases of the shares from the bank. The value of assets of enterprises that started the privatisation process through debt into equity swap transactions in 1994 totalled PLZ 7,094 billion, while the value of net assets - as at the initiation of bank conciliatory proceedings (the critical phase of the crisis) was PLZ 621,395 million. Estimated value of the share capital of those enterprises is PLZ 2,773 billion, and the post-financial restructuring value of net assets is estimated to be PLZ 6,184,917 million.

Figure 20

Basic economic indicators for enterprises subject to bank conciliatory proceedings



The enterprises that were privatised through financial restructuring employed approx. 40,000 people, whose jobs would otherwise have been seriously jeopardised.

PBG Investment Fund Co. Ltd.

Financial restructuring achieved through bank conciliatory agreements concluded by the Bank paves the way for far reaching operational restructuring in the areas of management, organisation and production. Transformation of the ownership structure of an enterprise resulting from a debt into equity swap in itself does not constitute a change in the way a given enterprise functions. Adjustment to the demands of open market competition is facilitated by the involvement of a strategic investor, who is aware of the limitations and scope for turnaround and is capable of devising a viable strategic development plan and make necessary know-how available. Debt into equity swaps lead to the emergence of creditors' companies lacking a private strategic investor. Private shareholdings are low in the owners equity of such a business, and relatively major stakes are held by PBG S.A. and still by the State Treasury. A commercial bank does not fulfil the role of a strategic investor in any of the enterprises, in which by virtue of debt into equity swaps it acquired significant equity interests. Management and owners' control are not the realm of a commercial bank. The problem is complicated twofold in the case of enterprises which are in the midst of a far reaching turnaround. In order to complete such exercises successfully skills in the area of corporate recovery and management of increased risk capital are required, which are crucial to the success of an operational restructuring process. Therefore PBG S.A. decided to set up a specialised company, which is to take over the shares acquired through the financial restructuring process and will exercise owners' control over the enterprises and manage them. The mission of PBG - Investment Fund Co. Ltd. is to manage assets, being primarily equity holdings in enterprises undergoing comprehensive turnaround processes, in order to achieve a substantial increase in their value in the forthcoming three to five

years, which is to be attained through investment of technical and financial resources. The primary operating goals of PBG - Investment Fund Co. Ltd. are:

- ensuring optimisation of the outcome of the main restructuring projects undertaken by PBG S.A.
- developing and implementing the initial phase of the long-term development strategies of enterprises, whose corporate recovery action is supported by the Bank.

Support for the restructuring processes, as with operational restructuring, is a long-term exercise extending from 3 to 5 years. It requires that PBG - Investment Fund gather skills that are not available, or scarce, in the enterprises being restructured. To that end PBG-Investment Fund hired qualified personnel and plans to co-operate with external experts and consulting firms offering the required experience and skills. The scope of the Fund's activity supporting the current operations of the enterprises encompasses:

♦ Experience and skills transfer in terms of management and operational skills to the enterprises included in the portfolio, and especially:

  - modifications of accounting systems in enterprises and implementation of management accounting systems;
  - planning and ongoing monitoring of costs and expenditure;
  - implementation of management information systems;
  - market-driven production decision-making;
  - implementation of sales procedures answering the demands of modern marketing;
  - design and implementation of controlling systems;
  - assistance in devising effective organisational structures;
  - co-operation with enterprise management aimed at developing already adopted restructuring paths and implementation of medium-term strategies and business plans, which essentially will evolve from restructuring plans previously agreed with the Loan Work-out Department.

♦ Design and implementation of monitoring systems for implementation of corporate recovery programmes which constituted the basis for entering into a bank conciliatory agreement. Results achieved by the enterprise will be measured against defined performance criteria. Variations form target value will be analysed and reviewed jointly with management of a given enterprise, and afterwards an adequate plan of corrective action will be agreed on.

♦ Securing short and long term funding of working capital needs and modernisation programmes in co-operation with PBG S.A. (bank conciliatory agreements which were concluded provide for making new money available to the debtor to finance the needs in the area of recovery programme implementation).

♦ Equity injections to portfolio enterprises to be effected from own resources of PBG-Investment Fund. The cash flow of enterprises in the midst of far reaching restructuring

is very sensitive to debt financing of working capital needs, as financing costs in Poland are a considerable burden. Therefore equity injections create incomparably better initial conditions for the non-financial restructuring processes.

Initial share capital of the company is PLZ 30 billion and all shares have been acquired by PBG S.A. The Bank signed a letter of intent with the Know How Fund, which will make GBP 4 million available to finance restructuring support projects for the PBG Investment Fund portfolio enterprises. The funding will be mainly channelled to provide capital injections to the enterprises and technical assistance in implementation of operational restructuring programmes. The funding is clearly insufficient to meet all the needs, but it is envisaged that exit from some projects through share disposals will allow the Fund to focus on the most interesting cases. Work is underway to source external capital for new restructuring operations and investment projects with a higher degree of risk.

Liabilities of enterprises from the separated problem loan portfolio in PBG S.A. subject to banking conciliatory proceedings

(25 bank conciliation agreements concluded before 30.04.94)

Item		Primary liabilities	Interest	Total liabilities	Write-offs	Debt-equity swap	Repayment
23	Liabilities to PBG S.A.	637,701	236,460	874,161	541,348	278,614	54,199
24	Liabilities by virtue of loans	452,392	368,201	820,593	551,873	213,378	55,342
25	Trade debtors	925,188	1,206,824	2,132,012	1,417,889	558,374	155,749
26	Amounts due to the State Treasury	1,116,658	661,716	1,778,374	1,076,798	558,079	143,497
27	Other liabilities	226,621	163,979	390,600	284,754	82,420	23,427
28	TOTAL;	3,358,559	2,637,180	5,995,740	3,872,661	1,690,864	432,215

Liabilities not covered by Agreements	1,054,136
Loans not covered by Agreements	0
Sundry debts	40,639
Debt at conclusion of Agreement	7,049,876

Appendix 2

Selected aggregate pre and post-restructuring balance sheet entries for enterprises which completed bank conciliatory proceedings managed by PBG S.A. (all figures in PLZ million)

ASSETS			LIABILITIES			Post Agreement Liabilities (^)
I	Tangible assets	4 675 347	I	Shareholders' equity	2 159 632	3 850 496
	of which: buildings and structures	3 025 129				
	equipment	719 742				
	construction in progress	567 767				
II	Current assets	2 418 895	II	Loans and advances	1 464 793	326 421
	of which: stocks	979 930				
			III	Debtors, special funds	5 008 017	1 417 448
				and accruals		
				of which: trade debtors	1 398 328	
				amounts owed to budgets	1 665 187	
				amounts owed to ZUS	726 955	
III	**Other assets**	503 052	IV	Reserves	84 673	84 673
			V	Net financial result	(1 622 913)	2 249 748
	Balance sheet total	7 094 205		Balance sheet total	7 094 205	7 928 786

(*) as of 31.12.93 r.

(^) includes basic post conciliatory agreement account posting according to the following assumptions:

swap parity: 1:1, postings effected directly after the agreement came into force; now new current liabilities, new loans in the amount of PLZ 216,880 million (treated as long-term), no changes in reserves