Restructuring Banks and Enterprises

Recent Lessons from Transition Countries

Michael S. Borish
Millard F. Long
Michel Noël
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Michael S. Borish
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Michel Noël

The World Bank
Washington, D.C.
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FOREWORD

Financial and enterprise sector restructuring have been prime components of Bank lending programs in transition countries from the beginning of reform efforts to devolve market-oriented economies. Approaches to financial and enterprise restructuring, the roles played by banks and non-bank financial institutions in enterprise restructuring efforts, and the degree of privatization have varied across countries due to monetary and fiscal prerogatives, political influences, institutional capacity, and the absorptive capacity of respective markets.

States and donors have promoted the push to increasing liberalization of the legal and regulatory framework, improved information flows, and general broadening and deepening of financial markets to stimulate enterprise privatization and to meet the growing financial needs of the emerging private sector. In some cases, this has occurred quickly and forthrightly via the imposition of hard budget constraints, commitment to rapid privatization, early separation of non-performing assets from bank balance sheets, and prudent macroeconomic policies. In these cases, governments assumed significant liability up front from the centrally planned period, and left future consequences to market forces. In other cases, reform has lingered over a longer period, with only gradual transformation to minimize shocks, but at great fiscal cost that threatens to undermine competitive advantages. Most transition countries have adopted an incomplete mix of reform components which has generated partial success during a difficult period, but added to the costs of transition due to missing elements required for rapid turnaround and sustainable growth.

This paper focuses on the key design variants of enterprise and financial sector reform programs, including the financial restructuring of banks, the financial sector enabling environment, and issues associated with banking system reorganization. The paper then looks at the role of banks and other financial institutions in the enterprise restructuring and privatization process, and then attempts to draw some conclusions and lessons from the initial experiences of transition country reform programs.

As most transition countries have only recently begun to pursue major restructuring and privatization campaigns in a meaningful way, the paper is primarily descriptive in nature. It is expected that a more evaluative review of results will follow when greater evidence is available, allowing a more subjective assessment of working models. This paper is part of a broader effort by our department to analyze financial and enterprise sector reform issues, with the intention of identifying desirable design features for current and future program interventions in transition countries.

Kemal Derviş
Director
Europe and Central Asia Department
Country Department II (EC2)
ABSTRACT

The collapse of central planning and the opening of the ex-socialist economies of Central and Eastern Europe and the former Soviet Union have had two major implications for enterprise and bank restructuring. First, State-owned and "socially owned" enterprises for the first time faced the test of the market. Facing competition with imports from the West, a sharp reduction in State subsidies, and the disappearance of their traditional CMEA markets, SOEs experienced dramatic cuts in output following economic liberalization. Second, many turned to banks to obtain credits that allowed them to temporarily escape hard budget constraints and delay restructuring or liquidation. This led to a rapid deterioration of State-owned commercial banks’ loan portfolios, which were already burdened by risky portfolios inherited from the former monobanks. Increasing spreads crowded out economically viable investments by the emerging private sector. The deteriorating position of the banks resulted in an increasing liability for the State, as implicit deposit insurance precluded the closure of large State banks.

The nexus created by SOE losses, deteriorating State bank portfolios, and increasing government liability is on the critical path to systemic transformation in transition economies. A growing number of governments recognize that the problem cannot be ignored or its solution postponed for long without incurring the risk of a major crisis of confidence by the newly emerging private sector. There is general consensus that this nexus must be addressed in an integrated manner for any lasting solution to emerge. But the consensus stops there.

In practice, governments are following a wide variety of approaches to deal with these problems. Key issues include: 1) the imposition of hard budget constraints on loss-making banks and enterprises to promote macroeconomic stabilization; 2) the pace of enterprise and bank privatization to improve management, governance and overall performance; 3) institutional capacity, legal and regulatory frameworks, bank supervision and financial sector infrastructure to improve the enabling environment; and 4) centralized vs. decentralized solutions to work out impaired loan portfolios, restructure loss-making enterprises and develop the human capital and market conditions needed for a competitive banking environment.

The purpose of this paper is to review early experiences in bank restructuring and the role of banks in enterprise restructuring in 23 transition countries. The discussion focuses on: 1) financial and operational restructuring of banks, changes in the financial sector enabling environment, and the reorganization of banking systems; 2) court-led bankruptcy/liquidation proceedings and out-of-court conciliation procedures for enterprise restructuring, including the role played by banks in the restructuring of enterprises; 3) the mode of Government intervention to recognize past losses incurred by SOEs, including the role played by Government in the restructuring of the enterprise sector; and 4) the timing and sequencing of enterprise and financial sector reforms in relation to the pace of privatization and systemic transformation in the economy.

The paper is intended for use by policy makers and managers in transition country governments, and officials engaged in program design and implementation at multilateral banks and bilateral agencies. Those involved in drafting new financial sector legislation and regulations, banking sector supervision and auditing, debt dispute resolution, and privatization strategies will also find this document useful for comparative examples in transition countries.
ACKNOWLEDGEMENTS

The authors would like to thank the many Bank staff who greatly assisted with the provision of information, data and commentary. Special thanks go to Andrew Ewing (PSD), Cheryl Gray (PRDTE) and Gerhard Pohl (EMTPS) for their helpful insights and recommendations. The authors wish to thank Task Managers in ECA departments responsible for financial sector reform programs, and Research Assistants in ECA departments, all of whom were generous with information and helpful with suggestions which improved the quality of the report. Special attention goes to Marguerite Nguyen for supervising the data collection effort, and to Mimoza Arapi for gathering banking sector and foreign exchange data. The authors would also like to thank Laila Tushan and Jacqueline Chase for their help in producing the document.
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I. BACKGROUND

A. Introduction

The collapse of central planning and the opening of the economies of Central and Eastern Europe and the former Soviet Union (FSU) to the West have had two major implications for enterprise and bank restructuring. First, State-owned and "socially owned" enterprises (SOEs and SoEs, respectively) for the first time faced the test of the market. Facing competition with imports from the West, a sharp reduction in State subsidies, and the disappearance of their traditional CMEA markets, SOEs experienced dramatic cuts in output following economic liberalization. Second, many turned to banks to obtain credits that allowed them to temporarily escape hard budget constraints and delay restructuring or liquidation. This led to a rapid deterioration of State-owned commercial banks' (SOCBs) loan portfolios, which were already burdened by risky portfolios inherited from the former monobanks. Increasing spreads crowded out economically viable investments by the emerging private sector. The deteriorating position of the banks resulted in an increasing liability for the State, as implicit deposit insurance precluded the closure of large SOCBs.

The nexus created by SOE losses, deteriorating SOCB portfolios, and increasing government liability is on the critical path to systemic transformation in transition economies. A growing number of governments recognize that the problem cannot be ignored or its solution postponed for long without incurring the risk of a major crisis of confidence by the newly emerging private sector. There is general consensus that this nexus must be addressed in an integrated manner for any lasting solution to emerge. But the consensus stops there.

In practice, governments are following a wide variety of approaches to deal with these problems. In most FSU countries, inflation has financially structured banking systems, effectively erasing balance sheet values. This has been accompanied by privatization programs which have quickly changed the ownership structure of the banking sector (Russia). Some countries have allowed banks to fail, with depositors assuming some of the losses (Estonia). In FSU countries, privatization has been promoted in advance of across-the-board bank restructuring, and government recapitalization of banks has not occurred. By contrast, virtually all non-FSU countries have recapitalized their banks at least once, or are planning to do so. This approach has generally been incomplete or insufficiently effective because recapitalizations have not been linked to a rapid enough pace of bank privatization for an effective change in incentive systems, management and governance. Instead, apart from the Czech-Slovak (CSFR) up-front recapitalization of SOCBs in 1991 and privatization in 1992, most recapitalization programs have generally been accompanied by partial reforms to restructure banks to set the stage for gradual/eventual bank privatization.

1/ State-owned Enterprises, or SOEs, are enterprises owned directly by the State. This form of ownership was common during the socialist phase, and is being scaled down at varying degrees of speed in the post-socialist period. Socially-owned enterprises, or SoEs, are enterprises owned/operated by workers and management, and commonly found in the former Yugoslavia. SoEs were often managed by Workers' Councils, with production targets set by government planning authorities and financing provided by banks owned by the producing SoEs. For convenience, this report uses SOE for both except when SoEs alone are the topic.
While it is too early in most cases to judge definitive successes and failures, the long-term effectiveness of reforms will be influenced by numerous factors, including:

- The willingness and ability of governments to impose hard budget constraints on loss-making banks and enterprises to promote the larger objectives of macroeconomic stabilization, fiscal balance and economic growth.

- The pace of systemic transformation in the economy, namely the speed of enterprise and bank privatization to improve management, governance and overall performance.

- Institutional capacity, legal and regulatory frameworks, bank supervision and financial sector infrastructure to improve the enabling environment.

- Centralized vs. decentralized solutions to work out impaired loan portfolios, restructure loss-making enterprises and develop the human capital and market conditions needed for a competitive banking environment.

The purpose of this paper is to review early experiences in bank restructuring and the role of banks in enterprise restructuring in 23 transition countries (see Table 1). The discussion focuses on the merits and country experiences of:

- Financial and operational restructuring of banks, changes in the financial sector enabling environment, and the reorganization of banking systems.

- Court-led bankruptcy/liquidation proceedings and out-of-court conciliation procedures for enterprise restructuring, including the role played by banks in the restructuring of enterprises.

- Mode of Government intervention to recognize past losses incurred by SOEs, including the role played by Government in the restructuring of the enterprise sector.

- Timing and sequencing of enterprise and financial sector reforms in relation to the pace of privatization and systemic transformation in the economy.
Table 1: Countries and Regions Profiled

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<th>FSU: Central and Southwest Asia</th>
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<td>1993 GNP (US$ Millions)</td>
<td>1993 Per Capita Incomes (US$)</td>
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* 1992 figures.

The paper is divided into four sections. The remainder of Section I provides a brief context regarding the transition of ex-socialist economies from centrally planned to more market-oriented economies. Section II describes financial sector reforms, including financial and operational restructuring methods applied to banks, the financial sector enabling environment, and financial system reorganization. Section III reviews bank and government roles in enterprise restructuring efforts. Section IV presents conclusions and some lessons for program design based on early reform experiences.
B. Macroeconomic Context: Economic Collapse and the Impact on Banks and Enterprises

At the outset of transformation, the economies of Central and Eastern Europe and the former Soviet Union (FSU) were highly distorted and overly industrialized, reflecting the organization, operations and incentive structures of centrally planned economies. These economies lacked "banks" in the market sense, instead using these institutions as accounting vehicles in support of larger planning requirements. The role of State-owned banks was to passively disburse funds to and collect from State-owned enterprises without regard to prospects for loan repayment, bank solvency, or other performance-based measures. State enterprises reimbursed banks upon instruction from government ministries, and only after enterprise allocations were made for production and the provision of benefits and social services to employees and their communities. When SOEs lacked resources to reimburse banks, government balanced the account. When government failed to replenish bank resources from the national treasury, banks accumulated and rolled over large stocks of loans that were technically in default. This mode of operation distorted the management and pricing of fiscal resources, failed to instill financial discipline in banks and SOEs with regard to resource scarcity, and ultimately led to a general collapse of socialist economies. This collapse was characterized by:

- Disintegration of domestic, regional and CMEA trade relations, resulting in drastic interruptions in production and distribution.
- Decline in domestic output, formal employment and real incomes.
- Sharply higher energy prices due to reduced subsidies, resulting in explicitly higher production costs and output prices.
- High inflation rates, resulting in reduced purchasing power and reduced fixed income values.

GDP fell nearly 15 percent in real terms from 1989-1992 in non-FSU countries, and by nearly 20 percent in the FSU region. In most transition countries, industrial employment has fallen by at least one third, and unemployment rates have risen to nearly 20 percent.

Macroeconomic decline manifested itself in a general deterioration of loan quality. This resulted from a combination of external factors (inflation rates, foreign exchange rates and reserves, trade liberalization, removal of subsidies, collapse of CMEA), as well as factors specific to banks and enterprises. Bank-specific factors included but were not restricted to:

- Poor credit risk assessment.
- Inadequate security/collateral.
- Lack of portfolio diversification.
- Inadequate legal framework for loan recovery.
- Inexperienced bank management.
- Inappropriate governance structures and ownership patterns.
- Limited bank supervision.


3/ These statistics are intended to be indicative. There are enormous discrepancies in transition country statistics due to differing methodologies and measurement techniques, and incomplete data.
Enterprise-specific factors included:

- Inexperienced or inappropriate management (within a market context).
- Rising labor and hard currency input costs (energy).
- Uncompetitive productivity levels.
- Outmoded technologies.
- Overstaffing.
- Poorly received products in thin consumer markets.
- Inadequate cash management and strategic planning capabilities.
- Conflict of interest in terms of enterprise ownership, management and governance of banks.

These factors are symptomatic of the old socialist system in which banks and enterprises were not required to carefully manage risk and resources. In the past, bad loans made by banks to enterprises were not perceived as bad as long as they were made to underwrite enterprise production goals set by government. As such, banks would get refinanced by the government when banks needed additional liquidity. In many non-FSU countries, continued access to public resources unaccompanied by incentives for prudent management represents the main reason why State banks accumulated such large stocks of non-performing loans after the crash of socialism, the main cause of bank insolvency.

With the demise of socialism, unsustainable fiscal deficits have required government imposition of hard budget constraints for macroeconomic stabilization. In FSU countries, hyperinflation has eliminated most of the book value of State bank balance sheets. This actually benefitted enterprises by eliminating their initial debts and debt servicing requirements, although it made access to future credit more difficult and devastated depositors' claims on bank assets. Tightened budgets and ownership transformation have largely privatized many FSU banking systems in advance of operational restructuring, while hard budget constraints have limited their access to public sector funds.

In non-FSU countries, most governments have recapitalized banks or "carved out" non-performing loans at least once in conjunction with reform efforts designed to limit future access to budgetary resources. This approach has partly succeeded at best, and been a costly deferral of needed privatization and institutional change at worst. The chief shortcoming of many recapitalization programs has been that they have not been matched by adequate restructuring and privatization to accelerate the pace of needed market reforms for a viable, competitive banking sector responsive to the needs of the emerging private sector.

In most cases, budget constraints have reduced the supply of loanable funds, exacerbating banks' operational liquidity problems. Large stocks of non-performing loans (if not removed by carve-outs) and limited new lending flows have reduced opportunities for the older State banks to build capital and reserves from operations. In the absence of rapid privatization to reverse the

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distorted incentive framework, many observers doubt that State banks would be able to recapitalize internally from operating cash flow even if loanable funds were more available. Without external (budgetary) support, State banks are generally stagnating, restricted or uncompetitive. Meanwhile, any public sector support for these institutions slows the emergence of private banks which, despite ongoing obstacles, have begun to increase their shares of trade finance and other fee-generating markets, and in some cases new lending flows.

While bank operational restructuring (governance, management, systems) is proceeding at varying levels of speed, new monetary and fiscal discipline in transition countries has changed the financial structure of State bank balance sheets and earnings flows. Banks often hold Government securities due to high reserve requirements and restrictions placed on lending. These securities often carry negative real rates of interest. This is beneficial to government budgets by keeping interest expense down, and reducing the risk of a government bail-out of mismanaged State banks due to continued imprudent lending to inefficient State enterprises. However, such restrictions lower accrual-based bank earnings, making it difficult to recapitalize and grow. Other balance sheet "assets" sometimes include non-performing loans "guaranteed" by pre-transition governments which are now the subject of external debt negotiations. These loans are still often carried on transition economy bank balance sheets, although they should be almost universally written off after charging reserves\(^5\) (which are usually insufficient). Combined with needed changes in the overall incentive structure and financial sector enabling environment, these factors constrain bank earnings and liquidity. This has prompted the need for comprehensive restructuring and privatization in the financial sector of transition countries, particularly as enterprises come under private ownership and operate within a market-oriented incentive framework.

C. Key Reform Program Components

Initial reform efforts have sought to achieve long-term growth objectives while mitigating some of the social costs associated with transition, adjustment and stabilization in the short term. In this context, the design of reform programs has placed significant emphasis on restructuring and privatizing banks and State enterprises. In practice, macroeconomic stabilization measures (hard budget constraints, fiscal balance, restrictive monetary policy) have induced significant financial restructuring at the bank and enterprise levels in most transition countries, with some operational restructuring resulting from less direct access to public resources. However, privatization has not proceeded as quickly as needed for market development. Some countries have succeeded in pursuing mass privatization schemes at the enterprise level, and most countries have at least partly privatized or liquidated a majority of their SOEs. Nevertheless, privatization in the banking system has lagged privatization in the enterprise sector, slowing progress towards a market economy.

Originally, reform programs anticipated State banks would play a lead role in enterprise restructuring efforts with appropriate assistance. Banks were expected to be able to conduct the needed diagnostic of their troubled borrowers, determine which enterprises should continue as going concerns and borrowers of the banks, provide financing and improved governance for surviving

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5/ Many of these "guaranteed" loans are for SOEs that no longer exist, at least legally as borrowers. In other cases, governments do not accept that they are the guarantors. In both cases, this leaves bank balance sheets with uncollectible assets, inflating the book value of their assets and capital.
enterprises, and initiate liquidation procedures against those that were unlikely to be creditworthy in the future. This role was perceived to be appropriate for the banks due to their familiarity with individual enterprises. Policy makers also believed bank-led restructuring was bound to be more efficient in resolving a greater number of debt disputes than if done through centralized non-bank (government agency) channels. However, due to their traditionally passive and non-commercial role, State banks generally lacked the institutional capacity to financially, physically and operationally restructure enterprises and provide effective governance. This has resulted in most transition countries following dual approaches, with banks leading some of the financial restructuring efforts of enterprises, while Privatization Agencies oversee the privatization of most SOEs. In some cases, this involves physical and operational restructuring of enterprises backed by budgetary and bank financing prior to privatization.

Reform programs have adopted a series of measures to transform existing financial systems to serve a market-oriented economy, restructure and privatize enterprises, and create stable macroeconomic conditions for growth. These approaches have met with varying degrees of success depending on the determination of governments to impose hard budget constraints, provide an open environment for the entry of new private banks, encourage private and foreign investment in the banking and enterprise sectors, and promote development of non-bank financial institutions (NBFIIs) such as securities markets and mutual/investment funds. Even where reforms have been adopted, the institutional capacity to implement these reforms and reverse the work culture from the past has been an obstacle to progress. Market development in the formal financial sector has also been slowed by the general restructuring of the economy and numerous political/ethnic disputes which have added to country risk from an investment perspective. To date, reforms have generally included:

**Banking Sector:**
- Recapitalization, loan work-outs and debt-equity swaps to strengthen bank balance sheets (in most non-FSU countries profiled).
- Improvements in the legal and regulatory framework, central bank licensing and supervisory capacity, corporate governance structures, accounting standards, payments systems and other forms of financial infrastructure to strengthen financial sector institutions and human capital (in virtually all transition countries profiled).
- Consolidation of the banking system to establish suitable capital requirements, rationalize resources and retail networks, and establish "critical mass" for bank competitiveness and profitability (in some of the profiled countries, mainly non-FSU).
- Expansion of the banking system to allow private banks to provide financial services (in most countries profiled).

**Enterprise Sector:**
- Restructuring and privatization of enterprises to encourage enterprises to operate in accordance with commercial criteria.
- Improved legislation to provide market-based incentives under which enterprises (and banks) can operate.
- Improvements in corporate governance, including reversing State enterprise ownership of banks, to promote better enterprise management and reduce conflict of interest in the management of banks.
• Introduction of international accounting standards to improve the quality of information about the financial condition of enterprises (and bank portfolios).
• Enhanced information systems, and access to information.
• Strengthening in-court bankruptcy and liquidation capacity, although this has been more formative at the institutional and legal level.

Enterprise sector reforms have occurred in varying degrees in virtually all transition countries profiled.

D. Central Challenges to Bank and Enterprise Reform

Key challenges facing State banks include illiquidity,6 insolvency and the configuration of banking systems. All relate directly to fiscal discipline and the imposition of hard budget constraints, increasing private sector share in the economy, and the enforcement of market discipline on banks and enterprises (including bankruptcy and liquidation in both sectors) as part of the new incentive system needed for systemic transformation and economic growth.

Illiquidity, or insufficient cash flow generated from assets, is a problem faced by many banks, primarily SOCBs. While on a stock basis banks appear to be liquid, on a flow basis they often are not. Excess liquidity on a stock basis derives from the predominance of short-term assets (securities, loans) on the balance sheet. However, earnings from these assets are often low (securities) or zero (large portions of loan portfolios), reducing banks' cash flow and constraining liquidity for ongoing operations. These financial weaknesses are symptomatic of larger operational weaknesses related to weak governance, management and incentive structures typically found in public enterprises and banks. While some progress has been made during a period of transition and stabilization, in most cases progress has not been rapid enough to reverse the liquidity problems faced by the State banks.

Negative operating cash flows, typical of SOCB results, have made these banks burdensome for governments to support. On the one hand, the fiscal burden of SOCB losses has given governments the incentive to restructure and privatize SOCBs. On the other hand, short of bank liquidation, governments have a current fiscal disincentive to restructure SOCBs because of the near-term costs involved, a task made all the more complex because of the political support these banks have from anti-privatization interest groups who are well represented in transition country parliaments. SOCBs need governments to assume financial responsibility for the inherited bad loans made before commercial criteria were introduced into the banking system. In some countries, inflation erased these values from bank balance sheets. However, continued government interference in some non-FSU countries led to an accumulation of bad loans after inflationary effects are taken into account. This impaired SOCB balance sheets, and has continued to weaken earnings, cash flow and liquidity. If SOCBs are to be restructured and privatized, this will likely have to happen with a clean balance sheet (along with new incentives and governance structures), which will add to the fiscal burden. Non-FSU recapitalization programs, which also have added to the fiscal burden, have

6/ This paper refers to liquidity and illiquidity on a cash or funds flow basis, not on the basis of current assets and liabilities on the balance sheet. Hence, liquidity problems or illiquidity reflect limited earnings flows to banks available for new lending, investments and operations. This may occur despite bank balance sheets holding substantial net current asset positions.
not been wholly effective partly because government believed restoration of nominal bank solvency would correct operating cash flow weaknesses. In the absence of sufficient changes in the ownership, governance and management of these banks, such cash flow weaknesses have continued and been exacerbated by reduced access to budgetary resources. However, because of the political complexities involved, most non-FSU governments have still not shed this burden.

In some countries, there is evidence that the financial and operating problems of State banks are being deferred by governments that hope to "grow out of the problem". Just as inflation masked many of the underlying weaknesses facing State banks, some governments still believe that State banks will be able to recapitalize from operations when their economies begin to show real growth, at which time they could be privatized with less political or economic pain. In addition to delaying needed reforms, this school of thought raises the risk that governments may reconsider subsidizing banks to stimulate lending for a revival of industrial and other production. Any reduction in fiscal discipline might lead to some short-term production and employment gains, but would likely lead to the more serious problems of reduced discipline at the enterprise and bank level.

Banking systems remain varied in their configuration. Non-FSU countries show a predominance of large SOCBs accounting for the greatest share of loans, assets, deposits and capital on a book valued basis, although small private banks exist and are slowly capturing new market share. The predominance of SOCBs continues to distort the banking system and slows the development of a market economy. In most FSU countries, the rapid privatization of the monobank system has led to a significant number of small, poorly capitalized banks. While ownership has changed, most of these banks will likely not be viable on a long-term basis due to weak governance and management, inadequate capital, and narrow markets. Along with weak loan portfolios and excess overhead, SOCBs in non-FSU countries are often characterized by excess product or market segmentation/specialization (State sector, housing loans, agriculture loans, savings mobilization, geographic region). The smaller private banks in most FSU countries also suffer from limited geographic focus. In all transition countries, these characteristics raise questions of appropriate scope and scale in banking systems. Having too many small banks with low capital and too narrow a focus jeopardizes deposit safety, and taxes the limited central bank supervision capacity available in transition countries. However, with a history of monobanks and, more recently, large and inefficient SOCBs, the presence of large banks that have benefitted from monopoly and protection serves to deter competition.

Meanwhile, smaller private banks have begun to emerge in most transition countries. These banks are often owned by recently transformed or privatized SOEs in FSU countries. In non-FSU countries, many of the larger private banks have benefitted from foreign investment. Private banks are generally smaller in terms of balance sheet values, head count and branch networks, usually focusing on a narrower market that caters to leading shareholders (FSU) or focuses on non-lending activities (non-FSU). The former limits portfolio diversification options, and places bank capital at

7/ This includes items on balance sheets that would be written down (stocks of non-performing loans) and other items that would be separated from the balance sheet or written down (performance guarantees, contingent liabilities) if international accounting standards were observed. If such write-offs occurred, the "private" share of aggregated banking system balance sheets would increase in terms of loans, assets and capital. Deposits would generally not be affected in countries where savings banks still retain significant shares of deposits.
risk because of high levels of concentration. The latter focus on non-lending banking activities often represents a prudent, risk-averse position during a period of major structural change and limited loanable funds. However, as SOCBs stagnate or restructure, private banking shares of new lending flows are slowly increasing. (Even in countries where this is not happening from the supply side, there has been a recognizable increase in the distribution of new lending to private sector borrowers.) While most private banks individually are too small to have a major impact on aggregate bank lending or deposit mobilization, their aggregated share in many transition countries is growing. In some cases (FSU and non-FSU), private banks are generating positive operating cash flows and impressive returns from earning assets.

However, not all private banks are prudently managed or capable of generating positive returns. In some countries (Estonia, Poland), an excess number of poorly capitalized and mismanaged banks has led to negative results, jeopardizing deposits and capital. This has raised questions about easy licensing requirements to encourage entry, particularly where bank supervision capacity and enforcement are weak. When governments show a willingness to let mismanaged banks (State and private) fail, this will permit more prudently managed banks to capture greater market share. This has begun in a few cases (Estonia), and the combination of higher minimum capital requirements (Slovenia), strengthened bank supervision capacity and willingness to allow bank failures may provide some needed stability without creating obstructive barriers to entry. However, to date, most transition governments have been reluctant to permit bank failures, deterring needed financial discipline and inviting the risk of moral hazard.

Despite promising shifts in many transition country banking systems, bank liquidity may remain problematic in the near term. The chief consequence of these liquidity problems is savings to the budget to counter unsustainable deficits, helping to construct a more stable macroeconomic environment for private sector-led growth. While credit resources available for new lending to the private sector may be partly constrained during the transition, a more stable macroeconomic environment should improve prospects for future bank and enterprise growth. Macroeconomic stability will be needed to improve lending quality and increase credit volume to counter rising formal sector unemployment and low investment levels. Development of capital markets to increase enterprise access to equity resources will be crucial in the future to provide enterprises with enhanced debt capacity and banks with better capitalized borrowers. Some banking systems (most notably the Czech Republic) permit banks to invest in enterprises through swaps and investment funds, representing a start (albeit with significant risks involved). Until then, transition economy financial sectors may have difficulty improving earnings and cash flow, making it difficult for many private enterprises to obtain needed financing from banks.

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8/ More developed capital markets will obviously provide enterprises, households, governments and other institutions with income-generating opportunities, all of which will also benefit banks in broadening the range of customers which fall into banks’ risk profiles for lending and other financial activities.
II. DESCRIPTION OF KEY DESIGN VARIANTS OF THE REFORM PROGRAM

A. Introduction

Transition country reform programs face the dual challenge of overhauling the financial system at a time of great macroeconomic and institutional change, and specifically restructuring, privatizing or liquidating banks which are burdened by stocks of non-performing loans of a magnitude far exceeding international norms. Such circumstances have created great uncertainty, adding to the complexity and difficulty of the transition period.

Reform programs have supported efforts to transform financial systems to serve market economies. This has led to bank financial restructuring, and improvements in the financial sector enabling environment. In some cases, it has led to a more rational consolidation of the banking system. However, reform programs have not necessarily moved fast enough to privatize banks (non-FSU countries), or they have done so without being accompanied by needed operational restructuring for long-term viability (FSU countries).

In most cases, reform has encouraged the entry of new private banks, particularly with the privatization of the monobank system in FSU countries. Russia now has 2,300 private banks which did not exist during the Soviet era except as branches of the monobank system. Other FSU countries have likewise experienced a rapid proliferation in the number of private banks, mostly from monobank privatization. This has generally been pursued by making banks a part of the mass privatization schemes introduced, and by keeping minimum capital requirements low by international standards.

For the non-FSU countries which have chosen or contemplated recapitalization, reform programs have had to identify structural problems and determine the financial cost of needed reforms. Lacking significant prior experience with commercial banking and market-oriented financial systems, these governments have not always been able to agree on the magnitude or pace of needed reforms. The difficulty of this immense challenge has been compounded by several factors:

- **Accounting**: Converting old "socialist" accounts to international standards has been necessary to quantify non-performing loan portfolio values, bank capital and reserves, and past losses. Bookkeeping has not always been complete or accurate, making this task more difficult.

- **Policy**: Transition countries have been reluctant to liquidate poorly managed State banks, and have sometimes put up barriers to the full development of private banking systems. This has perpetuated losses, added to the fiscal burden, slowed privatization of the banking system, and delayed development of appropriate incentive structures needed for efficient financial intermediation.

2/ In Russia, minimum capital for a bank license approximates US$-equivalent 100,000. These low levels are generally consistent across FSU countries, and explain part of the reason for the large number of banks in these countries. The European Union average approximates US$-equivalent 6 million. By contrast, most non-FSU countries show minimum capital to be in a range of US$-equivalent 5-15 million.
- **Legal**: Legal and financial responsibility for guarantees has not always been clarified between governments and banks. This should be a moot point because SOCBs were/are usually wholly-owned by governments. However, disagreements over liability dating back to the pre-transition period have slowed the reform process.

- **Human Capital**: Transition countries generally lack experienced professionals capable of restructuring, managing, governing and supervising banks to be commercially viable. This has created difficulties in the design and implementation of internal systems and operations, particularly credit risk management.

- **Governance**: In addition to the absence of experienced professionals, transition countries have only recently introduced prudential regulations to supervise and govern the banking system. Banks and central banks have not yet fully adapted to these new guidelines for effective implementation.

Bank financial restructuring has been meant to address immediate problems of bank solvency and, in some cases, liquidity. Meanwhile, improvements in the financial sector enabling environment and reorganization of the banking system have been designed to address structural and institutional weaknesses for long-term stability. These include:

- **Bank Financial Restructuring**: The financial restructuring of banks in non-FSU countries has involved direct recapitalization to meet minimum capital adequacy standards. In most cases, this has been based on government "carve-outs", or the exchange of Government bonds for banks' non-performing loans to restore solvency. Other techniques, used to a lesser extent, include: bank work-out units to recover non-performing loans, sometimes supervised by Bank Rehabilitation Agencies; debt-equity swaps, in which bank equity in enterprises has "replaced" non-performing loans; and loan sales and asset swaps. In FSU countries, bank financial restructuring has largely come from the hyperinflationary elimination of SOCB balance sheet values, and the general inability and refusal of governments to provide subsidies to banks for new losses (imposition of hard budget constraints).

- **Financial Sector Enabling Environment**: Promoting a financial sector enabling environment has been central to all reform efforts. This has involved policy, legal, regulatory and institutional reforms for efficient financial sector infrastructure (information systems, payments systems, accounting and audit professions), and more suitable forms of bank governance.

- **Banking System Reorganization**: In a few cases, consolidation of the banking system has occurred based on raised minimum capital requirements to encourage a more rational and better capitalized banking system. In most countries, the number of new private banks has increased significantly, often the result of monobank systems being privatized by branch or region. In these cases, minimum capital requirements are low.

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10/ While not a new approach, reform programs have incorporated some of the lessons learned from earlier efforts to improve the financial sector enabling environment.
In several cases, transition countries have applied a combination of approaches. These components and country experiences are described below.\textsuperscript{11}

B. \textbf{Financial Restructuring Methods of Banks}

\textbf{Bank Recapitalization}

Banks in transition economies are almost universally undercapitalized, with the exception of a small number of recently established private (or recently privatized) banks which usually represent only a small portion of the stocks of banking system assets, loans, deposits and capital. (On a flow basis, these banks are becoming increasingly significant in terms of loans, assets and capital.) Even savings banks, with large placements of household deposits, are often undercapitalized\textsuperscript{12} because of poorly performing loan portfolios, high proportions of non-earning or low-earning securities, and mismatches in the earnings structure of assets and payment requirements of interest-bearing deposits.

To be effective, bank recapitalization needs to be accompanied by changes in bank incentive structures (ownership, management, governance) and improvements in financial sector infrastructure. The central purposes of bank recapitalization have been to restore solvency and create the conditions needed for bank management to make their banks competitive and commercially viable. In a few cases (Czech Republic, Slovenia), this approach has worked as hard budget constraints were henceforth imposed, and comparatively developed economies grew based on increased investment, trade and purchasing power. In other cases, lack of fiscal discipline (Hungary) and continuing barriers to market liberalization (Poland) have reduced the effectiveness and added to the cost of recapitalization.

Governments have selected the recapitalization option to strengthen bank solvency, which has been interpreted to be less costly (economically and politically) than liquidating troubled banks. In the process, such a cushion provided from recapitalization is supposed to free up resources for new lending flows to the private sector, contain excess risk-taking by bank management/owners once capital is replenished, and strengthen bank capital to meet the stricter capital adequacy requirements imposed by new prudential regulations. While country experiences have varied, there is a clear risk of moral hazard and misallocated financial resources if recapitalization is not accompanied by sufficient changes in incentive structures. Because non-FSU governments have been slow to privatize SOCBs, recapitalization has generally not been sufficiently accompanied by needed reforms in banking system incentive structures. This has sometimes led to recurring demands for additional capital, a lack of financial discipline, delays in market development, and ongoing distortions with regard to deposit mobilization and lending activities. These problems strengthen the argument that bank recapitalization should not occur in advance of privatization. However, there are other cases where recapitalization has been at least partly successful prior to privatization. These successes have

\textsuperscript{11} For a concise review of banking sector restructuring options, see A. Saunders and A. Sommariva, "Banking Sector and Restructuring in Eastern Europe", Journal of Banking and Finance, 1993.

\textsuperscript{12} This is true in some "advanced" transition economy savings banks (Czech Republic, Poland), as well as in most of the less advanced economies.
been characterized by subsequent privatization of ownership and management (Czech Republic, and to a far lesser extent Poland), fiscal discipline (Czech Republic, Poland, Slovenia), and economic growth (Czech Republic, Poland, Slovenia). Potential advantages and disadvantages of recapitalization are highlighted in Box 1.

### Box 1: Potential Advantages and Disadvantages of Bank Recapitalization

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<th>Advantages</th>
<th>Disadvantages</th>
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<td>Recapitalization cleans up a bank's balance sheet by removing bad loans and restoring solvency. This should reduce the risk of rollovers and interest capitalization on exposure to bankrupt SOEs, and reduce bank incentive to assume excess risk to meet earnings and capital targets. Recapitalization should encourage banks to initiate restructuring plans for enterprises they want to continue to finance, and to curtail credit to those they believe non-creditworthy. All of this should encourage improved resource management and allocation. Recapitalization might preserve the &quot;franchise value&quot; of potentially viable banks as going concerns in their relations with depositors, creditors and borrowers, helping to preserve some stability in the banking system during a period of transition. For recapitalization to be successful, it must be accompanied by an explicit statement by government that future losses will not be covered from public resources. This is required for banks to become market-oriented, and adopt commercial and performance-based criteria. This is most efficiently achieved through privatization.</td>
<td>Recapitalization runs the risk of moral hazard, reduces the incentive to banks to become market-oriented in credit allocation and overall operations, and adds to the possibility of ongoing fiscal costs. Failure to liquidate insolvent and mismanaged banks defers needed bank privatization, slows development of a viable private banking system, encourages disintermediation and inefficiency, and undermines confidence. Recapitalization depends on Government financing in a period of limited budgetary resources. Because most recapitalizations are via the issuance of Government bonds, this increases direct Government control of the banks without Government having suitable supervisory experience to protect against mismanagement.</td>
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Most non-FSU recapitalization has occurred in the form of "carve-outs". Under this approach, governments have issued bonds (and guarantees, in the case of Hungary) to replace non-performing loans on bank balance sheets, thereby strengthening banks' solvency positions. Where these are interest-bearing bonds, carve-outs have eased some of the liquidity problems banks experience as a result of non-performing loans. Meanwhile, governments serve as the repository for bad loans, impacting public expenditure depending on the maturity and interest rate/yield features of the bonds issued.

Even in the case where banks do not collect interest on government bonds, separating out non-performing loans up to a specified date carries the benefit of creating a measure of transparency.

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14/ In Croatia, Macedonia and Slovenia, governments issued bonds approximating US$-equivalent 4.5 billion (about 26 percent of their aggregated book-valued assets) to banks to cover frozen foreign exchange deposits whose counterparts vanished with the disintegration of the former Yugoslav Federation. Previous to the break-up, it was mandatory for foreign exchange deposits to be placed with the National Bank of Yugoslavia in Belgrade. The issuance of these bonds is separate from bonds issued to carve out non-performing loans.
for bank balance sheets. For non-performing loans made before a specified date, carve-outs can cover the value of the loans. For non-performing loans made after that date, banks should be held responsible for loan collection and provisioning for losses. However, in most initial cases, the effectiveness of carve-outs has been undermined because bonds were issued for stocks of "old" loans before the full menu of needed changes in policy, regulation and incentives was introduced. In some cases, this has meant continued lending to loss-making enterprises and the use of banks in running up quasi-fiscal deficits (Hungary). Absent major changes in overall incentive structures, bank performance has not improved sufficiently to obviate the need for additional forms of recapitalization (Hungary) or to question the long-term prospects of banks which have been recapitalized once they are subject to real market competition (Poland). For these reasons, carve-outs have only in some cases (CSFR, Poland, Slovenia) helped to resolve fundamental problems associated with poorly performing loan portfolios, weak or negative operating cash flow, and resultant liquidity and solvency problems. In other cases (Croatia, Hungary), carve-outs did not resolve these problems because they were not accompanied by hard budget constraints (Hungary) or rapid privatization (Croatia, Hungary).

In addition to needed reforms in bank incentive structures, what has been lacking has been sufficient change in the enterprise sector and its relationship with the traditionally subordinated banks. While significant privatization has occurred in many countries, "strategic" enterprises and other large, loss-making enterprises which are significant employers have often been able to escape debt servicing and earlier repayment obligations. Neither governments nor banks have been particularly effective in collecting on old State enterprise loans for four major reasons:

- State enterprises are generating negative cash flow, are in arrears on tax and wage payments, and are more preoccupied with meeting supplier creditor requirements to stay in business.
- These enterprises are politically powerful or "strategic", and are able to disregard obligations to banks which are subordinated on the credit hierarchy to government and trade creditors.
- Some of these enterprises are no longer operating, although loans are still carried on the books.
- Some of these State enterprises have had their productive cores privatized, with neither the State (previous shareholder) nor the newly "privatized" enterprise (often worker- and/or management-owned) assuming responsibility for the loan.

While governments and banks have had difficulties collecting on outstanding old State sector loans, they have shown improvements in curtailing new lending to non-creditworthy enterprises. This reflects the importance of hard budget constraints which, in turn, have encouraged SOCBs and other banks to improve credit management. At a minimum, this has led to some financial restructuring of the enterprise sector, and had at least an indirect effect on enterprise operations. The increase in inter-enterprise debt and arrears is indicative of banks' efforts to instill financial discipline, albeit defensively to contain their own losses. If banks are not yet properly managed according to commercial criteria, there is evidence that they have made progress in a more market-oriented direction by virtue of the hard budget constraints imposed. By contrast, in countries where soft budget constraints prevail (in both the banking and enterprise sectors), reforms have been slow and recapitalization less effective. This points to the important linkage of macroeconomic stabilization, fiscal discipline, and appropriate incentive structures for the banking and enterprise sectors.
Country Experience

For about half the countries, primarily FSU countries with limited financial sector infrastructure and inexperienced personnel, recapitalization is considered unnecessary, premature, costly or unattractive as an option. This position has been supported by the high cost of recapitalization in Croatia, CSFR, Hungary, Romania and other non-FSU countries, leading to the view that recapitalization is an unnecessary expenditure during a period of monetary and fiscal consolidation. In Russia and most FSU countries, inflation eliminated most State bank assets, as well as the value of claims on those assets (deposits, capital). Combined with the privatization of the old monobank system, recapitalization is now viewed as unnecessary and fiscally unattractive.

Among non-FSU countries that have recapitalized (or are about to), the most common method has been by issuing bonds. Albania, Bulgaria, CSFR, Croatia, Hungary, Poland, Romania, and Slovenia have already recapitalized banks, or were expected to do so in 1994. These recapitalizations range from US$-equivalent 72 million in Albania to US$ 4.6 billion in Bulgaria and US$ 5 billion in CSFR. By design, these recapitalizations have usually been linked to reforms in the ownership, management, governance and operations of the banks. However, rates of success have varied based on the degree of implementation of these changes.

The CSFR countries (Czech and Slovak Republics) recapitalized the banking system in 1991 with US$-equivalent 5 billion to restore solvency in the technically insolvent commercial banking sector. The method used was to create a "loan hospital" through the Consolidation Bank to collect on non-performing loans, estimated to approximate 20 percent of total loans made prior to the collapse of socialism. While this recapitalization was expensive, it was done in a fiscally responsible manner. To pay for the recapitalization, offsetting cuts in public expenditure were made to achieve fiscal balance. Meanwhile, five major banks were privatized (up to 63 percent) along with enterprises in the 1992 mass privatization program. The CSFR approach is considered successful because of the improved financial sector enabling environment that emerged, reliance on across-the-board macroeconomic stabilization for growth, fiscal balance despite an eight-year amortization schedule for the bonds, and privatization of the banks to encourage a more stable banking environment.

In Slovenia, the DM 2.2 billion14 recapitalization of the three largest banks was directly linked to a formal restructuring program administered by the Bank Rehabilitation Agency (BRA) to bring the risk-weighted capital adequacy ratios of the banks to eight percent of assets by 1995. The recapitalization involved severance of non-private enterprise ownership of the banks in exchange for debt forgiveness (including anticipated loan losses). Initial results appear satisfactory as loan portfolios have been cleaned up, capital adequacy levels have improved, and internal operations and systems have been made more efficient in advance of privatization.

15/ This approximated US$ 1.3 billion.
Poland recapitalized seven State-owned commercial banks with US$ 750 million in 1991, approximating 12 percent capital adequacy after provisioning for loan losses and accrued interest.\textsuperscript{16} These banks were effectively "commercialized" with new corporate governance guidelines, and mandated by law to restructure their non-performing loans within a given deadline. To be eligible for recapitalization, banks had to obtain a financial audit, isolate non-performing loans in a work-out unit, and submit a loan portfolio restructuring plan to the Ministry of Finance for approval. This was accompanied by a plan to privatize a total of nine SOCBs, of which two were privatized without recapitalization (Poznan, Katowice), and a third which is underway after initial recapitalization and work-outs (Krakow). While banks have been able to restructure their balance sheets (largely through enterprise liquidations), the Polish banking system is still dominated by four specialized banks and has not yet opened up to full market competition. Until this occurs, it is unclear if the recapitalized SOCBs will be major players in the Polish financial sector. Nevertheless, privatization and recent foreign investment interest from West European banking concerns suggest some of these banks may well be competitive as the market opens up. If so, recapitalization may have been a less costly option than liquidation.

Hungary has recapitalized its banks three times since 1991 (a fourth was expected by end 1994) through guarantees and bond issuances approximating HUF 300 billion (about US$ 3 billion).\textsuperscript{17} Successive recapitalizations have proceeded without the measures needed to reform bank management practices, as Hungary has used its banks to run up quasi-fiscal deficits by lending to large loss-making SOEs. Combined with a lack of fiscal discipline, Hungary's efforts at recapitalization have proven to be unsuccessful.

Croatia issued DM 1 billion\textsuperscript{18} in "Big Bonds" to enterprises which were transferred to banks to replace their stocks of non-performing enterprise sector loans. In exchange, banks and enterprises were expected to become more commercially driven to preclude a recurrence of recapitalization requirements. War, limited progress shown towards enterprise "commercialization" or privatization, and continued public and SoE ownership of large banks rendered this initial recapitalization ineffective. In recognition of this, the Government of Croatia has enacted legislation that will sever majority ownership by non-private enterprises of banks by 1995. Many banks have already achieved a transformation of ownership, and are operating according to commercial criteria.

\textsuperscript{16/} Poland has established a US$ 1 billion Bank Privatization Fund to service the US$ 750 million in bonds issued in 1993 to the SOCBs. This Fund has been established to allay prospective investor fears of debt service complications that would interfere with bank privatization in Poland. The Fund was expected to be fully funded and operative no later than the end of 1994.

\textsuperscript{17/} These include Government guarantees in 1991 for 50 percent of bad loans transferred to banks in 1987 (HUF 21 billion), the 1992 Loan Consolidation Scheme (HUF 77 billion in bonds and cash), the 1993 Loan Consolidation Scheme (HUF 40 billion), and the Thirteen Plus One Program (HUF 56 billion). An additional recapitalization approximating HUF 80 billion (US$ 800 million) was expected to occur by end 1994.

\textsuperscript{18/} This approximated US$ 750 million at the time. These bonds have since been revalued on several banks' balance sheets due to hyperinflation which persisted until October, 1993. The effect of Big Bond revaluation has been to artificially inflate the revaluation reserves and secondary capital of some of the banks holding these bonds.
Bulgaria, Romania and Albania are issuing bonds for "old" stocks of bad loans that are to be written off, but are holding banks responsible for flows of new loans made after certain dates when new legislation was introduced and banks were expected to take responsibility for their performance. Thus, Bulgaria is recapitalizing banks with US$-equivalent 4.6 billion for non-performing loans made before 1991, while requiring internal bank work-out units to recover an additional US$ 1.6 billion for loans made since 1991. Romania is providing additional recapitalization resources of US$-equivalent 300 million for various SOE obligations through 1992, after guaranteeing 90 percent of non-performing loans at end 1990 and accumulated inter-enterprise arrears at end 1991. All Romanian banks aside from the Savings Bank are included in the country's mass privatization program. In Albania, the US$ 72 million in bonds apply to loans made before mid-1992 when new banking legislation was introduced. About US$ 44 million of the US$ 72 million in bonds will not be issued until a restructuring and privatization plan is in place for Albania's largest bank. Latvia, Lithuania, Slovakia and Uzbekistan are exploring recapitalization options.

As noted above, experience with bank recapitalization in transition economies has been mixed. Partial success has occurred in some cases when accompanied by improved bank management and governance, a better enabling environment, advances in financial sector infrastructure, and a healthier macroeconomic environment. The CSFR is considered the greatest success by virtue of its fiscal prudence and speed of privatization. In Poland, the recapitalized SOCBs are now better capitalized and show evidence of being able to properly manage loan portfolios. Alternatively, in the case of Hungary, bank recapitalizations have occurred since 1991 without sufficient changes in SOCB behavior to sustain stable profitability and maintain adequate capital. This has resulted in a recurrence of recapitalization requirements for SOCBs in the absence of hard budget constraints on enterprises, a slower pace of private sector development, and a rapidly growing burden for State finances.

In other countries, it is premature to judge results. Slovenia's recapitalization of banks has been combined with high minimum capital requirements (to US$ 35 million) and stricter capital adequacy requirements. These efforts should help rationalize the banking system and generate stronger capital bases for banks. Importantly, standards for achieving capital adequacy have been strengthened, increasing the likelihood that bank capital will be sufficient for stable growth and effective intermediation. This should also reduce the risk of future recapitalization needs from public expenditure. Croatia's issuance of Big Bonds in 1991 did little to change ownership, management and governance of banks, which were essentially captive finance companies of SoEs. The result is that today, most socially-owned Croatian banks need some form of recapitalization or reorganization. Recognizing that stricter conditions should have been placed on enterprises and banks in 1991 to avert additional recapitalization needs, the Croatian government is now enacting new legislation that should make envisaged recapitalization effective in rehabilitating troubled banks and building a more market-based banking system. Bulgaria has succeeded in consolidating its banking sector and permitting the emergence of small private banks, but has not yet developed a market-based commercial banking system detached from public ownership and control. Privatization of Bulgaria's six consolidated

12/ Slovakia has already recapitalized banks during the CSFR period with KCS 120 billion in non-performing loans transferred to the Consolidation Bank, and KCS 50 billion in bonds issued to the banks to recapitalize. This involved fiscal measures which effectively removed 30 percent of all outstanding SE loans from bank balance sheets.
SOCBs was expected to begin in late 1994-early 1995. Romania's recapitalization has contributed to progress in "commercializing" bank operations, although Romania is pursuing a gradualist approach to privatization. All banks except the Savings Bank are to be privatized, with the State retaining a 70 percent ownership stake in these banks to be gradually privatized over a seven-year period. The presence of foreign investment in the Romanian banking sector is likely to increase competitiveness and improve management and governance, although this is not sufficient for change; Hungary also has succeeded in attracting foreign investment in the banking sector without sufficient systemic reform.

**Box 2. Early Recapitalizations and Bank and Enterprise Behavior**

**Banks:** Earlier recapitalizations and swaps were intended to separate "old" and "new" banks, with new financing covering for the liquidity and solvency problems of the "old" banks with portfolios inherited from the centrally planned era. With cleaner balance sheets, the "new" banks were expected to follow commercial criteria for lending and general management to prevent a recurrence of "old" problems. However, "new" bank management and supervisory boards were often the same people. Even with personnel changes, new credit policies and procedures were not properly conceptualized or satisfactorily implemented. "Old" practices such as pressure from line ministries to lend to poorly performing State enterprises continued, particularly as unemployment and inflation rates increased or recessions deepened. In non-monebank systems, problem borrowers were often the largest shareholders of the banks, making it difficult if not impossible to deny credit. Without legal recourse or other methods to enforce loan collection, bank portfolios and financial conditions deteriorated once again.

**Enterprises:** Enterprise restructurings combined with macroeconomic policy reforms, improved legal and regulatory frameworks, and institutional development were expected to make enterprises more creditworthy. This is likely to occur over time, but many of the needed policy reforms have made uncompetitive enterprises' lack of creditworthiness more explicit during the transition, adding to the cost of bank restructuring. The removal/limitation of subsidies made enterprise operating costs and inefficiencies more explicit, and exposed many of them as loss-making operations that do not meet prudent bank creditworthiness criteria. The liberalization of interest rates increased the cost of borrowing for all firms, while the liberalization of exchange rates increased the cost of many needed inputs. Outmoded technologies require new investment, more difficult to achieve without profitability and access to credit at subsidized rates. Reflecting "old" concepts of enterprises as social institutions rather than economic units, excess labor and associated compensation made inefficiencies more explicit and added to unsustainable cost structures. These problems rendered most State enterprises non-creditworthy. However, because line ministries intervened in bank lending decisions, or because the enterprises themselves were the owners of the banks, they continued to access bank credit. In the absence of management changes, suitable corporate governance practices, stricter productivity standards, and competitive strategies adopted for changing market conditions, enterprises continued to operate largely as they had before. The result was a worsening of bank portfolios, and delays in the implementation of inevitable enterprise restructuring programs.

**Work-Out Units and the "Good Bank/Bad Bank" Approach**

With aggregate loan portfolios universally troubled by delinquencies and defaults in transition economy banking systems, some banks have opted to develop work-out units to improve loan portfolio quality. When work-out units are established, they are usually set up to deal with most of a bank's problem loans, effectively sectioning off non-performing loans from the broader bank portfolio of performing loans. The benefits expected from work-out units include:

- Concentrated focus on the recovery of problem loans.
- More developed banking expertise and credit risk evaluation skills.
- Improved internal bank systems (early warning systems, collateral requirements, credit information needs).
As discussed below, there is evidence in some countries that work-out units can make a significant difference in restructuring loan portfolios, particularly when supported by effective technical assistance. With support from the Ministry of Finance, work-out units have been useful in Poland when loan recovery approaches have been based on effective restructuring and privatization programs for borrowers. However, in many countries, the magnitude of loan portfolio problems facing banks exceeds their capacity in time and money to effectively restructure these enterprises in default. The viability of this approach tends to be threatened by:

- Lack of work-out traditions and staff experience.
- Insufficient public sector compensation and incentives.
- Local pressures on banks to roll over loans or forego repayment.
- Insufficient legal/regulatory framework regarding loan recovery (courts, collateral legislation, property registries).
- Absence of market mechanisms to effect loan repayment (valuation, repossession, liquidation and sale).

An alternative approach which was pursued by the CSFR Consolidation Bank involved the "good bank/bad bank" approach, in which non-performing loans from the major SOCBs were separated from their balance sheets and the Consolidation Bank pursued loan recovery. Combined with recapitalization, the banks showed improved capital adequacy and became more attractive for privatization. However, "bad banks" such as the Consolidation Bank are effectively loan collection agencies that wind down the bad operations of the previous bank(s). During the interim transition period, this option appears feasible only if underwritten by the public sector simultaneous with a commitment to achieve fiscal balance and to privatize the recapitalized banks as rapidly as possible. The banks in CSFR were financially restructured by the Consolidation Bank, but were not operationally restructured until privatized. Meanwhile, to achieve fiscal balance, the government cut public expenditure in other areas to prevent deficit financing. Such commitment to privatization and fiscal balance has not been evident in most transition countries. Ironically, Hungary is considering the "good bank/bad bank" option for its two largest SOCBs. Without commitments to fiscal prudence and accelerated privatization, two areas in which Hungary has not been recognized as a noted success, it is unlikely that the "good bank/bad bank" concept will work.

**Country Experience**

Only about one third of the sampled countries are using or expect to use work-out units to improve loan portfolio quality. These countries include Bulgaria, Croatia, CSFR, Estonia, Hungary, Poland, Slovakia (post-CSFR) and Slovenia. Bulgaria is supporting work-out units to collect US$-equivalent 1.6 billion in loans from banks to SOEs (usually the banks’ owners) made since 1991. Croatia is contemplating establishment of work-out units in banks undergoing rehabilitation. Estonia is relying on work-out units as the main form of immediate bank restructuring, having rejected an all-out recapitalization. The government of Hungary has subsidized work-out units by providing indirect "profit guarantees" to underwrite work-outs. The objective has been to provide banks with an incentive to restructure SOEs and their loans to prevent greater unemployment. Poland has used work-out units as part of its approach to recapitalization and out-of-court conciliation. These units have been successful in restructuring 75 percent of targeted non-performing loans through out-of-court procedures (mostly via liquidation) within the time frame mandated by law. Slovakia was planning to improve the legal framework for work-out units to restructure SOEs and their loans prior to the
recent elections. It remains to be seen if the new government will pursue this option. Slovenia has introduced work-out units for banks formally undergoing bank rehabilitation. The units report to the BRA, and are a critical element of individual bank restructuring programs initiated by BRA.

Work-out units have helped banks concentrate their focus on the recovery of problem loans, with successes shown in CSFR, Poland and Slovenia. Work-out units are also a valuable skills transfer tool for the development of needed banking expertise and credit risk evaluation for commercial bankers and central bank supervisors. Estonia, which has supported work-out units with hard budget constraints and a willingness to allow enterprise liquidations and bank failures, has utilized work-out units for institutional development and human capital formation. However, Hungary has demonstrated that work-out units show limited effectiveness unless accompanied by fundamental changes in bank governance and major borrower restructurings. Many of the SOEs on which Hungarian work-out units are focusing are large-scale in terms of employment. Because of growing unemployment and local pressures on banks to roll over loans or forego repayment, these SOEs have not been sufficiently restructured to repay loans.

**Debt-Equity Swaps and Loan Sales/Asset Swaps**

Unlike loan restructurings, which are common to all market-oriented banking systems, equity swaps resulting in bank ownership of enterprises occur with differing frequencies in different markets. In some systems, bank ownership of enterprises is common (German interlocking directorates, Japanese keiretsu), while in other systems bank ownership of enterprises is strictly regulated (United States). By permitting banks to swap non-performing loans for equity, banks can exercise more direct control/supervision over enterprise management while the enterprise benefits from increased debt capacity. The risk to banks is excess exposure to a risky investment which may jeopardize deposit safety and bank capital, and demand scarce management time and resources.

In transition economies, a handful of sampled countries are engaged in equity swaps for loans. Equity swaps in these countries are basically for non-performing loans, or the written down part of the loan. Two schools of thought regarding debt-equity swaps are summarized in Box 3.

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20/ C. Gray and R. Hanson, "Corporate Governance in Central and Eastern Europe", World Bank, September 1993.
**Box 3: The Pros and Cons of Debt-Equity Swaps**

**Pro:** Equity swaps represent nascent venture capital operations. Perhaps only one in 10 of these investments may succeed, but this should be sufficient to cover the risk of the other nine losing investments. Given existing low book values and the currently thin market that is likely to improve in the coming years, banks are prudent to allocate a small percentage of assets to enterprises they believe will generate significant profits at a later date. At that point, banks can sell their shares, and reap significant profits to bolster capital. All of this makes more sense given the current downside risk, which is limited, as most of these transactions are paper transactions that do not further impair bank liquidity.

**Con:** Bank equity swaps are indicative of the failure of governments and banks in transition economies to properly define banks' roles as financial intermediaries, streamline their operations, specialize in a few key areas within the limits of their current managerial and staffing capabilities, write down their assets to more accurate values, and progress toward a more stable and prudently managed system devoid of excess risk. Investment in losing enterprises raises the risk of future liquidity being drained to prop up these enterprises in the hope of eventual profitability, which puts depositors and shareholders (mainly government, and therefore the budget) at risk. With all the problems banks have had and currently face, there is no reason to believe that bankers as enterprise shareholders will be able to properly manage or supervise these enterprises. Meanwhile, these investments will consume valuable management time that could otherwise be used to resolve fundamental bank problems.

In addition to debt-equity swaps, which have been used by several transition countries to write down loan values, loan sales and asset swaps are an option that could be used to restructure bank balance sheets. However, this option has not been commonly found in the framework of transition economy reform programs. This is largely due to the absence of secondary market development. To develop secondary markets for sales and swaps, interbank markets and the emergence of non-bank financial institutions (NBFIs) specializing in discounted loan purchases/sales/swaps are necessary. However, as with bad loans that would be assigned to bad banks, there is currently little market demand and no market tradition. Banks are generally more concerned with cleaning up their non-performing loan portfolios and being liquid, rather than gambling on the future values of deeply discounted but low quality assets. Consequently, an interbank market for loans will only be viable at a future date when markets and bank portfolios stabilize, and banks syndicate performing loans, develop the expertise to discount, and have the liquidity to purchase sub-standard loans. The emergence of specialized NBFIs (or separate subsidiaries/units within banks) will be necessary for market development.

Only in Poland has an institutional structure and process been established to encourage these sales and swaps. As part of the Poland EFSAL, banks are permitted to sell loans at deep discounts to bank creditors to offset bank debt owed. The banks originally planned to sell about 70 bad loans in their portfolios (10 percent of non-performing loans) after pursuing restructuring or bankruptcy/liquidation measures. However, these efforts have been stymied by lack of developed secondary markets, and discouraging tax policies which disallow tax-deductibility for the amount of the loan write-off and charge a 40 percent corporate tax on the transaction.

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Country Experience

Several countries openly permit equity swaps for bad loans, or plan to introduce these swaps to restructure bank balance sheets. Among them, Bulgaria intends to permit the conversion of central bank loans into equity or subordinated debt. These loans were originally made by the central bank to cover non-performing loans made to SOEs. Croatia has permitted banks to exchange non-performing loans for equity in these enterprises. These swaps accounted for 2.5 percent of total banking system assets at end 1993, compared to less than one percent one year earlier. Slovenia has incorporated equity swaps as one of the BRA’s recapitalization options for banks undergoing rehabilitation. The BRA acquires the net worth of the rehabilitated banks after loan loss write-offs in exchange for these banks taking BRA subordinated debt. Thus, BRA swaps actually involve equity for banks’ bad loans in exchange for BRA debt.

Poland encourages the exchange of equity for non-performing loans as part of the out-of-court conciliation process featured as part of the EFSAL. About 50 of the 200 conciliation agreements concluded have involved debt-equity swaps, despite unfavorable tax treatment, de facto cumbersome negotiations with Ministry authorities, and potentially excessive bank exposure. Unfavorable tax treatment includes reversal of the provision taken for loan losses before the swap, repayment of taxes associated with the earlier provision, and a new non-deductible provision for 100 percent of the book value of the equity. Negotiations with Government officials have sometimes been difficult as government has attempted to convert outstanding enterprise tax arrears into equity stakes, sometimes slowing down the conciliation process. Some banks are taking on significant equity exposure through swaps. Because swaps have been large-scale, banks are finding the equity exposure limit of 25 percent of capital to be too low. This has prompted two banks to obtain central bank permission to increase equity holdings to 35-50 percent of capital, with others likely to follow.

It is too early to tell if banks are assuming excess risk or delaying necessary write-offs of non-performing loans through swaps, particularly in the absence of enterprise restructuring. This may be the case in Croatia, where banks are showing an increasing penchant for paper swaps in the hope that the anticipated post-war economic revival will lead to significant profits through share sales, which will then be used to recapitalize banks with troubled loan portfolios. Bank supervisors will need to factor the risks associated with these shares into capital adequacy ratios as they increase as a percentage of total assets. As suggested in Poland, one alternative is for governments to require banks to create separately capitalized subsidiaries to manage assets/equity obtained through swaps. Regulations could forbid the use of bank deposits for such risk-taking activities to avoid jeopardizing deposit safety.

\[\text{In Croatia, there is evidence from 1993 audited reports that banks swapped recoverable debt for equity after provisioning for loan losses. This more accurately reflects income streams and asset quality, and differs from the accounting and tax treatment applied in Poland.}\]
Bank Restructuring or Rehabilitation Agencies

Bank Restructuring or Rehabilitation Agencies (BRAs) exist in four of the 23 transition economies sampled. Western equivalents to BRAs generally have three responsibilities:

- Liquidate banks that have virtually zero salvage value. In these cases, banks generally have thin deposit bases, liabilities well in excess of salvageable asset values, limited retail networks and negative goodwill in the marketplace.
- Merge the viable portion of poorly performing banks (deposits, branches) with other banks to increase the franchise value of each, while liquidating the non-salvageable assets of the troubled banks. In these cases, banks have poor quality assets and negative net worth, but deposits and "franchise value" that can enhance another bank's value and contribute to a competitive market.
- "Purchase and assume" troubled banks, which can then be merged with or acquired by other banks. The BRA-equivalent then writes off the non-salvageable part of the bank, which is the least troublesome or costly of the three options. In these cases, banks have troubled balance sheets, but sufficient asset values, deposit bases, and franchise value to be attractive to other financial institutions.

In all three cases, BRAs centralize the problem of bad loans, leading to government-backed loan recovery efforts and/or explicit banking system write-offs. The benefits of such an approach for transition economies, particularly smaller countries with large numbers of small banks, are twofold:

- They can reconfigure the banking system, rather than maintaining the status quo.
- Faster clean-up may facilitate and accelerate the development of a private banking sector.

As with work-out units, widespread use of BRAs has been constrained primarily by the lack of experienced and trained staff. Most transition economies have little background in market-oriented banking practices, resulting in a shortage of needed personnel to staff these entities.

Country Experience

Four countries have formally established BRAs: Bulgaria, Croatia, Macedonia and Slovenia. (The Kyrgyz Republic is also exploring the possibility.) Bulgaria has adopted a period of consolidation as a necessary precondition for banking sector viability, consolidating 58 smaller SOCBs into six larger banks. The next step for BCC is to conduct diagnostic audits leading to the privatization of these six SOCBs. Slovenia's BRA is taking the lead in rehabilitating banks with less than four percent capital adequacy, focusing initially on Slovenia's three major banks. BRA recapitalization of banks automatically severs enterprise ownership of these banks by swapping equity for BRA subordinated debt. This permits BRA to take the lead role in loan recovery, supervising work-out units in the banks and applying pressure on SoEs to repay loans. Croatia introduced legislation in mid-1994 to establish a BRA, and is developing rehabilitation plans for four troubled

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22/ These countries are Bulgaria, Croatia, Macedonia and Slovenia. Previous to the split, the Czech and Slovak Federal Republic also had a rehabilitation agency for banks.
banks with 25 percent of book valued banking sector assets. Macedonia also has a BRA which is taking the lead in rehabilitating banks, although at a far less advanced stage than Slovenia. Macedonia's BRA has the power to issue bonds to recapitalize troubled banks once an assessment of the magnitude of the write-offs is finalized. Such recapitalization will also sever SoE ownership of these banks. Macedonia's BRA is responsible for preparing bank restructuring plans for eventual privatization.

Slovenia has made progress in rehabilitating its troubled banks, as evidenced by increased capital adequacy. Bulgaria's BCC has not addressed the problem of bad loans as much as reorganization of a fragmented banking system. In Croatia, where nearly 50 banks almost universally focus on limited geographic markets, the BRA should benefit from new legislation severing ownership of banks by non-private enterprises, new bankruptcy legislation to improve bank recourse in loan repayment disputes, and government determination to section off major sectoral portfolios where most of the problem loans are concentrated.

"Case-by-Case" Loan Restructurings

Case-by-case loan restructurings are common in market-oriented economies, particularly when borrowers are unable to meet the original terms of the loan agreement due to external factors. These restructurings invariably involve changes in the amount, terms and/or schedule of interest rates, principal repayment, and collateral values. Loan covenants (ratios, reporting requirements) often change to facilitate compliance. In some cases, radical measures such as replacing management are involved.

This approach is similar to what work-out units attempt to do: recover portions of loan portfolios which have deteriorated and are non-performing. However, work-out units are often organized on the basis of sector, location or bank exposure. Case-by-case restructurings are conducted on an individualized basis. The benefits of individual case-by-case loan restructurings include:

- Reinforcement of the bank-client relationship.
- Retention of the loan by the bank on its balance sheet, even if provisions are made for possible losses.
- Preservation of the firm's relations with other parties (trade creditors, other banks, buyers, employees), thereby maintaining its reputation without embarrassing and costly bankruptcy/liquidation procedures.

As with debt-equity swaps, the risk to the bank is that it is overly optimistic about prospects, and that additional resources are committed to the borrower adding to bank losses and reduced loanable funds at a future date. This has occurred frequently in transition economies.

In transition economy banks, the closest approximation to the Western loan restructuring has been the loan "rollover". This has been a common practice in sampled countries. Rollovers generally involve one of two techniques:

- Simple rollover of principal on/before the due date, with the enterprise meeting interest obligations.
• Rollover of principal on/before due date, with interest added back to the principal amount ("interest capitalization").

The first technique is legitimate and rational unless the enterprise is unable to repay principal, and likely to remain impaired in the future. The second technique often reflects a troubled loan and enterprise, and has been typically practiced in transition economy banking systems. Furthermore, the latter technique has been accompanied by accounting treatment which mistakenly recognizes these assets as performing loans, artificially inflating income statements and balance sheet book values.

What is different about transition economy rollovers from Western-styled loan restructurings is that rollovers have not been accompanied by changes in management or contract terms that increase the probability that banks will ultimately collect on their loans to these troubled enterprises. Because rollovers have primarily involved the second technique of capitalizing interest, beneficiary enterprises have usually been the ones least able to cover interest expense or repay principal from operating cash flow. This has reduced bank capital and liquidity, crowded out more viable private sector borrowers, and raised intermediation costs. State guarantees were supposed to serve as the buffer for banks if repayment from enterprises was not possible. With a decline in State subsidies during transition and a lack of clarity on the extent of State guarantees, many banks are now faced with the need for a major write-down of asset values. Meanwhile, banks remain illiquid and insolvent, largely the result of poor quality loans that have been rolled over for several years.  

One consequence in Russia and other FSU economies with high inflation rates is that rollovers obfuscated the problems of asset and earnings quality, and deferred needed bank and enterprise restructuring. As hyperinflation erased the nominal value of previous years' loans, borrowers benefitted from "debt reduction" since they only owed the nominal amount of the loans, while bank balance sheets showed revalued loans or interest capitalization which artificially inflated the value of those loans. Once policies were introduced to reverse the inflationary spiral, enterprise and bank losses were exposed at higher nominal (and real) levels. This shrunk bank balance sheets, with particular damage felt by depositors.  

The practice of rollovers and interest capitalization has also been evident in non-FSU countries, with or without high inflation rates. Only recently have transition banks begun to appropriately provision for loan losses that were otherwise carried on balance sheets as loans or other assets.

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23/ In Bulgaria and Poland, bank capitalization of interest accounted for 50 and 100 percent of 1991 loan growth, respectively (see A. Thorne, "Eastern Europe's Experience with Banking Reform", World Bank, December 1993).

24/ "By late 1993, inflation had eroded the value of household savings to less than 2 percent of GNP [in Russia], compared to 37 percent in 1990." See S. Claessens and G. Pohl, "Banks, Capital Markets and Corporate Governance: Lessons from Russia for Eastern Europe", World Bank, July 1994, p. 6.
C. **Financial Sector Enabling Environment**

**Introduction**

A series of policy, legal, regulatory, supervisory and institutional reforms have been introduced in virtually all transition economy banking systems to promote development of efficient financial sector infrastructure. Inadequate legal and regulatory frameworks, inexperienced supervisory staff, insufficient institutional capacity, and inefficient financial sector infrastructure have shown themselves to be common features in most transition economies. All of these deficiencies are capable of erasing short-term benefits provided to banking systems, as shown by the failure of earlier recapitalizations to transform bank behavior due to the absence of widespread reforms, prompting the need for additional recapitalizations. Efforts to enhance financial sector efficiency are described below.

**Policy Reform**

Under central planning, banks served as collection and disbursement agencies in support of government plans. To some degree, Central and Eastern European countries developed different models, ranging from extreme centralization (Albania, Romania, East Germany) to relative decentralization (former Yugoslavia). Nevertheless, there were several key features common to all these systems:

- Directed credits from banks to preferred sectors at subsidized interest rates to achieve centrally determined economic targets, and subordination of bank decision-making on credit and other resource allocation issues to line ministries (centralized) and State enterprises (decentralized). This precluded market-based or commercial criteria in the loan decision-making process by preventing banks from developing risk assessment and resource management skills necessary for stable banking in market economies. Such control also prevented banks from evolving as institutions that provide appropriate financial incentives to and induce financial discipline in enterprise management.

- Control of official inflation rates, exchange rates, interest rates and prices for all inputs, including the cost of money. This distorted resource costs downward, and prevented enterprise management from developing appropriate treasury and long-term investment planning skills and working capital management for ongoing operations.

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25/ Because enabling environment issues are common to virtually all reform programs, these are discussed generically in their application to transition economies. Boxes 4-7 highlight individual country approaches to differing enabling environment issues. Box 8 highlights some of the key privatization issues by country.

26/ To the extent that there is a black market, "control" of rates and pricing is bound to become increasingly theoretical. The actual inflation rate would be higher than the official rate, whose measurement is based on controlled prices.
- Guarantees for household deposits to induce confidence on the part of households. In most cases, these guarantees are implicit, but have been made irrespective of budgetary or extra-budgetary resources that would be required to make good on such guarantees.

Reform programs have supported the efforts of transition economies to adopt market-oriented policies that encourage positive real interest rates, reduce subsidies to preferred sectors, and limit directed credits. It is expected that such an approach should make resource allocation more transparent, prudent and efficient. Reform efforts have also supported the introduction of more indirect methods of central bank control of commercial banks, in addition to strengthening central bank supervision. These indirect methods have included reserve requirements, liquidity requirements, and the introduction of Treasury bill markets.

Legal/Regulatory Framework

The legal and regulatory environment for banks in transition economies has been universally weak, although reforms have led to improvement in recent years. Major problems have included:

- Unsatisfactory separation of central and commercial bank functions.
- Unsatisfactory separation of commercial bank functions from other financial sector services (insurance, securities).
- Unsatisfactory legal foundation and infrastructure regarding property rights, collateral, bankruptcy, liquidation, contract enforcement and loan recovery. This includes inadequate civil and commercial codes and collateral law, disorganized and incomplete property registries, a weak civil court system suffering from a backlog of cases, and limited extra-judicial vehicles for dispute resolution.
- Inappropriate management, ownership and governance structures.
- Fragmented or uneven deposit insurance schemes whereby one or a few selected banks offer deposit insurance.
- Weak prudential regulations governing bank licensing, loan classification, interest accruals, risk weighting, loan loss provisioning, capital adequacy, minimum capital, loan concentration, foreign exchange management and practices, registration and disposal of pledges, and credit policies and procedures.

Legal reforms have addressed some of these shortcomings, although not all. New and, where needed, amended banking laws have introduced two-tiered banking systems in countries that were generally accustomed to monobank systems until recently. These laws have generally cleared the way for private and foreign investment in the banking sector, and set the guidelines for prudent management practices. While these laws have clarified the different roles to be played by independent central banks vis-a-vis commercial banks, they have not always gone far enough in clarifying the different roles to be played by commercial banks and NBFIs. For example, in some countries where Investment Privatization Funds and stock markets are developing, additional laws/amendments could help ensure that bank investment exposure and stock market activities do not

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27/ Exceptions to the monobank model include Bulgaria, Croatia, Macedonia and Slovenia.
put customer deposits at risk. This may also be the case in the future if banks are permitted to enter insurance, real estate, venture capital and other markets which entail significant risks, sizeable resource allocations, and specialized management expertise.

Compounding problems of loan recovery are the issues of property rights, bankruptcy proceedings, out-of-court conciliation methods, and the exercise of collateral. Transition economies' laws generally provide insufficient protection or clarity regarding property rights, collateral pledges, and transfers of ownership. Bankruptcy laws are relatively new and rarely acted on through court proceedings. Liquidation of company/individual assets is hindered by the lack of legal tradition, weak courts, inexperienced judges and lawyers, and consequent absence of market tradition for valuation and liquidation. Some conflicts arise over disputed claims to property, which is made more complicated due to incomplete or disorganized property registries. The result is a backlog of cases which often take years to adjudicate, all of which adversely affects contract enforcement and bank loan recovery. Reform programs generally include legal reviews to assist transition country efforts to develop civil and commercial codes suitable for market economies. Reform programs are also supporting out-of-court approaches to circumvent the institutional weaknesses of court systems and to accelerate dispute resolution.

To protect depositor confidence in the banking system, countries have generally provided an implicit Government guarantee on household deposits. In some cases, countries have come up with partial explicit guarantees, although this non-unitary approach is bound to distort banking systems. Reform programs have generally supported stabilization efforts to protect deposit safety. Where countries have contemplated explicit guarantees, reform programs have encouraged movement towards unitary systems in which standards are based on criteria of broad eligibility, and costs are openly recognized and provisioned for.

Regulatory issues have factored significantly in reform programs. Regulation in transition economy banking systems has been universally weak, requiring improvements along with institutional strengthening and training for implementation. Key efforts have focused on the following:

- Licensing standards have been strengthened to clarify capital entry requirements, the scope of individual bank operations, management/shareholder requirements, impact on banking sector competition, and reporting requirements.

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28/ Hungary has been the most prudent in its regulatory framework, limiting the long-term equity investments commercial banks can hold to 15 percent of capital. Specialized banks can hold up to 100 percent of capital in long-term investments. By contrast, Poland allows commercial banks to hold up to 50 percent of capital in long-term equity investments. In Bulgaria and Romania, the limit is 100 percent of capital.

29/ For instance, Poland has explicit guarantees for household deposits held in SOCBs, while private banks at most have had access to ad hoc guarantees. This has provided a competitive advantage for non-private banks, and driven up the funding costs of private banks which either lack access to lower cost household deposits or have to pay more than non-private banks to attract them. SOCBs hold about 85 percent of bank deposits, partly resulting from the competitive advantage derived from the explicit State guarantee on deposits. To address this distortion (and as a condition of the Poland FIDL), Poland is currently preparing a deposit scheme to eliminate these distortions.
• Stricter loan classification, treatment of interest accruals and principal rollovers, risk weighting, loan loss provisioning, and capital adequacy requirements have been brought in line with international standards in some countries, and are a target to be achieved for others in the coming years.
• Restrictions on loan concentration to large borrowers, shareholders, managers and other insiders have been implemented in some countries.
• Foreign exchange operations and exposure are more tightly monitored, with many of the sampled countries enforcing liquidity requirements.
• Registration and disposal of pledges have begun in some countries, although this is an area that needs significant development.
• Credit policies and procedures have been tightened, although implementation is still problematic due to insufficient training of bank senior management, local pressures on loan officers, and insufficient intervention on the part of supervisory authorities.

30/ Liquidity requirements, routinely as high as 80 percent of total foreign currency deposits, are ordinarily placed with foreign banks. They are invested in low-risk assets to generate low but safe returns, and provide the resource cover required by transition country banks for foreign exchange transactions.
## Box 4. Legal/Regulatory Reforms

### Central Europe and the Balkans:
- **Albania:** Requiring 15-20 percent capital adequacy for new banks without international standing; strengthening prudential regulations; developing collateral and loan recovery legislation.
- **Bulgaria:** Introducing new contract law, insolvency legislation and loan recovery mechanisms; strengthening prudential regulations, including foreign exchange exposure and loan concentration.
- **Croatia:** Severing SoE ownership of banks; strengthening prudential regulations, including loan classification standards, capital adequacy; increasing minimum bank capital requirements.
- **Hungary:** Amending Banking Law to encourage bank-led restructuring and liquidation.
- **Macedonia:** Strengthening corporate governance, licensing guidelines and capital requirements; improving prudential regulations by limiting ownership and lending concentration.
- **Poland:** Amending legislation to reinforce central bank independence; tightening bank exposure limits and insider lending; introducing stricter licensing guidelines.
- **Romania:** Strengthening prudential regulations, including limits on insider lending, foreign currency exposure; increasing minimum bank capital and capital adequacy.
- **Slovakia:** Strengthening prudential regulations to improve governance, limit loan concentration.
- **Slovenia:** Reorganizing banking sector; enforcing high minimum capital; limiting deposit and loan concentration.

### Baltic States:
- **Estonia:** Strengthening property and collateral rights; raising minimum capital; improving provisioning guidelines for banks; improving trade finance legislation.
- **Latvia:** Amending Banking Law to strengthen prudential regulations.
- **Lithuania:** Limiting loan concentration; strengthening legislation pertaining to collateral and guarantees.

### FSU: Russian Federation and Eastern Europe:
- **Belarus:** Permits "private" banking.
- **Moldova:** Developing two-tiered banking system to separate banking and NBFIs; improving licensing criteria for new banks.
- **Russia:** New legislation to strengthen prudential regulations; limiting loan concentration to shareholders and managers.
- **Ukraine:** Permits "private" banking.

### FSU: Southwest and Central Asia:
- **Armenia:** Developing new licensing criteria to regulate new "private" banks.
- **Georgia:** Developing framework for new "private" banks; tightening licensing standards, reducing loan concentration.
- **Kazakhstan:** Strengthening prudential regulations and enforcement; permitting banks to invest in enterprises for privatization.
- **Kyrgyzstan:** Eliminating interest subsidies; initiating two-tiered minimum capital requirements for banks; limiting loan exposure to shareholders and borrowers; supporting development of foreign exchange operations.
- **Turkmenistan:** Strengthening regulations for supervision.
- **Uzbekistan:** Strengthening regulations for supervision.

*Source: Internal World Bank reports.*
Bank Supervision

Bank supervision is one of the most critical elements of successful financial sector reform. As a relatively new function in the post-monobank systems, bank supervision is plagued by a number of weaknesses:

- Insufficient numbers of trained supervisors capable of conducting adequate on-site inspections and off-site surveillance. Many supervisors have limited auditing experience, and even less experience with accounting, banking and financial analysis.
- Poor information systems, which impede off-site surveillance capabilities during a period of limited capacity. Information problems include quality as well as timeliness. The absence of timely data circumscribes the development of "early warning systems". Meanwhile, financial data are often of unsatisfactory quality for off-site examinations. Independent audit capabilities to bridge this gap are unavailable or too costly.
- Supervisors often lack enforcement powers, particularly because the largest banks are still State-owned. Measures that are financially and operationally prudent are not always accepted or implemented by management.
- Bank supervision tends to focus on immediate concerns (liquidity) without a longer-term approach to risk management. Developing a systematic approach to overall risk management is a universal requirement for Bank Supervision Departments, and will have to be developed in transition economies.

<table>
<thead>
<tr>
<th>Central Europe and the Balkans:</th>
<th>Baltic States:</th>
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</thead>
<tbody>
<tr>
<td>• Albania: Increased training and inspections.</td>
<td>• Estonia: Increased enforcement, with enhanced trace finance supervisory capacity.</td>
</tr>
<tr>
<td>• Bulgaria: Developing off-site &quot;early warning systems&quot; and increasing on-site inspections.</td>
<td>• Latvia, Lithuania: Training and increased enforcement.</td>
</tr>
<tr>
<td>• Croatia: Stricter enforcement of prudential regulations.</td>
<td></td>
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<tr>
<td>BRA to supervise work-out units.</td>
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<tr>
<td>• Hungary: Stricter enforcement of prudential regulations.</td>
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<tr>
<td>• Macedonia: Training.</td>
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<tr>
<td>• Poland: Stricter enforcement.</td>
<td></td>
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<tr>
<td>• Romania: Training to increase capacity.</td>
<td></td>
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<tr>
<td>• Slovakia: Training.</td>
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<tr>
<td>• Slovenia: Technical assistance. BRA supervising bank work-out units.</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>FSU: Russian Federation and Eastern Europe: Belarus, Moldova, Russia, Ukraine: Technical assistance and training.</th>
<th>FSU: Southwest and Central Asia:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Armenia: Creating supervision department in central bank.</td>
<td>• Armenia: Creating supervision department in central bank.</td>
</tr>
<tr>
<td>• Georgia, Kazakhstan, Kyrgyzstan, Turkmenistan, Uzbekistan: Training and technical assistance to increase capacity.</td>
<td>• Georgia, Kazakhstan, Kyrgyzstan, Turkmenistan, Uzbekistan: Training and technical assistance to increase capacity.</td>
</tr>
</tbody>
</table>

Source: Internal World Bank reports.

Reform programs have supported training and technical assistance in virtually all sampled countries to increase the volume of trained bank supervisors. To facilitate and accelerate the development of bank supervision, reform programs have also supported strengthened prudential
regulations, more preventive (on-site) approaches to supervision, improved licensing standards and requirements, better information systems (hardware, software, accounting standards), and improved courier systems to accelerate information flows.

**Corporate Governance**

Corporate governance of banks and enterprises has been weak in the absence of developed market mechanisms, information requirements, accountability standards, trained management and board supervisors, and a tradition of private ownership. For State-owned banks or banks owned by SOEs, the issue of governance has been compounded by the lack of autonomy derived from their ownership structure, irrespective of levels of (de)centralization. In both cases, bank resources have flowed to their owners (financing government budget deficits, lending to State enterprises), or to State enterprises as directed by government line ministries to achieve centrally planned production targets. Such lending and investment activities were carried out without regard to repayment prospects, net present value, returns on equity/assets, or other financial measures commonly used in market economies. Such disregard contributed significantly to the current problems of SOCB insolvency and illiquidity. Some private banks are also following similar practices, lending to their owners without prudently managing their risk.

**Box 6. Bank Governance**

<table>
<thead>
<tr>
<th>Central Europe and the Balkans:</th>
<th>Baltic States:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary: Increasing budgetary pressure on SOCBs to maintain strict financial discipline, develop restructuring and privatization plans.</td>
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<tr>
<td>Macedonia: Severance of SoE ownership of banks.</td>
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<tr>
<td>Poland: Management performance contracts and strengthened SOCB governance.</td>
<td></td>
</tr>
<tr>
<td>Romania: Improvements linked to commercialization and privatization.</td>
<td></td>
</tr>
<tr>
<td>Slovakia: Improvements tied to privatization strategies.</td>
<td></td>
</tr>
<tr>
<td>Slovenia: Improvements directed by BRA process.</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>FSU: Russian Federation and Eastern Europe:</th>
<th>FSU: Southwest and Central Asia:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus, Moldova, Russia, Ukraine: Ownership transformation of banks expected to &quot;privatize&quot; incentives and improve corporate governance.</td>
<td>Armenia, Georgia: Concern about proliferation of small private banks and implications for corporate governance.</td>
</tr>
<tr>
<td></td>
<td>Central Asia: Same as Russian Federation and Eastern Europe.</td>
</tr>
</tbody>
</table>

Source: Internal World Bank reports.

Efforts to reverse these trends have begun to strengthen bank governance. Severing government and State enterprise ownership of banks is a precondition for the emergence of efficient, privately managed banks. While governments are on record as committed to the development of private sector banking systems, immediately changing the ownership structure of banks has not been easy. Non-FSU countries have generally adopted interim measures symptomatic of the transition.
period, while radical transformation of bank ownership in FSU countries has accelerated due to the commitment to rapid privatization in advance of operational restructuring and the devastating hyperinflationary impact on SOCB balance sheets. Banks have been encouraged to apply commercial criteria in daily and strategic decision-making. Supervisory boards have been restructured and encouraged to monitor management performance based on commercial criteria (profitability, improved loan performance). This has sometimes been accomplished with representation from independent professionals on supervisory boards to break the link in traditional ownership-management relations. Management has been replaced or reorganized, and given remunerative performance incentives to encourage better operating results. In some cases, limits on equity investment have been applied to limit concentration of influence. Likewise, limits on loan exposure to shareholders and insiders have been applied to increase bank autonomy and introduce more market-based criteria for lending and investment decisions. While not sufficient, these changes in the corporate governance of banks are viewed as necessary during the transition phase, and an improvement over pre-transition methods of bank governance and management.

**Institutional Strengthening**

A financial sector enabling environment depends on properly functioning institutions. Conversely, the absence of properly functioning institutions makes it difficult (or impossible) for banks to properly intermediate resources in a manner responsive to economic and financial needs. Reform programs have supported institutional strengthening in a wide variety of areas. Central banks have received training and technical assistance to strengthen the regulatory framework and supervisory capacity, improve information flows and payment systems, and reorganize for better deployment of human capital. Banks have benefitted from technical assistance and training to improve a wide variety of fundamentals central to prudent bank management:

- New organizational structures.
- Credit policy and controls.
- Credit risk evaluation, loan syndications and co-financings.
- Corrective work-out units.
- Internal documentation and monitoring systems.
- Management of foreign exchange bureaus and foreign currency positions.
- General asset-liability and treasury management.
- Deposit mobilization strategies.
- Branch management.
- Introduction of new technologies for automation.
- Revised compensation schemes.
Box 7. Institutional Strengthening

Central Europe, the Balkans and the Baltic States: Training and technical assistance have been indispensable to larger reform efforts. In Poland, Hungary and Slovenia, most enabling environment reforms have been introduced, and the emergence of private sector-dominated banking should occur in the coming years. Estonia has focused on professional skills development in conjunction with its rapid progress towards a private banking system. Romania has demonstrated an ability to attract private and foreign investment in the banking sector. These improved enabling environments have been fostered largely by the contribution made by technical assistance and training to develop a more stable financial sector.

Non-Baltic FSU: Russian Federation, Eastern Europe and Central Asia: Technical assistance and training have been central to initial strategies for financial sector and institutional development. In some cases, technical assistance and training are being provided to develop export-oriented strategies in foreign currency-short countries (Armenia). This includes assistance to banks to enhance their trade finance and intermediation skills to respond to critical agroprocessing and industrial requirements (Moldova). In Russia and Ukraine, technical assistance and training are at the core of banking sector restructuring efforts. In Kazakhstan, technical assistance is indispensable to the reorganization of the banking system, as it has been in Bulgaria.

Source: Internal World Bank reports.

Central bank supervisors and accounting and auditing professionals have benefitted from pilot audits of banks that have served as training grounds for the development of inspection and auditing skills. Ministries of Finance and Privatization Agencies have been trained in supervisory board responsibilities during pre-privatization phases. In a few countries, technical assistance and training have been provided for stock exchange development and independent Securities Commissions. Financial sector professionals representing all of these institutions have benefitted from increased teaching staff and improved curricula at bank training institutes.

Accounting and Auditing Standards

Transition economies operated under different accounting principles during pre-transition periods. Regarding the banking sector, these accounting principles reflected the same weaknesses indicated by pre-transition regulation:

- Improper loan classification, interest accruals and principal rollovers overstated asset quality and values, and obscured potential liquidity problems.
- Loan loss provisioning rarely occurred, overstating earnings and capital.
- Risk weighting was inaccurate, overstating bank capital and masking technical bank insolvency.
- Minimum capital and capital adequacy standards were never adjusted as benchmarks for the healthy functioning of banks.

Along with imprudent lending practices (loan and sector concentration) and passive registration of collateral, banking sector accounting never accurately reflected solvency and liquidity problems and the poor earnings quality of the banks. Moreover, because of these traditions, accounting and auditing professions suitable for commercial management in a market economy never developed.

31/ Assistance is for post-privatization efforts in Russia’s case.
Reform programs have supported efforts to bring accounting standards in line with international standards, and to develop a professional class of accountants and auditors who can play this critical role in financial sector and market development. Transition economies are adopting international accounting standards (IAS), introducing new charts of accounts, and encouraging more open disclosure of information to correct data and informational shortcomings. Where introduction of IAS has been slow (FSU), the World Bank has introduced Broadly Adapted Financial Statements as an interim measure to convert Gosbank accounts to quasi-international standards. Some countries are revising their Accounting Laws, and others are introducing Audit Laws. Significant technical assistance and training have also been provided to ministries, central banks, banks, local auditing firms and universities to develop an accounting and audit profession.

**Payments Systems**

Payments systems in transition economies are often slow and inefficient, with frequent delays in bank transfers, verifications and settlements. Such delays have allowed excess "float" in the system, frequently combated by central bank assumption of bank liabilities without sufficient funds in correspondent accounts. This has been a problem in the Baltics and Central and Eastern Europe, but primarily in less developed transition economies of the former Soviet Union. These problems have been intra-bank, inter-bank within countries, and inter-republic/national across countries. Inefficient payments systems are characterized by long delays, high levels of float, risk of theft, and delays in settlement. Balance sheets often include "money-in-transit" under "other assets", in some cases accounting for 20 percent of total assets. Such inefficiency:

- Creates unnecessary delays for transaction settlement.
- Puts customer deposits at risk, potentially undermining confidence in the banking system.
- Limits business expansion.
- Encourages financial disintermediation.
- Serves as a critical operating constraint in the development of a modern financial sector.

Reform programs have provided technical assistance and training to strengthen payments systems. These efforts have included:

- Developing more efficient payment methods and clearinghouse systems.
- Investigating the feasibility of service bureaus to upgrade service levels.
- Facilitating the introduction of checks.
- Assisting with the development of courier systems.
- Helping with settlements systems to accelerate processing across banks and countries.


33/ One of Albania's major banks routinely showed in-transit items as 20 percent of total assets due to delays in transaction deliveries and settlements. This percentage of exposed assets is expected to decline dramatically with the introduction of a new courier system.
D. Banking System Reorganization

Key Issues

Along with other problems associated with the banking sector inherited from the socialist period, transition economies have had to address the issue of the "optimal" scale of banking sectors, taking into account past distortions, current institutional weaknesses, and appropriate licensing and capital requirements. Distortions generally have consisted of excess specialization on the part of banks by sector (agriculture, housing, industry), function (savings) or territory (regional) which have limited portfolio diversification opportunities. Current institutional weaknesses include limited bank supervisory capacity (on- and off-site), and the degree to which central banks are able to play this role with large numbers of small banks. Licensing and capital issues impact on private entry, with low capital and easy licensing requirements encouraging entry, but raising the risk of poor management and imprudent lending practices which can undermine banking sector stability. The alternative approach to licensing and high minimum capital requirements may provide critical mass to banks and a greater likelihood of long-term stability, but place immediate barriers to entry that can slow the emergence of small-scale private banks responsive to private sector and household needs.

Transition countries have dealt with these challenges in a variety of ways. Some have consolidated systems to limit the number of banks, and create market parameters large enough to provide attractive prospects. Other countries have gone the other route, privatizing rapidly to encourage increasing entry of new banks. The latter approach implies a rationalization of the banking sector will occur at a later date as market opportunities develop, more competitive banks assert themselves, and less competitive banks fail. These approaches are briefly discussed below.

Consolidation

In non-monobank countries, banking sector reform has involved the consolidation of loose branch networks into banking organizations with some measure of critical mass. Bulgaria and Slovenia have consolidated their previously decentralized banks into less decentralized organizations. In the case of Bulgaria, the number of banks has been reduced by two thirds since 1990. In the case of Slovenia, consolidation is part of a sector strategy to have five to seven well capitalized banks providing financial services in a competitive and open market. While Croatia has not consolidated its banking system, an increase in minimum capital requirements may encourage movement in this direction.

34/ Population density in Central Asia is low. Tajikistan, Turkmenistan and Kazakhstan have 38, eight and six people per square kilometer. With GNP per capita incomes of about US$ 1,500 (and often less), this represents a small market which would have high branch networking costs for any bank interested in mobilizing deposits. Russia has the lowest figure: one person per square kilometer. This may be one of the reasons why FSU countries have pursued branch privatization of the monobank system. By comparison, other transition economies that are considered middle income have the following population density figures: Poland (122), Romania (97), and Bulgaria (81). This should provide enhanced interest in multi-branch banks. See World Development Report, World Bank, 1994.
Bulgaria and Slovenia have therefore reorganized their banking systems by contracting the number of banks. However, banking system consolidation is not the same as banking sector stabilization. **Consolidation** focuses on the configuration of banks/branches in an economy available to provide needed financial intermediary services, preferably within a competitive and transparent environment. **Stabilization** is an interim rehabilitation or restructuring period which focuses on banks achieving capital adequacy and establishing the conditions for sustainable earnings. Stabilization usually involves significant bank portfolio restructuring (including more forceful efforts at recovery, and recognition of write-offs), partial or total liquidation of banks (and enterprises), and a reorganization of bank boards, management, personnel and practices. On that basis, Slovenia has made more progress than Bulgaria, as evidenced by the rising capital ratios of Slovene banks currently under rehabilitation.

**Bulgaria's** Bank Consolidation Company (BCC) has reconfigured the Bulgarian banking system from 74 banks in 1990 to 28 in 1993. As a decentralized and segmented banking system prior to BCC, Bulgaria adopted a period of consolidation as a necessary precondition for banking sector viability. The next step for BCC is to conduct diagnostic audits, and then privatize these banks. **Slovenia** has likewise reduced the number of SOCBs to three, all of which are currently under rehabilitation. Consolidation has primarily come from the rise in minimum capital requirements to US$-equivalent 35 million for full-service banks. **Croatia** may consolidate some of its 48 banks, all but two of which are regionally focused. However, Croatia's minimum capital requirements are less than half of Slovenia's, so consolidation would likely be less concentrated than in Slovenia.

**Expansion and Decentralization**

While non-monobank systems are consolidating, most monobank systems have experienced a proliferation of private banks due to the break-up of the monobank system. This is rational given the elimination of monobank asset-liability values due to hyperinflation, consequent rapid privatization of monobank branches, and small scale and limited geographic scope of most new private banks. These private banks are generally the units of the old State banking system that served as collection points for deposits and pension contributions, and disbursement points for loans. While Russia is noteworthy by virtue of its rapid privatization and sheer number of private banks, all other FSU countries have experienced a similar growth in private banks. Most remain small and limited in capacity. Many are likely to fail, with a subsequent phase of consolidation likely to follow. This has begun to occur in Estonia, which had more than 40 banks in 1992 and now has 21.

**Privatization of the Banking System**

Overall banking system efficiency is not likely to occur until transition economy banking systems are privately owned, managed and governed. The needed change in incentives is required for improved resource management and credit allocation, better governance, and enhanced levels of competitiveness to meet emerging private sector needs. Until resources and institutions (banks and enterprises) are properly managed and governed, banks will not be able to play an appropriate role in properly assessing risk, pricing credit and services, mobilizing deposits, capitalizing balance sheets

35/ The BCC has consolidated 58 SOCBs into six, while permitting the entry of new private banks.
for growth and competitiveness, and imparting financial discipline on borrowers. Meanwhile, enterprises will fail to properly calculate their debt capacity, manage their cash, plan out their working capital and capital expenditure needs, and compete in a market economy without wasting resources and reducing shareholder value.

<table>
<thead>
<tr>
<th>Box 8. Bank Privatization</th>
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<tbody>
<tr>
<td><strong>Central Europe and the Balkans:</strong></td>
</tr>
<tr>
<td>• Albania: Licensing encouraging private/foreign banks. Restructuring plans for two SOCBs to be developed in 1995 after audits and diagnostic studies. Privatization plan for third SOCB developing.</td>
</tr>
<tr>
<td>• Bulgaria: Restructuring now proceeding after bank system consolidation. Licensing encouraging new entry.</td>
</tr>
<tr>
<td>• Croatia: New legislation severing SOE ownership. Ownership privatization encouraged.</td>
</tr>
<tr>
<td>• Hungary: Government reducing ownership in banks to 25 percent, OTP to 50 percent. Good environment for private and foreign banks.</td>
</tr>
<tr>
<td>• Latvia: Licensing encouraging new entry.</td>
</tr>
<tr>
<td><strong>Baltic States:</strong></td>
</tr>
<tr>
<td>• Estonia, Latvia: Significant privatization of State banks into smaller banks, along with significant problems.</td>
</tr>
<tr>
<td>• Lithuania: Encouraging private and foreign investment in banking sector, twinning arrangements, increasing role for NBFIs, &quot;formalization&quot; of informal financial agents.</td>
</tr>
</tbody>
</table>

| **FSU: Russian Federation and Eastern Europe:** |
| • Belarus, Ukraine: Significant number of new "private" or "commercial" banks without suitable skills, incentives or market conditions. |
| • Moldova: Diagnostic studies underway. Privatization a long-term goal. |
| • Russia: 2,300 new "private" banks created in last two years out of monobank system. |

| **FSU: Southwest and Central Asia:** |
| • Armenia: Rehabilitating and writing down bad assets before privatization/liquidation. Proliferation of new "private" banks owned by ex-SOEs. |
| • Georgia: New private banks owned by ex-SOEs. |
| • Kazakhstan: New private banks owned by ex-SOEs, including ownership of investment funds for mass privatization program. |
| • Kyrgyzstan: Investigating prospects of BRA as pre-privatization measure. |

Source: International World Bank reports.

Despite difficulties associated with banking system privatization, significant progress has been made. In Russia and most FSU countries, most of the monobank system has been privatized, and private banks now represent a significant share of intermediation. In Estonia, private banks have formed out of the old State banking system, with about half the banks having already failed from 1992-1994. In some of the non-FSU countries, private banks account for significant shares of total banks (Croatia, Poland, Romania), although their share of total banking system assets is still small. Joint ventures and equity stakes exist in some cases between foreign banks and

36/ Most of these banks are small. The failure of more than 20 banks will permit the remaining 21 Estonian banks to increase loan and deposit shares. If minimum capital requirements are increased, consolidation and additional share increases will occur.
domestic banks (Czech Republic, Hungary, Poland, Romania), transferring skills and strengthening systems and international networks. In other cases, skills transfers and improved operating systems have resulted from "twinning" arrangements involving the placement of Western bankers in transition economy banks via management contract (Poland). Some public sector banks have been privatized, while other public sector banking systems have been consolidated to achieve a "critical mass" of deposits and loans as a pre-privatization measure (Bulgaria, Slovenia). Improved licensing criteria have established minimum capital and capital adequacy thresholds, while revised legislation has encouraged the entry of NBFIs. In several countries, diagnostic studies have been carried out to help develop reorganization plans in advance of privatization. Hence, while privatization in non-FSU countries and needed restructuring in FSU countries may not have occurred as quickly as needed for banking sector stability, there has been indisputable progress made towards more market-oriented, commercial banking systems. This should improve resource management, governance and intermediation capacity in the coming years.
III. THE ROLE OF THE FINANCIAL SECTOR IN ENTERPRISE RESTRUCTURING/PRIVATIZATION

A. Introduction

There are many reasons why banks have poorly performing loan portfolios. Irrespective of these causes, banks have an obligation to shareholders, depositors and creditors to maximize cash flow from assets, the most troublesome aspect of which has been the poor record of banks in recovering loans. It is this factor which has most contributed to bank insolvency, and in the current stabilization period which has contributed the most to liquidity constraints. This has prompted new approaches to enterprise financial restructuring to prevent a recurrence of non-performing loans of the magnitude currently experienced.\footnote{Non-performing loans exceed aggregate book values of SOCB capital in most transition economies, rendering these systems technically insolvent in the absence of other earning assets capable of covering capital and reserves from earnings.}

There are several complementary options available to banks to restructure problem loans and portfolios, including:

- Exercise of collateral (liens against property, inventories) through judicial or extra-judicial means.
- Out-of-court settlements that may focus exclusively on debt negotiation, restructuring and repayment, or lead to the financial, physical and operational restructuring of the enterprise.
- Bankruptcy/liquidation procedures through formal court proceedings. This may involve liquidation, reorganization or privatization of an enterprise to enforce partial or total loan repayment.

These options work in tandem, with out-of-court settlements more common for work-outs and collateral exercise. However, bankruptcy is an effective complement to out-of-court approaches, and serves as a last stage of debt collection, providing creditors with control over debtors in financial distress and prompting their restructuring. For this reason, several countries have developed and are seeking to expand the use of formal bankruptcy to broaden the array of dispute resolution mechanisms, provide banks with long needed recourse, and instill greater financial discipline on enterprises.

Transition countries have pursued variations of these approaches. Most countries have followed more "centralized", government-led approaches to debt restructuring of troubled enterprises through enterprise privatization/restructuring agencies (EPRAs).\footnote{EPRA is used for purposes of convenience. Transition economies often have two agencies, one for privatization and the other for restructuring. The former usually deals with existing stocks of enterprises from which the state wishes to free its ownership. These enterprises are often small, or parts of larger enterprises. Restructuring Agencies, which are less frequently featured in reform programs than Privatization Agencies, often deal with larger and "strategic" enterprises which are politically sensitive. Enterprise Privatization and Restructuring Agencies are separate from Bank} Others have at least partly relied...
on "decentralized", bank-led restructuring efforts. The use of Bank Rehabilitation Agencies (BRAs) in a few countries to coordinate bank loan recovery efforts represents a mix of "centralized" and "decentralized" approaches. To a lesser extent, bankruptcy procedures have been used. All have led to the financial restructuring of enterprises and their debts. In some cases, such restructuring has directly impacted enterprise operations. These approaches are discussed below.

B. Out-of-Court Approaches to Debt Resolution and Enterprise Restructuring

Out-of-court approaches to debt resolution and enterprise restructuring have been pursued to recover loans and restore bank solvency. The larger effort to promote more general levels of enterprise creditworthiness and sustainability is a medium- to long-term goal in most cases. Originally, reform programs identified banks as lead restructuring agents because they were presumed to know the condition of the enterprises better than non-banks (including government), and they could serve as a vehicle for decentralized debt resolution. Notwithstanding reservations about bank preparation for such a complex task, the bank-led approach was considered preferable to a more centralized, government-led effort to restructure the enterprise sector. Governments knew less about the enterprises than the banks. Governments were also vulnerable to bureaucratic and political factors that could slow the enterprise restructuring process.

Bank-led restructuring of the enterprise sector originally anticipated banks assuming a comprehensive role. This included:

- Conducting an analysis of each problem debtor to determine the level of debt owed, and how to have principal repaid and interest serviced.
- Restructuring the debt of potentially viable enterprises.
- Financing the physical restructuring of potentially viable enterprises.
- Exercising corporate governance over these enterprises.
- Writing off the debts of, curtailing new credit to, and in some cases liquidating non-viable enterprises.

Thus, the bank-led approach assumed banks would take the lead in the financial (debt), physical (property, plant, equipment, inventories) and operational (governance) restructuring of viable enterprises, and accelerate the liquidation of non-viable enterprises. This proved to be an overly ambitious conceptualization of banks' roles and capacity in general enterprise restructuring in transition countries.

Banks have conducted analyses on major enterprise debtors and, to some degree, financially restructured these enterprises. This has been in the form of restructured loans to viable enterprises, and curtailment of lending to non-viable enterprises. However, to date, banks have had little direct impact on the operational restructuring of viable enterprises due to limits on banks' understanding of enterprise operations and their capacity for corporate governance. For non-viable enterprises, the curtailment of lending has reduced the scale of their operations, increased their reliance on cash, their...
and/or transferred their borrowing requests to suppliers (inter-enterprise debt) and government
(arrears on wage and tax payments).

Thus, while banks have influenced enterprise restructuring efforts, bank-led restructurings
have been less comprehensive in transition economies than originally anticipated. Internally, most
banks lack the financial resources and operational expertise to assume responsibility for the
restructuring and governance of enterprises. As these banks are SOCBs, they have been preoccupied
with their own reorganization and financial needs during the transition, much as have SOEs. This has
often necessitated drastic changes in policies, procedures, management and governance at banks,
taking away from time available to do more than financially restructure SOE debt. Furthermore, the
ability of banks to restructure enterprises has been complicated by the magnitude and simultaneous
occurrence of economic, political, legal and institutional change in transition countries. These factors
have resulted in governments attempting to assume a more direct role in enterprise restructuring.
These two approaches, followed simultaneously in most cases by transition economies, are described
below:

- **Bank-Led Restructuring:** In individual "decentralized" cases, banks have taken the
  lead in restructuring the loans of selected enterprises while curtailing loans to other
  enterprises. In the case of the former, banks believe they can obtain at least partial
  repayment. In some cases, troubled enterprises place large deposits with the banks,
  and/or pay substantial fees throughout the year for services even if they are unable to
  service their debts. This provides the bank with an incentive to restructure selected
  enterprise loans, even if their debt performance is unsatisfactory. In cases where
  banks curtail lending, banks believe these enterprises are non-viable and/or not
  important enough customers of the bank to justify the cost of restructuring. As a
  consequence, some enterprises are being restructured financially, while other SOEs
  are effectively going out of business (a form of restructuring) by being deprived of
  bank loans (and trade credit and government subsidies). In this approach, banks are
  agents of *direct* financial restructuring of enterprises, and agents of *indirect* physical
  and operational restructuring.

- **Government-Led Restructuring:** In "centralized" cases, governments have taken the
  lead in restructuring the enterprise sector financially, physically and operationally
  through multiple institutional channels. This has involved multi-faceted approaches by
  which governments have directly restructured some SOEs, and privatized/liquidated
  other non-priority enterprises. Such an approach has led to various institutional
  approaches (direct Ministry involvement, ERAs, BRAs) in which State banks are one
  of several agents responsible for enterprise restructuring, albeit subordinated to
  Ministries and government agencies. Most transition economies have adopted this
  approach because governments believe that State banks are incapable of leading
  enterprise restructuring efforts. Doubts about bank institutional capacity are
  reinforced by other doubts, namely that most enterprises cannot service their debts or
  be competitive in the near term irrespective of bank efforts, and that time (and
  sometimes subsidies) are required for enterprises to be viable in the long term due to
  currently thin markets and troubled economies. While governments are correct in
  believing that most banks lack institutional capacity, the government-led approach has
  two possible but major shortcomings: maintenance of an active role of the State in
  the economy, despite the demonstrated failure of this approach over the last several
decades; and obstruction or delays to faster privatization and formal private sector development, including needed foreign investment to generate market linkages, production efficiencies, management skills and capital.

**Country Experience**

There is enormous diversity in the specifics of restructuring approaches employed. While a few countries have assigned an active role to State banks in the enterprise restructuring process (Poland, Slovenia), most countries have established EPRAs to initiate pre-privatization programs, consolidate and/or privatize enterprises, and/or liquidate enterprises with no hope of recovery. Some countries such as Albania, Kazakhstan, Kyrgyzstan and Romania are using ERAs to restructure or liquidate a comparatively small number of SOEs (about 30). In all four cases, these efforts complement larger privatization efforts. Romanan and Kazakh banks will also be active in the management of Investment Privatization Funds used for government-designed enterprise privatization programs, adding a shareholder dimension to the financial restructuring of enterprises instead of a purely creditor role.

Country experiences to date with out-of-court restructuring exercises are summarized below based on "decentralized" and "centralized" approaches, and then described by region in Annex 1. In general, banks restructure or curtail loans and, to some extent, set financial targets for enterprises to which they are lending. However, in most cases, enterprise restructuring is being coordinated by separate privatization and pre-privatization agencies (EPRAs). More often than not, governments are combining these approaches to restructure the enterprise sector.

- **"Decentralized" Bank-led Restructuring:** Most countries in Central Europe and the Balkans engage State banks in the financial restructuring of enterprises. Poland comes closest to using both a "decentralized" and "centralized" approach. The "decentralized" approach uses State-owned banks (to be privatized) to lead the financial restructuring process. However, even in Poland, this approach has relied heavily on the active involvement of the Ministry of Finance, and has also utilized bankruptcy, court conciliation and SOE liquidation. Thus, Poland's approach represents an amalgam of bank-led work-outs and bankruptcy proceedings, combining elements of "centralized" and "decentralized" approaches. Slovenia's BRA is supervising the performance of bank work-out units, charged with implementing the loan restructuring process as a vehicle for enterprise restructuring. This represents another type of

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39/ Albania's ERA has targeted 32 SOEs for restructuring and liquidation over a two-year period. A Restructuring Committee organized by Romania's State Ownership Fund determined that 24 SOEs were to be restructured and another six liquidated. Also see S. Dhar and M. Selowsky, "Dealing with the Bad Debt Problem in Transition Economies", *Finance and Development*, June 1994.

40/ This approach originated with the first wave of mass privatization in the Czech and Slovak Republics (CSFR). Initial investment from ordinary citizens holding privatization vouchers was disappointing. Consequently, banks established Investment Privatization Funds to manage portfolios on behalf of voucher holders and others interested in investing. These Funds significantly stimulated investment activity. See N. Shafik, "Making a Market: Mass Privatization in the Czech and Slovak Republics", *World Bank*, December 1993.
"decentralized" restructuring with elements of "centralization" as the BRA coordinates below and reports back to central government authorities. Hungary's banks have played less of a role in direct financial restructuring, although they have invoked the country's strong bankruptcy laws when enterprises have been in arrears longer than 90 days. Interestingly, banks have not initiated bankruptcy proceedings against large, so-called "strategic" enterprises in Hungary. Albania, Bulgaria and Slovakia have seen their banks reduce lending to problem enterprises. In Macedonia, the three largest banks are leading efforts to settle medium-sized enterprise debt problems. Macedonia expects its BRA to coordinate bank efforts to restructure major problem enterprises when conditions are more stable.

In FSU countries, most countries are focusing on mass privatization and the restoration of monetary and fiscal stability. In Eastern Europe, only in Russia is there an active role for private commercial banks and autonomous Regional Enterprise Funds to be part of a larger bank and enterprise restructuring effort during the post-privatization period. This "decentralized" approach is linked to "centralized" efforts involving Privatization Centers. Much of the financial and operational restructuring of Russian enterprises has already taken place through hyperinflation, mass privatization, and the imposition of hard budget constraints. By contrast, banks in Belarus, Moldova and Ukraine have had little to do with what privatization has occurred. In the Baltic States, bank capacity is viewed as too weak to play a lead role in the restructuring of SOEs. Instead, hard budget constraints on banks and SOEs are viewed as the most efficient way to restructure the enterprise sector. In Central Asia, Kazakhstan is utilizing bank management of investment funds (of which about half are private) to encourage enterprise restructuring. Kyrgyzstan hopes to have a BRA, although institutional capacity is limited.

- "Centralized" Government-Led Restructuring: This approach has been most common in FSU countries where bank capacity is weakest. The Baltic States are relying on hard budget constraints to restructure their enterprises, along with some EPRA input. This approach has been combined with significantly improved legislation, accelerated efforts to privatize the enterprise sector (particularly in Estonia), and a willingness to let banks and enterprises fail (Estonia). In Eastern Europe, Russia is combining the efforts of Privatization Centers with financial institutions to promote reform and enterprise restructuring. Ukraine and Belarus have shown little progress in restructuring. Moldova is trying to involve its banks, but is constrained by capacity limits and has been hampered by political instability. In Central and Southwest Asia, Armenia and Georgia have been severely disrupted by ethnic and civil strife. These two countries could be said to be following a "decentralized" approach, but their banks have traditionally been public institutions and are captive to enterprise financing needs. This may preclude any bank role in enterprise restructuring in the near term. Uzbekistan is relying on EPRAs for enterprise restructuring. In Central Europe and the Balkans, Albania and Bulgaria have pursued predominantly centralized approaches. Albania has only three major banks, all of which were part of the State Bank of Albania until 1991. The government is playing the lead role in "strategic" enterprise restructuring, although banks have curtailed loans to non-performing SOEs. Bulgaria's BCC has focused on banking system consolidation in advance of bank-led restructuring and privatization of SOEs.
### Box 9: Poland’s Experience With “Commercialization” and “Conciliation”

**Restructuring Requirements:** In exchange for debt restructuring and rescheduling, Poland’s out-of-court “conciliation” has involved a series of enterprise changes intended to prevent a recurrence of non-performing loans, including:

- **Conversion of the enterprise to a joint stock company, with a supervisory board to scrutinize management performance.** This sometimes involves a change in the distribution of share ownership, and is designed to shift the company’s decision-making influence to management and improve corporate governance.

- **Dissolution of Workers’ Councils (WCs), de-linkage of wage settlement requirements regarding government and State enterprise employees, and elimination of the requirement of WC legal consent to privatize an enterprise.** These measures are intended to reduce employee influence in management decision-making, and lower the cost structure of troubled enterprises.

- **Divestiture of SOE social services (water, heating, housing, day care, health) and other non-core assets**. Banks try to get enterprises to focus on their competitive advantages for sustainable growth and creditworthiness. Sales of non-core assets sometimes provide cash for loan repayment and interest arrears.

**Preliminary Results:** It is too early to tell how successful out-of-court conciliation procedures and other methods will be in restructuring SOEs and transforming them into creditworthy firms. Initial results in Poland have been favorable, at least insofar as stabilization is concerned. Within 15 months of EFSAL effectiveness, recapitalized Polish SOCEs had resolved approximately 90 percent of their bad debt problems through restructuring, bankruptcy/liquidation, swaps, sales and repayment. In most cases, this occurred through liquidation of non-viable enterprises. Questions remain about whether this approach can be applied universally given the weaknesses of bank governance in many transition countries. It has also been argued that significant restructuring has been taking place in many SOEs by themselves without being a part of the conciliation process. However, this is largely due to incentives tied to their privatization program. With regard to Poland, strengthened bankruptcy procedures may be needed for future debt resolution if the Ministry of Finance plans to be less involved in encouraging the resolution of creditor-debtor disputes.

### C. Bankruptcy and Liquidation Proceedings

Formal bankruptcy/liquidation proceedings in transition economies are encumbered by a wide range of judicial and market constraints:

- **Bankruptcy laws are limited in scope, and incomplete for market economies.**
- **Court systems are limited in judicial capacity (number of courts, trained judges and lawyers familiar with commercial law), resulting in long delays and inefficiency.**
- **Market infrastructure for repossession and asset liquidation is lacking (valuation firms, repossession firms).**

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41/ As an example in Poland, the Szczecin shipyard included 2,700 apartments, three schools, nine kindergartens, 12 child-care centers, three resorts, a fire department, 60 yachts and a pig farm before restructuring in 1991 to become one of Europe’s fastest builders of medium-sized container ships (see *Washington Post*, July 3, 1994).

42/ Legally, transition economies could use pre-transition laws as a basis for liquidating non-viable firms. That this has not occurred to any great extent indicates incentives for closure are lacking or negative due to repayment, employment, social service provision or other considerations.
The actual bankruptcy of companies is hindered by the lack of legal and market tradition. When rare instances of liquidation occur, they are often limited to inventories rather than enterprises or banks.

Firms responsible for the bulk of non-performing loans are State enterprises, hence bankruptcy procedures would involve bank claims against the government. In most cases, large or troubled banks are owned by the government or enterprises, hence the net benefit of bankruptcy/liquidation may be zero or negative. When collateral is challenged, this collateral is also usually property of the State, posing the same set of legal difficulties for the banks as liquidating agents.

On the demand side, there are likely to be few buyers under current market conditions. Cash constraints, lending limitations, and undeveloped stock markets are three reasons why there is limited demand for bankrupt enterprises. This also reduces salvage value, consequently reducing the attractiveness of possession and sale of the enterprise as an option for the claimant.

Enterprises are often large depositors, and customers for other bank services (trade finance, payment services, payroll, transfers). Thus, banks may be hesitant to initiate bankruptcy proceedings against an enterprise despite its poor record of debt service.

Bankruptcy/liquidation of enterprises that employ large numbers of workers is politically sensitive, particularly in countries where these enterprises dominate town economic life. State enterprises have traditionally accounted for social welfare functions as well as employment, making bankruptcy and liquidation more difficult for large blocks of people to accept.

Transition countries are working to reverse these problems in recognition of the benefits of bankruptcy/liquidation as a complement to out-of-court methods and final stage of debt collection. These benefits include instilling financial discipline in borrowers, providing banks with overdue leverage for loan recovery, and freezing existing levels of debt to prevent a worsening of the situation. However, it should take time to develop the legal and market infrastructure to ensure an orderly process that is transparent.

Reform programs are supporting government legal reviews for the introduction of new legislation, harmonizing existing laws (reconciling bankruptcy and privatization legislation), strengthening courts’ enforcement powers, providing training in commercial law, and exposing judges and lawyers to market-based systems. In some cases, countries have introduced modest efforts to liquidate value-subtracting enterprises through the courts. However, most of the effort has been dedicated to developing new legislation, legal infrastructure and enforcement powers, with in-court settlements expected to be more common in the future once constraints are eased and institutional capacity developed.

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43/ In Poland in 1990-1991, zero large SOEs were declared bankrupt or liquidated, while only 526 small- and medium-scale enterprises were liquidated among several hundred thousand (see B. Pleskovic, "Financial Policies in Socialist Countries in Transition", World Bank, 1994). It is during this period that Poland experienced "shock therapy", with significant changes in GDP, per capita incomes, unemployment rates and other macroeconomic indicators that would reflect the likelihood of a significant incidence of bankruptcies.

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Country Experience

Most countries do not routinely engage in in-court bankruptcy and liquidation procedures to restructure enterprises. Hungary and Poland are the major exceptions, although Estonia has also developed bankruptcy procedures. Adopted in January 1992, the Bankruptcy Law in Hungary was the strictest in transition countries. The original law required enterprises to file for bankruptcy if they were 90 days in arrears on loans. Within less than two years after adoption of the Bankruptcy Law, more than 5,000 bankruptcy and 16,000 liquidation proceedings were submitted to Hungarian courts for resolution.44 By mid-1994, about 7,000 filings had resulted in court decisions to liquidate enterprises, and another 1,500 had resulted in reorganization plans acceptable to creditors. A majority of these cases have been settled out of court. Extensive use of bankruptcy and liquidation proceedings has not been without cost. Shortly after the new bankruptcy legislation took effect, more than 2,000 enterprises filed for bankruptcy to protect themselves from creditors. The result was large losses for banks, and delays in the restructuring and liquidation of non-viable enterprises.45 However, significant asset transfers to the private sector took place, and proceeds were used to repay some of the outstanding debts, which might not have occurred through other methods. Subsequently, in 1993, the law was revised to introduce a more flexible and systematic restructuring approach. This included eliminating the automatic trigger of 90-day interest accruals which forced enterprises into bankruptcy, requiring creditors to initiate bankruptcy proceedings against enterprises in default, and protecting creditors from fraudulent asset diversion by the defaulting enterprise once a court order is issued.

While Poland has not emphasized the use of bankruptcy proceedings to the extent Hungary has, most of the enterprise restructurings that have occurred in recent years have been through in-court liquidation proceedings or conciliation, and not out-of-court conciliation efforts. Meanwhile, Estonia is revising its Bankruptcy Law to reduce the need for court bankruptcy proceedings. Revisions to the law effectively halt bankruptcy proceedings against enterprises slated for privatization. This should encourage the use of bankruptcy proceedings as an option of last resort, and promote the use of out-of-court settlements.

Bulgaria, which has been slow to liquidate loss-making SOEs, is now preparing to support revisions to the Bankruptcy Law that will permit courts to restructure or liquidate troubled enterprises, including value-subtracting SOEs in the mining sector. Macedonia permits the automatic liquidation or auctioning of small enterprises that cannot be privatized to reduce the impact of loss-making SoEs on the budget. However, the vast majority of transition countries lack sufficient incentives, legislation, court capacity, and/or out-of-court market infrastructure for broader use of bankruptcy/liquidation proceedings.

To correct this, several other transition economies are revising legislation with the intention of using courts more frequently. In the Baltic States, Latvia is adopting a Privatization Law which


should include court-led restructurings and liquidation to complement tenders and auctions. Lithuania is improving collateral registration and enforcement capabilities. In Central Europe, Albania is planning to support new legislation to improve collateral registration and loan collection procedures to facilitate court settlements. Croatia and Slovenia are planning to increase court capacity to deal with bankruptcy by introducing new legislation. In Central Asia, where court-led bankruptcies and liquidation are virtually non-existent, Kyrgyzstan has introduced commercial legislation to allow court bankruptcy and liquidation procedures dealing with ownership, property rights, collateral and contracts. Other FSU countries are planning to develop in-court capacity as an enterprise restructuring option in the future.

Legal reform efforts to utilize court-led bankruptcy/liquidation is intended to complement out-of-court methods. Both approaches are intended to instill financial discipline in borrowers, and provide banks with leverage for loan recovery. In some cases (Bulgaria, Hungary, Macedonia), budgetary concerns have encouraged legal reform.
IV. CONCLUSIONS AND SOME LESSONS FROM EARLY REFORM EXPERIENCES

A. Introduction

This paper has reviewed the essential design variants of reform programs in transition economies regarding bank and enterprise restructuring. While most programs are still being designed or at an early stage of implementation, some lessons can be drawn from early experiences acquired in a few countries, which may be instructive during later stages of implementation in other transition economies. These lessons are discussed below.

B. Financial Restructuring of Banks

Bank Recapitalization

Bank recapitalization can improve asset quality, restore solvency, encourage growth, and enhance public confidence. However, to be effective, bank recapitalization needs to be accompanied by the subsequent imposition of hard budget constraints on banks and enterprises, fiscal balance for macroeconomic stabilization, and a change in the incentive structure of banks and borrowers. This includes allowing banks and enterprises to fail if they are not viable, thus expanding the market for more competitive banks and enterprises and instilling financial discipline in those that are restructured or recapitalized. If governments are unwilling to maintain fiscal discipline and commit to rapid privatization and hard budget constraints, recapitalization is a poor option that invites moral hazard. Under such circumstances, it is probably better to replicate Russia and Estonia by privatizing in advance of bank restructuring to avoid the fiscal cost and systemic burden of moral hazard. However, as demonstrated in CSFR in 1991-1992, recapitalization can be useful if accompanied by fiscal discipline and a commitment to rapid privatization. Key considerations in determining the viability of recapitalization as an option should include:

- **Role of Private Capital:** If private and foreign capital are available to invest and privatize banks, there is limited rationale for providing public resources to prop up a troubled bank. Private ownership is likely to transform banks into viable financial institutions far more quickly than State-run approaches. Thus, subject to private investors (domestic and foreign) meeting licensing criteria, these applications should be approved. Interim measures accompanied by performance-based restructuring could be warranted, but these recapitalizations should be justified by prospects of privatization linked to an explicit timetable and government resolve to impose hard budget constraints.

- **Recapitalization and Post-Recapitalization Prospects:** Recapitalization of SOCBs should only be considered if it is associated with a performance-based restructuring program that alters incentives and is tied to a privatization timetable. In conjunction with enforcement of prudential regulations, management should be required to pursue strategies that reduce costs, enhance earnings, bolster capital and reserves, ease liquidity strains, and establish their bank as a viable concern capable of competing in the market based on commercial criteria. Bank governance should demonstrate adequate supervision of management performance to protect/increase shareholder
value. This should include management adherence to prudential regulations, avoidance of conflict of interest in borrowing/lending decision-making, evidence of effective credit policy and control, protection of deposit safety, prudent asset-liability management, and retention of earnings to achieve capital adequacy for immediate needs and future growth. If these management and supervisory board assumptions are unrealistic, bank recapitalization should not be pursued unless government assumes full liability for the non-viable part of the SOCB. This could be done by establishing a "good bank" and writing off the "bad bank". If government is unwilling to assume these liabilities, it should then move to liquidate the bank.

**Role of Government:** As these banks are SOCBs, a determination should be made of the role and capacity of government to be effective in the process. SOCB problems derive from the bad SOE loans they hold. As both are State-owned, the government (as shareholder) should require banks and enterprises to resolve these problems. The incentive of government (as de facto loan guarantor) to pressure SOEs (borrower) is reduced fiscal cost during a period of budgetary strain in most transition countries. Government hesitation to require dispute resolution will only slow the restructuring process of the enterprise and banking sectors, and add to the fiscal cost of financial restructuring. If government does not appear committed to or capable of accelerating the dispute resolution process, recapitalization of SOCBs is likely to fail and should not be pursued. In such a case, it is likely better to allow part or all of the SOCB to be liquidated.

CSFR and Slovenia have been the most successful with bank recapitalization to date. CSFR recapitalized its major problem banks, privatized them after the carve-out, recovered a significant portion of the loans through the Consolidation Bank collection efforts, and maintained fiscal balance in the process by cutting expenditures in other areas. Slovenia has restructured its three major State-owned banks, consolidated the banking system, increased capital adequacy, and severed enterprise ownership of the banks. Standards for achieving capital adequacy have been strengthened, increasing the likelihood that bank capital will be sufficient for stable growth and effective intermediation. This should also reduce the risk of future recapitalization needs from public expenditure.

Poland has been partly successful with bank and enterprise restructuring and privatization. To date, reform efforts have restructured commercial bank portfolios, strengthened their capital adequacy, and changed their management and governance. Recapitalized commercial banks now show evidence of being able to properly manage loan portfolios based on efforts to financially restructure enterprise debt. In all three cases-- CSFR, Poland and Slovenia-- bank recapitalization was designed as a one-time exercise, explicitly linked to privatization, and provided up front to strengthen bank balance sheets.

Without the imposition of hard budget constraints and a commitment to rapid privatization, bank recapitalization is likely to invite moral hazard and delay needed financial sector reforms. Without changing the incentive structure of banking systems, bank recapitalization is likely to fail in accelerating changes in bank and enterprise ownership, management and governance, bank lending practices, and borrower incentives. In turn, problems of bank solvency and liquidity are bound to persist. Above all, the failure of governments to explicitly rule out the possibility of multiple recapitalizations invites moral hazard. Hungary has recapitalized its banks several times at great
budgetary cost, but failed to sufficiently reform bank management practices and borrower incentives to avert the need for additional recapitalization.

**Work-Out Units**

Work-out units can help banks concentrate their focus on the recovery of problem loans, and can be useful in developing needed banking expertise and credit risk evaluation skills for commercial bankers and central bank supervisors. However, this can be an expensive approach at first because of the training and technical assistance involved. Furthermore, in many countries, the magnitude of loan portfolio problems facing banks exceeds their capacity in time and money to effectively restructure the enterprises and loans in default. In the absence of adequate legal and regulatory frameworks for loan recovery, market mechanisms for enterprise liquidation, and satisfactory staff skills and compensation, the viability of work-out units may be questioned. In these cases, it may be more useful for governments to write off the value of these loans up front, restructure bank incentives based on market criteria, and encourage banks to develop their own work-out units themselves based on need.

Work-out unit effectiveness (along with recapitalization and other restructuring efforts) is more likely if attached to a privatization timetable with benchmarks to be achieved. Poland has used work-out units as part of its approach to bank recapitalization, out-of-court conciliation and eventual bank privatization. These units have been successful in restructuring 75 percent of targeted non-performing loans through out-of-court procedures within the time frame mandated by law. Slovenia has likewise effectively used BRA-supervised work-out units to restructure SOCB loan portfolios, partly because the approach is explicitly linked to a pre-privatization rehabilitation program for the banks. Estonia is utilizing work-out units to develop skills and accelerate bank privatization.

By contrast, Hungary has demonstrated that work-out units show limited effectiveness unless accompanied by major borrower restructurings at both the financial and operating levels. Hungary has subsidized bank work-out units with "profit guarantees" as an incentive for banks to restructure SOE loans to prevent greater unemployment. However, since these financial restructurings have not been accompanied by operational restructurings at the enterprise level, the result has been continuing poor performance in the enterprise sector which endangers bank portfolios, fueling additional requests for further recapitalization.

**Debt-Equity Swaps and Loan Sales/Asset Swaps**

Debt-equity swaps can be useful to banks in strengthening their balance sheets, and potentially generating large profits at a future date when markets are stronger. The danger to banks is excess exposure to risky investments which may jeopardize deposit safety and bank capital, and the need for additional financing for these poorly performing enterprises. Such risk could be reduced by observing two prudent measures regarding swaps and deposit safety: swap non-performing loans for equity only after these loans have been written down, and set up separately capitalized subsidiaries to take the equity risk of loan swaps.

Most of the swaps in Croatia are for equity stakes in enterprises whose loans are non-performing. Fortunately, Croatian banks write down these loans before swapping them for equity in
enterprises. However, even after write-downs, investment in loss-making enterprises raises the risk of future liquidity being drained to prop up these enterprises in the hope of eventual profitability.

Poland encourages the exchange of equity for non-performing loans as part of the out-of-court conciliation process. This has facilitated bank and enterprise financial restructuring, strengthening bank loan portfolios and balance sheets. However, despite official encouragement for swaps, unfavorable tax treatment in Poland serves as a deterrent to an increased volume of swaps. As with Croatia, banks in Poland have generally adopted swaps as part of normal banking business, rather than establishing separate subsidiaries.

Loan sales and asset swaps have generally not been found in transition economy banks. Only in Poland has an institutional structure and process been established to encourage these sales and swaps. However, these efforts have been stymied by the absence of developed secondary markets and discouraging tax policies. To develop secondary markets for sales and swaps, interbank markets and the emergence of non-bank institutions specializing in discounted loan purchases/sales/ swaps will be necessary. However, as with bad loans that would be assigned to bad banks, there is currently little market demand and no market tradition. Improved loan recovery mechanisms and legislation encouraging NBFI entry should help stimulate secondary market development.

**Bank Restructuring or Rehabilitation Agencies (BRAs)**

BRAs are responsible for the consolidation and stabilization of banking systems and individual banks. The benefits of BRAs are the reconfiguration of inefficient banking systems, and faster clean-up of bank loan portfolios. These dual efforts can also accelerate the emergence of private banking. However, as with work-out units, widespread use of BRAs has been constrained by the lack of experienced staff.

As far as bank rehabilitation efforts are concerned, Slovenia’s BRA is showing initial signs of success. BRA recapitalization of troubled banks automatically severs enterprise ownership of these banks and permits BRA to take the lead role in loan recovery, supervising work-out units in the banks and applying pressure on SoEs to repay loans. These efforts have resulted in improved operations and increased bank capital to meet improved adequacy standards.

**C. The Role of Banks in Enterprise Sector Restructuring**

**Out-of-Court Settlements**

Because of the constraints faced in their court systems, most transition countries have relied on out-of-court approaches to restructure enterprises. Many transition countries have combined "decentralized" bank-led restructurings with more "centralized" government-led approaches. Banks in CSFR, Poland, Slovenia, and, to some degree, Croatia and Estonia have played an active role in the financial restructuring of troubled enterprises. In most countries, banks have simply begun to curtail credit to smaller, non-viable enterprises. Along with this "decentralized" bank-led approach, governments have established Restructuring Agencies to focus on selected enterprises that they view as strategic or essential for reasons of infrastructure, services and/or employment. Governments have come to recognize that they cannot bail out most enterprises. Hence, most governments have
designed or begun to pursue a two-tiered approach to enterprise restructuring by which government is active in the restructuring and privatization of a limited number of "strategic" enterprises, while banks are active in the financial restructuring and liquidation of "non-strategic" enterprises.

"Decentralized" Bank-led Restructuring: Bank-led restructuring is more common in Central Europe. However, banks have engaged in the direct operating and physical restructuring of enterprises less than original expectations, due to their lack of capacity, experience and skill level. Rather, bank-led restructuring in transition countries has focused on the financial restructuring of enterprises, specifically enterprise debt. To the extent that the financial restructuring of enterprises is linked to the presentation of an enterprise business plan, this has served as the basis for operating and physical restructuring. In this manner, banks are indirect agents of enterprise operating and physical restructuring. However, banks have had less involvement in the governance of viable enterprises and initiated fewer bankruptcies of non-viable enterprises than expected at the earliest stages of transition.

The most active bank-led restructuring efforts are found in the Czech Republic, Poland and Slovenia. Czech banks (along with NBFIs) have Investment Privatization Funds (IPFs) which serve as shareholders in enterprises. Because of their large shareholdings, IPFs are in a position to influence management financial and operating decisions, thereby actively restructuring enterprises in which they have invested. Poland's "conciliation" and "commercialization" process also actively restructures enterprise debts, governance and management. However, this approach relies on the public sector more than in the Czech Republic.

"Centralized" Government-Led Restructuring: Given the limitations faced by banks in comprehensively restructuring enterprises, governments have established multiple institutions with the objective of implementing a more direct approach to restructuring enterprise operations. The risks to this approach are duplication of effort, continued State involvement in the economy, and a slower pace of private sector investment and development.

The government-led approach has been most common in FSU countries where bank capacity is comparatively limited. In the Baltic States, particularly in Estonia, governments have shown macroeconomic stabilization and hard budget constraints on banks and enterprises are effective in curtailing imprudent lending and moral hazard. (Estonia has also pursued elements of a bank-led approach by developing work-out units in SOCBs). Russia's aggressive privatization program has transformed ownership without initially addressing enterprise and bank restructuring needs. Hyperinflation restructured the finances of banks and enterprises. It will take time to see if subsequent reform efforts through Privatization Centers, banks and Regional Enterprise Funds are effective in restructuring the enterprise sector (and banks) on a sustainable basis. Albania has pursued a predominantly centralized approach, although Albania's banks have shown some recent autonomy,

46/ This is true in the Slovak Republic as well, but IPFs have been less active there than in the Czech Republic.

47/ IPFs mainly purchased shares in small- and medium-sized enterprises to be able to influence management decisions. Among 2,243 IPF investments, 1,970 were in small- and medium-sized enterprises. Investments in larger enterprises were limited, partly because of doubts about being able to sufficiently influence management. See N. Shafik, "Making a Market: Mass Privatization in the Czech and Slovak Republics", World Bank, December 1993.
shifting the mix of credit from SOEs to private sector enterprises since late 1992. This has not been accompanied by improvement in loan quality, with seriously high rates of non-performing loans found in both the SOE and private sectors. Consequently, the government has endorsed a plan to restructure and privatize its three SOCBs, curtail bank lending to its most troubled SOEs, and privatize the vast majority of its non-strategic SOEs. Albania's ERA is restructuring or liquidating 32 selected SOEs within a two-year time frame, with the restructured enterprises expected to be creditworthy and viable.

**In-Court Bankruptcy/Liquidation Proceedings**

Aside from Hungary and, to a lesser extent, CSFR, Estonia, Macedonia and Poland, transition countries rarely engage in formal bankruptcy and liquidation procedures to restructure enterprises. Bankruptcy and property laws are generally incomplete, court systems are underdeveloped, collateral cannot be repossessed and sold, and infrastructure and skilled personnel are lacking. Bank creditors are usually third in the creditor hierarchy after government and trade creditors, reducing chances for repayment unless government waives wage and tax arrears and other enterprise obligations. Furthermore, enterprises that need to be liquidated are often State-owned, thus bankruptcy proceedings represent claims against the State.

Hungary stands out as the major exception in transition economies (along with Poland), frequently using in-court proceedings for debt resolution and enterprise restructuring. In January 1992, Hungary adopted the strictest Bankruptcy Law in transition countries. The original law required enterprises to file for bankruptcy if they were 90 days in arrears on loans. However, more than 2,000 enterprises filed for bankruptcy to protect themselves from creditors, resulting in large losses for banks and restructuring delays of non-viable enterprises. The Bankruptcy Law was subsequently revised in 1993 to introduce a more flexible and systematic restructuring approach based on U.S. bankruptcy codes, and to lessen the burden on Hungary's court capacity. While not without its successes and accomplishments, the case of Hungary demonstrates that strict laws alone do not guarantee that prudent loan and enterprise restructuring will follow. Many loss-making SOEs escaped the bankruptcy provisions because of political and social pressure applied on banks to delay restructuring initiatives. Meanwhile, significant numbers of enterprises filed for bankruptcy for protection from creditors, at great cost to the banks. This form of restructuring depleted rather than strengthened bank capital.

**D. Financial Sector Enabling Environment**

**Legal/Regulatory Framework**

The legal and regulatory environment for banks in transition economies has not been fully responsive to banking system needs, although recent reforms have led to improvements in some countries. Non-FSU countries and the Baltic States have introduced legislation and new regulations ahead of most CIS countries. Notwithstanding new legislation, most countries still need significant help with additional reforms and implementation.

Several major improvements need to be made. Apart from CSFR, Hungary and Poland, laws concerning property rights, collateral pledges, and transfers of ownership are unclear, weak or non-
existent. More developed court capacity, information systems and valuation skills should result in more effective implementation of reform programs. Second, non-FSU transition countries often hesitate to let banks fail, instead of developing an orderly bank liquidation process that allows market failures without undermining depositor confidence. Such hesitation forestalls needed banking sector reform and privatization. Third, in countries where Investment Privatization Funds and stock markets are developing, laws/amendments are ineffective at protecting customer deposits from bank investment exposure and stock market transactions. This allows a level of risk that jeopardizes deposit safety, bank capital and fiscal resources. Fourth, apart from Albania and Poland, transition countries have set eight percent as the needed capital adequacy ratio based on international standards. Nevertheless, transition country banking systems carry more risk than more mature banking systems, and would therefore benefit from higher ratios. Fifth, transition countries lack a basic framework to serve as a guideline for factoring, leasing, insurance, real estate, mutual fund, venture capital, brokerage, loan collection agency and other non-bank financial sector institutions. This slows development of needed formal sector non-bank intermediation. Sixth, deposit insurance systems lack balance, transparency, and clarity with regard to deposit ceiling coverage and cost-recovery mechanisms. This distorts the development of competitive markets and fails to limit the potential liability of an implicit State guarantee on deposits. Finally, tax laws often discourage banks from following prudent provisioning practices for loan losses. Banks should be permitted to expense provisions for loan losses before profit taxes are assessed. This would provide an incentive to banks to report more accurate profitability, capital and reserve figures.

**Bank Supervision**

As a relatively new function in the post-monobank systems, bank supervision is plagued by insufficient numbers of trained supervisors, poor information systems, and inadequate enforcement powers. Reform programs are supporting efforts to increase the number and quality of supervisors, enhance enforcement powers, and develop appropriate on- and off-site examination strategies. Inadequate enforcement is partly related to the debate surrounding bank supervision autonomy and authority. Most countries house bank supervision in the central bank, while some believe it should be an autonomous function reporting to the Ministry of Finance. In at least one instance (Hungary), multiple supervisory institutions exist. There are strong arguments for several approaches, although none of these approaches is effective unless bank supervisors have the authority to enforce prudential regulations. Strengthened enforcement and more developed institutional capacity are needed to enhance risk monitoring capabilities, particularly as banks adapt to new accounting principles. The risk of underdeveloped bank supervisory capacity is the possible failure to detect bank solvency and liquidity risks early enough to avoid the need for costly State recapitalizations.

**Corporate Governance and Privatization**

Corporate governance of banks and enterprises has traditionally been inadequate due to the absence of developed market mechanisms, information requirements, accountability standards, trained management and board supervisors, and a tradition of private ownership. Many countries have adopted interim corporate governance reforms in advance of privatization. This has been reflected in bank governance, where many transition countries have adopted new legislation placing limits on insider lending, borrower concentration, and ownership of SOCBs. Even as banks remain State-
owned, several countries have strengthened the role of supervisory boards to scrutinize management performance and enforce stricter credit standards.

The key change that needs to occur is privatization of banks. While governments are on record as committed to the development of private sector banking systems, this has occurred only in FSU countries and the Czech Republic. Immediately changing the ownership structure of SOCBs has been cited as infeasible in non-FSU countries. This has resulted in slower development of private commercial banking, and introduction of the interim governance measures described above. Results have varied based largely on the commitment of governments to privatize the banking sector, and the capacity of public sector officials to enforce stricter governance standards in the interim. CSFR, Poland and Slovenia have shown progress, while most other transition countries continue to have troubled State-owned banking sectors.

The privatization of existing State banks and emergence of new privately-owned banks has been hindered by weak enabling environments, thin markets, the reluctance of governments to allow State banks to fail, and the inability of governments to face up to the financial cost associated with obligations from the pre-transition period. Notwithstanding these problems, some countries show increasing numbers of private commercial banks (Croatia, Poland, Romania, Russia), joint ventures and direct foreign investment (Czech Republic, Hungary, Poland, Romania), and public sector bank consolidation in advance of privatization (Bulgaria, Slovenia).

**Institutional Development**

Apart from CSFR where recapitalization and bank privatization occurred quickly, reform programs have supported institutional strengthening in a wide variety of areas, making use of technical assistance and training for central and commercial bankers and bank supervisors. This support will need to continue, focusing on improved implementation through explicit incentives, clear strategies and reasonable timetables. Russia's commercially-oriented strategy using Regional Enterprise Funds managed by investment bankers whose compensation is based on performance should be a useful approach in this direction. Poland's conciliation and commercialization strategy has benefitted from an explicit banking sector privatization strategy with stated deadlines. Slovenia's BRA-led restructuring program has likewise benefitted from an explicit strategy to consolidate and stabilize the most troubled banks in advance of privatization.
ANNEX 1. BANKING SECTOR EXPERIENCE WITH ENTERPRISE RESTRUCTURING IN TRANSITION COUNTRIES

Banking sector experiences to date with enterprise restructuring exercises are summarized below. They show that banks are involved in loan restructurings and, to some extent, set financial targets for enterprises. However, aside from a handful of countries, enterprise restructuring is being coordinated by separate privatization and pre-privatization agencies (EPRAs). Annex 2 provides greater country detail on privatization programs to date.

Central Europe and the Balkans

- **Albania:** Albanian bank efforts to restructure enterprises have been limited to freezing deposits, and restructuring or collecting on loans. Out-of-court restructuring is expected to come from outright privatization (coordinated by the National Agency for Privatization) and enterprise restructuring (coordinated by the Enterprise Restructuring Agency, or ERA), indicating that a more government-led approach is being put in place. Banks lack the expertise and capacity to play a lead role in the restructuring process. Proceeds from earlier privatizations have not been used to repay Albania's three major banks for outstanding loans.

- **Bulgaria:** Bulgaria's 28 banks are currently unable to lead full-scale conciliation and enterprise restructuring efforts. As such, a government-led approach has been in place to consolidate the banking system. Banks intend to focus more on the ability to collect on delinquent loans, rather than taking the lead on enterprise restructuring. For this, banks need strengthened loan collection and default mechanisms, expected to be part of the Bulgarian FESAL.

- **Croatia:** Many of Croatia's 48 banks have the technical capacity to restructure troubled enterprises and are currently doing so except with the largest enterprises. Larger banks were often deterred from enterprise restructuring because of the traditional ownership of banks by enterprises. For this reason, banks were traditionally passive in their approach to enterprise restructuring. However, this has begun to change with the implementation of reforms. Some banks have begun to swap debt for equity, and in the process set financial targets (debt repayment, return on equity) for these enterprises. Some of the smaller "niche" banks are rendering advisory services to enterprise borrowers, effectively restructuring these enterprises in a private sector mode.

- **Hungary:** Hungary's 31 banks are not expected to play a lead role in enterprise restructuring, although a more "decentralized" approach is being considered due to the fiscal strain of propping up loss-making enterprises and the cost of Hungary's bankruptcy procedures. Out-of-court processes in which banks are more active should be applied in the next phase of privatization in conjunction with bankruptcy proceedings. As Hungary has a comparatively developed banking system among transition economies, it is expected that banks will be able

48/ Albania has six banks. The three largest State-owned banks account for 99 percent of balance sheet values.
to play a more active role in enterprise restructuring on the condition that the political will exists.

- **Macedonia**: Macedonia's three largest socially-owned banks are taking the lead in out-of-court conciliation procedures for medium-sized enterprises, while a special task force is preparing plans for the privatization of large-scale enterprises. It is unclear if there will be any role in enterprise restructuring for Macedonia's other 18 private banks.

- **Poland**: Out-of-court "conciliation" involving nine (now seven) SOCBs serving as lead agents for loan and enterprise restructuring has been effective in facilitating privatization and "commercialization" (pre-privatization restructuring guided by commercial principles). Each of the original nine SOCBs were responsible for 200-300 SOE work-outs, restructurings or liquidations. Debt-equity swaps and other methods were permitted by legislation to achieve needed work-outs and restructurings. For the 250-300 enterprises expected to emerge from conciliation procedures, a target of 30 percent was set for outright privatization, and 70 percent for "commercialization". Conciliation procedures can be initiated by any creditor holding 10-20 percent of SOE liabilities. Conciliation is considered complete once creditors representing 50 percent or more of claims are in agreement (subject to appeal by minority creditors). By March 1994, 85-90 percent of bad loans had been restructured, liquidated, written off, sold, swapped or repaid. Restructured enterprises were expected to be more viable in the future.

- **Romania**: The commercialization of Romania's four SOCBs and growing strength of its 16 private banks indicates banks are likely to play an influential role in financial and, perhaps, enterprise restructuring as the private sector develops. However, Romania's 20 banks do not currently have a lead role in enterprise restructuring. Romania's ambitious seven-year privatization program is generally government-led, although it is designed to stimulate banking capabilities in the lending as well as investment field.

- **Slovakia**: Slovakia's 26 banks are expected to have new incentives to take the lead in loan restructuring. This will include improving the legal framework to promote the use of workouts for loan/enterprise restructuring. Slovakia permits banks to be direct shareholders in enterprises, and to place shares with institutional intermediaries who invest in enterprises on behalf of their clients (similar to mutual funds/investment trusts). Thus, enterprise restructuring in Slovakia may involve a range of commercial and investment banking options, and in-court and out-of-court approaches.

- **Slovenia**: Slovenia's three largest banks are currently focused on the ability of their work-out units to restructure and recover non-performing loans under the auspices of the BRA. The other 27 banks are less involved, although they are engaged in financial restructuring of delinquent borrowers. The government is working on legislation to govern the process by which banks would play more of a role in out-of-court conciliation. Separate Development Funds have been established to dispose of shares in companies, recapitalize banks, develop small businesses, restructure loss-making enterprises, reschedule debts, and liquidate non-viable enterprises.
Baltic States

- **Estonia**: Enterprise privatization and restructuring efforts involve work-out units at Estonian banks. However, the government’s focus is on maintaining hard budget constraints, improving legislation, strengthening the Privatization Agency, and adopting new methods and techniques of privatization. Hence, the "centralized" approach is more predominant than the bank-led approach to enterprise restructuring.

- **Latvia**: Latvia’s 67 banks are unable to play a lead role in enterprise restructuring, and for this reason the government has turned to EPRAs. The government intends to improve the legal framework for banks and enterprises to accelerate privatization and facilitate loan recovery. Enabling legislation is expected to focus on strengthening bankruptcy provisions, property rights, and the use of collateral for loans. New guidelines are being devised for debt restructuring and loan recovery.

- **Lithuania**: Lithuania’s 28 banks are ill-equipped to take the lead in enterprise restructuring. The government is focusing on privatization through pre- and post-privatization units. The Ministry of Industry and Trade will help with a pre-privatization unit to prepare enterprises for privatization.

FSU: Russian Federation and Eastern Europe

- **Belarus**: Belarus’ 28 banks are in no position to lead enterprise restructuring efforts. The government was focused on legislative reforms to de-monopolize the economy, strengthen property and ownership rights, break up State monopolies, increase private sector entry, and facilitate small-scale privatization. Currently, the government is focused on sorting out its differences with Moscow about how to introduce the monetary and customs union which was agreed, postponed and then rejected by Russia. When these issues are sorted out, it is expected that a government-led restructuring program will be introduced.

- **Moldova**: Moldova’s 20 banks are not expected to play a lead role in enterprise restructuring, although their financial input will inevitably require business plans that may lead to some restructuring.

- **Russia**: Most of Russia’s 2,300 banks do not currently have the skills to change Russia’s enterprise weaknesses. However, some private banks monitor the financial condition of enterprises (sometimes owners) and prepare their financial statements. To supplement bank capacity and provide financial incentives and discipline to privatized enterprises, post-privatization assistance is to be provided to medium- and large-scale enterprises with a minimum 75 percent private ownership. This assistance will be delivered by 10 local Privatization Centers overseen by the Russian Privatization Center. Assistance will involve credit and equity, thereby serving as a basis for banking sector restructuring as well. Medium- and long-term credit will come from 20 accredited private commercial banks and from bilateral export credit agencies. Equity financing will be provided by Regional Enterprise Funds (REFs). REFs will be managed by professional fund managers from market economies, and should operate on a commercial basis without the involvement of Russian government entities in their investment decisions. REF managers will be recruited from the
investment banking industry on a competitive basis, with a large percentage of remuneration tied to realized profits.

- **Ukraine:** Ukraine's 150 banks are incapable of leading enterprise privatization and restructuring. The government’s focus for enterprise restructuring has been to improve legislation, and strengthen the administrative capacity of public institutions responsible for privatization. In the aftermath of recent elections, Ukraine is expected to intensify efforts to resolve differences with Russia, establish broader trade alliances, and attract foreign aid to promote financial and enterprise sector reforms.

**FSU: Central and Southwest Asia**

- **Armenia:** Armenia's 47 banks are not able to lead the enterprise restructuring effort. The government's focus for enterprise restructuring is to accelerate ownership privatization, largely to prevent further budgetary pressure resulting from SOE losses.

- **Georgia:** Georgia's 107 banks lack the capacity to restructure enterprises. The government's focus for enterprise restructuring is ownership privatization. The government is designing plans for mass privatization through the Committee for State Property Management (SPM). As banks have been public enterprises (owned by the government), banking personnel are inexperienced and incapable of leading restructuring efforts.

- **Kazakhstan:** Kazakhstan's 180 banks are currently unable to lead efforts to restructure enterprises. However, by owning Investment Privatization Funds, banks can effectively restructure enterprises in which their funds have equity stakes. This may lead to the financial as well as physical and operating restructuring of enterprises in the future (as in the Czech Republic). However, it will take time and technical assistance for the banks to develop this capacity.

- **Kyrgyzstan:** Most restructuring or liquidation of large loss-making SOEs is expected to be in conjunction with the proposed BRA. Kyrgyzstan's 19 banks are not currently able to lead enterprise restructuring procedures. The government is introducing commercial legislation to allow for court liquidation and bankruptcy procedures to facilitate future in-court procedures to instill financial discipline. This includes ownership and property rights, contract law, bankruptcy and liquidation procedures, and collateral, all of which should benefit the banks in the future.

- **Turkmenistan:** The government’s focus for enterprise restructuring is privatization. Turkmenistan’s 22 banks are in no position to play a lead role.

- **Uzbekistan:** Bank-led enterprise restructuring is not currently feasible. The government’s focus for enterprise restructuring is institutional development at the Privatization Agency and Development Fund ("Uzgofond"), rather than having Uzbekistan's 24 banks take the lead.

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49/ Kyrgyzstan is the only country in our sample that is adopting a BRA after having had a monobank system for several decades.
ANNEX 2. SUMMARY OF ENTERPRISE SECTOR RESTRUCTURING AND PRIVATIZATION PROGRAMS IN TRANSITION COUNTRIES

Country experiences with enterprise restructuring and privatization are summarized below. They show that enterprise restructuring is being coordinated primarily by separate privatization and pre-privatization agencies (EPRAs), not banks.

Central Europe and the Balkans

- **Albania**: Albania has privatized more than half of its SOEs, most of them "units" of former companies (buses, warehouses, machines, small shops). This has been accompanied by a proliferation of very small private enterprises in the rural and informal sectors. Most privatization has been carried out by auctions, with purchases primarily made by workers and managers at book value. Proceeds have not been used to repay Albania's three major SOCBs for outstanding loans. Albanian bank efforts to restructure enterprises have been limited to freezing deposits and restructuring or collecting on loans. Out-of-court restructuring is expected to come from outright privatization (coordinated by the National Agency for Privatization) and enterprise restructuring (coordinated by the Enterprise Restructuring Agency, or ERA). Banks lack the expertise and capacity to play a "conciliation" role in the restructuring process. The government has still not determined the methods to use to accelerate privatization. ERA restructuring will initially involve 32 SOEs, be funded by the budget, and take no more than two years. If ERA companies are unable to become viable within two years, they will be liquidated. Enterprises receiving budgeted funds (from PIP, ERA) will not be allowed to borrow from banks. Enterprises to be privatized will not receive budgeted or extra-budgetary funds.

- **Bulgaria**: The government intends to initiate a mass privatization program to accelerate enterprise restructuring and privatization, which have been slow to develop. The reasons for slow progress are manifold: political pressures concerning unemployment, which has approximated 16 percent since 1993; lack of consensus on privatization strategy; resistance to privatization from SOE workers and managers; bureaucratic obstacles regarding SOE valuation; changes of management and Supervisory Boards; conflicts over land ownership rights between municipalities and the central government; lack of inter-ministerial coordination; SOE ownership of banks, which prevents banks from imparting financial discipline on loss-making SOEs; and weak corporate governance structures, which permits management/boards to strip assets away from SOEs, leaving only unattractive and indebted assets for future privatization. Despite these constraints to privatization, SOEs continue to generate losses of 11 percent of GDP, contributing significantly to the fiscal deficit. In addition, SOEs have significant arrears to government for taxes and Social Insurance payments, and to employees for wages. To accelerate privatization, the government intends to set quantitative targets, remove policy and administrative obstacles, and encourage financial discipline through improved corporate governance. Improved corporate governance is expected to come from reformed Supervisory Boards, the majority of which will be independent, non-government professionals rather than shareholders.

- **Croatia**: By and large, privatization has been slow to develop in Croatia. Privatization strategy has been predicated on the principle that insiders (workers, managers) should be able to acquire SoEs at low sales prices with payment made over a period of several years. For
this reason, corporate governance has not significantly changed. However, hard budget constraints and legislation severing SoE ownership of banks is expected to change incentives, governance and performance.

- **Hungary:** Privatization of State enterprises is now expected to proceed based on the 1994-1995 program designed by the State Property Agency (AVU). Hungary permits concentrated ownership of firms, which has facilitated and accelerated their privatization and attracted significant foreign investment. All remaining SOEs are to be "transformed", predominantly via worker and management buyouts. Hungary has strong budgetary reasons for accelerating privatization: 603 loss-making enterprises account for more than HUF 100 billion (US$ 1.1 billion) in outstanding debt, or 40 percent of total SOE debt. Three quarters of this debt is classified as non-performing, the main reason for bank insolvency and illiquidity. The 41 largest loss-makers account for 17 percent of outstanding SOE debt and 36 percent of non-performing loans.

- **Macedonia:** Parliament passed the Law of Transformation of Enterprises with Social Capital in June 1993 to facilitate and accelerate privatization. The government set a five-year target of privatizing nearly 1,500 firms, of which 100 are large-scale and 300 are medium-sized. Ownership incentives and corporate governance are to be strengthened, providing owners and managers with more autonomy. Supervisory boards are expected to play a more active role in ensuring management performance is consistent with shareholder objectives. Macedonia has strong budgetary reasons for accelerating privatization: loss-making SoEs showed losses exceeding 10 percent of 1993 GDP, and the budget cannot afford additional losses.

- **Poland:** Out-of-court "conciliation" has been effective in facilitating privatization and "commercialization" (pre-privatization restructuring guided by commercial principles), with nine (now seven) SOCBs serving as lead agents for loan and enterprise restructuring. Annex I describes the process in greater detail.

- **Romania:** Romania is pursuing a phased privatization program, with the State Ownership Fund (SOF) and five Private Ownership Funds (POFs) privatizing enterprises over a seven-year period. From 1989 to 1991, Romania "corporatized" its 6,000 SOEs to prepare them for eventual privatization. Most of these enterprises are now joint-stock companies, owned 70 percent by the SOF and 30 percent by a POF. The SOF is required to sell off its holdings on an equal amortization basis of 10 percent per year for seven years. Buyers are the general population, who have been issued one Certificate of Ownership in each of the five POFs. Through April 1994, eight percent of commercial companies representing four percent of employees had been privatized. To accelerate the pace, the government is contemplating mass privatization. The government intends to retain companies which are significant in terms of employment and GDP contribution, natural monopolies of public interest, or enterprises considered vital to national security. The government has also decided to restructure selected

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50/ See C. Gray and R. Hanson, "Corporate Governance in Central and Eastern Europe", World Bank, September 1993.

51/ At the time this publication was prepared, the Greek blockade of Thessaloniki (Salonika) had been in effect for months, cutting off Macedonia's traditional outlet to the Mediterranean.
SOEs in poor financial condition. As of end 1993, 24 SOEs were to be restructured and six liquidated.

- **Slovakia:** Enterprise restructuring and privatization are urgent priorities for the government because SOEs continue to generate losses equivalent to 12 percent of GDP. Enterprise restructuring and privatization already began with about 500 Slovakian State enterprises privatized by coupon between 1991 and 1993 during the first privatization wave of the previous CSFR period, and several hundred additional SOEs privatized by other methods. Slovakia permits banks to be direct shareholders in enterprises, and to place shares with institutional intermediaries who invest in enterprises on behalf of their clients (similar to mutual funds/investment trusts). Thus, enterprise restructuring in Slovakia may involve a range of commercial and investment banking options, and in-court and out-of-court approaches, rather than relying on a narrow list of options. A second wave of National Property Fund privatizations was expected to include 520 enterprises. This was to include the use of vouchers to accelerate privatization, with an original target of 50 percent of State-owned assets to be privatized. The Ministry of Finance, Ministry of Privatization and National Property Fund were to coordinate the ambitious voucher scheme. However, recent election results have put this next phase of privatization on hold.

- **Slovenia:** Enterprise restructuring and privatization have been urgent priorities for the government. SOEs were generating losses equivalent to 17 percent of GDP, weakening the banking sector and jeopardizing monetary control. Enterprise restructuring and privatization have been supported by enabling legislation to privatize 2,700 medium- and large-scale SOEs. Enterprise ownership "transformation" has been accelerated by employee and management buyouts, mass participation through ownership certificates, and participation in investment funds similar to investment trusts or mutual funds. For enterprises that have not been "transformed" within one year, these rights are transferred to the Privatization Agency (PA). The PA then designs and implements privatization through stock offerings or other mechanisms. Separate Development Funds have been established to dispose of shares in companies, recapitalize banks, develop small businesses, restructure loss-making enterprises, reschedule debts, and liquidate non-viable enterprises. Enterprise restructuring and privatization have also benefitted from government decisions to improve the corporate governance of enterprises. Severance of enterprise ownership of banks requires enterprises to be more commercially viable to qualify for loans. This provides an incentive for enterprises to be competitive and prudently managed. Debt relief requires enterprises to build their internal capital and competitive strength by suspending dividend payments and refraining from transferring assets to third parties. Reduced Workers' Council influence on management decision-making and more flexibility governing wage settlements have enhanced incentives for better corporate governance, improved management performance, and lowered enterprise cost structures for export competitiveness.

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52/ Nearly 1,000 Czech SOEs were also privatized during this period by coupon. An additional 1,347 SOEs in CSFR were privatized without the use of coupons.

Baltic States

- **Estonia:** The main thrust of reform efforts is focused on improving legislation, strengthening the Privatization Agency, and adopting new methods and techniques of privatization. The Ministry of Economy (MoE) and Privatization Agency (PA) are both considered insufficiently staffed to effectively attend to corporate governance responsibilities (MoE responsibility) of SOEs before their transfer to the Privatization Agency, and to manage the privatization process (PA responsibility). To address these needs, the government has improved coordination between MoE and PA, and increased staff and compensation to discharge their responsibilities. The government supports expanded use of best-price auctions, sale of sector-wide assets, reduced buyer conditions regarding employment, investment and bank guarantees, clarification of the voucher scheme, and management buy-outs and other techniques to accelerate privatization. Other measures the government supports to facilitate and accelerate privatization include improving the public information campaign, settling environmental clean-up issues, and coordinating with municipalities to divest SOE social services (water, housing, heating, health, day care).

- **Latvia:** Privatization was slowed for a variety of reasons. The introduction of the Privatization Law, which includes tenders, auctions, certificates and liquidations as methods to be used, took time to pass Parliament. Restitution claims and restrictions on employee layoffs slowed the privatization of small enterprises. Large enterprise privatization was slowed by delays in voucher and leasing laws. Bureaucratic delays have resulted from the case-by-case approach followed by the Latvian Privatization Agency (LPA) and State Property Fund (SPF). To correct these problems and accelerate the pace of privatization, the government initiated a mass privatization program, with a target of up to 200 SOE privatizations per year from 1994-1996. The government set up the LPA as a joint stock company with a Supervisory Board and performance targets. New institutional and foreign investors are being encouraged to participate. The government has also supported enhancement of administrative capacity at LPA and SPF with technical assistance and training to assist with pre-privatization restructuring (product and market studies, financial and legal due diligence, organizational structure, capital restructuring, asset sales, labor reductions, supplier relations). The government is improving the legal framework for banks and enterprises to accelerate privatization and facilitate loan recovery. Enabling legislation is strengthening bankruptcy provisions, property rights, and the use of collateral for loans. New guidelines have been devised for debt restructuring and loan recovery. Demonopolization efforts are expected to broaden participation in the privatization campaign by making it more affordable to more investors.

- **Lithuania:** The government is focusing on privatization through pre- and post-privatization units. The Ministry of Industry and Trade is helping with a pre-privatization unit to prepare enterprises for privatization. The Ministry of Economy has established a post-privatization unit to help privatized enterprises with business planning and restructuring needs. Both are being helped with technical assistance and training. Enterprise restructuring is expected to come from reorganization where privatization has failed. Such reorganization involves transfers, partial sales, rehabilitation and liquidation. The government is encouraging out-of-court approaches to loan restructuring by developing operating procedures to restructure or liquidate non-viable State enterprises that have been offered for sale, but for which there has been no expressed market interest.
**FSU: Russian Federation and Eastern Europe**

- **Belarus**: The government is focused on legislative reforms to de-monopolize the economy, strengthen property and ownership rights, break up State monopolies, increase private sector entry, and facilitate small-scale privatization. Prior to recent elections, the government wanted to initiate a mass privatization program. Whether this approach will be pursued is currently uncertain. Mass privatization will require more developed privatization regulations, methodologies and procedures, simplification of licensing and registration procedures, and a public information campaign to increase public participation in the privatization effort. In the meantime, the Belarus government has been simplifying licensing and registration procedures for small-scale private ventures to facilitate private sector development. The government has also supported office parks and business centers to provide skills transfer and business planning services to these nascent enterprises. One of the ongoing constraints to privatization and private sector development is the lack of private sector tradition. The Belarus economy has been tightly integrated with the Russian economy for decades. However, Russia’s recent rejection of the previously agreed monetary union may change some of Belarus’ traditional production and trade patterns, while still remaining closely tied to the Russian economy.

- **Moldova**: The government is focusing on the broader need for private sector development to assist with the transformation of the economy, characterized largely by the production of industrial goods by SOEs unsuited for non-FSU markets. Privatization strategy is focused on broad ownership, with citizens using “patrimonial bonds” (privatization vouchers) at auctions to purchase enterprises and units. About 1,600 enterprises accounting for 35 percent of the book value of state assets were to be initially auctioned off in early 1994. Broad-based privatization is expected to provide the thrust for enterprise restructuring in an environment expected to benefit from the liberalized pricing of goods and services to stimulate competition, liberalized labor legislation to permit lay-offs, increased management autonomy, and strengthened corporate governance. The government has also agreed to permit increased enterprise autonomy in the management of cash resources for operations and investment. Enterprises are expected to benefit from a more systematic legislative and regulatory reform process, better communication of changes to encourage a more stable environment for business investment, and technical assistance and training to improve financial management skills and develop suitable business plans. The government is supporting specialized training in these areas, with special emphasis on the conversion of military plants to commercial civilian use.

- **Russia**: The government has completed a mass privatization campaign to change the ownership and financial burden of these enterprises. Today, most SOEs have been privatized, albeit in advance of needed restructuring. Russian enterprises are uncompetitive by international standards, characterized by severe overstaffing, inefficient resource use (particularly of energy), obsolete technologies, plant and equipment, inadequate business and financial management skills, weak planning, and poor market research. Few of Russia’s 2,300 private banks have the skills to change these weaknesses. To provide financial incentives and discipline to privatized enterprises, post-privatization assistance is being provided to medium- and large-scale enterprises with a minimum 75 percent private ownership. This assistance is being delivered by 10 local Privatization Centers overseen by the Russian Privatization Center. Assistance involves credit and equity, thereby serving as a basis for banking sector restructuring as well. Medium- and long-term credit is coming from
20 accredited private commercial banks and from bilateral export credit agencies. Equity financing is being provided by Regional Enterprise Funds (REFs). REFs are managed by professional fund managers from market economies, operating on a commercial basis without the involvement of Russian government entities in their investment decisions. REF managers have been recruited from the investment banking industry on a competitive basis, with a large percentage of remuneration tied to realized profits.

**Ukraine:** The government's focus for enterprise restructuring has been to improve legislation, and strengthen the administrative capacity of public institutions responsible for privatization. Targets for privatization in 1994 were 32,000 enterprises and 1,680 unfinished units of construction. Procedures for dispute resolution, contract enforcement, and rights of appeal were being developed for expediency. Property rights were to be clarified, opening commercial real estate (land, housing, plant) to private ownership. Business registration and licensing procedures are being simplified. These measures are intended to reduce the bureaucratic obstacles and local regulatory abuses that have precluded private ownership, private sector development and business expansion in Ukraine. In anticipation of future privatization, pilot privatizations have been supported in four cities as models for future replication. These privatizations have been coordinated by the State (and Regional) Property Fund(s) and city coordinators. The government is supporting the de-monopolization of selected enterprises to stimulate competition and make privatization more affordable to more investors in the Ukraine. Much in the Ukraine will depend on policy reforms to stabilize monetary and fiscal policy and revive the moribund and largely informal economy. Reforms will also be influenced by outstanding disputes with Russia, and the state of relations with neighboring countries (including Russia) in the region. Recent election results suggest the new government intends to improve Ukrainian-Russian relations while accelerating reforms that will stabilize the economy. This will depend largely on donor assistance, restoration of trade with the former CMEA states, and increased trade with and investment from the West.

**FSU: Central and Southwest Asia**

**Armenia:** The government's focus for enterprise restructuring is to accelerate ownership privatization, largely to prevent further budgetary pressure resulting from SOE losses. The government intends to strengthen the Privatization Law of 1992, develop a comprehensive privatization strategy for SOEs, and reform SOEs to make them privatizable. The Privatization Law is expected to more clearly delineate the different roles of the Privatization Board and Privatization Commission. The Board will develop needed information and data base systems on SOEs. The Commission will be responsible for developing privatization strategy and implementation. Privatization strategy will involve developing targets and objectives for export-oriented industrial sub-sectors. Restructuring and privatization requirements are to be carried out within the context of these targets and objectives. Methods of privatization will include a voucher scheme, investment funds, leasing, employee and management buy-outs, joint ventures, and performance contracts. For SOEs that are not privatizable, the government is supporting efforts to "commercialize" the orientation and management of these enterprises. This is intended to contain SOE losses and their consequent drain on bank capital. To improve SOE performance, the government is encouraging greater management autonomy, accountability based on performance targets and evaluations, improved performance incentives, better management information systems, and preparation of
corporate plans for some of the large SOEs. The Ministries of Finance and Economy and other government bodies are to serve on Supervisory Boards.

- **Georgia:** The government's focus for enterprise restructuring is ownership privatization. The government is designing plans for mass privatization through the Committee for State Property Management (SPM). SPM intends to initiate pilot privatizations, with accelerated privatization to occur once the legal framework is in place and the country has had some time to stabilize. Georgia suffers from weak public sector capacity to implement privatization. As banks have been public enterprises (owned by the government), banking personnel are likewise inexperienced and incapable of leading restructuring efforts. SOE management requires significant levels of training and technical assistance to improve enterprise performance. The government is supporting such training.

- **Kazakhstan:** The government has focused on improving legislation, strengthening corporate governance, and developing a strategy for privatization. The government intends to de-monopolize the economy and encourage foreign investment. Anti-monopoly policies are intended to break State control of the economy, and stimulate competition. Internationally competitive tax rates and an efficient investment approval process are designed to attract foreign investment. Corporate governance is to be strengthened by the conversion of most medium- and large-scale SOEs to joint-stock companies, with property rights and functional Supervisory Boards. SOEs remaining in the public sector will be governed in similar fashion, with performance targets set for management and Supervisory Board powers to recommend changes in personnel at all levels. The government initiated a mass privatization program in 1994, with privatization vouchers distributed to 96 percent of the population. These vouchers can be used only for investment in one or more of 146 registered Investment Privatization Funds, sometimes owned by banks, which will bid on enterprises at auctions and manage their portfolios for maximum share value. By virtue of their ownership position in enterprises through the investment funds, banks may have a direct impact on the future operational restructuring of enterprises. However, it will take time to develop this capacity. The government expects privatization vouchers to be used for the privatization of 5,000 medium-sized SOEs by mid-1996. Case-by-case privatization will be an option for 200 large-scale enterprises. It is expected that smaller enterprises will be privatized rapidly, often through employee and management buyouts or other schemes which will reduce the cost of enterprises to the budget.

- **Kyrgyzstan:** Most restructuring or liquidation of large loss-making SOEs is expected to be in conjunction with the proposed BRA. The State Property Fund (SPF) will administer the privatization of small SOEs, and the restructuring, privatization or liquidation of large SOEs. The government is restructuring SOEs by reducing subsidies and transfers, converting these enterprises to joint stock companies with Supervisory Boards, and subjecting SOEs to the transitional State Purchases system. Non-viable SOEs are to be liquidated. Most industrial SOEs are to be reorganized into smaller units for eventual privatization. The government plans to privatize most SOEs rapidly, through mass privatization. Vouchers are to be used to privatize 70 percent of SOE fixed assets by 1996. Industrial SOEs and monopolies are being reorganized into smaller units to be affordable to domestic purchasers. A new **Law and Concept Note on Privatization** has been prepared to ensure competitive methods of privatization are used (auctions, investment funds, vouchers). All of these efforts are within the context of significant policy reform and improved legal and regulatory framework for
private sector development. The government has liberalized the State Order system, characterized by mandatory purchases of inputs from producer SOEs, and mandatory sales to other SOEs for further processing, storage and distribution. These transactions were all conducted under a price-controlled regime, protecting monopolies and limiting market development. Without competition and appropriate incentives, these SOEs became inefficient and accumulated losses. The government has reversed these policies, eliminating mandatory pricing, purchasing and sales. In its place has come the State Purchases system, where prices are freely negotiated between suppliers and purchasers. The government is strengthening the framework for private sector entry and foreign investment based on ownership and property rights, de-monopolization, and commercial legislation on contracts, bankruptcy, liquidation, secured transactions and intellectual property rights. State subsidies, transfers and subsidized credits to SOEs are being reduced. Meanwhile, the government is introducing commercial legislation to allow for court liquidation and bankruptcy procedures to facilitate future in-court procedures to instill financial discipline. This includes ownership and property rights, contract law, bankruptcy and liquidation procedures, and collateral, all of which will benefit the banks in the future.

- **Turkmenistan:** The government's focus for enterprise restructuring is privatization, although little has occurred in this domain. The government intends to develop a comprehensive privatization strategy for SOEs, with accelerated privatization of small SOEs and selective restructuring of potentially viable, larger SOEs. Privatization could develop within the broader context of overall private sector development. To achieve this, the government intends to propose remedial measures to ease barriers to competition, reduce preferential access to credit by SOEs, and identify other constraints that slow private sector development. Corporate governance is to be strengthened by providing training to Supervisory Board members of SOEs that will not initially be privatized. These SOEs will have performance targets set for management, and Supervisory Boards will be able to change personnel at all levels if these enterprises do not achieve targets.

- **Uzbekistan:** The government's focus for enterprise restructuring is institutional development at the Privatization Agency and Development Fund ("Uzgofond"), rather than having Uzbekistan's 24 banks take the lead. Technical assistance and training are being provided to the Privatization Agency and Uzgofond for public enterprise reform and privatization methodologies and strategies. Public enterprise reform involves improved management and corporate governance based on performance targets, improved planning, financial management, organizational structure, production schedules, market research and distribution. Privatization efforts involve partner searches for joint ventures, improved financial management, and development of data bases and information systems. Technical assistance is also being used to improve communications between regional and central offices of the Privatization Agency and Uzgofond, and to develop a framework for environmental liabilities.
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