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Credit contracts in transition countries: contractual problems and different solutions

1. Transaction-costs features of credit contracts

Credit contracts present interesting features from the point of view of transaction costs theory, even if they depend on the type of credit and on the agent being granted a credit. In particular, **long-term financing** of investment projects, in existing or newly created enterprise, is subject to important **level of uncertainty** (objective and subjective, due to information asymmetry between the two parties to the detriment of the banks granting credit) and the funds engaged are necessarily non-transferable. **Frequency** of transaction (in the sense of contract conclusion or re-negotiation with the same agent) is low. This kind of features would necessarily lead to high level of ex ante and ex post transaction costs and require special governance structures.

While it is fully admitted that in the relations between the banks and their customers in the credit business there is a high asymmetry between the partners brought about by the characteristics of the contracts [Cahuc 1993] the relevance of asset specificity hypothesis is subject to discussion. In principle, purely financial asset is supposed to have no specificity at all. But not when dedicated to the borrower in the particular credit contract. This type of contract (in its classical form) puts in fact the partners in highly asymmetric positions. The lender first has to bear the cost of risk-evaluation and to furnish the totality of his service while it is only after some time and over a long period that the borrower fulfils his obligations. The financial asset once engaged by the lender can not be withdrawn. Even if there is a legal possibility to sell the creditor's rights to another party, this is rather

exceptionally applied and not without a loss [Chavallier-Farat 1992]. Thus one of the partners, the bank, has to freeze its financial assets dedicating them for a long time for the transaction. This is why the financial asset borrowed by the bank may be treated as a specific asset dedicated to the transaction [Williamson 1994].

The credit contract (especially concerning investment project) is subject to a very strong uncertainty in objective terms due to both long time period and specific investment risk. But the limits to rational decision of both parties are unequal due to essential information asymmetry between them as to the perspectives of future revenue from the contract. While the borrower is affected only by objective risk, the lender bears additionally that of eventual unfair information submitted by the borrower [Sharpe 1990]. This is recognized as a potential source of adverse selection of borrowers [Bhattacharya Thakor 1992].

In fact the uncertainty of the credit contract for the bank depends on the type of the partner and of the type of credit (delay and subject of finance).

As types of clients one may distinguish:

- big and medium enterprises, their situation being subject to instability, but well observable (from external and internal resources); in this case the element of reputation and desire to continue the relation with the bank is a factor of importance reducing the opportunism of managers
- physical person: their situation is in general function of their (predictable) revenues and their behavior can be forecasted on the basis of the statistical analysis of their "reference group"
- small enterprises, being as well subject of instability and of difficult analyzability.

As far as the technical characteristics of the contract are concerned, the delay of repayment is important, long term credits being much more risky than short-term or subject to renewal, giving the bank an opportunity to ask for information at each term of the loan. The loan may

be better observed if granted for a well defined object – for example a precise investment project – on which the data may be requested.

In such a case the optimal solution should be either to organise a three-party governance structure (with an arbiter) or to reduce asymmetry by forcing credible engagement of the partner by taking hostages [Williamson 1994]., in the terms of guarantees and collateral in the formula of the agreement. Hostages may take the form of mortgage, collateral, caution, letters of guarantee of the other financial institutions or other according to the law in force in the particular society.

Nevertheless guarantees as hostages for the bank are subject to numerous deficiencies:

- their value and judicious status are often difficult or costly to verify and this verification (by the experts, by searching additional information) is costly
- they are rarely remitted physically to the bank and their recovery may be difficult, uncertain and costly due to the judicious procedure or to the difficulty to sell them
- often the clients do not dispose of any potential guarantee (they have no real estate, they can not present any letter of guarantee) or their institution (in the case of hostage on assets or blocking bank deposits) may considerably reduce the freedom of their operation and thus the possibility to repay the loan.

Asymmetry of information acquisition capacity of both partners and unequal distribution of their obligations in time in traditionally very complete contract exposes only one partner (the lender) to the opportunism of the other during contract fulfillment. This was the source of numerous arrangements that the banks seek to impose: contracts formulas postponing the part of obligations of the lender (credit installments, credit renewal), guarantee requirements, project monitoring and different forms of bank supervision (up to participation in property). Those efforts aiming at reducing risk mean nevertheless a substantial additional cost especially in the terms of information acquiring and processing.

The banks are practicing the sharing of risk in the case of big projects, in the form of a joint financing by a number of banks and their collaboration in control over the project. In this case competition between the banks gives way to cooperation by information sharing.

The other risk reducing solution implemented by the banks and replacing guarantees are of informational type. They enable better risk evaluation and are based on better contents of information or better use of information, or both. They are aiming at rejection of the most doubtful partners, thus reducing ex post transaction costs (at the expense, nevertheless, of higher ex ante information gathering and processing costs).

As far as the contents of information is concerned, it is now admitted in the banking theory that it is a resource of the value comparable with finance and it may be used as a commercial service highly appreciated in financial intermediation [Chevallier-Farat 1992].

An example of improvement of information contents may be that of gathering richer information on own actual or potential customers and their operations (thus the big bank is in a much better position than the small one), better organizing this information (centralization of information, using the form of databases, especially relational), using external sources of information (of rating agencies, of the central bank).

The example of better use of information are all the methods, sometimes very sophisticated, of risk evaluation, as scoring and grading of customers according to potential risk.

2. Specific transition countries problems relevant to credit contracts

In transition-phase countries the degree of difficulty of governance of those contracts is even more acute because of deficiencies of institutional environment (underdeveloped, and not covering all the conflicts, unstable and with insufficient enforcement) and of information accessibility (mostly due to the level of development)

A particularly heavy pressure of potential failure of relation (endangering the financial standing of loan granting banks) imposes an intensive search of private governance solutions.

The evolution of **general institutional environment** in Poland was one of the reasons of the sudden growth of irregular loans. The introduction of the market system required new rules of behaviour and, in general, a significant rise of freedom granted to the enterprises. In many respects liberalization has been exaggerated. For example, the system transformation made possible some irregular practices advantageous for debtors. In the framework of liberalization the interdiction to perceive proceeds in cash was abolished. So, even having it's bank accounts completely blocked, the enterprise could pay it's customers in cash and dispose of the proceeds as it wished [Zych 1992].

From the point of view of the relations of banks and debtors the problem has been not only changing rules, but as well (or mostly) the particularities of their enforcement. In a new system, where any political and administrative intervention was considerably weakened, the unsatisfied part of the contract had to address to the court to obtain sentence and an execution order. At this moment it encountered a sort of "barrier to approach" in the terms of:

- time: legal procedure can take several months or even years, even if the case is quite clear,
- cost: a party making a claim is obliged to depose an amount of up to 12% of the liability in question.

In Polish law there exists a Bankruptcy Law dating of 1934. For a special case of State-owned enterprise there was as well a possibility of liquidation and of bankruptcy (according to the laws: of 1981 on State-owned enterprises and of 1983 on restructuring of State-owned enterprise and on it's bankruptcy). In all those ways the bankruptcy procedure may take even years (and, in addition, the liquidation of State-owned enterprise may be postponed by 4 years for social reasons). Moreover, the dues of the banks are far from having priority: they pass

after costs of liquidation, due wages of employees for the last year, taxes and contributions due to social security for the last 2 years. In practice, if the credit has not secured by mortgage or hostage, it had little chance to be recovered.

Besides high costs of eventual claim there were as well another reasons of « **creditor passivity** » [Mitchell 1994]. The most important was that of low value of assets the creditor could hope to recover because of the number of other creditors (especially the number of trade creditors was unknown and potentially important because of exploding inter-firms credit) and underdeveloped real estate market. This issue will be developed further with respect to the guarantees included in bank credit contracts. Sometimes the creditors preferred to choose the « wait option » not being able to distinguish really insolvent or just illiquid (because of debt inherited from the past, lack of sufficient external finance, or deliberate collapse before manager's bail-out) debtors. For those reasons the creditors of an agent in trouble were often postponing their legal steps up to the situation when the borrower was deeply insolvent and the sentence of the court could not be executed.

Taking into consideration poor possibilities of legal enforcement of agreement execution, the credit agreements signed by the Polish banks should logically include large range of **guaranties and arrangements enforcing contract execution**. In Polish system the banks can theoretically use numerous measures foreseen in the Civil Code: mortgage, hostage or registered hostage on assets, letter of guarantee of a physical or moral person (including the other bank or the Treasury), drafting bill for guarantee, blocking deposits in bank, transferring rights to the loan granted to a third party, transferring of property of assets for guarantee [Bączyk 1991]. Nevertheless, most of those measures could not be used efficiently, due to the problems of information and of execution.

As to the letters of guarantee, in the case of projects of medium and large enterprises only those given by financial agents could be sufficient. The difficulty to obtain bank guarantee

becomes similar to this of credit itself once the non-performing loans problem was recognized. The system of guarantees of the Treasury have been formalized only in 1993.

Guarantees relatively sure for the bank in the case of bankruptcy - hostage and mortgage - have many deficiencies in Polish situation. It is due to numerous irregular legal situations inherited from socialist system and to the backwardness of those measures as compared to the needs of contemporary economy [Szmyt 1990].

In Polish reality mortgage records are often incomplete, especially when previous owners of real estate have been expropriated after the World War II. The records did not follow real transactions and investment so now a huge work should be done to put them in order. Many small and medium enterprises simply rent land and sometimes buildings so they have not any mortgage of their own. According to Polish legislation the parts of real estate can not be charged separately. The possibility to create a mortgage record on enterprise working assets (as a changing set) does not exist. Least but not last, as the real estate market is underdeveloped, often even mortgage can not assure satisfaction of interests of the bank (because real estate property in some regions is difficult to sell).

As to hostage, this form in it's simplest version (putting the object in temporary disposal of the bank) is practically unfeasible, because it necessitates huge storage surface managed by the bank. Some alternative possibility is registered hostage (assets out of physical disposal of the creditor, but registered as such in the court), which is nevertheless much less safe for the creditor.

In practice of in particular private enterprises at the beginning of transition very often the same assets were put in hostage to secure numerous agreements. As there was no sufficient information between creditors, they all could find themselves in a situation of impossibility to recover their dues. As the fact that the object is in hostage was difficult to discover (inter-

bank information being insufficient), the enterprise could even sell it to an innocent purchaser.

The consequences of those conditions – a diversity of appearing contractual, organizational and informational arrangements will be studied, together with the relations between them: substitution or complementarity, and the reasons of their adoption or abandon.

3. Trade-off of contractual and informational solutions

As has been mentioned, the solutions applied by the banks in order to reduce risk they have to bear when granting credit may be of different types:

- choosing the most reliable hostages,
- taking or promoting informational measures,
- elaborating organizational measures aiming at monitoring and influencing behaviour of the debtor.

The range of possible solutions (“opportunity set”) is determined and/or influenced by institutional environment (legal rules of general application and their enforcement) and by organizational structures (for example, the structures designed for keeping information records). This environment directly limits the scope of measures that can be applied in conformity with legislation in force (this is for example the case of guarantees one can require). Indirectly, institutional and organizational environment decides upon the level of transaction costs (ex ante and ex post) of any solution and thus should influence on it’s adoption or rejection [North 1990]. Nevertheless, between the objective level of transaction costs and decision to be taken there is a subjective perception gap and usually it is only after a certain time that the relative costs are perceived. In the case of credit contracts, due to their low frequency, the process of choice rectification may be particularly long and slowness of

adaptation may endanger the interests of the party in negatively asymmetric position, the banks.

The condition of particular importance in the case of credit contracts is still a very weak **enforcement** of legal rules. The experience of recovering debt on judicial way proved to be of very low efficiency and high cost, as mentioned above. It was not only due to the shape of bankruptcy procedure and of priorities of unsatisfied creditors, but as well to the general attitude of the juries, treating the banks as “stronger party” and thus favoring the debtors.

This condition forces the banks to adopt measures avoiding reliance on judiciary enforcement. One of those measures is credit scheduling and monitoring the standing of the debtor. It is the Banking Law obliging the bank to request regularly information about the project being financed and the financial standing of the enterprise. If substantial deterioration is detected, the contract may be broken off and the loan instantaneous repayment requested. This is, besides, in the case of bigger agents, the first signal of their insolvency given by the bank to the other commercial partners. Of course, enterprises try to disguise their difficulties in financial statements submitted.

A stronger formula of control over the behaviour of the debtor could be a partial integration, by taking by the bank shares in indebted industrial agents. This solution have been applied in conversion of debt into shares in the framework of the Law on Financial Restructuring of Enterprises and Banks of 1993 [Lachowski 1995] concerning non-performing loans unconsciously granted in the early 90's. This solution has not been positively evaluated due to the disastrous initial situation of debtors and lack of specialized personnel in the banks.

The other institutional condition forbidding the banks to acquire too much shares in industrial agents have been the prudential rules of the Banking Law: no bank is permitted to have than 25% of it's own equity as credits to one enterprise. This rule is due to risk concentration

avoidance. Even if the rule does not concern shares, the banks are reluctant to get engaged as co-owners.

The same prudential regulation forbidding risk exposure invites the banks to take a measure of risk sharing by creating a consortium of banks in order to finance big projects. The advantage of this solution, meaning local suspension of competition between banks, is a possibility of information sharing between creditors.

Both weakness of enforcement and of generally accessible information records influenced the choices of guarantees. After introduction in 1996 of the Law on Registered Hostage those guarantees became much safer. Nevertheless, due to the length of procedures of registration, the creditor can not be absolutely sure about the state of those guarantees. The same is relevant to the case of mortgage.

This is why arrangements on guarantees giving to the bank an opportunity to maximally avoid judicial enforcement are very willingly required. This is, besides mortgage and hostage the case of blocking the part of deposits of the potential debtor or of temporarily transferring property over hostage to the bank. Of course, those guarantees, excluding the agent of their use or heavily complicating use, are accepted by the debtor only with extreme difficulty.

The other measure, largely applied by the banks, is that of the **bank's execution title**, used as an institutional complement to guarantee requirement. This is a possibility granted by the Banking Law to the banks as specially faithful (and exposed to risk) agents to prepare a project of execution order needing only rapid approval by the court. This gives an opportunity to avoid the long judiciary verification of proofs. This measure, very often applied by Polish banks nowadays, needs a preliminary (before contract signature) consent by the debtor. Nevertheless, as regularly required by the banks enjoying of somehow monopolistic position, this type of consent is habitually accepted.

It is evident, that safe taking of the “classical” guarantees and monitoring the behaviour of the debtor requires information gathering and processing. The fulfillment of those tasks may be based on public information resources or the records private to the banks. Their role may be different as well: that of securing guarantees (complementarity) or replacing them (substitution).

The typical information records used as complements for the secure taking of guarantees are registered hostages and mortgage books. Those are, for obvious reasons, public records. Nevertheless, the banks as interest group have been lobbying for voting of the Law of Registered Hostage and for initialization of registers by the courts.

Private information resources of the banks are used for verification of some guarantees. In the case of the letter of guarantee of a physical or moral person, her financial standing may be verified or on the movements on accounts in the bank (in the case of client) or on the information in the interbank Bureau of Credit Information (will be described further) or the case of a big enterprise, on the rating of a specialized agency.

As in all the developed countries, due to deficiencies of guarantees in unstable modern society and in economy disposing of numerous measures of funds transfer, there are efforts for replacing them by information and it's risk-detecting analysis.

The first, organizational, measure, has been the initiative of the Polish Society of Banks in the mid-90's to create the record of unreliable debtors especially those trying to get credit in many banks in parallel. A special organism (Bureau of Credit Information) has been finally created. Up to now, this Bureau is struggling with different institutional and technical obstacles. The first problem is a conflict between centralizing information on physical and moral persons and the principles of privacy of information. The other, more technical problem, have been deficiencies of information systems of different banks supposed to transfer data to the central database. Those systems have been often decentralized, organized

as flat files and not databases. There were incompatibilities even between data identifying clients in different banks, thus one could not know whether the client is the same or different. The other effort of the banks have been to use internal information for scoring credit requests of the clients (or, in the case of enterprises, rating them in different risk groups). Those efforts have been made in majority of banks. In the case of rating enterprises requirement came from Banking Supervisory Commission and obligatory reports. Nevertheless, the value of the scores obtained is doubtful due to above-mentioned deficiencies of internal and external information. Thus, those measures can not really replace guarantees, but rather be used in parallel (for example, to avoid evidently unfeasible customers).

4. Dynamics

Finally, some ideas will be exposed on the process of adjustment, in typical for a transition country situation of a very deficient initial set of governance mechanisms.

The initial change in co-operation networks and institutional conditions have been so deep that the banks found themselves in competition – decision gap as to credit granting. They undervalued information asymmetry, opportunism of the debtors and weakness of enforcement of legal claims. It was why the burden of non-performing loans grew so fast in the early 90's.

For the further adaptation of governance solutions the contractual characteristics of credit contracts have been of crucial importance: namely their low frequency and high asset specificity. Thus the only mechanism of competition proved to be insufficient for adaptation. The degree of rigidity of contracts concluded endangered solvency of the banking system in general. In this situation the intervention of the state in the terms of financial aid and as well of redesigning of governance measures have been necessary. This has been formulated in the Law on Financial Restructuring of Enterprises and Banks of 1993.

The following elements of dynamics of institutional environment and of proportions of costs are of crucial importance for the choice of governance structures by the banks:

- still very weak, unreliable and costly judicial enforcement
- slowly emerging with high cost, but still too scarce information sources on actual or potential debtors.

In this situation the banks choose:

- generally, to be very prudent and rather discourage potential customers (this, of course, is contrary to the requirement of profit-seeking); the result of this contradiction are periodical waves of particular credits granted, supposed less risky or better secured – for cars, for apartments, as credit line,...., all of them finally provoking the echo-wave of non-performing loans
 - to require high value of guarantees and to choose the measures avoiding judicial enforcement
 - under incomplete security of guarantees and information tools, combining both and usually using multiple guarantees in parallel
 - under insufficient information, the measures aiming at discouraging doubtful partners (relatively high interest rate - about 20% nominally, and high guarantees required) may have some adverse selection effect (discouragement rather of the customers with “normal” financial standing than those in really difficult situation)
- [Mesjasz 1999].

As a result, nowadays the phase of contract preparation is heavy in ex ante transaction costs. This is aiming at avoiding even heavier ex post transaction costs (or a loss due to non-recovery of the loan).

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