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**KPMG Peat Marwick, LLP  
(Barents Group LLC)**

**Bank of Latvia: Strengthening Credit Institution (Bank) Supervision, Phase II  
Final Report**

(This Report includes information for the Second Quarter Report period ended June, 1997)

Project # 1100-005

Contract # EPE-0005-1-00-5048-00

Task Order #5

Name of Contracting Officer's Technical Representative (COTR): Ms. Jean Lange

**Prepared by Lori Bittner Yerzyk, Project Coordinator  
with information from Resident Advisor Kathryn Woolford**

**June 1997**

## **Background**

This technical assistance program, which commenced February 1, 1996, was carried out in accordance with the Task Order referenced on the cover page. The team structure consisted of:

Washington, DC  
James J. Hightower, Project Manager  
Lori Bittner Yerzyk, Project Coordinator

Riga, Latvia  
Kathryn Woolford, Onsite Resident Advisor

The objectives for the Task Order were to assist the Credit Institution Supervision Department of the Bank of Latvia:

- (1) to strengthen and refine its supervision and monitoring capabilities;
- (2) to develop efficient and appropriate enforcement mechanisms; and
- (3) to develop the procedures to deal with problem banks, including liquidation techniques.

## **Tangible Results/Benchmarks**

The Tangible Results to be achieved as a result of the technical assistance as reflected in the Task Order are as follows:

1. The Credit Institutions supervision authority will have examined all licensed banks according to an annual schedule based on priority.
2. The credit institution supervision authority will have developed a basic examination manual based on CAMEL components (capital adequacy, assets, management, earnings and liquidity), which is used during on-site inspections.
3. The on-site examination manual will have been customized to Latvian conditions and refined based on testing of policy and procedures during on-the-job training at on-site inspections.
4. Selected BOL inspectors will have been trained as specialists in key areas of the manual so that they can become trainers.
5. The credit institution supervision authority will have developed standardized documents relating to on-site examinations e.g., request letters to bank management, and formatted working papers, but focusing on reports of examination and the written and oral communication of conclusions.
6. The credit institution supervision authority will have developed a training program for inspectors which leads to certification.
7. The credit institution supervision authority will have developed a manual or guidelines regarding the rehabilitation, merger, acquisition, liquidation of failed credit institutions.

8. BOL staff will have been trained in international accounting standards so that they can ensure that the banks are using IAS properly as required by law.

### **Brief Summary of Banking Sector Activities**

The Latvian financial system has gone through significant changes in both its composition and stability during the period of this project. It currently has 35 banks of which 15 are allowed to take private person deposits. The system has features of universal banking and many of those banks not allowed to take private person deposits are not deposit taking banks, but securities brokerage firms, foreign exchange banks or trust operations, therefore their ability to take private person deposits is not a clear reflection of their condition.

The Law on Credit Institutions was enacted in November of 1995. It has been in full force for 18 months and has been enhanced by some minor changes. As amended, it is in more or less full compliance with the 25 core principals of banking as set forth by the Basle Committee. Commercial banks are generally in compliance with all tenants of the law and operate in a generally safe and sound manner. A milestone for some of the lowest capitalized banks will occur in April of 1998 when they are required to increase their capital to LVL 2 000 000. At that time, merger or surrender of their license will be some of the options exercised by the approximately seven banks estimated to fall (remain) below the required capital level.

Problem banks continue to exist within the financial system, but problems are not pervasive throughout the system and are resolved in an orderly and conservative manner. The Bank of Latvia supervision staff is generally aware of all problem conditions within the financial system.

### **Current Activities**

The workplan developed to carry out the task requirements indicates the following activities would occur during the current quarter:

- classroom training developed and given in communications, advanced credit institution supervision topics and credit analysis.
- on-the-job training geared to chapters in the manual begun during on-site inspections.
- revision/refinement of manual chapters has begun
- the BOL has identified those staff to receive specialist training
- seminars with banking community held on on-site supervision and corporate governance
- on-site examinations take place as scheduled

Many accomplishments were achieved during 1997. These accomplishments have led to the completion of the requirements of the Task order. The tasks and the progress made toward their completion are detailed below.

1.a. The advisor will be responsible for assisting the Credit Institution Supervision Department ("CISD") in completing the inspection schedule for all licensed banks.

All banks are scheduled for examination during 1997. All banks have been routinely examined by the supervision staff for the past three years. The examination schedule is reasonable. Senior supervisors are rotated from bank to bank, therefore, creating no special relationships between senior supervisors and banks. Examinations are carried out on a surprise basis. The examination staff maintains a more or less continuous presence at the largest institutions and problem banks. Off site examiners maintain a generally good level of communication with the banks in their portfolios.

2. The advisor will assist the CISD in refining examining/inspection techniques.

The Bank of Latvia CISD examination techniques are modern and effective. To the extent possible, examination techniques are equivalent to those currently in use in the United States. Federal Reserve examiners working with this contractor through the FSVC have brought modern and up to the minute examination practices as a part of this program.

Six members of the Bank of Latvia supervision staff attended structured training programs in the United States. The most recent attended the Financial Analysis school presented by the Federal Reserve Board in Washington, D.C. During these training classes, they not only learned the relevant material taught but compared practices and policies with examiners from other countries.

The Bank of Latvia Bank Examiners Handbook is up to date and treated as a dynamic body of work and reviewed and updated as necessary.

3. The advisor will provide support to the CISD to further enhance regulatory practices through implementation of a risk-based supervisory approach.

Risk based supervision as promulgated by the Basle Committee has been adopted by the CISD. Bank capital is evaluated in proportion to risk weighted assets. Examiners have a good working familiarity with the aspects of various risks elements pertaining to areas such are investment, lending and foreign exchange.

4. The advisor will assist the BOL in the implementation of formal guidelines and standards to ensure that regulatory responses to specific bank problems are appropriate.

Since the banking crisis of 1995, the Bank of Latvia has worked diligently in developing appropriate responses to specific bank problems. In this regard, it has taken a unique approach to addressing problem institutions and sanctions.

By publishing those banks which are allowed to take private person deposits, it has created a high level of transparency in addressing problem institutions.

Recently, the Bank of Latvia has put forth changes to the Law on Credit Institutions which address bank bankruptcy and give additional powers to the Bank of Latvia in this area. This strengthening of the law increases the power of the bank to address problems and to respond in a timely manner.

5. The advisor will provide support to the BOL in the inspection and resolution of problem banks and in the development of Enforcement Action guidelines and standards for troubled banks.

During 1997, problem banks were on the decline within the financial system. Progress was made in strengthening regulations and the Law on Credit Institutions, but existing enforcement action guidelines have been in place for approximately a year and continue to function well.

6. The advisor will provide guidance to the BOL to assist in the strengthening of banking laws and in implementation of International Accounting Standards.

The International Accounting Standards and the International Standards of Auditing have been translated into Latvian. This will be a land mark in the establishment of accounting and auditing standards for Latvia. Due to some misunderstandings, and the extreme difficulty at arriving at proper translations of some of the accounting terminology, neither the IAS or the ISA translation had been published by the end of the resident advisor assignment. The Bank of Latvia elected at the eleventh hour to request permission to publish the IAS and took over all of the review work to prepare for publication. If approval for this publication is obtained from the IASC then the work will be published in the fall of 1997.

The first draft of the ISA was delivered to the Latvian Association of Sworn Auditors at the close of business on Monday, 30 June 1997. The request for rights to publish the translation were requested by this association from the International Federation of Accountants. During the preparation of the first draft of the translation for the ISA, assistance was promised from the LASA but no assistance materialized due to conflicts within the Auditors Association.

Despite the aforementioned difficulties, both documents were translated and this project is considered to be completed. The World Bank has a project proposed which will continue with this program and will fund publication of both work products and will work on developing an accountancy education program in Latvia.

An accounting specialist within the Methodology Department of the Bank of Latvia worked very closely on the translation project and now works with both the

bank supervisors and the banking community on information and clarification for the International Accounting Standards. All supervisors will have a copy of the translated standards for their use and have been given a general overview of the standards and their use.

7. The advisor will assist the CISD in developing ongoing training programs for inspectors and bankers.

A comprehensive training program was developed and delivered during the project. Supervisors were trained as specialists in the areas of foreign exchange, securities, trusts, problem banks, money laundering and other fraudulent activities, and derivatives. Course presentations both general and specific were given in the analysis of financial statements, loans and risk. Outside experts delivered lectures on the role and function of multinational banks and the operation of the Latvian Stock Exchange.

Mr. A. Steinbergs, Department Head of the Credit Institutions Supervision Department, is committed to training and development. He has devoted time and attention to the improvement of the education and experience of the supervision staff. He recognizes that the training and development of credit institutions supervisors will never be complete. As each new investment product or lending vehicle or operations practice arises within the banking community there will be a further need to educate the supervisors. This is an area which has great potential for further development. An internship project is in development in cooperation with the Latvian Banking Academy. See the attached memorandum, Beyond Strengthening Bank Supervision.

8. The advisors will assist the CISD in establishing comprehensive internal communication systems.

The CISD has developed an effective internal communication system. It is as open and transparent as that of any western country. The senior management of the CISD is open and communicative and the staff is generally well informed.

9. The advisor will provide assistance regarding priority issues facing the BOL, as requested.

During the two years of this resident advisor's project, a Deposit Compensation Program was developed, a system of guidelines for bank liquidation administrators was set up and many other activities were performed based on requests from the Bank of Latvia.

**Progress in Achieving the Benchmarks To Date**

The following Benchmarks were anticipated to be completed by quarter end June 1997:

Classroom training developed and given in communications, advanced credit institution supervision topics and credit analysis.

  X  met          unmet

On-the-job training geared to chapters in the manual begun during on-site inspections.

  X  met          unmet

Revision/refinement of manual chapters has begun

  X  met          unmet

The BOL has identified those staff to receive specialist training

  X  met          unmet

Seminars with banking community held on on-site supervision and corporate governance

  X\*  met          unmet

(Partially met - no formal Outreach Seminars were conducted in which all bankers were invited as a group. However, the BOL and Advisor Kathryn Woolford had ongoing contact with the banking association, the Latvian Banking Academy, and other donor projects which impact the financial community.)

On-site examinations take place as scheduled

  X  met          unmet

## STATUS OF THE TANGIBLE RESULTS

**1. The credit institution supervision authority will have examined all licensed banks according to an annual schedule based on priority.**

Complete

**2. The credit institution supervision authority will have developed a basic examination manual based on CAMEL components (capital adequacy, assets, management, earnings and liquidity) , which is used during on-site inspections.**

Complete

**3. The on site examination manual will have been customized to Latvian conditions and refined based on testing of policy and procedures during the on-the-job training at on-site inspections.**

Complete

**4. Selected BOL inspectors will have been trained as specialists in key areas of the manual so that they can become trainers.**

On going

**5. The credit institution supervision authority will have developed standardized documents relating to on-site examinations e.g., request letters to bank management, and formatted working papers, but focusing on reports of examination and the written and oral communication of conclusions.**

Complete

**6. The credit institution supervision authority will have developed a training program for inspectors which leads to certification.**

Complete. 30 examiners received certification in a ceremony during the month of May. This was after the completion of three separate proficiency tests which assessed knowledge of banking law and regulations, general accounting knowledge, knowledge related to the Latvian bank chart of accounts, understanding of risks and trust, and credit evaluation proficiency. The final test was a case study which further evaluated the individual's knowledge and application of the above.

**7. The credit institution supervision authority will have developed a manual or guidelines regarding the rehabilitation, merger, acquisition, liquidation of failed banks.**

The CISD has extensive guidelines concerning the above named elements for the resolution of problem banks.

**STATUS OF THE TANGIBLE RESULTS - continued**

**8. *BOL staff will have been trained in international accounting standards so that they can ensure that the banks are suing IAS properly as required by law.***

Ongoing. This training is being carried out by the bank staff. All examiners have access to the translated standards and to the official English version. There are staff members who are fully conversant with the standards who stand ready to answer questions posed by examiners and banking staff as needed.

**Project Administration**

**Task Order Data:**

Total level of effort	562
Total estimated costs	\$781,354

- |  |                     |
|--|---------------------|
| a) Cumulative Level of effort (estimated as of 6/30/97): | 413 workdays or 73% |
| b) Unused level of effort:                               | 149 workdays        |
| c) Cumulative Expenditures (estimated as of 6/30/97):    | \$545,940 or 70%    |
| d) Remaining unexpended balance                          | \$235,414           |