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October 18, 1996

Ms. Jean Lange
Senior Financial Advisor
USAID
SA15, Room 3236
ENI/PER
Washington, D.C. 20523-0039

RE: National Bank of Lithuania-Strengthening Bank Supervision: Contract No. EPE-0005-I-00-5048-00, Task Order # 4

Fourth Quarter/Completion Report-- September 30, 1996

Dear Jean:

The fourth Quarterly Report which is also the Final or Completion Report as required by the above noted Task Order is enclosed for your review. Task Order No. 4 ended as of October 1, 1996 and our Onsite Resident Advisor Diane Buckshnis returned to the United States.

During the term of our technical assistance program, under this Task Order and a previous contract, several changes and significant progress in the Bank Supervision Department of the Bank of Lithuania were realized. The supervisory process became more structured and institutional changes were implemented. Specifically, the achievements include the development and implementation of:

- an onsite inspection function;
- an onsite inspection policy and procedure manual;
- a standardized Report of Inspection format;
- an inspector cross-training program; and
- appropriate supervisory response techniques.

Also of importance, the Bank Supervision Department completed onsite inspections in all commercial banks. The Bank Supervision Department has now begun the 'second- round' of reviews.

During the tenure of our Problem Bank Advisor, Michael Edwards, efforts were made to assist the division responsible for the oversight and resolution of troubled institutions in establishing internal systems, policies, and controls. This guidance has proven to be very valuable as Lithuania works to resolve problems and strengthen the financial system. As a follow-up to Mr. Edwards' efforts, a short-term advisor, provided guidance to the problem bank department for approximately one week at the end of September, 1996. She provided insight to problem bank resolution techniques in a neighboring country and also methods used in the United States.

Overall, the Resident Advisors, complemented by short-term advisors, have successfully achieved the Objectives and addressed the Task/Work Requirements as outlined in Article IV and V, respectively, in the Task Order. The Task Order divided the project into two phases. The onsite resident advisor remained in-country for both phases while the problem bank advisor departed after the completion of the first phase. Even with the early departure of one advisor, compliance with Article VI, Tangible Results and

Benchmarks, was achieved for Phase I and substantially achieved for Phase II. One Tangible Result for Phase II was only partially met and is described in detail in this Final Report in addition to previously submitted Quarterly Reports.

All Deliverables as required by Article X, Reporting Requirements, were met. Reports were submitted each month during the term of the project highlighting activities accomplished based on the individual advisors' Workplans. Quarterly Reports dated January 31, 1996; April 30, 1996; and July 31, 1996 were also provided. The Quarterly Reports outlined progress made in achieving the Benchmarks and Tangible Results on a periodic basis, and detailed any hindrances to achieving the stated goals that arose during the quarter.

We appreciate the opportunity that we have had to assist the Bank of Lithuania in strengthening the bank supervision and problem bank functions both under this Task Order and prior contracts. We acknowledge the progress that has been made and congratulate the Bank Supervision and Problem Bank Departments in their efforts. We also appreciate the cooperation and efforts expended by both Washington and in-country USAID staff.

If you have any questions regarding this Final Report or previously submitted reports please telephone me at (202) 331 - 4549.

Sincerely yours,

Lori Bittner Yerzyk

Lori Bittner Yerzyk
Manager

cc: Mr. Aldas Kriaucinas, USAID- Vilnius, Lithuania
USAID- Directorate for Policy, Washington, DC (2 copies)
Ms. Marie-Renee Bakker, IBRD, EC4PE, Room H7123
Project File

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KPMG Peat Marwick, LLP
(Barents Group LLC)

National Bank of Lithuania- Strengthening Bank Supervision Final Report for the year ending September 30, 1996

Contract # EPE-0005-1-00-5048-00
Task Order #004
Name of Project Office: Ms. Jean Lange
Name of Contracting Officer's Technical Representative (COTR): Mr. J. Grossman

Prepared by Lori Yerzyk, Project Coordinator
with information provided by Resident Advisor Diane Buckshnis

September 30, 1996

Background

This technical assistance program, which commenced November 1, 1995, was carried out in accordance with the Task Order referenced on the cover page. The team structure consisted of :

Washington, DC
Lori Bittner Yerzyk, Project Manager

Vilnius, Lithuania
Diane Buckshnis, Onsite Inspection Resident Advisor

The technical assistance was divided into two parts: Onsite Inspections and Problem Bank Rehabilitation. The Problem Bank Advisor's role ended at year end 1995 at the conclusion of Phase I of this Task Order. The objectives of the technical assistance were to assist the Bank Supervision Department of the National Bank of Lithuania ("BoL"):

(1) to strengthen and refine its supervision and monitoring capabilities;
(2) to develop efficient and appropriate enforcement mechanisms; and
(3) to develop the problem bank unit at the BoL and to institute liquidation techniques for failed banks.

ONSITE SUPERVISION

Tangible Results

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

Phase II (January 1, 1996 through October 1, 1996)

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

_X_ Met ____ Not Met

2. The bank supervision authority will have developed a basic inspection manual based on CAMEL components (capital adequacy, assets, management, earnings and liquidity), which is used during onsite inspections.

X_ Met ____ Not Met

3. The bank supervision authority will have developed standardized documents relating to onsite examinations e.g., request letters to bank management, reports of examination and formatted working papers, which they are using for every onsite bank inspection.

X_ Met ____ Not Met

4. The bank supervision authority will have developed an internal training program for inspectors.

X_ Met ____ Not Met

5. The bank supervision authority will have completed a manual and guidelines regarding the rehabilitation, merger, acquisition, liquidation of failed banks, which they have used in dealing with problem banks.

X*_ Met ___ Not Met (*Partially Met)

6. New commercial law has been submitted to Parliament, which strengthens bank supervision authorities.

X_ Met ___ Not Met

The Tangible Results were fully achieved with one exception. Tangible Result #5, was Partially Met as the problem bank advisor's tenure ended at the completion of Phase I. The Problem Bank Advisor, while in-country provided assistance in the development of a policy manual. However, the finalization and full implementation of this manual did not transpire due to his departure. Guidelines and policies that were developed by the advisor are being used, but potentially, additional efforts in this area may be needed.

Final Report Summary --Phase I and II of the "Strengthen Bank Supervision" National Bank of Lithuania:

The National Bank of Lithuania ("BoL") project progressed according to the Tasks outlined in the Omnibus Contract between USAID and KPMG Peat Marwick/Barents LLC, and for the most part, the Benchmarks were achieved. The project was divided into two phases with Phase I ending in December 1995. In addition, the project was divided into two parts: one part being that of onsite inspection technical assistance, and the other part being problem bank rehabilitation technical assistance. At the request of the BoL, the problem bank rehabilitation technical assistance ended after Phase I. Therefore, limited assistance in the problem bank area was provided during Phase II.

Summary

BoL Management
During this technical assistance program, a tremendous amount of activity occurred within the Central Bank and Banking Supervision department. Moratoriums placed on two banks in December 1995, sent the banking system into a "crisis" situation. Several senior officials were asked to resign including the Governor, the Director of Banking Supervision and two Deputy Directors-- Onsite Inspection and Policy & Regulation. A new Governor was appointed in February 1996 and a new Director of Banking Supervision was named. The Deputy Director in charge of Policy & Regulation did not resign and she still remains in that position today. Under the new regime, the entire Central Bank was restructured. The inspection team grew from a staff of 10 to 19, which includes one Manager of the Inspectors. The staff has since been reduced to 16 as two inspectors are on personal leave, and one inspector was promoted to an offsite monitoring position. In September 1996, a new Deputy Director of Onsite Inspection was hired.

Onsite Inspections
All banks have received an inspection and the second cycle of reviews have begun as of August 1996. Of the 20 banks that were operating one year ago, only 11 remain fully operating. Two of the eleven are State owned. The inspection cycle took approximately two years to complete all 19 banks with one bank being closed without any inspection.

As of this date, there are 11 credit unions and an inspection cycle has yet to begin. Currently, three inspectors have been selected to work in this area and it is anticipated that the credit union cycle will begin next quarter. A formal inspection process or procedures have yet to be developed for these inspections.

Inspection Process/Procedures

The inspection process for banks has been standardized and are based on the CAMEL system adopted by regulatory agencies in the United States. An additional component "F" for Foreign Currency Exchange Management was added to adapt to the Lithuanian standards. An inspection protocol was approved by the Central Bank Board which outlines the procedures of the inspection process and Inspection Report completion timeframes.

At the conclusion of the inspection, an exit meeting with management is held where the inspectors provide preliminary conclusions and findings. Inspection Reports are then prepared using a standardized format. For each 'macro' area, the Report contains a scope of work; concise conclusions and supporting details; strengths and weaknesses; and recommendations for problem resolution. The bank is given the Inspection Report and a response to the Report within a specific timeframe is required. The Inspection Report and the bank's response is then reviewed by Banking Supervision officials, and an Executive Summary and Letter of Recommendation is then presented to the Central Bank Board for approval or denial of specific sanctions.

The loan classification process is standardized with lineslips being created for all loans reviewed. Liquidity and asset/liability management procedures utilize a simplified maturity matching schedule similar to the GAP analyses utilized in the United States. Earnings and Capital also have standardized ratios for analyses of adequacy, stability, and trends.

The Inspection Manual is not complete but a commitment for the completion of the manual was received from the Director of Banking Supervision in August 1996. The manual is expected to be completed by December 1, 1996.

The off-site monitoring department within Banking Supervision was also restructured. A new Division Manager was appointed along with a Deputy Manager in charge of the early-warning system. The Deputy Manager is a former senior inspector that worked with the resident Advisor on creating the early-warning system under the guidance of a EU Phare consultant. The early-warning system was placed on-line in August 1996 and its implementation, which included training of off-site analysts and senior officials, began in late September 1996. Future work in this area will be necessary especially once International Accounting Standards (IAS) are implemented.

Training Program

Inspectors have been trained in all 'macro' examination areas. A train-the-trainer or "cross-training" method was used which identified individuals to be 'specialists' in an examination area. It is anticipated that these 'specialists' will provide training to others going forward.

Problem Bank Resolution

At the conclusion of Phase I, the BoL chose not to extend technical assistance in this area. During Mr. Edward's tenure of one year, 11 banks were placed into the Problem Bank division. Currently, a total of 15 banks are in the division with 13 being in some form of liquidation. Two banks are not being liquidated, but have administrators that the BoL is working with regarding rehabilitation plans. One of those two banks is State owned. Recently, one of the 13 problem banks was converted into an Asset Management Bank which will purchase bad loans within the system. However, the laws and means in which the assets will be transferred has yet to be established.

Assistance in the problem bank area was provided by a short-term advisor in late September 1996, for a one week period. The advisor assisted in reviewing the problem bank division's procedures for handling bankrupt banks and provided suggestions on current liquidation laws and regulations (refer to the Appendix section for additional information.)

Banking Law/Decrees

During the year, key laws were passed which will effect the banking system in the future. They include:

- Deposit Insurance Law was passed, but the Ministry of Finance has yet to appoint a Deposit Insurance Administrator. A U.S. Treasury Advisor working in this area recommended waiting until the fourth quarter of this year or the first quarter of next year prior to appointing an Administrator. The main reason for this recommendation was to wait until the implementation of IAS standards which most likely will cause further financial impacts to the banks (see Conclusions and Other Matters section of this Report).

- Laws and regulations were passed governing the establishment of credit unions. As of this date, 11 credit unions have been licensed with a membership totaling about 600 members. The credit unions comprise less than 1 percent of the total assets within the financial system. Future technical assistance may be required in this area to assist the onsite inspectors in supervising credit unions.

- Laws and regulations governing the establishment of foreign banks were revised. However, foreign banks have yet to enter the market due to the current banking situation. Three banks within the system have foreign investors that are major shareholders.

- The BoL's regulations surrounding accounting and the chart of accounts will need revisions beginning in January 1997 when compliance with IAS standards will be mandated.

In summary, all Tangible Results were achieved and the Benchmarks were substantially met for both Phase I and Phase II - Onsite Supervision Strengthening technical assistance. The Problem Bank Rehabilitation advisor met all Benchmarks and Tangible Results for Phase I.

Brief Summary of Banking Sector Activities during the period:

This Report covers the period from August 1, 1996 to September 30, 1996. It is the Fourth Quarter Report and also the Final or Completion Report as the Task Order ended at October 1, 1996.

During the two month period, another bank filed for bankruptcy during the period which increased the total number of banks in bankruptcy to 13. In addition, at one of the State Bank's, shareholders voted the share capital to zero as required by Article 34 of the Law on Commercial Banks of Lithuania. An administrator is in the bank and the bank is operating under a limited license arrangement. A business plan or management plan has not been submitted.

Currently, there are 15 banks with administrators of which two are operating under either a moratorium or a limited license. The one bank operating under a moratorium is currently attempting to convince large depositors with frozen accounts to convert those funds into share capital. This method would raise capital and allow the bank to re-open. However, if this method does not raise sufficient capital, the depositors will only receive 4,000 litas from the recently passed Law on Deposit Insurance. The resolution of this bank will be known in the fourth quarter of this year.

The World Bank signed an agreement with the Government, Prime Minister, Minister of Finance, and Bank of Lithuania for a Structural Adjustment Loan (SAL). The SAL Agreement places a tremendous amount of responsibilities onto Banking Supervision. Lithuanian delegates recently visited Washington DC to discuss the first tranche funding.

On a more positive note, Director Ramonas appointed a Deputy Director to Banking Supervision during the period. This individual has experience in Banking Supervision and banking. She came from one of the banks that was placed under a moratorium in December 1995 in which she was the appointed administrator. Her direct responsibilities include oversight of the onsite inspector staff.

Current Activities

The workplan developed to carry out the task requirements indicated that the following activities would occur during the fourth quarter of this project:

- All banks will have been examined under the new standards.
- Two inspectors will have a good understanding of the capital markets area.
- Cross training in all 'macro' areas of the inspection process will continue.
- Techniques to allow for a more efficient and effective process of planning the inspection schedule will be introduced.
- Approval from the Central Bank Board on additional Inspection Manual Chapters will be received.
- "Pre-scoping" techniques for the second round of banks will have been introduced.
- The chapters of asset quality and asset/liability management will have been tested in the field.
- Continued guidance will be provided to BoL to assist in the development of a system for communications (internal and external)
- Assistance will be given to the BoL, as requested, for instance, in the area of external audit.

Specific activities that have occurred during the period are (as compared to the Workplan):

Task #1 - Continue with the implementation of the inspector's schedule for all licensed banks:

1.a. Comments: This goal was achieved. All banks within the system have been inspected according to the new standards. An inspection schedule has been planned through year end. Inspections have not been based on early-warning system indicators, but on the timing since the last inspection.

1.b. Comments: This goal was achieved and the Advisor participated in all inspections .

Task #2: The Advisor will assist the BoL in refining examining/inspection techniques:

2.a Comments: This goal was achieved. Cross training in all the macro areas occurred. One inspector is fully trained in the area of capital markets. Two inspectors had been fully trained which met this goal, but one inspector left in September 1996 due to maternity leave.

2.b Comments: This goal was achieved. The Advisor provided training on IAS methodology for asset classification as the BoL's regulations do not parallel IAS standards. The Advisor was unable to provide training on present value cashflow techniques as financial statements or cashflows of businesses are not reliable due to inadequate tax laws. Nonetheless, continued discussions between the Advisor and the inspectors on the accounting methods for impairment cost occurred. The Advisor worked with the inspectors on understanding the difference between a specific loan loss reserve and general reserves and when each reserve would be applicable.

2.c Comments: This goal was achieved. The Executive Economist (inspector) is fully trained in all areas of the inspection. His expertise is well recognized within Banking Supervision and he was offered the position of Deputy Manager of onsite inspections. He declined the promotion as it is his belief that he needs a couple more years of experience as an onsite inspector prior to fulfilling this managerial role. He was instrumental in assisting in the completion of one of the largest State owned banks. He assisted those inspectors that required help in completing their sections of the Inspection Report. He then edited the Inspection Report prior to submission to the Director of Banking Supervision and completed the Executive Summary and Letter of Recommendation for the Central Bank Board's meeting. This role of assisting the inspectors, editing and oversight, and Central Bank Board participation has never been performed by one person before in the inspection division.

Task #3: The Advisor will provide support to the BoL to further enhance regulatory practices through implementation of a risk-based supervisory approach:

3.a Comments: This goal was achieved. The inspectors are divided into two teams based on specialties. Cross-training occurred during this quarter under the guidance of the Advisor and continued cross-training will occur in the future.

3.b Comments: This goal was achieved in part. The Central Bank Board has not formally approved any chapters of the Inspection Manual (see comments under task #4). However, the inspectors did perform pre-scoping techniques for the recent onsite inspection using the new guidelines.

Task #4: Continue with offering guidance in the drafting of a comprehensive inspectors manual.

Comments: This goal was achieved in that a basic inspection manual has been developed. However, the final review, approval by the Central Board has not been obtained. Even though, the chapters are being used during the onsite inspections. Continued efforts will be necessary to finalize all chapters, and to ensure that a comprehensive manual is developed with both basic and complex inspection topics.

The BoL set a goal of December 1, 1996 for completion of the inspection manual. A change from the proceeding opinion of the inspectors being responsible for writing their own manual came after the BoL discovered that the Bank of Latvia is using the National Bank of Poland's Inspection Manual as their guide. The Advisor and the Lithuanian inspectors will use the National Bank of Poland's Manual as a guide to assist in the completion of the BoL inspection manual. The Advisor began a systematic approach to completing the manual by finishing each section in its entirety. As an example, in the August 31, 1996 monthly report, the Advisor included sub-chapters on Internal Controls and Internal and External Audit which would finish the area of Management. Exhibit 1 of this Report displays the current index and the stages of completion for each area. Exhibit 2 provides an edited version of Chapter 2 on the Overview of the Inspection Process. This chapter is now complete and is being translated.

To obtain the Central Bank Board's approval several steps must occur. The Inspection Manual will have to be completed first, and then reviewed by the inspectors, and then reviewed by the methodology department. Even without a completed Inspection Manual, the inspectors have over six different inspection guides from various countries to assist them in any area that may be new to them.

Task #5: The Advisor will assist the BoL in establishing a comprehensive internal communication system:

Comments: This goal was achieved. Internal communication channels continue to be enhanced to ensure effective and efficient sharing of information.

One method that has been implemented to improve communications/identification of potential issues is the early-warning system. The Deputy Manager of Offsite Monitoring has completed methodology for the early-warning system. Currently, he is working on preparing a "bank rating" system similar to the Federal Deposit Insurance Corporation's CAEL (Capital, Asset Quality, Earnings, and Liquidity) standards. Once this system is completed, training of the offsite specialists on interpreting the system and preparing monthly or quarterly reports will be performed. These types of processes will assist the BoL in formalizing communication methodologies and data sharing.

Task #6: The Advisor will provide assistance regarding priority issues facing the BoL as requested:

Comments: The Advisor was involved in a couple of priority issues facing the BoL within the banking system. The issues were confidential and are not disclosed in this report.

CONCLUSIONS AND OTHER MATTERS

As seen in this report and all the monthly reports submitted to USAID, the impact from USAID's funding to the National Bank of Lithuania has been noteworthy. Continued technical assistance in the area of bank supervision could be instrumental in assisting the Central Bank in working through an extremely difficult period in the history of banking. Public confidence has yet to be restored and most banks within the system are not capital sufficient despite their registered capital requirements. With the implementation of IAS beginning in January 1997, financial transparency will be more prevalent and all banks will have standards for financial reporting purposes. It is foreseen that banks will be required to establish additional loss reserves as current regulations require only the establishment of losses based on loans reviewed. Thus, general reserves will be required on loans that are not reviewed, other assets that are not loans, and securities that would require mark to market accounting treatment. Additionally, regulations covering a wide range of accounting activities will have to be changed and the Supervision staff, including the senior officials, will have to be trained.

Progress To Date

Listed below are the Benchmarks to be achieved by the end of this quarter:

1. At the end of every third month after the starting date of Phase II, the completion of onsite inspections according to the timetable laid out in the workplan and the inspection reports.
   __X_met ____not met

2. At the end of every third month evidence that KPMG is assisting BoL staff to strengthen their enforcement capabilities both generally and regarding specific banks which may have deficiencies, e.g., memoranda relating to and/or drafts of policy guidelines and procedures regarding enforcement and regulatory reform.
   __X_met ____not met

3. At the end of every third month after the starting date of Phase II, evidence of the development of an internal training program which outlines minimum requirements for inspectors and evidence that training of trainers is steadily progressing. This would include for example, KPMG training materials and memoranda, internal BoL memoranda relating to the program, internal BoL communications to inspectors regarding requirements.
   __X_met ____not met

4. At the end of every third month after the starting date of Phase II, evidence that KPMG is providing assistance regarding the improvement of standard bank supervision documents, for example, memoranda and training materials regarding preparation of documents to support the normal functions of the bank supervision systems. This may include development of processes to evaluate risk, implementation of a system to ensure comprehensive internal communication channels, or participation in special projects or involvement with BoL priority issues.

__X_met ____not met

5. At the end of every third month after the starting date of Phase II, written analysis by advisor or progress made in the development and implementation by the BoL of merger and acquisition related policies regarding specific problem/failed banks as recommended by the advisor.

____met __X__not met- Problem Bank assistance not continued in Phase II

6. At the end of every third month after the starting date of Phase II, reports by the advisors on the status of the new Law on Commercial Banks including memoranda or other materials written by the advisors on elements in the new law relating to strengthening bank supervision.

__X_met ____not met

Project Administration

Task Order Data:

Total level of effort	495 workdays
Total estimated costs	$590,956

a) Cumulative Level of effort (Est. through contract end):	340 workdays or 69%
b) Estimated Unused level of effort:	155 workdays
c) Cumulative Expenditures (Est. through contract end):	$400,000
d) Estimated unexpended balance:	$191,000

APPENDIX

Exhibit 1: Inspection Manual Table of Contents and Status

***Revised 8/26/96 after review from Alditas and chapters completed**

METHODOLOGY OF BANK INVESTIGATION

I. Inspection Procedures

				Status
*	1.	*Inspector's Right and Responsibilities*		Translated
	2.	*Overview of Inspection Process* -		Completed
		2.1	Inspection Strategy and Purpose	
		2.2	Inspector-in-Charge Responsibilities	Translated
		2.3	Role and function of Inspector	
		2.4	Inspection Policies	
		2.5	Preparation for Inspection and Scoping	Translated
		2.6	On-site Inspection Procedures	Translated
		2.7	Inspection Closing Procedures	Translated
		2.8	Completion of Report of Inspection	Translated
*	3	*Management*		
		3.1	*Council and Board Management*	Completed
			3.1.1 The Council	
			3.1.2 Responsiblity of Council	
			3.1.3 The Board	
			3.1.4 Planning	
			3.1.5 Policy Making	
			3.1.6 Human Resource Administration	
			3.1.7 Control Systems	
			3.1.8 Management Information Systems	
*		3.2	*Internal Controls*	Completed not Translated
			3.2.1 Purpose and Function of Internal Controls	
			3.2.2 Basic Elements of Internal Control System	
			3.2.3 Organization Structure	
			3.2.4 Accounting Procedures	
			3.2.5 Protection of Physical Assets	
			3.2.6 Computer System and Software	
			3.2.7 Audit Program	
			3.2.8 Inspector's Responsibilities	
			3.2.9 Money Laundering	
			3.2.10 Bank Fraud	
			3.2.11 Inspection Procedures	
*		3.3	*Evaluating the Audit Function*	Completed not Translated
			3.3.1 Internal Audit Function	
			3.3.2 Independence of Internal Auditors	
			3.3.3 Competence of Internal Auditors	
			3.3.4. Internal Audit Review	

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3.3.5 External Audit
3.3.6 External Audit Opinion and Report
3.3.7 External Audit Review
3.3.8 Inspection Procedures

* 3.4 *Connected Person and Related Transactions* Translated
3.4.1 Responsibilities of Council and Board
3.4.2 Self-Serving Practices
3.4.3 Bank Policies and Reporting
3.4.4 Connected Person Transactions

4. *Asset Quality:*
4.1 *Credit Committee and Lending*
4.1.1 Inspection Objective
4.1.2 Banking Law, Policies and Regulations to Credit Committee
4.1.3 Credit Committee Oversight and Adequacy
4.1.4 Credit Policy
4.1.5 Internal Loan Review and Classification
4.1.6 Types of Credits and Their Use
4.1.7 Inspection Procedures and Sampling Techniques
4.1.8 Concluding Discussions with Board Members

4.2 *Classification of Assets and Other Exposures in an Irregular Situation*
4.2.1 Purposes for Classification Exposures
4.2.2 Compliance to Internal Policies
4.2.3 Preliminary Procedures and Analytical Procedures
4.2.4 Adequate Support for Loan Request
4.2.5 Inspection Procedures

4.3 *Collateral and Collateral Documentation*
4.3.1 Purpose and Attributes of Collateral
4.3.2 Physical Securities
4.3.3 Personal Securities
4.3.4 Bank Policies
4.3.5 Inspection Procedures

4.4 *Large Exposures*
4.4.1 Reasons for Diversification
4.4.2 Legal and Regulatory Requirement
4.4.3 Implications of Bank Policy and Practice
4.4.4 Inspection Procedures

4.5 *Provisioning and the Reserve for Loan Losses*
4.5.1 Types and Purposes of Loan Loss Reserves
4.5.2 Establishing the Reserves for Loan Losses
4.5.3 Accounting and Disclosure
4.5.4 Determining Adequacy
4.5.5 Changes in Credit Policies

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4.5.6 Inspection Procedures

4.6 *Property For Sale (Movable and Immovable)*
- 4.6.1 Definition
- 4.6.2 Accounting Treatment
- 4.6.3 Documentation
- 4.6.4 Holding Period of Property
- 4.6.5 Classification of Acquired Properties
- 4.6.6 Additional Inspection Procedures
- 4.6.7 Inspection Procedures

5. *Capital:*

5.1 *Capital Stock and Ownership:*
- 5.1.1 Sources of Capital
- 5.1.2 Legal Requirements
- 5.1.3 Records and Accounting; Compliance and Control

* 5.2 *Capital Adequacy:* Completed by Inspector
- 7.2.1 Capital Adequacy Factors
- 7.2.2 Capital Planning
- 7.2.3 Capital Ratio and Trend Analysis
- 7.2.4 Capital Filing Requirements

6 *Earnings*

6.1 *Financial Reports and Records*
- 6.1.1 Accuracy and Timeliness of Reports
- 6.1.2 Adequacy of Clearing Accounts
- 6.1.3 Correspondent Banking Relationships

6.2 *Operational Analysis* Completed by Inspector
- 6.2.1 Adequacy of Earnings
- 6.2.2 Stability of Earnings
- 6.2.3 Effectiveness of Financial Budgeting
- 6.2.4 Ratio and Trend Analysis
- 6.2.5 Effects of Asset Classification on Earnings
- 6.2.6 Profitability Analysis

7. *Liquidity*

7.1 *Liquidity Management*
- 7.1.1 Asset Management
- 7.1.2 Liability Management
- 7.1.3 Off-Balance Sheet Activities
- 7.1.4 Policy/Management Reporting System
- 7.1.5 Contingency Funding/Liquidity Planning
- 7.1.6 Liquidity Requirement and Ratios

7.2 *Interest Rate Risk Measurement Techniques:*
- 7.2.1 Interest Rate Risk Management

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Exhibit 2: Inspection Procedures- Overview of the Inspection Process

DRAFT DOCUMENT

Chapter 2 * changed and revised as of 9/3/96
Overview of the Inspection Process:

Introduction:

This Handbook Chapter discusses the BoL's inspection strategy, inspectors responsibilities, and it gives specific guidance for "scoping" and "managing" inspections. Inspection "scoping" is the process of guiding the assisting inspectors with specific inspection procedures which should be performed and the depth of coverage for each of the CAMELF factors. Effective management of the inspection can expedite and enhance the inspection process by ensuring that all the objectives within the CAMEL factors are met efficiently.

The inspection of banks is intended to identify the level of risk prevalent in the bank and the capabilities of the bank's management to effectively control and manage that risk. The inspection seeks to determine the overall condition of an institution and the causes and factors that impair safety and soundness. Overall, liquidity and solvency are determined by an evaluation of an bank's management, its asset quality, and its sources of earnings and control of expenses. These factors establish the liquidity and capital needs of an institution. Within these few evaluative factors is a wide range of activities, products, and services that must be examined for their risk (i.e., the degree to which they affect the liquidity and solvency of the bank). This is the job of the inspector and of banking supervision.

2.1 Inspection strategy:

Effective January 1995, the BoL's inspection strategy is for on-site presence in every bank within a 12-14 month cycle. More frequent inspections may be scheduled as necessary. Special limited inspections will not satisfy the strategy of the BoL's 12-14 month cycle, and these inspection should be used only as a supplemental review. The reason for this cycle is to ensure that the BoL has a current and accurate record of each bank (via an inspection report) and it allows inspectors to time to verify that no new problems or significant developments have transpired. The frequency of regular inspections will allow that regulators to find problems in the early stages when most problems can be easily resolved or managed.

The inspectors should conduct more frequent inspections of banks that undergo a significant change in the condition of the bank or if directed by the Director of Banking Supervision. This data should be highlighted by the off-site analyst or from the "early warning system" reports. However, since the off-site analyst have yet to develop an system of analytical review to provide early warning signals, the inspectors may have to gather the data from the off-site analyst while doing their "scoping".

More frequent or supplemental inspections should be necessary for: 1) newly formed banks or credit unions; 2) banks that have had a recent major change in management, or a major change in the counsel or board members; and 3) banks that are under some type of BoL enforcement agreement. To determine whether a bank needs a on-site inspection, the off-site analyst or the inspector should focus on the following factors:

- Changes in key financial ratios and indicators.
- Changes in business activity and/or strategies.
- Bank's compliance to the recommendations made by the inspectors.
- Bank's compliance to any BoL enforcement agreement

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- Negative earnings or unfavourable earnings trends.
- The level, trend, and composition of capital.
- An excessive rate of growth in assets or liabilities that exceeds capital levels.
- Other information provided for in the external audit report, news articles, correspondence, and information obtained from inspection at other banks.
- The Annual schedule as specified in the department

2.2 Inspectors in Charge (IIC) Responsibilities:

To help the BoL meet its strategy, the IIC should attempt to place a greater emphasis on risk analysis and to prioritize the inspection work to focus on the major areas of concern. To achieve this strategy, each assisting inspectors should be notified to vary the scope of review in each of their areas to first focus on the major risk of the bank. This procedure will help ensure that the inspectors are more efficient without compromising accuracy (i.e. there is less risk and therefore less review of that area and more time is spent in the significant concern areas).

The IIC should do *preliminary scoping of the bank to determine its current profile and what major risks can be identified.* With the review of the off-site data, the IIC should be able to assess a current status of the bank and should be able to provide specific guidelines for the assisting inspectors. The scope of the inspection should include procedures that enable all inspectors to determine if the bank's level and management of risk is unsafe or unsound. The scope should also concentrate on the changes occurring in the bank, since any changes in operations or management can pose a significant risk. The scope must be approved by the Director of Banking Supervision.

Managing Inspections

Managing inspection is as important as scoping. The level and sophistication of management methods and procedures will vary depending upon the activities that are performed in the bank and its size and structure. The IIC holds the primary responsibilities for managing the inspection. Key elements that the IIC should consider are:

a) The IIC must ensure that the assisting inspectors understand the objectives of the inspection and more specifically, their desired area of review;

b) The IIC is responsible for the organisation of the inspection which includes scheduling meetings with bank personnel, arranging appropriate workspace for the inspection, communicating the inspection findings to management, preparing and editing the final inspection draft, communicating the inspection findings with senior officials of the BoL.

c) The IIC must determine the expertise necessary to perform certain aspects of the inspection and make the assignments accordingly. When necessary, major areas such as loans should be assigned to one individual with assistants working for that particular person. Whenever possible, assistants should be assigned an area that can be completed, included the draft inspection report pages, before leaving the assignment. Utilizing this strategy provides for accountability and it can provide good on-the-job training as assistants are forced to support their conclusions. Assistants should be monitored throughout the course of the inspection to ensure that inspection procedures are met and if necessary, the IIC will have early identifications of work-related problems. The IIC must consider the time constraints of the inspection, the staff that is assigned to the job, and the activities that are to be completed.

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d) The IIC serves as the primary communication link between the inspectors and bank management, and senior officials of the BoL. The IIC should work towards creating a positive work environment which means being diplomatic and professional in the approach to the job, the inspectors, and management.

2.3 Role and Function of the Inspector

Ideally, the role of the inspector would be to make an independent, qualitative appraisal of the overall condition and performance of the bank. Ideally, management will be sufficiently competent to manage risk and to install sound internal control systems of accounting and administration. Ideally, the audit function will be effective in identifying control system weaknesses and breakdowns. Ideally, the inspector should not need to duplicate work done reliably by others.

The inspector has a duty to the depositors and shareholders of the bank, to the general public, and to the Bank of Lithuania to fulfill his or her job responsibility. The general public relies on the results of the inspector's work. The inspection results are also the basis for many decisions which are made in the Central Bank. The inspector assures the existence of assets, the non-existence of liabilities, and the reliability of financial records. This assurance is obtained through a reliable system of internal controls and an acceptable inspection (internal audit) and/or external audit.

The purpose of the inspection is <u>not</u> to perform an audit. However, accounting and administrative systems of control and the audit of those systems are sometimes weak and, therefore, unreliable. When this is the case, the inspector must expand his or her role to perform audit/verification functions to establish the accuracy and reliability of bank records before undertaking the qualitative appraisal. This is often the case in a developing market-based banking system, a newly-organized bank, a newly merged bank, or in an environment of high staff/management turnover and inadequate training or experience. While performance of these audit/verification procedures can be tedious, they are necessary. The fact that the inspector must perform them (in lieu of bank management and auditors) is a cause for criticism by the inspector because it is evidence of a deficiency within the institution.

The inspector's main role is to identify the risks in the bank and to obtain the timely correction by bank management of weaknesses and problems noted in the bank. This identification is to help protect depositors and ensure the stability of the banking system by trying to prevent bank failures. Of course, not all bank failures can be prevented. It is important to note that a bank can be in compliance with all banking laws, regulations, and recommendations and still fail. That is why it is imperative that the inspector focus attention on the RISKS in the bank and not just with legal compliance.

The inspector must make decisions dependent on the situation and on the information available. Since the inspector constantly gains further information as the inspection progresses, it is essential that the inspector remain flexible. Inspectors are encouraged to use judgement and go beyond the inspection procedures when appropriate. Inspectors should use their experience and knowledge to adapt to specific and unusual circumstances in order to achieve inspection objectives. Upon the receipt of additional information, the IIC may decide to focus an inspector efforts on different areas of the bank or perform more or fewer procedures than was previously planned.

It is essential that the inspector be aware of the entire inspection process to understand how each activity fits into the full scheme, to know what information is needed by other inspectors, and to properly analyze and summarize findings. Inspector assignments should be rotated so that all examining staff become familiar with each manual segment at an appropriate point in their professional development.

At the end of the inspection, the inspectors should be able to answer the following basic question: What are the risks of the bank and is the bank adequately controlling these risks?

The inspection procedures listed in each chapter of the manual provide a guideline for steps to take in examining the specific banking activity. They provide a guide to help the inspector obtain an adequate assessment of the risks of that activity to the bank. The inspector may be under time constraints. Some procedures may be impossible or difficult to perform because of the size of the bank, for instance, or the unavailability of information. In certain cases, performing additional procedures may not give the inspector any further information than what he already knows and the trade-off between time and effort and the benefit received may not be worth it. The inspector is free to pick and choose the procedures as the situation warrants. Each bank is different and thus each requires the use of different procedures and different approaches. However, the inspector needs to perform enough of the procedures to give himself confidence of the risks of the activity in the bank and to support his findings for the report of inspection. Inspectors must be flexible, use their common sense, and be creative at times. In cases where customary inspection practices are not practical, alternative procedures and the extent to which they are applied should be documented. The need for completeness during the inspection requires that there be no open items, unfinished operations or unanswered questions in the workpapers at the conclusion of the inspection.

After determining the risks, inspectors are responsible for "encouraging" banks to develop written policies and related procedures in all areas where none exist and to correct situations where there are deficiencies in, or a lack of compliance with, existing procedures. Inspectors should be able to increase the level of professionalism and the soundness of the banking system by encouraging all banks to follow procedures to reduce risks.

2.4 Inspection Policies

Generally, supervisory authorities have overall policies governing the inspection process. These policies often detail the following information and certain areas are currently being developed:

- inspector authority
- the bank rating system
- off-site monitoring

Inspector Authority

Inspectors represent the legal supervisory authority of the banking system. Chapter one of this manual discusses the Inspector's Rights and Responsibilities. Inspectors should be permitted access to all of the bank's books and records in order to determine safety, soundness, and compliance. If depositors are to be protected, it is important that when the inspectors find weaknesses and problems, that this information be communicated to the bank's management so that they can be corrected as soon as possible. One of the important roles of the inspector is to convince management of the need to correct weaknesses.

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To do the above, the inspectors must make recommendations to the bank when they are on-site. If the recommendations are made only later, the period that the bank is subject to risk is prolonged unnecessarily. In addition, the discussion on areas of weakness with bank management during the inspection gives management an opportunity to respond and if there are any misunderstandings, these would be cleared up then. Any undue risks should be dealt with immediately, not a month or so later.

Chapter II of the Law of the Bank of Lithuania provides the guidance necessary to allow the inspector the authority to request all information from the bank.

Bank Rating System

Inspection policies normally include a description of the bank rating system to be used. While the Bank of Lithuania has yet to adopt a bank rating system, a bank rating system provides a standardized method for categorizing all banks, and enables supervisors to place banks on a comparative basis. A typical bank rating system rates the major risk components of the bank, such as capital, asset quality, management, earnings, liquidity, and the internal control/audit function and also arrives at an overall rating for the bank. This type of system aids in foreseeing potential problems in the banks, thus enabling their timely correction before they turn into difficult situations.

Off-Site Monitoring

Off-site monitoring systems are used to monitor banks between inspections. These systems consist primarily of the review and analysis of the reports and information submitted regularly by the banks to the Bank of Lithuania. Currently, an "early warning system" can be utilized by both the inspector and the off-site monitoring department to analyze the on-going trends of banks. Since this information is used to monitor the performance and condition of the banks and the need for future inspections, it is essential that these reports are accurate and reliable. In addition, the off-site monitoring analytical staff needs to be well-trained. If problems are noted, then inspection or audit teams can be sent to the banks. Adequate off-site monitoring provides a means for banking supervision to address weaknesses early before they mushroom into larger, more difficult problems. Many potential problems can be resolved and corrected early, thus avoiding or reducing losses and bankruptcies.

2.5 Preparation for Inspection or Scoping Techniques:

Preliminary scope may provide information needed to determine staff expertise and the strategies of the inspection, but once on-site, the scope may change depending upon what is found by the inspectors. A well-defined scope can significantly improve inspection productivity. It is not efficient to begin with a broad scope and then try to narrow it over the course of the inspection. Instead, the inspection should *begin focused* on the major risk areas and then expand if other significant problems are uncovered or suspected.

Scoping can be done off-site and on-site and items that can be reviewed off-site include:

- Documentation pertaining to enforcement actions;
- The previous inspection report and correspondence that followed;
- The Bank's business plan or Annual Report;
- BoL's financial reports;
- Economic information that has been obtained via the media;
- Any off-site information provided by the off-site monitor.

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The scope has to be approved by the Director of Banking Supervision.

2.6 On-Site Inspection Procedures:

The on-going determination of the scope and more specifically, the depth of review within each CAMELF program, requires involvement from each assisting inspector. The IIC is responsible for ensuring that the "team" is aware of the procedures needed to effectively meet the scope. The IIC should discuss any significant changes in the scope with the Manager, Director and Deputy Director to ensure that overall planning can be changed if the inspection is extended beyond its normal terms.

Upon commencement of the on-site inspection, additional information that may affect the scope should be reviewed as soon as possible. On-site material that could be requested to aid the on-site inspection process are:

- Minutes of the meetings for the Counsel and Board of Directors;
- Minutes of Credit Committee and other Executive Committee;
- Board or Management reports;
- Internal Audit Reports
- External Auditor Reports
- Business Plan
- The Operating Budget
- BoL Financial Reports
- Loan registers, asset/liability reports, other internal reports

As soon as practical, the IIC should meet with the senior executives of the bank to discuss any items pertinent to the inspection and to discuss the process of the inspection. At this meeting, administrative details should be clarified. The IIC should be prepared to discuss any topics of interest with bank management. Items that could be discusses are as follows: changes in management, operating performances, pending laws or regulations, economic and competitive conditions within the market area, budget and business planning. Items that could be discussed from administrative details could include: the availability of inspectors to answer questions from the staff preparing the information; names of key contact people; method in which to request data; expected duration of the inspection, any planned interruptions, and names of assisting inspectors and area in which they will be working; meeting schedules; and finally, the exit meeting with management.

While on-site, the IIC should be available to assist inspecting assistants and to coordinate and oversee the review of materials obtained from the Bank. It is also the IIC's responsibility to ensure that management is informed of any potential problems that have appeared during the inspection. If necessary, the inspection schedule should be adjusted to accommodate the need for additional time. In addition, the IIC as a rule, is responsible for the "management assessment" part of the inspection. The IIC is responsible for objectively looking at how management manages through the various means such as: the review of minutes of board meetings, internal auditors reports and external auditors reports and how management addresses this issues; observing various committee and how adequately these committees function, and discussing with management the concerns of the industry, the bank and the market. For more information regards the review of management, refer to the management chapter.

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2.7 Inspection Closing Procedures

After the IIC has reviewed all the inspection material, discussed all items of concern with the inspection assistants and management, an exit meeting should be set. The exit meeting should incorporate the preliminary findings that will be report comments in the inspection report. Bank management should be able to invite board members as long as it is understood that this meeting is strictly confidential and the findings are preliminary. Inspectors that have assisted in major areas of the inspection should attend to provide the attendees of the meeting their conclusions and recommendations. **However, the IIC must at all times be aware of the conclusions and be willing to add a "second" voice to the meeting should questions or comments from management occur.**

The exit meeting should be a "no surprise" type of meeting and any areas of concern found during the inspection should have already been discussed with management. At all times, inspectors should maintain a professional and courteous attitude and is disagreements occur, the most diplomatic approach should be taken and the IIC should take control of the meeting. Recommendations for administrative actions should be addressed and if disagreements occur, the IIC should prepare a confidential memorandum discussing the problem and the potential resolution.

After the closing conference, the inspection report comments should be finalized within the week being off-site. Each inspector should be responsible for his/her comment and if necessary, should utilize the IIC as an editor to ensure that the inspection report is consistent in format, style, and utilizes proper Lithuanian grammar. The IIC should also review any necessary workpapers that support the inspection report comment. Inspection report comments should be concise and comprehensive and should answer the basic question "Why is this statement going into the Report". Report drafts must be completed within one week and inspectors should go over the basic draft with the IIC.

2.8 Completion of the Report of Inspection

The preparation of the Inspection Report (Report) is the most important step in the entire inspection process. While the inspection has taken a number of weeks to complete, the data that is put into the Report must be well thought-out and organized. The Report should be written to inform the counsel members, and board of directors and communicate the findings and conclusions to BoL's regulatory authorities.

It is desirable to list the conclusions and comments in the order of importance rather than in the order in which they will appear in the report. In other words, the comments should be arranged in the matter of importance so as the arrangement will add force to the inspector's remarks. It is very important to clearly and concisely focus the report on significant areas that will require management's attention. The comment should end with persuasive recommendations regarding corrective action to be taken.

The contents of the Report, including the responses from bank management (if necessary) must be presented in an accurate, objective, and professional manner. Management should have been able to clarify their position on major issues during the exit meeting, and the inspector may comment on specific commitments from management regarding actions that needs to be taken. All corrective action that is taken during the inspection or promised to be taken in the future should be noted.

The general format of each of the components of the report should be described as follows:

1) Scope of the inspection relating to the section.
2) Concise Conclusions (either positive and/or negative).
3) Supporting analysis for the conclusions.
4) Recommendations and Corrective Action and if appropriate, management's plans for resolution.

The comments should not contain all the information that is processed during the course of the inspection. The inspectors should consider the relative need for items based on the level of regulatory concern, the need for corrective action, and the importance in presenting a comprehensive picture of the institutions overall condition and performance specific to the section. Due to the interrelationship of the different factors that are in the Report, it may be appropriate to cross-reference between sections in order to reduce unnecessary repetition.

If bank management responses to the inspector's concerns and proposed corrective action relative to those concerns noted during the inspection, these issues should be identified within the Report. However, the Report should not be utilized as a vehicle for bank management to debate inspectors' findings. Where disagreement exist, it is acceptable to briefly note the disagreement and item that is under discussion.

The use of appendix pages serve as an effective means of setting forth technical or detailed information within the Report. Use of the appendix page may be necessary in the event that additional information is needed to support more generalized conclusions contained in the Report narrative. When appendix pages are used, it is beneficial to reference the appendix page within the narrative of the Report.

The key to good Report writing is to carefully think of what is the most important information that needs to be portrayed to management. The inspector is in the best position to obtain, analyse, and report the facts pertinent to the individual association. The more concise the comments are written, the more easily the reader will understand the importance of what the inspector is attempting to portray.

After the Inspection Report has been completed and reviewed by the IIC, the Report will then be given to the necessary officials for final review. Refer to the inspector protocol covering the timing of the completion of the inspection report. If necessary, follow-up information should be given to the off-site supervisors to ensure that the recommendations that were presented in the Report will be corrected in a timely manner by management.

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Exhibit 3: Problem Bank Assistance Memorandum(s) - prepared by Short-Term Advisor Ms. Kathryn Woolford

Memorandum To: Barents Group, LLC

From: Kathryn Woolford *Kathryn Woolford*

Date: 7 October, 1996

Subject: Short Term Advisor Assignment
Bank of Lithuania

During the week 23-27 September, this advisor worked with the Bank of Lithuania to answer questions concerning problem bank resolution and to provide information on the Latvian Law on Credit Institutions and the methods by which other countries including Latvia and the United States resolve problem banks. In addition, this advisor provided to the Bank of Lithuania several chapters of the Latvian On Site Examination Manual.

The Bank of Lithuania is confined by law to a particular method of problem bank resolution and limited by the Law on Deposit Insurance, but the management and staff of the Bank of Lithuania felt that they could gain information on other techniques of liquidation and bank bankruptcy which would give them insight into development of their approach to problem bank resolution.

This short term assignment was loosely structured and developed into afternoon seminars on the subject material. This advisor met with the Bank of Lithuania problem bank resolution department staff each afternoon during the assignment period to address different topics and to answer any questions. These meetings ranged from two to three hours every afternoon and were translated by a Bank of Lithuania employee.

All comments were prefaced by the acknowledgment that Latvia does not currently have a deposit insurance program and is not bound by the constraints imposed by such a system.

<u>Latvia -- Bank Resolution - Bank of Latvia</u>

The first element of Monday's presentation and discussion involved the Law on Credit Institutions of the Republic of Latvia. Using a copy of the English translation of this law the group discussed various components of the law regarding problem bank resolution. The stages of problem bank resolution as governed by the law and under the control and direction of the Bank of Latvia are as follows:

1. Imposition of Sanctions

    a) Occurs when Bank of Latvia becomes aware of deficiencies during examination or audit.

    b) May involve a requirement for increased capital infusion.

c) Does not necessarily involve a limitation on the bank concerning deposit accounts.

2. Intensive Supervision Period

   a) Occurs when the problem bank is determined to be unable to meet its deposit liabilities.

   b) Deposit limitation sanctions are imposed.

   c) Authorized Agent or Proxy is appointed by the Bank of Latvia.

      i) Losses incurred by the Proxy are the responsibility of the Bank of Latvia.

      ii) Period during which the bank is able to reorganize, recapitalize or restructure, or merge.

      iii) Proxy acts under the direction of the Bank of Latvia.

      iv) Proxy usually is a supervisor in the Department of Bank Supervision.

      v) The period of the Authorized Agent may not exceed one year according to law.

      vi) If the Authorized Agent or Proxy determines that the bank is not able to be rehabilitated, he may recommend that the Bank of Latvia apply to the courts for liquidation prior to the termination of the one year period.

   d) One of the underlying rather than stated charges of the Proxy is to make sure that private person deposits are honored.

3. Liquidation

   a) The Bank of Latvia applies to the court for Liquidation or Bankruptcy of the problem bank.

   b) The management or owners of the problem bank may have seven days to appeal the application of the Bank of Latvia.

   c) There is a distinction implied in the law between Liquidation and Bankruptcy.

   d) The Bank of Latvia recommends an administrator for the liquidation which may be a legal entity.

   e) The creditors are paid according to a schedule listed in the Law on Credit Institutions.

f) Once liquidation is recommended the possibilities of restructure and reorganization expire except for the seven day period allowed by the court for appeal.

g) The Bank of Latvia takes a minimal role in the direction of the administration of the liquidation except for the Bank Baltija case that had significant political and economic impact.

h) There has been some discussion about requiring administrators to make a monthly report to the Bank of Latvia for information purposes only.

The second question and discussion involved the public sentiment over the failure of financial institutions and the public's attitude toward the Bank of Latvia and its staff. In response to this question the advisor explained how the Bank of Latvia has mitigated the impact on the private depositor thereby cooling public sentiment by the implementation of the resolution program as it exists today. This advisor detailed the general situation in Latvia as it pertains to the enforcement of the Law on Credit Institutions and the Bank of Latvia's use of the sanction concerning the taking of private persons' deposits and its effectiveness in reducing the loss to private persons, and the strengthening of the financial system.

After the large losses to private persons that occurred with the failure of Bank Baltia, the country of Latvia and the Bank of Latvia reacted with a strong law on credit institutions. During the development of this law, the Bank of Latvia instituted a program whereby a list of banks allowed to take private person deposits was regularly published. At the inception of this publication and shortly after the Bank Baltija failure 95% of the Lats Private person deposits were held in the Krajbanka which is the state owned savings bank where there was an implied government guarantee of deposits.

In the year since the implementation of the tenets of the Law on Credit Institutions, few banks have failed and the financial system has strengthened considerably due to a 10% capital requirement and other measures imposed by the Bank of Latvia. Still, several have been put under intensive supervision while their ability to receive private person deposits has been suspended. Generally the effect of this is to limit the amount of private person deposits which would be subject to limitation in the event of the liquidation of the bank. Therefore, the combined effect of the publication of the banks allowed to take private person deposits and the intensified supervision program has conditioned depositors to take their funds to only published institutions and as of this time depositors are moving from the state savings bank into other institutions with confidence.

When asked what happens if one of the published institutions fails, the response was that the period between the imposition of sanctions and the application for liquidation is generally sufficient to liquidate assets to pay off at least the private person deposits of the bank. Once a bank is removed from the published list, depositors begin to remove their existing deposits from that institution. In the event that the bank is not able to meet the demands of the depositors, they are notified to return at a later date for payment. While this system seems to the western eye somewhat inefficient, the depositors are generally hopeful that they will be paid at some time and in some cases surprised when this happens. The negative attention deserved by a bank which is unable to pay its depositors is directed toward the bank rather than the supervisor. However, during the intensified supervision period the bank has much more latitude in the negotiation and disposition of its liabilities and assets.

The Bank of Lithuania staff asked for information on the structure of the Bank of Latvia supervision department. This advisor listed the areas of Licensing, Methodology, On-site supervision, and off-site supervision and gave the number and professional status of the staff working in each section.

The Tuesday session was attended by the Deputy Director of the Problem Bank Resolution Department in addition to other members of his staff. This presentation, discussion and questions centered on the disposition of assets subsequent to the inception of liquidation, different methods of setting up liquidation banks and loan valuation.

The assets of primary concern during the Tuesday discussion were loans. Lithuanian law dictates that once a business has been removed from the register of enterprises it may no longer legally collect obligations owed it. In this case, loans should be passed to the Bank Rehabilitation Agency(BRA) either prior to the bank's removal from the enterprise registry or simultaneously with the application for the name to be removed from the registry. Passing loans to the BRA and assigning the appropriate value to these loans is an issue critical to the bank resolution process. Some loans may be negotiated to creditors also as a means of settling obligations. These transactions occur sometime between the time that the bank's license is removed and the application is made to the court to have the enterprise removed from the enterprise register.

Loan Classifications at Liquidation

For the purpose of evaluating loans for liquidation all previous classifications of loans should be ignored. That is to say, that if a loan was previously a commercial loan or a consumer loan, its new classification should be based on it collectibility rather than its character. Four categories of loans exist in any failed or failing bank. Those are as follows:

1. Loans which are collectable in any environment.
2. Loans which are only collectible through restructure and intensive management.
3. Loans which are uncollectible based on either a bankruptcy court decision or other irrefutable documentation.
4. Transit loans which are obligated to a specific creditor. An example of this type of credit would be G-24 loans or other types of multilateral bank on-lending programs.

Once the condition categories are established, the negotiating parties should reclassify the loans within these condition categories into their classification by type, i.e., commercial or real estate.

The subject of loan valuation is a pivotal issue in the Bank Rehabilitation Agency type of problem bank resolution particularly in instances where the loans are being replaced by government bonds and the restructured banks are allowed to remain open. Since one of the fundamental tenets of this type of agency is that it will not pay or credit banks for loans at book value nor acquire those loans which are fully collectible, it is important to address the various types of loan valuation. This discussion will address the above types of loans by category.

Loan Valuation Recommended for Consideration

Since there is no established market for trading in problem credits and appraisals can't be based on historical value or true liquidation value, it is very difficult to arrive at an exact value for any loan other than that which is immediately collectible or secured by liquid collateral which is in the possession of the bank and which has a value similar to book value of the loan.

1. Loan valuation for collectible loans should not be at issue in this sense, but if it is generally accepted that the loan is collectible then the loan should be valued at book value. Loans guaranteed by the government or government obligations may fall into this category by definition rather than by true established value.

2. Loans which may have some value after restructure may be valued in a number of methods.

   a) Value recommended by bank inspectors. Historical experience in some western countries has proven that experienced inspection staff has the best overall view of value of loans within a specific environment. This is due to the fact that the inspectors have reviewed loans of a similar nature in most banks within the system and have a reasonable frame of reference to make judgments on the value of loans in a particular financial system.

   b) Value arrived at by an independent audit evaluation also called a due diligence.

   c) Value dictated by any type of court decision such as one involved in bankruptcy.

   d) Value arrived using a present value calculation based on projected cash flows.

   e) Value arrived through negotiation using a combination of the above.

3. Loans which are determined to be currently uncollectible should be given a nominal value such as four Lita, perhaps would provide for the possibility of a prorata share of any future collection. It would keep the loan on the books of the depository agency yet not inflate the values of its assets.

For any loan which is transferred to the Bank Rehabilitation Agency, there should be some allowances made for collection and holding costs which will ultimately effect the value of the loan.

The subject of loan valuation is critical when exchanging problem loans for bonds in open bank restructuring programs.

Various Methods of Resolution or Liquidation of Failed Institutions

Latvia - Bank Resolution and the Bank of Latvia

(See page one under the same heading.)

United States Method- banks and the Federal Deposit Insurance Corporation

The United States has a strong deposit insurance program which arose from a response to the banking crisis which occurred during the Great Depression. Almost 99% of all banks in the United States have this deposit insurance which covers the individual's aggregate deposits in a bank up to a cap of $100,000. The Bank Insurance Fund which is managed by the Federal Deposit Insurance Corporation is funded by Deposit Insurance Assessments paid quarterly by open banks. This fund is augmented by collections received from the liquidation of failed banks.

When an insured bank is declared insolvent by its chartering agency , either the Office of the Comptroller of the Currency or the state commissioner of banking, the bank is automatically turned over to the Federal Deposit Insurance Corporation(FDIC) for liquidation. The actual declaration of insolvency is formalized through the court and once approved by the court is immediately enacted. At the time of the court's decision, two entities are created. The failed bank is recognized as an entity which had a legal character and the second entity maintains the character of the former bank but is entitled as the "failed bank, in liquidation". The new entity has no obligation to the stockholders of the former bank while retaining some of the rights and privileges pertaining of the former bank in respect to the collection of loans and the disposition of other assets and liabilities.

As Receiver of the failed bank, the FDIC then pays all insured depositors, using money from the deposit insurance fund. This payment of insured deposits gives the FDIC a priority claim over all other creditors to the proceeds of the assets of the failed bank.

The FDIC has many divisions but the division which deals with the liquidation of failed banks is the Division of Depositor and Asset Services. This division is responsible for both the physical payment of insured depositors and for the collection of the assets of each failed bank. There are several different transactions which the FDIC may use to dispose of the failed bank. These transactions are described under the section headed FDIC Resolution Transactions.

If the FDIC Division of Depositor and Asset Services acquires loans or investments after the failure of a bank, it has a staff which is trained in the liquidation of such assets. As a result of the banking crisis of the 1980s, this liquidation staff rose from 125 persons in 1982 to over 6,000 in 1992. In 1992, however the number of banks closing dropped dramatically and the FDIC no longer needed this large staff. Reducing this large staff has been quite costly and difficult. For the future, it is examining and testing different methods of liquidating assets through the use of the private sector.

United States - Savings and Loan Associations and the Southwest Plan

In Texas and Louisiana, the Office of Thrift Supervision in cooperation with the Federal Home Loan Bank Board and the Federal Savings and Loan association orchestrated the merger of several thrifts in order to address the problems in these institutions. The plan was titled the Southwest plan since most of this type of transactions were consummated in the south and western parts of the United States. These merged institutions would be similar to the mythical Phoenix, a new and successful institution rising from the ashes of the problem thrifts. The Federal Savings and Loan Association paid the "Phoenix" for management and collection of the loans which arose from the combination of the thrifts. One of the problems in this arrangement was that generally the resulting "Phoenix" did not receive a capital injection sufficient to cover continuing losses and the "Phoenix" was paid for the management of the assets which was a disincentive for collection and resolution. Frequently FSLIC paid more than the value of the assets for its "Management".

The fundamental theory of the Southwest Plan program was sound but the resulting merged institutions were frequently unwieldy and there were some basic faults in the execution of the plan. Most of the Southwest Plan transactions met with some criticism and difficulty. The plan to leave the assets and their disposition to the private sector is similar to some plans used in Europe and Japan. There are some very major advantages to this type of program. The labor force with the most skill in collecting and administering loans and real estate is in the private sector. As with the resolution process in Latvia, this type of transaction also focuses the public's attention on the activities of the private sector rather than at the government.

United States - Savings and Loan Associations and the Resolutions Trust Corporation

The Savings and Loan industry in the United States experienced a serious crisis during the late 1980s and early 1990s. The United States government created the Resolution Trust Corporation(RTC) to liquidate the assets of the failed savings and loan associations or thrifts. Realizing that the crisis was severe but one of a limited time span, the RTC was given a "sunset date" by which all of its activities would cease and the remaining assets would be merged with the FDIC.

Because of the volume of assets, the senior management of the RTC devised a plan whereby they used private enterprise for the bulk of the liquidation effort. There were a number of plans which were used but two of the primary programs were loan sales and loan securitization programs. Groups of similar assets were aggregated and sold under sealed bid auctions or securities were sold which were backed by these assets. These securitized pools are collected by private loan servicing companies who collect the payments, funnel payments to the RTC which in turn makes payments on the securities issued. Either method spreads the risk of collection of the portfolio between the government as represented by the RTC and the purchasers of the securities and both methods represent an immediate return for the problem assets. Both of these programs were easily executed in the United States particularly because of the existence of a established loan sales and securitization market.

Private asset management and collection companies also worked on the assets of failed thrifts on a contractual basis. These contracts had performance incentives built in to address the errors of the Southwest Plan transactions.

FDIC Resolution Transactions

Depositor Payout

These transactions occurred when the condition of the bank was so poor that acquirers were not available. Frequently these transactions occurred when there was significant fraud discovered in the bank. The FDIC paid off insured depositors and liquidated the assets of the failed bank. One of the largest deposit payouts was Penn Square Bank of Oklahoma City, which had deposits totaling $250,000,000.

Deposit Insurance Transfer Agreement(DITA)

The insurance deposits of a failed institution were transferred to an open institution. Generally several local open institutions were allowed to bid on the transaction. The FDIC paid the open institution an amount equal to the deposits transferred. The attraction to this transaction was the acquisition of an additional deposit base and the immediate injection of cash. Most demand deposit accounts transferred in this type of transaction stayed in the new institution and provided additional funding for investments of the agent bank. The FDIC generally retained all of the assets of the failed bank.

Purchase and Assumption (P&A)

The P&A was the transaction most favored by the FDIC in resolving failed banks. Local banks meeting FDIC's eligibility criteria of safety and soundness were given the opportunity to bid on Assuming the deposit liability and purchasing assets of the failed banks. These types of transactions generally covered all deposits of the failed bank, not just insured deposits. The FDIC usually offered this as the first transaction when putting the assets and liabilities of the failed banks out for bid. The reason for this was that assets were passed to the open bank and this reduced the FDIC's expense of collection. Assets were valued by a FDIC team of examiners and liquidators prior to the banks failure and this valuation was used to determine the reasonableness of the bids for acquisition. Failed banks were sold in these transactions to the highest bidder as long as the bid exceeded the FDIC estimate of value. In the case of the P&A the credit risk was passed to the winning bidder, but was mitigated by the estimate of loss calculated by the acquiring banker.

Open Bank Assistance

Open bank assistance programs usually involved large commercial banks such as First Pennsylvania and Continental Illinois Bank and Trust Company of Chicago. These were banks who were determined to be too big to fail. In the case of Continental which was a large retail and commercial bank, its failure would have cause a serious crisis in the midwestern United States. The FDIC invested in Continental and in exchange received stock warrants to be exercised at the discretion of the FDIC. The FDIC liquidated problem assets of the bank and exercised significant control over the daily activities of the bank. In these situations, both the assisted bank and the FDIC share the credit risk.

Other specific transactions

In the late 1980's the FDIC tested a program whereby it transferred the management of assets and deposits of several large failed banks to open banks without passing the ownership of those same transactions. In these transactions, FDIC representatives participated in an oversight capacity with agent bank representatives. The object of this program was to pass the administrative and management risk to an open institution while leaving the credit risk with the FDIC. First Republic of Texas, along with Southeast Bank of Miami and Bank of New England were all liquidated using this type of transaction. The contracts were all performance based with incentives for early collection and resolution. This type of transaction limited the amount of funds that FDIC was required to pay at the inception of the liquidation while still giving it supervision over the liquidation process. Public perception of the deposits and assets was that they remained in the private sector. This had a very positive impact on the resolution of the failed banks. Most of the institutions involved in this type of transaction were multi-billion dollar institutions.

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