PDTAS 282

United States Agency for International Development
Project for the
NATIONAL BANK OF LITHUANIA
Strengthening Bank Supervision - Phase IV

COMPLETION REPORT

USAID CONTRACT EPE-0005-I-00-5056-00
Task Order #4
Task Order: EPE-I-04-95-00056-00

Submitted to:

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A. CONTRACTOR'S REPORT

I. Background

This is the completion report for Task Order EPE-I-04-95-00056-00, which represents Phase IV of the U.S. Agency for International Development (USAID) effort to provide technical assistance to the Credit Institutions Supervision Division (formerly Banking Supervision Department) of the National Bank of Lithuania (BoL). USAID began this technical assistance program in May 1994 to strengthen the BoL's ability to provide oversight and regulation to Lithuania's evolving banking sector and to support the development of a professional bank supervision, examination and enforcement department within the BoL. Phase IV, which began in October 1997 and was extended until July 31, 1999, was designed to provide a continuation of technical assistance to the BoL through the use of intermittent, visiting advisors, rather than rely on resident advisors, as was the practice in the previous phases of the assistance program.

The objective of the Phase IV project continuation was to help consolidate the progress the BoL had made to date in strengthening its ability to provide supervision to Lithuania's credit institutions and to ensure that USAID left a solid and sustainable foundation of strong and effective bank supervision that would permeate to the banking sector and the economy in general. The specific focus areas of the intermittent advisors were: 1) to continue the institutional development of the BoL's Credit Institutions Supervision Division (CISD) through policy advice; 2) to train CISD personnel in more sophisticated supervision techniques and in a few advanced areas not yet covered; and 3) to further develop a range of techniques for dealing with banks which are not in compliance with BoL regulations.

This completion report summarizes the technical assistance provided by the contractor, International Business & Technical Consultants, Inc. (IBTCI) and evaluates the gains made by the BoL relative to the task/work requirements established in Article V of the Phase IV Task Order, and its subsequent modifications.

II. Expected Results

The expected results of this Task Order were to fulfill USAID's ENI Bureau's objective to support the development of a safe and sound banking system that operates according to market principles. This objective is part of USAID/Lithuania's strategic objective 1.4, which is to develop a more stable financial environment. The objective also fits into the primary intermediate result 1.4.1, which is to increase confidence in the banking sector. Work plans to implement the specific tasks to be performed to meet these expected results were developed for 1998[1] and 1999[2] and were submitted to USAID by the contractor.

[1] December 1997 Quarterly Report, Exhibit #1.
[2] December 1998 Quarterly Report, Exhibit #1.

III. Specific Tasks to be Performed

The following task/work requirements are delineated in Article V of the Phase IV Task Order:

1. Assist the Credit Institutions Supervision Division in fully implementing the inspection schedule for all licensed banks;
2. Assist the CISD in refining examination/inspection techniques;
3. Provide support to the CISD to further enhance regulatory practices through implementation of a risk-based supervisory approach;
4. Assist the CISD in developing an on-going training program for inspectors and training for bankers;
5. Provide support to the BoL in legal advisory work;
6. Assist regarding priority issues facing the BoL.

IV. Review of Banking Activities

The Lithuanian banking sector experienced many changes over the one and one-half year duration of the Phase IV Task Order, but overall, it continued to grow and to attract foreign investors. The improvement in the banking sector is perhaps best reflected by the growth of foreign ownership of bank share capital and foreign entry into the market. As of June 1, 1999, five private banks had foreign investor ownership of more than 50 percent and there were seven foreign banks represented in Lithuania either as branches (two), a subsidiary (one), or representative offices (four).

The remaining state-owned banks continued to be labor-intensive for both the Ministry of Finance (MoF) and the CISD. However, a merger (and partial liquidation) of one state-owned bank into another successfully reduced the number of state-owned banks to two. The smaller of the remaining state-owned banks was supposed to be privatized by September 1998, but privatization attempts were not successful. In early 1999, the MoF attempted to structure a debt-to-equity swap with the European Bank for Reconstruction and Development for this bank, but this transaction did not transpire. As of the date of this report, another privatization tender for this bank was in the process of being drafted.

There have been discussions in Parliament regarding the possibility of merging the second bank with the other, larger state-owned bank. There are many adversaries to this idea, however, as an earlier merger involving the larger bank nearly doubled its size. For the past year, this enlarged bank has been attempting to restore itself to profitability and manage the additional assets, liabilities, and personnel that were transferred. Opponents of the merger idea also fear that the Government will then have a difficult time finding any interested investors for this last state-owned bank. Its privatization is scheduled to take place one year after the resolution of the second state-owned bank. Opponents also believe that the merger of the two remaining state-owned banks would create a bank that would be "too large to fail."

A comparison of banking sector asset ownership on December 31, 1997 to that on June 1, 1999, shows that private ownership of bank sector assets grew while asset ownership by state banks decreased. Even though the two state-owned banks remain important players in the banking sector, two private banks have emerged and together command almost the same market share as do the state-owned banks (45 percent versus 41 percent, respectively). As of the date of this report, these two private banks are engaged in merger discussions. These discussions began in 1998 and were called off at year-end, but have again resumed. In the interim, Parliament passed a law that prohibits private bank mergers that would command more than a 40 percent market share. To date, no specific merger agreements have been sent to the CISD for review.

In December 1997, there were 14 local operating commercial banks with assets totaling 8.30 billion litas ($2.075 billion). Three of the banks were state-owned and had assets totaling 4.06 billion ($1.015 billion) or 49% of total banking sector assets. Foreign investors owned banking share capital representing 32 percent of the total share capital of the sector. There was one branch of a foreign bank and two foreign branch representative offices operating in Lithuania. Three banks had special limited licenses. Two of these banks had state ownership (an asset management bank and an investment bank) and the third bank could not accept deposits. There were 23 licensed credit unions with assets amounting to less than .03% of banking sector assets.

As of June 1, 1999, there were 10 local operating commercial banks, including two which were state-owned. Banking sector assets totaled 10.58 billion litas ($2.65 billion) and the state-owned banks reported assets of 4.8 billion litas ($1.2 billion) or 45 percent of total banking sector assets. Foreign investment in private bank share capital reached 43 percent of the total. There were two foreign bank branches, one foreign bank subsidiary and four foreign banks with representative offices operating in Lithuania. Two banks had specialty licenses, with one bank being an asset management bank, and the other an investment bank with limited state-ownership. The third specialty-licensed bank had merged in 1998 into a private bank. The investment bank recently applied for a license to become a fully operating commercial bank, and as such, there will soon be only one specialty-licensed bank, the asset management bank (for problem asset resolution). There were 29 licensed credit unions with assets totaling .08% of banking sector assets.

From a global perspective, the Lithuanian private banking sector saw minimal impact as a result of economic difficulties specifically linked to the financial problems experienced in Russia. Direct lending to Russian entities by Lithuanian creditors was small (less than 2 percent of total lending) but over 40 percent of Lithuanian exports go to Russia and that is where problems have been seen. With the assistance of the USAID technical advisor, the Policy Division of the CISD amended key regulations relating to capital, general reserves, and liquidity so as to tighten controls regarding Russian-related assets and/or liabilities. (Please see the Task 3 review below).

In December 1997 and also as of June 1, 1999, there were 16 banks in the Credit Institutions in Bankruptcy Division of the BoL. This area continues to be a strain on the personnel of the CISD, since all of these banks are held within the court system awaiting liquidation. Two of these banks are self-liquidating.

V. Performance Review

Task 1. Assist the Credit Institutions Supervision Division in fully implementing the inspection schedule for all licensed banks.

The reform made in this area is sustainable. The CISD's inspection department prepares quarterly inspection schedules and is now on its fifth cycle of inspecting banks according to the CAMEL (capital, asset quality, management, earnings, and liquidity) system. All Lithuanian banks were inspected during 1997 and 1998.[3] During 1999, on-site inspections continued to occur according to the quarterly plans. In 1998, inspections that were of a risk-focused or special limited nature began to occur.[4]

Due to the growing experience of the BoL's on-site inspectors, on-site assistance from IBTCI's technical advisors was limited. Advisor Buckshnis assisted during one on-site inspection in reviewing the data generated from the early-warning system.[5] As a result of this on-site assistance, errors were found in certain calculations and changes were made to the system.[6] While on-site, the advisor trained two new inspectors in the areas of asset quality, management, and profitability.[7]

MIS/IT Advisor Richard Stitcher assisted the on-site inspection division in performing its first basic electronic data processing (EDP) inspection and Year 2000 reviews.[8] Basic information, technique review and training were provided, but further training in the area of EDP and information technology (IT) inspections may be needed to ensure that progress made in this area is sustainable.

Task 2. Assist the CISD in refining examination inspection techniques.

IBTCI's technical advisors have helped the CISD refine and upgrade its bank supervisory techniques in a number of areas, and the progress made in this area is sustainable. Evaluation areas addressed by the advisors are listed below.

- <u>Management and inspection writing techniques</u>

Advisor Buckshnis provided specific guidance in the area of management assessment, as the CISD's senior officials expressed concerns over the quality of the "management" comment section of the Inspection Report.[9] Specific comments were reviewed from reports and the

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3 December 1997 Quarterly Report, and December 1998 Quarterly Reports, respectively.
4 September 1998 Quarterly Report.
5 Refer to the Task 3 review below for information regarding reform in the early-warning system.
6 March and June 1998 Trip Reports and September 1998 Quarterly Report.
7 March 1998 Trip Report.
8 June 1998 Quarterly Report, Exhibit #3 and December 1998 Quarterly Report, Exhibit #1.
9 March 1998 Trip Report, Exhibit #3.

advisor provided a quick mini-seminar on inspection writing techniques utilizing data[10] from the On-site Inspection Manual.[11] Further discussions occurred regarding the rating of the various CAMEL components and the advisor provided the Federal Financial Institutions Examination Council (FFIEC) revised regulations on "Uniform Financial Institutions Rating System"[12] to assist the inspectors in working on standardized methods and developing a rating system. At the end of the Task Order, the CISD had implemented a confidential rating system based on the FFIEC model. These ratings are for internal use only.

- Futures, swaps and forwards

IBTCI's advisor held a training session with CISD inspectors over the accounting treatment of an off-balance sheet foreign currency swap.[13] Concerns were voiced over the treatment of swap income as the issue of income recognition had been contested at a bank inspection. During the meeting, specific areas such as swaps, forwards, spot, and futures transactions were discussed, along with a definition and illustration of hedging. Certain International Accounting Standards[14] (IAS) were reviewed to determine if specific guidance could be located on this issue and the only guidance located was in Exposure Draft #62.[15] Resolution of this matter was based on the level of risk associated with the counter-party, which happened to be a Russian bank. The advisor also provided the inspectors with a manual of inspection techniques utilized by an American regulatory agency[16] and a copy of a memorandum that the advisor had prepared for the Policy Department commenting on the BoL's regulation on financial derivatives.[17]

- Modeling techniques

Advisor Buckshnis spent most of 1998 and 1999 continuing her work with the inspectors in the area of interest rate risk management.[18] Various modeling techniques were highlighted and reviewed in detail.[19] The information provided to the inspectors and senior officials of the CISD

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10 Inspection Manual: Chapter 1.4: Outline of an Inspection Report.

11 Provided to the BoL in December 1996 as part of Tangible Result #4.

12 March 1998 Trip Report: Federal Register/Volume 61/Number 245/December 19, 1996 Notices.

13 January 1999 Trip Report, Exhibit #5.

14 IAS 25 (Accounting for Investments); and 1997 IAS - Exposure Draft #48 on Financial Instruments: sections #133 - #213.

15 Exposure Draft #62 – Financial Instruments Recognition and Measurement, June 1998.

16 Office of Comptroller of the Currency, Commercial Bank Examination Manual: Section 7100.1: "International – Foreign Exchange."

17 June 1998 Trip Report, Exhibit #2.

18 September 1997 Trip Report, Exhibits #3 and #4; March 1998 Trip Report; January 1999 Trip Report.

19 March 1998 Trip Report, Exhibit #1 and attachments 1 through 5; Attachment #1: the BoL's on-site inspection manual chapter 7.4.9 on GAP analysis; Attachment #2: "Economic Value of Equity: Where's the benefit?" by George K Darling; "The Risk of Rate Shock on EVE - Part 2" by W. Randall Payant; "OCC Issues Interest Rate Risk Guidance" by Drew Wilson; Attachment #3: "The New BIS Guidance on Interest Rate Risk Management: A Detailed Version of the US Joint Policy Statement on IRR by Gerald A Hinkle and Elliott R. Carpenter; "Effective Risk Management in the Investment Firm" by Mark Brickell; Attachment #4: "Taking the Angst out of Taking a Gamble" Business Week: July 14, 1997; Attachment #5: "Capital Adequacy Convergence" by Edward J. Waitzer.

illustrated varying opinions of both the positive and negative attributes of each modeling technique.[20] Most literature supports the notion that banks that are either engaged heavily in investments or are engaged internationally will eventually utilize the Value at Risk (VaR) modeling techniques, as these indicators provide the most precise basis for establishing capital risk requirements via the factoring in of benchmarks.[21] An example of bank-specific VaR modeling was provided to the inspectors,[22] and the areas of global VaR matrix modeling and bank reporting were also illustrated.[23]

Further assistance in the modeling area may be needed to ensure sustainable progress by the BoL. The CISD recently obtained funding from the EU Phare program to assist in the development of a VaR model of the banking system. Additional advisory assistance may be needed, as VaR is still under review by most international banking specialists and regulators, and specific benchmarks are required to be established (i.e. credit indicators, foreign exchange indicators, country risk indicators, capital calculation multiple, etc.) in order for the model to provide accurate indicators for each benchmark. Concern has also been voiced within the banking industry regarding the timing of running these complex forecasting models on a daily basis and deciphering the data, which is a requirement of VaR.

- Basle Committee's Capital Accord for the Incorporation of Market Risk

In a continuation of her work with the BoL in the areas of market risk and interest rate risk,[24] Advisor Buckshnis worked with the inspectors in regards to the capital convergence guidance illustrated in the Basle Committee's Capital Accord.[25] The Basle Committee will require bank regulatory agencies to determine if Tier 3 capital will be needed within their specific countries. As such, additional work with the CISD's policy department also occurred regarding whether

Angst out of Taking a Gamble" Business Week: July 14, 1997; Attachment #5: "Capital Adequacy Convergence" by Edward J. Waitzer.

20 March 1998 Trip Report defines Value at Risk modeling (see footnote #22) and Market Value of Portfolio Equity (from the Office of Thrift Supervision in the U.S.) and the Economic Value of Equity (from the Office of Comptroller of the Currency in the U.S.). All three models are tools to assist management and the regulators in defining the effects of interest rate risk on the balance sheet with MVPE and EVE utilizing a present value technique of the balance sheet (both on and off) and then shocking those items at various increasing and decreasing basis points.

21 The "value at risk" (VaR) models were first developed by investment firms to provide management with an estimate of the maximum loss exposure of a portfolio within a 24 hour time period and with a 95 percent confidence level. VaR has received international attention as it provides calculated benchmarks for areas such as credit risk and market movement risk of foreign currencies.

22 1997 Annual Report for Citicorp.

23 June 1998 Quarterly Report.

24 March 1998 Trip Report, Exhibit #1; December 1997 Trip Report; September 1997 Trip Report, Exhibits #3 and #4.

25 "International Convergence of Capital Measurements and Capital Standards", Committee on Banking Regulation and Supervisory Practices, July 1988; "Overview of the Amendment to the Capital Accord to Incorporate Market Risk", "Amendment of the Capital Accord to Incorporate Market Risk", "Supervisory Framework for the Use of "Backtesting in Conjunction with the Internal Models Approach to the Market Risk Capital Requirements" January 1996: BASLE Committee on Banking Supervision.

banks in Lithuania will need Tier 3 capital.[26] One particular inspector had specific interest in this topic as she was in the process of obtaining her doctorate degree and her research paper was in the area of capital convergence. The advisor reviewed her work during each trip.[27] The Basle Committee literature requires estimating capital requirements for market risk via static measures. The BoL inspectors now have detailed information regarding capital convergence and static measures, and as such, the reform and development in this area are sustainable.

- Asset/liability management and managing net interest income

To further assist the inspectors in the area of market risk, asset/liability management, and profitability, the advisor provided an article to the inspectors to show how asset/liability management can enhance profitability.[28] Even though the inspectors generally did an excellent job within each of the macro areas (i.e. capital, asset quality, earnings, asset/liability management, and liquidity), individuals at times had difficulties inter-relating each of the areas. The article and review provided helped demonstrate and reinforce the interrelationship between a bank's balance sheet and its income stream.

- Asset quality and loan review

The IBTCI advisor worked with new inspection staff members on asset classification techniques.[29] Specific issues discussed were: loan sampling techniques, loan structuring and restructuring, loan renewals, changes in loss reserves and the review of the minutes of the Loan Committee and the Asset Classification Committee.

- EDP inspections and draft manual and Year 2000 compliance

MIS/IT Advisor Richard Stitcher provided information and review in the area of electronic data processing (EDP) inspection and Year 2000 review.[30] In November 1998, Advisor Stitcher provided the CISD with a draft EDP inspection manual, compiled with information available from the Federal Financial Institutions Examination Council (FFIEC) Examination Handbook on Information Technology (IT). This manual can be utilized to assist in training and working on EDP inspections in the future.[31] Numerous other workprogarms and guidance materials were also provided.[32] Year 2000 programs from the FFIEC Phase II Year 2000 Workprogam and Guidance Handbook were provided as well.[33]

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[26] See Task 5 review under Basle Committee's Capital Accord.

[27] Ms. Aldona Jociene received her doctorate in 1999 and is in the process of publishing a book on capital convergence as a result of her work.

[28] "Managing Interest Rate Spreads for Improved Margin" by J. Kimball Hobbs. March 1998 Trip Report, Exhibit #2.

[29] March 1998 Trip Report.

[30] June 1998 Quarterly Report, Exhibit #3 and December 1998 Quarterly Report, Exhibit #1.

[31] December 1998 Quarterly Report, Exhibit #2.

[32] www.ffiec.gov/wp4web.htm

[33] 1996 FFIEC IT Examination Handbook.

In addition to the reference and inspection literature provided to the BoL, the following activities and policy review tasks were carried out:

- Senior officials of the BoL were provided knowledge in the areas of IT and Year 2000 training related activities. Management officials were able to discuss different aspects of IT supervision, IT/Year 2000 training issues, and Year 2000 related project issues;

- Work-programs for Year 2000 activities which can be used as guides for inspectors in future on-site inspections were provided;

- The status of the BoL's Year 2000 remediation related policies issued by the Central Bank Board in July were reviewed; and

- Initial development of an IT inspection handbook was carried out.

- Capital stock issues

A number of different issues regarding capital stock were addressed by the IBTCI advisor. The issue of treasury stock became an item of discussion when one of the banks asked an inspector about purchasing its own stock in order to avoid any hostile takeovers. Additionally, the off-site department requested how the stock would be valued should the treasury stock increase in value. The advisor utilized various annual reports to provide examples of how par value stock is viewed.[34] Another topic discussed utilizing these annual reports was the category "assets held available for sale" and the accounting treatment of these assets.[35] This data is discussed further below in the Task 4 review regarding general reserves and mark to market activities.

Task 3. Provide support to the CISD to further enhance regulatory practices through implementation of a risk-based supervisory approach.

The progress and reform made in this area are sustainable. The following are areas in which the IBTCI advisors assisted the CISD's off-site and/or on-site departments. Information provided in the reviews of Tasks 2, 4, and 5 also provides evidence that work in these areas can assist the CISD in implementing a risk-based supervisory approach.

- Early warning data integration between departments

Advisor Buckshnis participated in an on-site inspection[36] and worked with both inspectors and an off-site specialist on methods to integrate data generated from the early-warning system into the

[34] Citicorp 1997 Annual Report, Washington Mutual Bank 1997 Annual Report and 10-K, West Coast Bancorp 1997 Annual Report, and Centennial Bancorp 1997 Annual Report.
[35] June 1998 Trip Report.
[36] March 1998 Trip Report.

inspection process. The data received from the early warning system, while comprehensive, was dispersed throughout different reports[37] and thus a working draft for the inspectors to utilize was developed. Testing of the formulas that comprise the early-warning system occurred and errors were found.[38] It was determined that one of the ratios was incorrectly calculated and this ratio inaccuracy effected ten other profitability ratios. As a result of this discovery, the early-warning system reports were corrected. The reform made is this area is sustainable. However, once the CISD implements VaR modeling, the information from the VaR will need to be integrated into the early-warning system.

- Inspections triggered by off-site monitoring

During March 1998, a specialized inspection was triggered as a result of the Russian economic crisis and its perceived potential impact on the Lithuanian banking sector.[39] The off-site monitoring analysts and the on-site inspectors were involved in this specialized inspection. Specialized and limited inspections were occurring as early as 1997.

- Off-site CAEL rating system

The CAEL (Capital, Asset Quality, Earnings, and Liquidity) rating system used by the off-site monitoring division has gone through various developmental stages over the term of the Phase IV Task Order.[40] The CAEL rating system used in Lithuania was patterned after the Italian model, which has a 100 point potential. The advisor was asked to review the concept of allowing the off-site monitoring department to rate banks in the area of overall management, and 20 points of the CAEL rating system were reserved specifically for this management rating.[41] The advisor finally convinced the CISD's senior official in this area that the 20 points should be utilized instead for rating sensitivity to market rate risk.[42] Information regarding the Basle Committee Capital Accord guidance was provided to the CISD manager in charge of the CAEL system.[43]

Task 4. Assist the CISD in developing an on-going training program for inspectors and training for bankers.

The progress made in this area is sustainable. As described in the reviews of Tasks 2, 3, and 5, a number of memoranda were provided to the CISD to continue to assist with the training of the inspectors. The following is a summary of the work that the IBTCI advisors performed to provide on-going training within the CISD and to the banking sector as a whole.

37 December 1997 Trip Report, Exhibits #2 and #3.
38 March 1998 and June 1998 Trip Reports.
39 March 1998 and June 1998 Trip Reports.
40 September 1997 Trip Report, Exhibit #5; December 1997, March and June 1998 Trip Reports.
41 March 1998 Trip Report and June 1998 Trip Report.
42 Federal Register/Volume 61/Number 245/December 19, 1996 Notices.
43 Inspector Jociene provided her work to the Department for their review as described in footnote #26.

- Inspection manual training

During 1998, three new on-site inspectors were added to the CISD's inspection staff. Most of the CISD's inspectors have past banking experience, and all have or are pursuing economic or business degrees. The advisor held meetings with all of the inspectors and discussed a variety of inspection techniques and issues such as: inspection report writing techniques, asset quality and credit analysis techniques, problem loan work-out plans, bank ratings, and liquidity. The inspection manual was used to illustrate ways to obtain training and resource material.[44]

- Financial derivatives

In a continuation of work first performed in 1997,[45] the IBTCI advisor worked closely with the BoL's on-site inspectors and the policy department in the area of financial derivatives. The policy on financial derivatives and their accounting was developed with the assistance of Advisor Buckshnis, and numerous policy amendments occurred thereafter.[46] Specific examples were also provided by Advisor Buckshnis, such as those described in the Task 2 review under futures, swaps, and forwards, which assisted the department with its understanding and treatment of these instruments.[47]

- Bank subsidiary investment

Specific question regarding a bank's subsidiary investments into another company became a topic of conversation. The regulation limits subsidiary investments to 10 percent for capital requirements. IAS standards (IAS 22-Acquistions and IAS 25-Business Combinations), the Basel Committee's capital requirement, and the Joint Forum on Financial Conglomerates for the Supervision of Financial Conglomerates[48] were reviewed to determine if an answer was available. Specific guidelines could not be located and the CISD continued to rely on information regarding prudential requirements used in the United States.[49]

- Related party transactions

During many trips, the senior advisor worked with the examiners, the off-site monitoring team and the policy department regarding the accounting treatment for subsidiaries and methods of preparing and reviewing consolidated financial statements.[50] Topics included the original

44 January 1999 Trip Report. Inspection Manual presented to the CISD in December 1996 with Lithuanian translated Manual presented in October 1998. Chapters reviewed: Management Chapter 3.1, Classification Chapter 4.3, and Large Exposure Chapter 4.5.

45 September 1997 Trip Report, Exhibit #2

46 June 1998 Trip Report, Exhibit #2.

47 June 1998 Trip Report, Exhibit #2, January 1999 Trip Report, Exhibit #5.

48 www.bis.org/publ/index.htm.

49 www.bog.frb.fed.us. and www.ustreas.gov.

50 June 1998 Trip Report; September 1998 Trip Report; January 1999 Trip Report, Exhibits #3 and #4.

drafting of the regulation[51] and other areas such as bank subsidiaries and the treatment of related party transactions (specifically loans). There are a number of International Accounting Standards (IAS) that address the issue of related party transactions,[52] and due to the complexity of the subject, a memorandum was provided to the Deputy Director of Policy.[53]

- General reserves

During a number of trips, IBTCI's advisor met with the off-site monitoring department and the policy department to discuss the topic of general reserves.[54] Numerous reasons were highlighted for allowing banks to establish general reserves in such areas as assets held for sale (mark to market activities) and investments in subsidiaries. The most recent example that the advisor discussed with the CISD was the establishment of general reserves to ensure that banks had sufficient reserves as a result of the concern over the Russian economic crisis. Banks became engaged in the controversy as to which treatment should be allowed, as described in IAS 30,[55] and the CISD eventually required banks to establish general reserves that were specifically related to loans made to Russian borrowers.

- Consumer loans versus commercial loans

The advisor was asked to comment on the differences between consumer and commercial loans as one of the local banks was in the process of developing a consumer loan program. The advisor provided information regarding this topic, which was later shared and discussed with the bankers.[56]

[51] September 1998 Trip Report: Basle Publication no. 30 "Core Principles for effective Banking Supervision"; Basle Publication No. 20, The Supervision of Financial conglomerates and Capital Adequacy Principles.

[52] IAS 5 (Information to be Disclosed in Financial Statement) requires the disclosure of significant intercompany transactions and investments in and balances with group and subsidiary companies and with its directors. IAS 27 (Consolidated Financial Statements and Accounting for Investments in Subsidiaries) and IAS 28 (Accounting for Investments in Associates) require disclosure of a list of significant subsidiaries and associates. IAS 8 requires the disclosure of extraordinary items and items of income and expense within profit and loss of ordinary activities such that the size, nature and/or incidence that the disclosure is relevant to explain the performance of the enterprise. IAS 24 (Related Party Disclosures) provides guidance to the disclosure of related party transactions; however, the standard allows for a degree of flexibility in the price-setting process that would not be present in transaction between unrelated parties.

[53] January 1999 Trip Report, Exhibit #7.

[54] September 1997 Trip Report, Exhibit #1; October 1998 Trip Report, Exhibit #4; January 1999 Trip Report.

[55] IAS 30: Disclosure in the Financial Statement of Banks and Similar Financial Institutions with the controversy being over IAS #30-45 and IAS #30-50. One treatment allows for the establishment of general provisions through a direct hit to equity (IAS #30-50). The other treatment allows for the establishment of general reserves as a function of expenses and allows for accrued provisions (IAS #30-45).

[56] March 1998 Trip Report, Exhibit #6.

- Factoring

The BoL requested information regarding the issue of factoring in banks as certain banks were attempting to develop a factoring program. The advisor provided information regarding the difference between factoring and accounts receivable financing, which was later shared and discussed with the bankers.[57]

- Training on MIS/IT and Year 2000 issues

In addition to helping the CISD refine its examination techniques in the MIS/IT areas (see the Task 2 review above), Advisor Stitcher provided the following training activities in this area:

- A cross section of staff members from the on-site inspection division, off-site monitoring division, and the policy and procedural division have enhanced their knowledge of IT security and controls risks via a concentrated training seminar;
- Three senior on-site inspectors received a higher level of IT technical training that will assist them in providing a more complete review of the IT risks found during a safety and soundness inspection;
- A cross section of staff members from the on-site inspection division, off-site monitoring division, and the policy and procedural division have enhanced their understanding of Year 2000 issues controls via a concentrated training seminar;
- Three senior on-site inspectors received a higher level of Year 2000 technical training which will enable them to perform Year 2000 reviews at safety and soundness inspections;
- The management of a one small bank and one large private bank were provided insight on their Year 2000 remediation programs via management meetings on this topic; and
- Direct on-the-job training with one senior inspector on Year 2000 bank compliance issues was conducted.

- Develop and prepare seminars for the Lithuania Deposit Insurance Fund

IBTCI's Deposit Insurance Advisor Dean F. Cobos was asked to develop and present a series of seminars on deposit insurance issues for the benefit of the insurance fund staff and interested

[57] October 1998 Trip Report, Exhibit #3.

officials from the MoF.[58] The seminars focused on comparing and contrasting Lithuania's current practices with those employed by other deposit insurance organizations around the world. The specific topics that were covered at the seminars were:

1. Deposit Insurance Systems - Overview and Best Practices;
2. Funding and Financing of the Insurance System:
    - Deposit Insurance Premiums; and
    - The Deposit Insurance Fund;
3. Risk Management and Control of Risks;
4. Bank Resolution and Bank Receiverships.

Please refer to the Task 6 review section for a further review of technical assistance provided in this area.

Task 5. Provide support to the BoL in legal advisory work.

While no legal advisor was requested by the BoL, the technical advisors did evaluate a number of banking regulations over the duration of the technical assistance program and provided policy advice and recommendations as to the appropriateness of the regulations. Suggested changes led to the development of stronger regulations, which in turn provided guidelines for inspectors in refining their skills. Policy issues reviewed by the advisors covered the areas listed below.

- Basle Committee's Capital Accord for the Incorporation of Market Risk

Advisor Buckshnis was given data relating to the Basle Committee's Capital Accord[59] and CISD senior officials requested a comprehensive review of the data to determine if Lithuania should incorporate Tier 3 capital into its statutory capital requirements.[60] Differing opinions regarding Tier 3 capital were discussed with BoL officials a number of times throughout 1998.[61] Based on the analysis and information provided, the policy department of the CISD is currently in the process of determining if Tier 3 capital is necessary.

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[58] June 1999 Quarterly Report, Exhibit #2.

[59] "International Convergence of Capital Measurements and Capital Standards", Committee on Banking Regulation and Supervisory Practices, July 1988; "Overview of the Amendment to the Capital Accord to Incorporate Market Risk", "Amendment of the Capital Accord to Incorporate Market Risk", "Supervisory Framework for the Use of "Backtesting in Conjunction with the Internal Models Approach to the Market Risk Capital Requirements" January 1996: BASLE Committee on Banking Supervision.

[60] Tier 3 capital is to allow for market risk and provides the regulator with a number of static measures to determine the potential exposure.

[61] March 1998 Quarterly Report, Exhibit #1. The concept of Tier 3 capital (short-term subordinated debt) is to be used for market risk purposes for trading portfolios. The Accord documents and various amendments provide specific techniques for measuring and determining capital calculations for risks associated with interest rate risk, equity position risks, foreign exchange risk, and commodity risks. These standardized measures are based on duration and spread analyses. The accord documents also provide qualitative standards information which discusses the use of internal models and "value at risk" modeling is highlighted.

- Subordinated debt used as capital

The advisor was asked to review the use of Tier 2 subordinated debt to be used for capital. Opinions were provided on the methods in which banks could issue subordinated debt in order to purchase new shares of capital.[62]

- Business plans

The senior advisor was asked to comment on the possibility of having regulators obtain business plans from all banks on a yearly basis.[63] This concept was to be used in refining the Law on Commercial Banks.

- Liquidity

Liquidity rules have been reviewed by advisor Buckshnis and amended on several occasions.[64] The advisor assisted the BoL in further refining the regulation to ensure that certain instruments that may not be rated or are from countries in economic distress are excluded[65] and to clarify certain instruments to include items in other assets and other liabilities. The amended regulation was changed to tighten the requirements of defining liquid assets.

- Consolidated supervision in Lithuania

The IBTCI advisor assisted in the development of the regulation regarding the policy and procedures for the preparation of consolidated financial statements and the consolidated supervision in Lithuania.[66] Information obtained from the Basle Committee Principles,[67] International Accounting Standard 27,[68] and the European Council Directives[69] was obtained to assist in the development of this regulation. The advisor assisted in preparing and reviewing further amendments to the regulation.[70]

- Regulation regarding large exposure

The advisor reviewed the Commercial Banking Law's amended regulation relating to large exposure. The regulation was amended to include lending to bank subsidiaries.[71]

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62 June 1998 Trip Report, Exhibit #3.

63 October 1998 Trip Report, Exhibit #2.

64 September 1997 Trip Report, Exhibits #3 and #4; June 1998 Trip Report, Exhibit #1; October 1998 Trip Report; January 1999 Trip Report, Exhibit #2.

65 December 1997 Trip Report, Exhibit #1; May 1998 Trip Report, Exhibit #3.

66 January 1999 Trip Report, Exhibits #3 and #4; June 1999 Trip Report, Exhibit #1.

67 Basle Publication no. 30 "Core Principles for Effective Banking Supervision"; Basle Publication No. 20: "The Supervision of Financial Conglomerates and Capital Adequacy Principles."

68 IAS #27: Consolidated Financial Statements and Accounting for Investments in Subsidiaries.

69 European Directives: 83/349/EEC and 92/30/EEC.

70 June 1999 Trip Report, Exhibit #1.

71 June 1999 Trip Report.

- Deposit insurance regulatory assistance

As part of the technical assistance provided regarding the establishment and implementation of a deposit insurance system, (see Task 6 below), Advisor Cobos assisted in reviewing the Lithuania Deposit Insurance Fund's charter and mission statement, defining its responsibilities, reviewing the fund's capabilities and drafting changes to its existing regulations. This included assisting the Fund in amending its regulation excluding itself from paying taxes.[72]

Task 6. Assist regarding priority issues facing the BoL.

Guidance and information were provided by the IBTCI advisors on the following issues related to bank supervision, as identified and requested by the BoL.

- International Accounting Standards (IAS) issues

Advisor Buckshnis provided numerous reviews of IAS as they relate to financial institutions to the CISD and BoL officials. Many of these standards have been footnoted within the context of this report. The advisor attempted to rely solely on IAS and other European Directives and Literature to support memoranda written to address the areas listed in the reviews of Tasks 2, 3, 4, and 5.

The CISD's Director specifically requested that the advisor provide information regarding why IAS requirements for banks are more stringent than those for other enterprises. IAS #30, for example, requires the financial reports of banks to disclose more financial footnotes than those of other financial enterprises.[73] Information relating to this issue was made a part of the memorandum provided to the Director addressing the topic of combining all financial regulatory agencies into a "super-regulator."[74] There are currently discussions in certain groups of the Parliament regarding this topic.

- Financial super-regulator

The Director requested information regarding the positive and negative reasons for combining financial regulatory authorities (banking, capital markets, insurance) into a "super-regulator." Advisor Buckshnis developed a paper for discussion purposes only,[75] which included articles from The Economist magazine regarding Britain's recent decision to combine its financial regulatory agencies.[76]

72 March 1998 Quarterly Report, Exhibit #3.

73 IAS #30: Disclosure in the Financial Statements of Banks and Similar Financial Institutions

74 June 1998 Trip Report, Exhibit #4.

75 March 1998 Trip Report, Exhibit #3. The paper does not necessarily reflect the opinion of IBTCI or USAID.

76 "Banking-Britain, New Regulatory Framework", Economist: May 24, 1997; "New Regulatory Organizations-Britain's New Financial Super-Regulator", Economist: October 4, 1997.

- Foreign branch regulations

The advisor was asked to provide information on issues related to regulating the Lithuanian branches of foreign banks and what reporting requirements should be imposed on these branches.[77]

- Merger information

The Manager of CISD's licensing division requested information regarding bank mergers, as this activity may occur in the future in Lithuania. The advisor was able to provide the manager a "merger prospectus" prepared for the merger discussions between Centennial Bancorp Inc. and West Coast Bancorp Inc. in the U.S.[78] The prospectus provided specific examples relating to the new holding company structure, the new management structure, forecasted business operating plans, the forecasted financial statements, and highlighted the complexity of the issues involved.

- CISD Director's trip to the United States

Advisor Buckshnis assisted in developing a specialized training trip to Seattle, Washington for the Director of Banking Supervision and an off-site monitoring specialist.[79] Local banking regulatory supervisors from the Federal Deposit Insurance Corporation, the Office of Comptroller of the Currency, and the Office of Thrift Supervision hosted the CISD individuals for two or three days each. The Lithuanians were also able to meet with Justice Department officials and review how the U.S. Government pursues and prosecutes white-collar crime. The trip was very successful and provided the participants with a good understanding of a number of regulatory areas.

The Director returned to Lithuania with the idea that the CISD should begin working on a bank modeling system, and the EU Phare program was approached to provide funding, which was received at the conclusion of this Task Order.

- Assistance on the establishment and implementation of a deposit insurance system

The contractor's Deposit Insurance Advisor, Dean F. Cobos, provided technical assistance and advice to the Lithuania Deposit Insurance Fund in several areas.[80] Advisor Cobos discussed the advantages and disadvantages of adopting a risk-based insurance scheme with the Fund's Director

77 December 1997 Trip Report: Federal Reserve Regulations provided: SR 96-27 dated November 12, 1996 (Guidance on Addressing Internal Control Weaknesses in U.S. Branches and Agencies of Foreign Banking Organizations through Special Audit Procedures; SR 96-36, dated December 19, 1996 (Guidance on Evaluating Activities under the Responsibility of U.S. Branches, Agencies, and Non-bank Subsidiaries of Foreign Banking Organizations); SR 97-9, dated April 9, 1997 (Revised Examination Guidelines for Representative Offices of Foreign Banks); and SR 97-22 dated July 18, 1997 (Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks).

78 Approved by shareholders on February 28, 1998. Both are on the NASDAQ as CENT and WCBO, respectively. The new holding is on NASDAQ as WCBO.

79 September 1998 Quarterly Report and October 1998 Trip Report, Exhibit #1.

80 March 1998 Quarterly Report, Exhibit #3; June 1999 Quarterly Report, Exhibit #2.

and General Counsel. Advice was also provided on the development of an appropriate risk benchmark for the industry and methods that would assist the LDIF in getting the banking industry to accept such a scheme.[81]

Advisor Cobos also coordinated a training trip for the Fund's Director to attend an international conference hosted by the U.S. Federal Deposit Insurance Corporation. While the Director was in the United States, Mr. Cobos also designed a three-day specialized training program for the Director with officers of the FDIC.[82]

Please refer to the Task 4 review above for the training assistance provided on deposit insurance issues and to the Task 5 section for information on the regulatory review assistance provided in this area.

- Policies and procedures for inspecting credit unions

The initial credit union inspection schedule was developed in 1997 and it is now prepared every quarter, similar to the inspection schedules for the banks. Three inspectors have been identified as credit union inspectors, and as of 1997, over three-quarters of the credit unions had received their first inspections. By the end of 1998, all 29 credit unions had been inspected according to a similar CAMEL system and some credit unions were on either their second or third inspection cycle.[83] Special limited or risk-focused inspections of credit unions are also occurring. The reform made in this area is sustainable.

VI. Tangible Results and Benchmarks

This section reviews the work performed by the contractor to meet the Tangible Results and Benchmarks delineated in the Terms of Reference for the Phase IV Task Order.

Tangible Results

1. *The bank supervision authority will have examined those banks scheduled for on-site examination during the period and communicated final reports of inspection to the bank(s) management. A new examination cycle will be prepared at the completion of each cycle, outlining banks to be examined, dates, and resources needed.*

This result was achieved as described above in the review of Task 1.

2. *The inspectors will have the advanced skills to perform an examination in accordance with the CAMEL components (capital adequacy, assets, management, earnings, and liquidity).*

This result was achieved as described above in the review of Tasks 2, 3 and 4.

81 June 1999 Quarterly Report, Exhibit #2.
82 September 1998 Quarterly Report, Exhibit #2.
83 December 1997 and March 1998 Quarterly Reports.

3. *The bank supervision authority will have developed an advanced internal training program for inspectors.*

This result was achieved as described above in the review of Task 4.

4. *The bank supervision authority will have developed a basic inspection manual based on CAMEL components, which is used during on-site inspections. The draft on-site inspection manual will be 100 complete by December 31, 1996 (completed on schedule).*

This result was achieved, and the On-site Inspection Manual was provided to the BoL in December 1996. A translated version of the inspection manual was provided in October 1998 by the USAID/Lithuania Project Manager, Aldas Kriauciunas. Additional assistance was provided to the BoL in developing a condensed version of the manual.[84] The preparation and delivery of an EDP review and inspection manual is discussed in the Task 2 review area.

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

This result was achieved, as described above in the review of Tasks 1, 2, and 3. On-site inspectors have standardized documents for bank management letters, report of inspection based on CAMEL ratings, loan lineslips, profitability models, and board, credit and asset/liability management committee minutes.

6. *The two inspectors who received training in the U.S. will develop reference materials or a case study for the CISD on specialty areas in which they received training as well as provide training, and hold seminars as appropriate, in these areas for the BoL bank supervision staff to transfer information and skills.*

This result was achieved and the inspectors went to the U.S. in June of 1997. As part of their training, specific items were highlighted, such as a bank ratings system (see Task 2) and accounting methods for securities. At the conclusion Phase IV, the manager of the inspection division was working on creating an inspection certification program.

Also during Phase IV, the Director of Banking Supervision and an off-site monitoring assistant participated in a training trip to the U.S. (see Task 6). The trip was very successful and gave the Director the chance to observe first hand various methods used by American bank regulatory agencies for effective supervision.

[84] January 1999 Trip Report, Exhibit #1.

The Phase IV Task Order was modified in November 1998 to include the additional tangible results listed below.

7. *The BoL's on-site inspection team will have good skills to perform electronic data processing (EDP) audits.*

This result was achieved as described above in the review of Tasks 2 and 4. IBTCI Advisor Richard Stitcher assisted the CISD inspectors in this area in June 1998 and November 1998.[85]

8. *The BoL will have instituted new training procedures related specifically to risk management and capital convergence.*

This result was achieved as described in the review of Tasks 2, 3, 4, 5 and 6.

9. *The BoL will have skilled staff as well as information and training material related to possible year 2000 problems.*

The result was achieved as described above in the review of Tasks 1, 2 and 4.

10. *The overall prudential supervision of banks carried out by the BoL will be more effective in identifying and managing risks in the Lithuanian banking sector.*

This result was achieved as described in the review of Tasks 2, 3, 4, 5 and 6.

Benchmarks

1. *At the end of every third month, the completion of on-site inspections according to the timetable laid out in the workplan and the inspection reports.*

The benchmark was achieved as described in the review of Task 1. The progress made in this area is sustainable.

2. *At the end of every third month, evidence that the contractor 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.*

This benchmark was achieved as described above in the review of Tasks 3, 4, 5 and 6. The progress made in this area is sustainable.

3. *At the end of every third month, evidence of the development of an advanced internal training program which outlines advanced capabilities and competencies for inspector and*

[85] June 1998 Quarterly Report, Exhibit #3.

evidence that training of trainers is steadily progressing. This would include for example, contractor training materials and memoranda, internal BoL memoranda relating to the program, internal BoL communications to inspectors regarding requirements.

The benchmark was achieved as described in the review of Tasks 2, 3, 4, 5 and 6. The progress made in this area is sustainable.

4. *At the end of every third month, evidence that the contractor 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.*

This benchmark was achieved as described above in the review of Tasks 2, 3, 4, and 6. The progress made in this area is sustainable.

5. *At the end of every third month, reports by the advisor on the status of the new Law on Commercial Banks including memoranda or other material written by the advisors on elements in the new law relating to strengthening bank supervision.*

This benchmark was achieved as described in the review of Tasks 4 and 5. The commercial banking law has been amended a number of times with the advice and assistance of the technical advisors. A number of memoranda and reports addressing specific topics and issues identified by the BoL and the advisors were prepared during almost every advisory trip and have been included in the relevant trip report.

The Phase IV Task Order was modified in November 1998 to include the additional benchmarks listed below.

6. *End December 1998: Specialized EDP systems training will have been provided to select BoL officials and a manual for EDP audits will have been drafted.*

This benchmark was achieved as described above in the review of Tasks 2 and 4.

7. *End March 1999: Assistance will have been provided to the BoL's off-site monitoring department to refine further the CAEL (Capital, Assets, Earnings, Liquidity) system that is currently under review. Additional work in the are of modeling and capital convergence will have continued.*

The benchmark was achieved as described above in the review of Tasks 3 and 4. Work on the CAEL (Capital, Asset Quality, Earnings, and Liquidity) system began as early as December 1997 and proceeded over the duration of Phase IV.[86] The Deputy Director of the Off-Site Monitoring Department and the IBTCI senior advisor discussed the issue of the rating of a bank's management as part of the CAEL system many times[87] and the CAEL system also began to address the implementation of the market risk area as well.[88]

8. *End June 1999: Training will have been provided to BoL officials to deal with anticipated MIS problems associated with the Year 2000 issues.*

The benchmark was achieved as described above in the review of Task 4.

The Phase IV Task Order was modified in May 1999 to include the additional benchmarks listed below.

9. *Complete final tasks related to integration of on-site and off-site inspection and improve examiner skills related to risk management.*

This benchmark was achieved as described above in the review of Tasks 2, 3, 4, 5 and 6.

10. *Present a deposit insurance system overview and best practices for both the deposit insurance fund and Ministry of Finance; review options for funding and financing the deposit insurance system related to a) insurance premiums and b) the insurance fund; strengthen skills related to risk assessment, risk management and control of risks; provide guidance on bank resolutions and bank receiverships.*

The benchmark was achieved as described above in the review of Task 4.

VII. Follow-up Work Recommendations

As described above, the IBTCI technical assistance team has successfully implemented tasks to meet the work requirements, tangible results and benchmarks required by the Phase IV Task Order and its modifications. The ability of the National Bank of Lithuania to effectively supervise and regulate Lithuania's financial institutions has been improved and strengthened and the progress made in these areas should be sustainable beyond the USAID assistance program.

The following areas may require follow-up attention and technical assistance:

- The CISD will need to develop regulations in the area of corporate governance and conflict of interest to disallow the practice of bank directors and other managers granting employees and/or shareholders loans at favorable or preferential terms (often zero percent). The CISD has been given all of the manuals from American banking regulatory

[86] December 1997 Trip Report, Exhibit #3.

agencies regarding Code of Ethics issues, as well as Regulation O regarding bank directors and officers, and many advisors have also provided sufficient information in this area. However, the CISD has yet to implement these restrictive types of regulations and should begin to address this area soon.

- Specialized training will be needed for inspectors in the area of new product development, specifically aimed at such speculative banking practices as calls, puts, options, currency forwards, swaps, caps, collars, etc. Regulations identifying these high-risk activities will have to be developed first.

- Additional work will be needed in developing regulations that sufficiently deal with the issue of bank subsidiaries and the need for a complete segregation of the activities of a subsidiary from those of its parent bank. This "corporate veil" issue is important to ensuring that banks are not utilizing their personnel and operating expenses to fund the activities of the subsidiaries. Additionally, stricter regulations will be needed to allow BoL on-site inspectors to inspect the relationship between the bank's subsidiaries and the bank and comment if any abuse is evident, which could lead to civil money penalties.

- The CISD may need additional technical assistance in the area of modeling techniques. As indicated above in the Task 2 review, the EU Phare program has approved funding to the BoL for VaR modeling work. The terms and conditions for this funding have yet to be finalized.

- The Manager of the CISD's On-Site Inspection Department requested information in regards to developing an inspector certification program. This request occurred during the last advisory trip and, therefore, only limited information and advice were provided.

B. ADMINISTRATIVE INFORMATION

I. Advisory trips made under Task Order

Advisory trips were made by the IBTCI technical advisors as follows:

Diane M. Buckshnis: December 1 to 13, 1997; March 3 to 26, 1998; May 21 to June 4, 1998; September 30 to October 15, 1998; January 14 to February 5, 1999; June 9 to 19, 1999.

Dean Forrester Cobos: March 16 to 26, 1998; May 25 to June 4, 1998; May 24 to June 4, 1999.

Richard M. Stitcher: June 6 to 17, 1998; November 16 to December 15, 1998.

II. Reports prepared under Task Order

Reports prepared and submitted under the Phase IV Task Order included:

Quarterly reports for the periods ending December 31, 1997; March 31, 1998, June 30, 1998, September 30, 1998, March 31, 1999 and June 30, 1999.

Trip reports for all of the advisory trips listed above were prepared and attached to the quarterly report for the quarter in which the advisory trip took place.

This completion report.

III. Resources committed and utilized

Cost ceiling:	$856,515.00
To be billed through final invoice:	$856,459.00
Balance:	$56

ACKNOWLEDGEMENTS

IBTCI gratefully acknowledges the efforts of its technical advisors, Diane M. Buckshnis, Dean Forrester Cobos and Richard M. Stitcher in the successful completion of this Task Order. A special thanks is extended to Diane Buckshnis for her assistance with the development of the project work plans and the preparation of all of the deliverable reports, including this completion report.

International Business & Technical Consultants, Inc.
July 31, 1999