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LITHUANIA

BANKING SYSTEM ASSESSMENT

Finance and Private Sector Development Department
Central Europe and the Baltic Countries Department
Europe and Central Asia Region
The World Bank

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A. BACKGROUND, STRUCTURE, AND RISKS OF THE LITHUANIAN BANKING SYSTEM

I. The Lithuanian Banking System

1. ***The Bank of Lithuania (BoL), the Central Bank, was established in 1990.*** BoL has the exclusive right to grant and revoke licenses to local and foreign banks and to supervise their activities. Private commercial banking boomed from 1991 to 1994 while bank regulation was lax. In late 1995, a bank crisis caused failures of most of the Lithuanian banks, and the remaining banks resulted in better managed and supervised institutions. BoL also applied tougher regulation on the banking sector. All commercial banks now need to have their financial records audited every year by an international auditing firm.

2. ***BoL's regulation of the banking sector is comprehensive and the quality of the banking system has risen dramatically.*** This has been accomplished via the rapid introduction and integration of updated banking principles. BoL inspects each bank at least once a year. The objective of the examination is to evaluate the internal governance, efficiency of risk management, and internal control system. The ICAAP process and other risk management procedures, including credit risk, market risk, liquidity risk and operational risk are in the scope of the examinations. BoL also verifies the regulatory reports and financial statements submitted by banks, reviews banks' compliance with laws and other legal acts, and assesses the activity and condition of banks. Another important aspect of BoL's regulation is to diagnose problems and provide instructions and recommendations to address deficiencies.

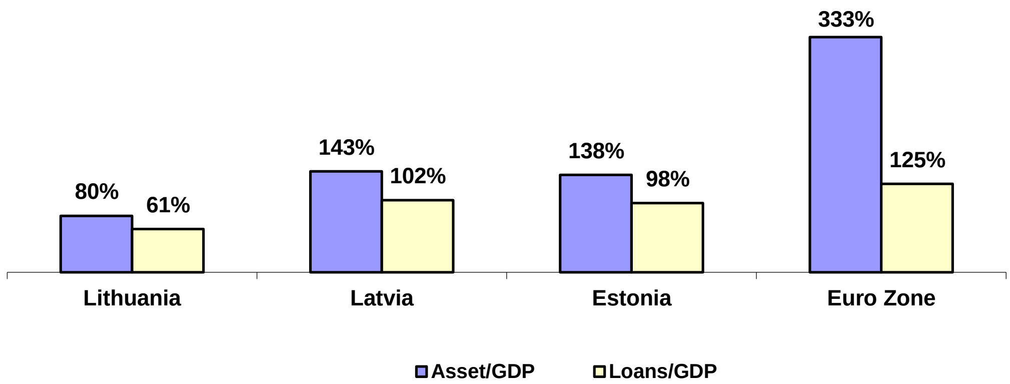
3. ***Lithuanian banks have experienced steady growth since 2000.*** Loan growth continued until 2007 when initial signs of the global financial crisis began. In 2008, Latvia had the largest number of banks, Lithuania the highest GDP, and Estonia the highest GDP per capita, among the three Baltic countries. The following table compares the economy and banking aspects of the three Baltic countries.

Table 1: Comparison of Baltic Countries

	Lithuania	Latvia	Estonia
Number of Banks	16	27	14
Inhabitants (million)	3.4	2.3	1.3
Inhabitants per bank	212.5	85.2	92.9
GDP (€ million)	32,292	23,115	15,859
GDP per capita (EU27 Avg = 100)	60.6	55.1	65.1
Scandinavian capital share	80%	55%	95%

4. ***Although Lithuania has larger population and bigger economy overall, Lithuanian's banking sector still has the lowest banking sector penetration.*** This is measured by bank assets over GDP, inhabitants per bank, and bank loans over GDP, which may indicate that Lithuanian banks have further potential. The following figure shows the penetration ratios of bank sector of the Baltic countries.

Figure 1: Bank Sector Penetration Ratios in 2008



5. ***Foreign banks and foreign bank branches play a dominate role in the Lithuanian's banking system.*** As of mid 2009, the banking system of Lithuania consisted of 9 banks holding a license issued by the BoL, 8 foreign bank branches, and 5 representative offices of foreign banks. In the 2nd quarter of 2009, foreign banks and foreign branches held 85.3 percent of the total bank assets in Lithuania. On the liability side, liabilities to foreign banks and other non-residents steadily climbed from around 20 percent in 2003 to 51 percent in 2009 (see Table 3).

6. ***The Euro is widely used in the Lithuanian banking business, especially for lending.*** However, Lithuania, among the three Baltic countries, has used local currency most for lending and deposits. Of the loan portfolios of Lithuanian banks, 64.3 percent are in Euro and 32.7 percent in local currency. In the other two Baltic countries, Latvia and Estonia, have 82.2 percent and 84.7 percent respectively, of loans in Euro. On the deposit side, 68.6 percent of deposits are in local currency and only 26.3% in Euro. Latvia has 44.4 percent of the deposits in local currency while in Estonia 59.5 percent of the deposits are in local currency. During the 2008-9 economic downturn, the worry about devaluation of the local currency made the Euro more attractive. The slower economy also caused a decrease in deposits in local currency.

Table 2: Foreign Currency Use in Baltic Countries' Banking Operations

		Lithuania	Latvia	Estonia
Loans	EUR	63.4%	82.2%	84.7%
	Local Currency	32.7%	9.9%	13.6%
	Other	3.9%	7.9%	1.7%
Deposits	EUR	26.3%	50.2%	29.4%
	Local Currency	68.6%	44.4%	59.5%
	Other	5.1%	5.4%	11.1%

7. The following table summarizes the banking system structure of Lithuania. Three out of the five largest banks are foreign banks, and the assets of the three foreign banks account for almost 80 percent of all banking assets in Lithuania.

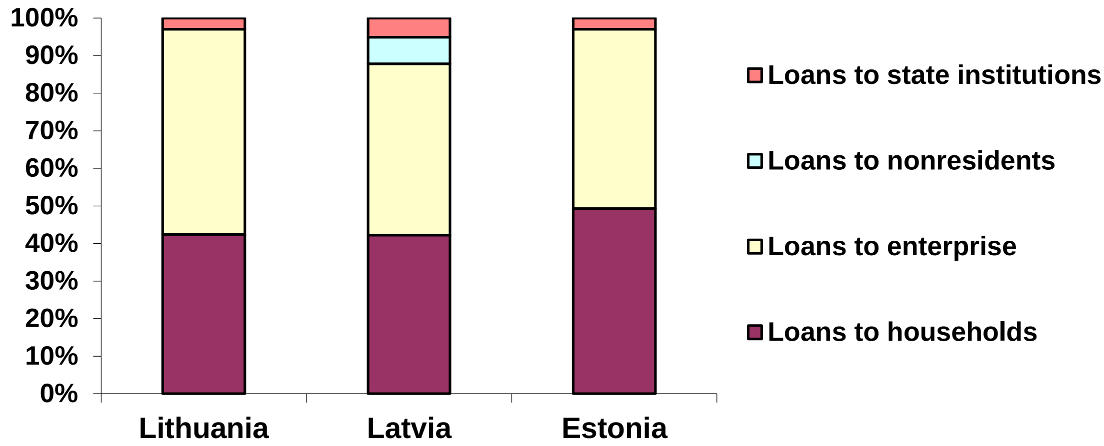
Table 3: Lithuanian Banks (2009-Q2)

Bank	**Total Assets (LTL 000s)**	**Percentage**
1. AB SEB bankas	24,910,285	34.92%
2."Swedbank", AB	19,023,641	26.66%
3. AB DnB NORD bankas	12,596,542	17.66%
4. AB bankas SNORAS	5,620,369	7.88%
5. AB Ukio bankas	4,176,194	5.85%
6. AB PAREX bankas	2,102,750	2.95%
7. AB Diaulio bankas	2,086,207	2.92%
8. UAB Medicinos bankas	766,448	1.07%
9. AB bankas FINASTA	61,891	0.09%
Total Commercial Banks (9)	71,344,327	
Foreign Banks (5)	58,695,109	82.27%
Domestic Banks (4)	12,649,218	17.73%
Total Commercial Banks & Foreign Branches	85,877,203	
Foreign Commercial Banks (5)	58,695,109	68.35%
Domestic Commercial Banks (4)	12,649,218	14.73%
Foreign Bank Branches (8)	14,532,876	16.92%

* Foreign banks are highlighted in grey. "Swedbank, AB" – is the only bank whose data is Dec. 2008.

8. ***As of mid 2009, 78.4% of Lithuanian banks' assets constituted loans.*** The other two Baltic countries, Latvia and Estonia, had similar shares. In Lithuania, 54.8 percent of the loans were given to enterprises and 42.6 percent to households.

Figure 2: Loan Portfolio Breakdown by Borrower



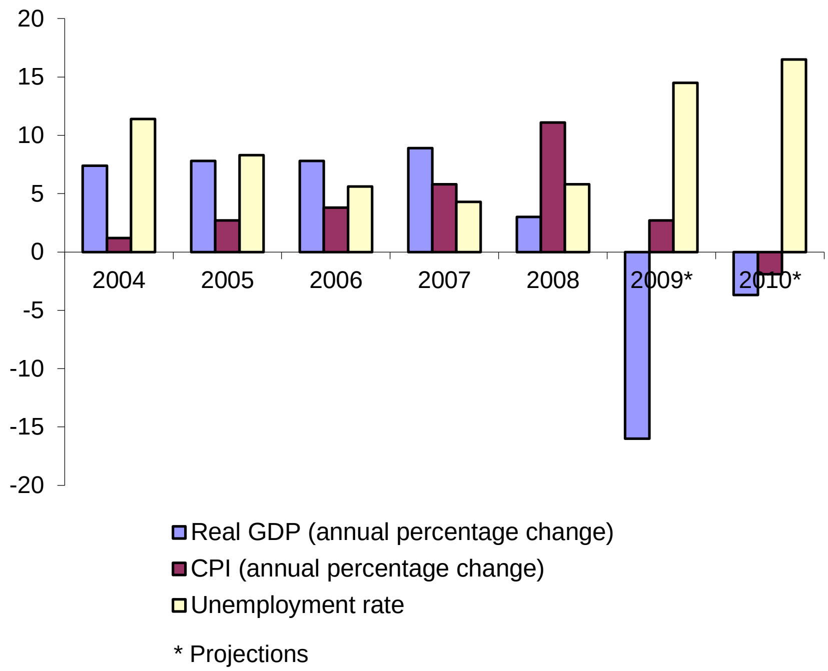
II. The Financial Crisis and Macroeconomic Conditions in 2009

Economic Downturn in 2009

9. ***Following rapid economic growth over the past ten years, the Lithuanian economy headed toward a severe downturn.*** Lithuania's economy boomed after it joined European Union in 2004. The GDP growth reached 8.9% in 2007, and continued strong growth during the first three quarters in 2008. However, as the financial crisis spread through Europe, Lithuanian's economy took a hard landing starting from 2009. In the first quarter, the economy plunged 12 percent compared to that of the second quarter of 2008 when the economy had peaked. Based on a preliminary estimation, the economy shrank by 18 percent versus a year ago. It marked the worst recession since its independence in 1990. The decline was the deepest in the European Union, marginally worse than Latvia. To avoid a currency devaluation, private sector wages adjusted dramatically followed by government cuts in public sector wage levels.

10. ***The outlook for the economy is not optimistic.*** IMF forecasts that real GDP will decline by 18.5 percent by year-end and drop another 4 percent in 2010. In the first quarter of 2009, unemployment reached 11.9 percent, and the IMF projected an average of a 16.5% unemployment rate for 2010. The IMF expects a recovery of the economy in 2011, and the growth gradually rise to around 4 percent, driven by adjusted factor costs and improving exports. However, the recovery is not pronounced as there are many uncertainties going forward, which include a slow global recovery and adjustment of factor costs, potential deflation, and large amounts of non-performing loans within banking system. The following figure shows the annual Real GDP growth, CPI, and unemployment in Lithuania.

Figure 3: Selected Economic Indicators, 2004 - 2010



11. ***Imports and exports have declined significantly during the economy downturn.*** Imports are expected to decrease by about 36 percent, and exports are projected to decline about 26 percent. The larger decline of imports may create a temporary surplus on the current account, which is projected to be 0.6 percent of GDP in 2009. However, as the economy recovers, the current account is expected to reverse to a deficit in the following years. The following table shows the balance of payments of Lithuania.

Table 4: Lithuania: Balance of Payments, 2007-2011

	2007	2008	2009 Est.	2010 Proj.	2011 Proj.
		(euro billion)			-
Current account balance	-4.1	-3.7	0.2	0.0	0.2
Capital and financial account balance	5.0	3.1	-0.9	0.0	2.0
Capital transfer balance	0.5	0.6	0.5	0.8	0.9
Foreign direct investment balance	1.0	1.0	0.5	0.7	0.3
Portfolio investment balance	-0.2	-0.1	0.3	0.3	0.1
Other investment balance	3.7	1.6	-2.3	-1.7	0.7
Overall balance	0.9	-0.8	-0.6	0.1	1.7
Financing (International Reserves)	-0.9	0.8	0.6	-0.1	-1.7
		(% of GDP)			
Gross eternal debt	72.3	71.4	88.1	95.7	95.1
Public	12.5	10.1	17.5	24.1	24.6
Short-term	1.1	0.1	0.9	1.2	1.2
Long-term	11.4	10.0	16.6	22.9	23.4
Private	59.8	61.2	70.6	71.7	70.5
Short-term	21.3	20.6	21.6	20.8	21.2
Long-term	38.4	40.6	49.0	50.9	49.2
Net external debt	25.5	29.1	38.5	34.6	29.7
Net International investment position	-56.4	-51.8	-59.9	-58.0	-52.8

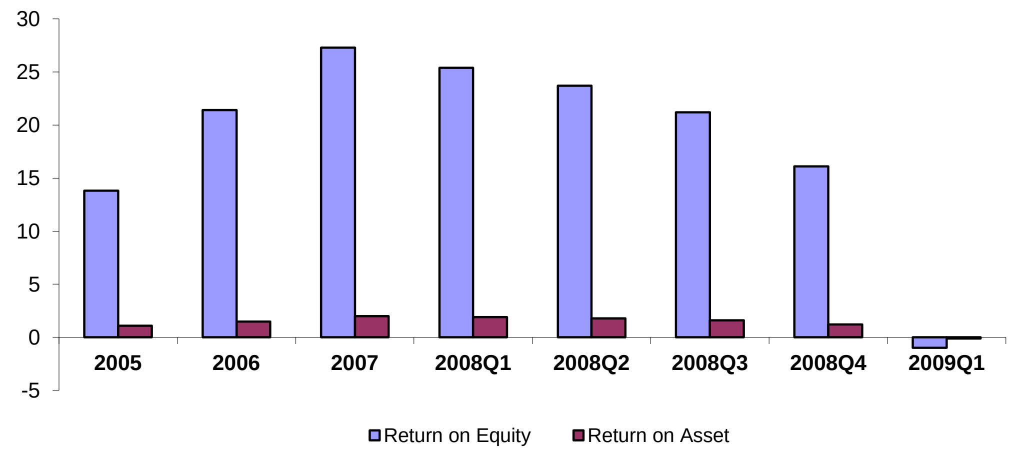
Source: IMF

12. ***The economy has accumulated significant external debt over the years.*** In 2009, net external debt is projected to be 38.5 percent of GDP, an increase from 29.1 percent in 2008. The figure is expected to be 34.6 percent and 29.7 percent in 2010 and 2011 respectively.

III. The Banking System during the Financial Crisis

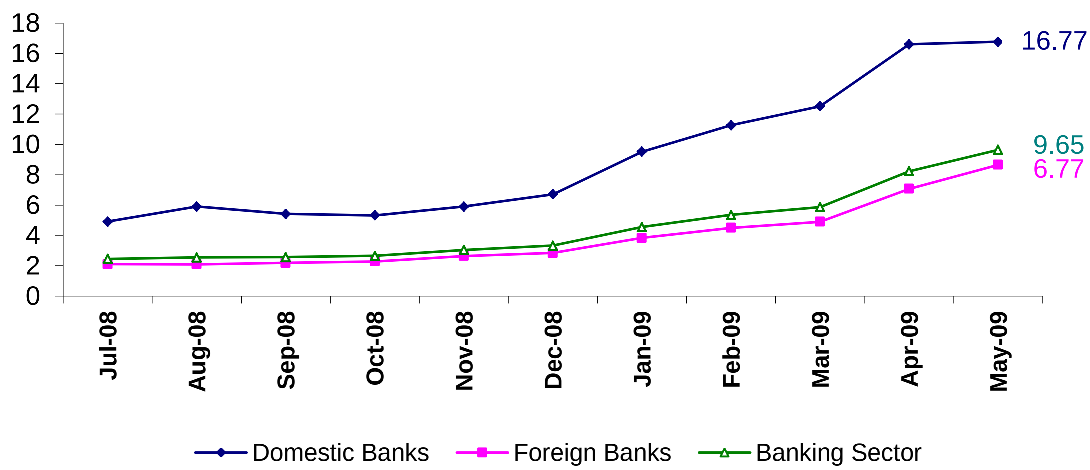
13. ***Returns of banks turned negative in the first quarter of 2009.*** The banking system had enjoyed stead growth before the global financial crisis started in 2007, and managed to stay profitable through 2008. Figure 4 illustrates the profitability of Lithuanian banks.

Figure 4: Returns of Lithuanian Banks



14. ***One of the biggest concerns of the banking system in Lithuania is the mounting non-performing loans, which increased at a very fast pace during 2009***. Impaired loans to capital were 54.9 percent in the first quarter of 2009, up from 36.3 percent of Q4 in 2008. Overdue loans which are yet to reach impaired status increased from 12.2 percent in Q4 2008 to 29.9 percent in Q1 2009. The percentages of non-performing loans and overdue loans are significantly higher for domestic banks than foreign banks. Figure 5 shows the problem of non-performing loans.

Figure 5: Non-performing Loans / Total Loans



15. ***Overall, foreign banks performed much better than domestic banks, particularly in terms of non-performing loans, during the crisis.*** Based on the data provided by the Credit Institutions Supervision Department of BoL in May 2009, the loan performance of foreign banks or foreign banking subsidiaries was significantly better than domestic banks or local banks.

16. ***It appears that Lithuanian banks currently have a sufficient capital buffer for expected and unexpected losses in the near future.*** The average capital ratio was 13.9 percent in the first quarter for all banks, which is much higher than the 8 percent regulatory capital requirement. The capital ratio of foreign banks was 14.2 percent, a little higher than that of domestic banks which had 12.7 percent capital ratio. Most banks are sufficiently capitalized, and would have enough capital to cover potential losses. However, the fast growth of non-performing loans is likely to further reduce capital buffers. Therefore, it is necessary for the banks to boost loss provisioning for the potential losses brought on by rapidly increasing non-performing loans.

Table 5: Non-performing Loans and Capital Adequacy

Indicator	Foreign Banks	Domestic Banks	Total Banks
NPL/total loans	8.66%	16.77%	9.65%
Impaired loans/total loans	5.94%	7.25%	6.10%
60 days overdue/total loans	2.72%	9.53%	3.55%
90 days overdue/total loans	1.46%	6.97%	2.13%
Capital adequacy	14.2%	12.7%	13.9%
Impaired loans/total loans	5.94%	7.25%	6.10%

Source: BoL

17. ***As occurred in many other countries during the credit contraction, liquidity risk remains a concern.*** Deposits have shifted to foreign currencies since a bank run in October 2008. Domestic banks are weaker than foreign banks because they have difficulties in funding and accessing contingent resources. Parent bank funding of subsidiaries has also declined. Nonresident deposits contracted by 41 percent since end 2007. Another potential risk is that the problems of banking systems of another country in the region could spread to Lithuania as financial crises in nearby countries negatively reinforce each other. External shocks may trigger confidence problems in the banking system. Losses in other countries may also force Nordic banks to repatriate capital from Lithuania.

18. ***BoL has moved swiftly to address the potential weakness of the banking sector.*** In response to the crisis, BoL reduced reserve requirements from 6 to 4 percent to help ease liquidity pressures. In autumn 2009, BoL revised and updated rules on providing liquidity loans, and is ready to provide these loans to banks if necessary. The deposit insurance limit was raised to €100,000 and speedier bank resolution has also been enhanced through the draft version of Financial Stability Law in Parliament. The new framework provides for government guarantees of interbank lending which is 3 percent of GDP, and public support for bank recapitalization and asset purchases. A financial crisis preparedness committee was also established to enhance

coordination and contingency planning. On the bank regulation side, BoL requested banks to capitalize their full 2008 profits. It also conducts on site examinations to ensure the timely build-up of loan loss provisioning.

19. ***So far, the Lithuanian banking system has held up well against the financial crisis.*** No bank has needed any assistance from BoL or the Government. Parent banks of the commercial banks operating in Lithuania have sent letters of comfort informing that they will continue financing of their subsidiaries. It is likely that funding will thus be continued from foreign banks.

IV. Stress Tests Performed by the Bank of Lithuania

<u>Stress Tests conducted by the Financial Stability Department</u>

20. ***The Financial Stability Department of the BoL performed a credit risk stress test on the banking system in June 2009.*** Credit risk stress testing is conducted to estimate the magnitude of potential loan losses under extremely severe scenarios and to assess capital adequacy of the banks under such scenarios. Key risk factors identified in the stress test included various gradations of worsening, following by decline of house prices and rising interest rates.

21. ***Data from five largest Lithuanian banks*[1] *were used in the stress test.*** By the end of 2008, these five banks constituted 76 percent of the total loan portfolio in the system, and 84 percent of total deposits of the banking system. The probabilities of default (PD) over 12 months were estimated for households, for six economic sectors: real estate, industry, trade, construction, transport, and agriculture. Loans granted to these sectors cover the major part of the analyzed portfolio. The loss given default (LGD) is assumed to be 50 percent.

22. ***Medium-term macroeconomic forecasts of BoL were used as the baseline scenario, and shocks included a 6.1 percent point increase in the interest rate and a 40 percent drop in house prices.*** The interest rate shock was based on the data analysis of financial crises in other European, American, and Asian countries in the last 25 years, and the house price shocks were based on the data of housing price developments in other Baltic States and other countries that experienced financial crises.

23. ***The effect of the shocks on credit risk was evaluated using credit risk stress testing models based on the Conditional Probability of Default.*** This included use of Consistent Information Multivariate Density Optimizing methodologies. The Conditional Probability of Default methodology models the empirical frequencies of loan defaults (PDs) as functions of (identifiable) macroeconomic and financial variables. The consistent information multivariate density optimizing CIMDO methodology allows the modeler to recover the multivariate

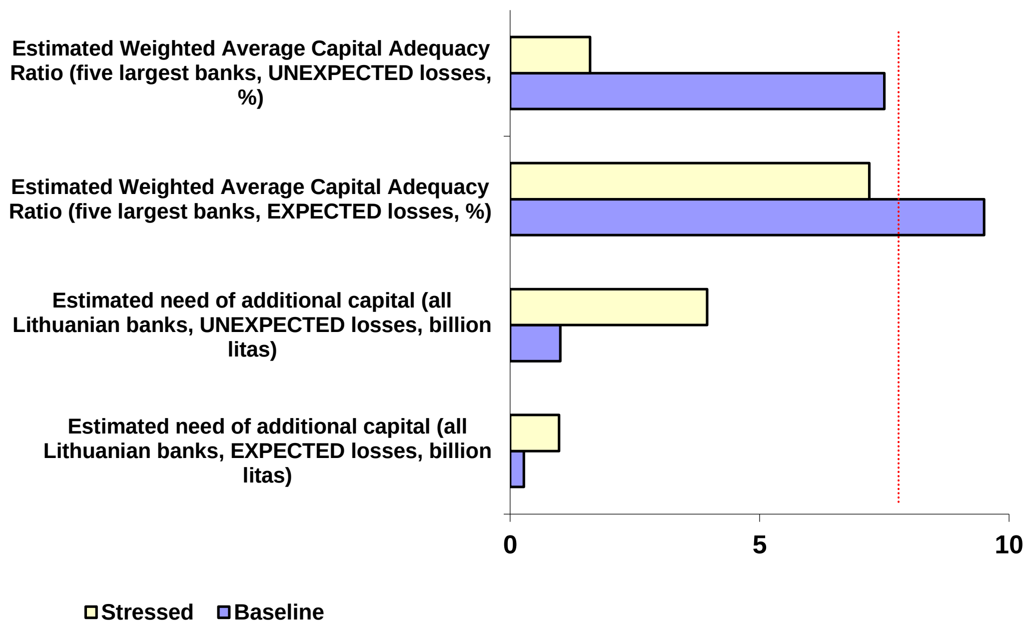
[1] AB SEB bank, “Swedbank” AB, AB DnB NORD Bank, AB bank “Snoras” and AB Ūkio bank.

distributions that describe the joint likelihood of credit risk quality changes in the loans making up a portfolio.

24. ***The effect of initial shocks on other macroeconomic and financial variables have been evaluated using a structural macroeconomic forecasting model.*** Such as model was developed, maintained and updated by BoL. It is estimated that combined interest rate shock and housing price shock would considerably increase the PDs. The estimated portfolio losses are then compared with the existing loss buffers to evaluate the capital adequacy of the banks under the extreme scenarios.

25. ***Overall the stress test results show that banks need to further strengthen their capital base to absorb potential credit losses under extremely severe economic scenarios.*** More specifically, the capital adequacy ratio of individual banks would fall by 2 to 4 percent by the end of 2009 due to increased expected loan portfolio losses under such scenarios. The capital ratio of the five largest banks would still remain above the 8 percent regulatory capital. However, under highly unfavorable economic situations, the average capital ratio could fall below 8 percent in 2010.

Figure 6: Stress Test Projections for 2010



Note: Vertical dotted line represents 8% capital adequacy level.

26. ***The stress test results indicate that banks may need 150 million litas (approx. $63 million) of capital by the end of 2009 and up to 1 billion litas (approximately $430 mn.) by the end of 2010 to cover expected credit losses.*** An estimated capital of 300 million litas (approx. $125 mn.) may be needed to cover unexpected losses in 2009 and unexpected losses may be up to 4 billion litas (approx. $1.7 bn.) in 2010 based on the stress test scenarios. An expected loss

projection is based on a reasonable scenario based shock, while an unexpected loss even reflects an arbitrary extreme 'tail' event.

Stress Tests Conducted by the Credit Institutions Supervision Department

27. ***The Credit Institutions Supervision Department of BoL also conduct stress tests using top down and bottom up approaches.*** Data is submitted by banks using the same scenarios and calculation methods for all banks (top-down), as well as banks themselves using own methodologies and models that meet general requirements established by BoL (bottom-up).

28. ***Since 2002 all banks, except foreign bank branches have been tested for the effect on capital from factors such as credit risk, market risk, liquidity risk, and operational risk.*** Additional material risk types that were identified during ICAAP have also been tested since 2008. Each risk type is tested under three scenarios: a standard or baseline scenario, a most plausible scenario of likely stresses, and a worst case scenario. The following table summarizes the scenarios in the stress tests.

Table 6: Bottom-up Stress Test Scenarios

Risk Type	**Standard**	**Most Plausible**	**Worst Case**
Credit Risk			
Loans loss event %	5%-7%	10%	15%
Real estate prices down %	20%	30%	50%
Interest Rate Risk			
Change of interest rate in basis points	50-100bps	100-150bps	150-200bps
Equity Securities Price*			
Average decline of prices	15%-20%	30%-40%	50%-75%
Liquidity Risk			
Decrease of Deposits	10%	15%	20%-30%

* Lithuania's banks don't have large equity securities portfolio, so a large decline in their prices will not affect banks performance significantly.

29. ***The BoL did not consider an "unpegging" of the exchange rate versus the euro, as the BoL and Government policy is to strictly maintain the Lithuanian currency board at all costs.*** For the risk of foreign currency exchange rate, different preconditions can be used and normally the stress scenarios would be between a 1% to 30% depreciation range. Given that the banking system's loan portfolio is invested in two thirds foreign currency, a 30% depreciation, would have a significant additional effect on credit risk and non performing loans. However, a depreciation alone would be insufficient to cause a capital/solvency problem for banks. Nevertheless if coupled with the stress scenarios described below for other risks, this would generate capital shortfalls in some banks.

30. The stress test results for credit risk and interest rate risk are shown in the following table.

Table 7: Stress Test Results: Credit Risk and Interest Rate Risks

	Scenario	Actual Capital Adequacy Ratio	CAR with Credit Risk Stress Testing	CAR with Market Risk Stress Testing
Foreign Banks	Standard	14.06%	12.13%	13.9%
	Most Plausible		11.61%	13.7%
	Worst Case		9.7%	13.2%
Local Banks	Standard	13.32%	11.04%	13.0%
	Most Plausible		10.07%	12.9%
	Worst Case		8.98%	12.7%

31. For the capital adequacy ratio, the results show that the capital ratio for both domestic and foreign banks would remain much above the 8 percent regulatory capital level, even under the worst case scenario.

32. ***The liquidity risk stress test results indicate that domestic banks may face liquidity problems under worst case scenario.*** This is because domestic banks have limited access to funding and lack of contingency resources under extreme scenarios, and do not count on any parent bank funding conduits. However, under the Stability Law discussed later, BoL would provide short term liquidity facilities to banks experiencing funding shortfalls.

33. ***The operational risk stress test results show that this risk has limited impact on capital adequacy ratios.*** Even in the worst case scenario, the capital adequacy ratio would be close to 13 percent and 14 percent for domestic and foreign banks respectively.

Table 8: Stress Test Result: Liquidity Risk

	Scenario	Actual Liquidity Ratio	Liquidity Ratio After Testing
Foreign Banks	Standard	38.5%	31.6%
	Most Plausible		31.6%
	Worst Case		29.0%
Local Banks	Standard	40.0%	33.3%
	Most Plausible		30.3%
	Worst Case		14.1%

34. ***The overall results indicate that under standard and the most plausible scenarios, both foreign banks and domestic banks could keep capital ratio comfortably above the 8% level.*** However, under the worst case scenario, the capital ratio of domestic banks is barely above 8%, indicating domestic banks may need to raise more capital to cover losses in extreme downturn scenarios. An additional depreciation shock in addition to the above would move more domestic banks into a undercapitalized situation, though as mentioned, this explicit stress test was not

conducted given the government's commitment to maintain the currency peg. The overall stress test result for the four main risks combined, are shown in the following table.

Table 9: Stress Test Result: All Risks

	Scenario	**Actual Capital Adequacy Ratio**	**Capital Adequacy Ratio After Testing**
Foreign Banks	Standard	14.06%	11.89%
	Most Plausible		11.19%
	Worst Case		8.61%
Local Banks	Standard	13.32%	10.42%
	Most Plausible		9.41%
	Worst Case		8.02%

35. Based on the stress test results, a number of contingency plans were recommended by Credit Institutions Supervision Department of BoL.

V. BoL's Plan for Financial Crisis Management in the Future

36. ***BoL has published a "Procedure of the Bank of Lithuania on Identification of Financial Crisis Prevention and Management Stages and Exchange of Information."*** This would help BoL to better forecast, control and manage any imminent financial crisis. The procedure aims to develop an early warning system for possible financial crisis procedures in response to a financial system shock. Since February 2009, the Credit Institutions Supervision Department which is the bank supervisor of Lithuania, would assess risk information regarding the identification of early warning signs of a financial crisis. Table 10 shows some of the details of BoL's risk weight assessment template.

37. ***BoL would be expected to take preemptive actions to address the potential risks.*** The actions have three levels: financial crisis prevention, financial crisis control, and financial crisis management, all depending on the stages of the financial problems encountered.

Table 10: BoL's Risk Assessment Template

Main Ratios	
1	Capital adequacy (percent)
2	Liquidity (percent)
3	Total open position in foreign currencies (percent)
4	Meeting reserve requirements
5	Bank does not perform payments
6	Number of performed payments in the payment systems
7	Amount of performed payments in the payment systems
8	Non-performing loans (NPL) compared to total loan value (percent)
9	Change of deposits over a month (percent)
10	Change of liabilities to parent banks and credit institutions of the banking group over a month (percent)
11	Liquid assets compared total assets (percent)
Additional Ratios	
1	Adequacy of Tier 1 capital (percent)
2	Loans vs. total assets (percent)
3	Loans compared to GDP forecast (percent)
4	Loans to state institutions, state and municipal enterprises compared to the loan portfolio (percent)
5	Loans to financial institutions compared to the loan portfolio (percent)
6	Loans to private companies compared to the loan portfolio (percent)
7	Loans to private individuals compared to the loan portfolio (percent)
8	Change in profit (loss) over a month (percent)
9	Changes in debts for banks and other credit institutions over a month (percent)
10	Changes in deposits of state authorities and municipal enterprises over a month (percent)
11	Changes in deposits of financial institutions over a month (percent)
12	Changes in deposits of private companies over a month (percent)
13	Changes in deposits of private individuals over a month (percent)
14	Net interest income compared to net profit (loss) (percent)

38. ***Understanding the potential risks of inaction, in coordination with BoL, the Government approved a new Stability Law which provides increasingly flexible tools for crisis management and resolution of weak banks.*** The tools under this law as well as the diagnosis of the economic contraction effects on the banking system, are discussed in the next section, along with recommendations for further reforms. These would improve the regulatory and supervisory framework for crisis management as well as develop tools to maintain funding in stressed markets in order to keep the banking system liquid and sufficiently capitalized.

39. ***In the meantime a sharp adjustment process has permitted Lithuania to survive and count on fiscal resources without international support.*** The Government, through its macroeconomic and wage policies (as well as the private sector which has adjusted wages even more rapidly) has to-date succeeded in an "internal devaluation" approach given the 18% GDP contraction. This has avoided a currency devaluation and even allowed the government to issue sovereign bonds for fund raising, albeit at expensive spreads.

PART B: RISKS AND CONTINGENCY CRISIS MANAGEMENT MEASURES IN THE LITHUANIAN BANKING SYSTEM

I. Financial Sector and Macroeconomic Context

40. ***Banking, Regional and Fiscal Issues.*** Lithuania's country risks are threefold: (a) contraction-linked banking portfolio deterioration coupled with contingent risks to local banks' solvency, (b) regional contagion including outflows, if Latvia's fiscal program and/or the currency board proves unsustainable, and (c) fiscal funding gap risks, to some extent ameliorated, at least temporarily, with the successful Lithuanian eurobond issue.

41. ***Potential Trigger Events.*** Nevertheless, a lack of a sustainable and credible fiscal funding strategy could potentially trigger investor capital outflows if this were coupled with additional macroeconomic/monetary stress in Latvia.[2] Thus, the government's key strategic pillars should be ensuring a fiscal path with ample pre-planned funding, and a generous cushion in the banking system to maintain financial and monetary stability.

42. ***Bank Portfolio Developments and Capital.*** While banks appear to have sufficient ***regulatory*** capital at the moment (capital adequacy ratio of 14.1% for foreign banks and 13.3% for domestic banks versus the 8% minimum requirement), the sharp GDP downturn, projected at 15% for 2009 coupled with the ongoing drop in real estate prices and an export slowdown, implies an accelerated increase in non performing loans.

43. ***Impairment and Loss Provisions.*** The banking system's non performing loans stand at 8.2% of the portfolio while loss provisions amount to only 1.7%. Of the non performing loans, 5.3% are impaired requiring immediate provisions, and 2.9% are past due. Even if only impaired loans are considered, loan collateral (given the drop in real estate prices in the past year and the continued expected decline) could be insufficient to supplement a large part (e.g. 50%) of provisioning requirements and also given the fact that any collection on collateral needs to be discounted for the time taken to realize it (or the sale-ability of the asset in a negative growth period). Thus, impaired loans appear under-provisioned, and *if past due loans are a leading indicator of future impairments, the current provisioning levels may need to be more than doubled* (1.7% + (5.3%/2 – 1.7%) + (2.9%/2) = 4.1% and likely increased even further under the assumption of further NPL increases.

44. ***Scenario Stress Testing.*** The Bank of Lithuania (BoL) has taken the above concerns into account via scenario stress tests including rising NPLs, and further sharp drops in real estate values (e.g.: -40%) including through 2010. Under plausible extreme expected loss scenarios, increased capital requirements of banks could easily amount to Litas 1.7 billion (equivalent to EUR 300 million) which, according to BoL can be absorbed by them while maintaining regulatory solvency. *However, the mission noted that credit risk default probabilities relied on*

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[2] The risk of outflows, however, may be tempered given the composition of external 'investors' where the major shares are for FDI (32%), bank loans (mostly parent banks, 39%), then only followed by portfolio investment (9%).

loss provisioning trends which might require a correction given the anticipated rises in these during 2009. In addition, tests did not evaluate credit risk losses against a possible devaluation, something which might have significant impacts given the system's loan exposure of 65% in euros.

45. ***Unexpected Losses (1% statistical probability).*** Under extreme unexpected loss scenarios, however, including interest rate increases and continued GDP declines and loan defaults through 2010, capital ratios would go below the minimum regulatory requirements, and some domestic banks (already paying deposit interest differentials of five percentage points versus foreign banks) could be more heavily affected and strain their solvency. Under such an extreme 'unexpected' loss scenario, incremental capital requirements could exceed Litas 4 billion (EUR 1.2 billion), of which EUR 360 million might constitute domestic bank needs that could not be covered by parent bank sources as available for foreign banks.

II. Policy Initiatives and Contingent Crisis Management Measures

46. ***Contingency Planning and Fiscal Implications.*** The Government and the BoL have considered certain scenarios carefully and are considering increasing their policy tool kit to affront potential vulnerabilities. However, any such challenge, if it materialized, would stress an already tight fiscal situation and require advance contingency planning to maintain macroeconomic and financial sector stability. In addition, while currently not contemplated, the deposit insurance fund may require additional State resources if depositor concerns arose – yet another fiscal demand – though this sort of demand is less likely especially for foreign banks, and the deposit insurance fund has reached a generally acceptable target of 3.4 percent of deposits, though insufficient to cover all the deposits of domestic banks.

47. ***The Prominence of Fiscal Signals.*** Therefore, a strong and well resource-cushioned fiscal program with a credible deficit reduction path appears to be the first line of defense and the largest challenge, to allow Lithuania to differentiate itself from other vulnerable countries. For this purpose a realistic fiscal and debt sustainability analysis (including expected sources of fiscal debt) should be laid out to provide the basis for a sound and deficit reducing macroeconomic program, taking into account further expected GDP reductions in 2009 and possibly 2010.

48. ***Financial Policy Engineering for Crisis Prevention.*** Beyond the fiscal vulnerability, the risk of bank failures, especially for some of the domestic banks, is not insignificant, if GDP continues to decline with ensuing portfolio defaults. While the worst case stress scenario calculates a 15% portfolio loss where domestic banks barely escape technical insolvency, such an event is not unlikely given the current NPL level and NPL losses in countries with similar or less severe GDP declines. Thus, the Government and BoL should be prepared, even if it does not materialize, for potential and expeditious bank bail-outs or orderly closures generating minimum financial system disruption. In this regard, the proposed Financial Stability Law is encouraging though some implementation gaps remain which should be addressed.

49. ***Financial Stability Law.*** The proposed new draft law[3] provides additional options and powers for the government and the BoL in order to address banking problems if they emerge. They widen the options for the government to become involved in serious liquidity or solvency scenarios while maintaining the original spirit and procedures already permitted under the existing banking law. Essentially the Stability Law adds more flexibility for (a) providing bank debt guarantees, (b) allowing the government to purchase bank assets in exchange for safer assets, (c) providing capital via government shares in banks, and (d) taking over/nationalizing banks too weak to manage in the market, via forced purchase of its equity (if any remains).

III. Recommendations – Ensuring the Efficient Resolution of Troubled Banks

50. ***Implementation of New Policy Tools and Constraints.*** The tools included in the proposed new law appear well considered but require (a) speed of execution, and (b) adequate funding. The debt guarantee feature which counts on a budget allocation of Litas 1.5 billion may just be sufficient to address liquidity shortages for the domestic banks (assuming the foreign banks receive parent support). However, it is not clear if the government has budgeted for contingencies such as (i) bank capitalizations, (ii) purchase of assets, or (iii) purchase of shares. Given the much higher EUR 100,000 guarantee, supplementary funding for the deposit insurance scheme, if used, should be considered as well. The government should thus quantify scenarios to obtain a realistic view as to incremental fiscal demands that might emanate from adverse probable financial sector developments.

51. ***Execution of Crisis Management Measures and Bank Takeovers.*** The second constraint to the effectiveness of the Stability Law measures, concerns anticipated speed of execution. Loss of speed during the takeover of an institution's equity, for example, can easily result in loss of value and shareholder lawsuits. To correct any such problems, the government should replicate, in the Stability Law, the same Banking Law clauses allowing BoL takeover of an insolvent institution, without being subject to lawsuits based on a reading of the Banking Law alone that could halt the process, to prevent a reversal of the decision. While this may build in some legal redundancy (given its coverage in the Banking Law), this might be necessary to close any inadvertent legal gaps and avoid unanticipated challenges.

52. ***Valuation of Assets and Capital under Emergency Procedures.*** As discussed, the Financial Stability Law contemplates government takeover of shares or purchase of assets, and any such situation would require speedy conclusion of such a transaction. For this purpose, internal BoL operating procedures should begin identifying risky banks and conducting in the next weeks or months, reliable asset and capital valuations (including with the use of external experts, as part of inspection procedures) to obtain independent valuation assessments to be used or adjusted quickly when the time comes for conducting the aforementioned actions. Such valuations, potentially with the help of specialized experts or auditors, should not wait for the decision of the Government to intervene as that would entail subsequent delays and increase the eventual costs to shareholders, creditors, and the State.

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[3] Following the preparation of this report, the Seimas of the Republic of Lithuania passed the Law on Financial Stability on July 22, 2009. This report's comments are based on the draft version provided to the mission in June.

53. ***Reprivatization of Banks Taken Over.*** The Financial Stability draft law mandates the resale of a taken over bank as soon as it becomes fully solvent again. In line with the paragraph above, the law may wish to specify the option of using an intermediate stage allowing the resale of a part of the bank's balance sheet, either as a modified institution or as a transfer/sale to a third party/solvent bank. While the law specifies (in line with EU State Aid rules) that any bank taken over needs to be resold promptly once solvent, the law may also wish to specify that the government (and the taxpayer) should be able to obtain a minimum return (e.g.: zero or above) on its purchased equity, or a minimum level of recovery even if partial, as part of an eventual resale price in order to make such operations more fiscally sustainable.

54. ***Least Cost Criteria for Government Involvement.*** The Stability Law or associated regulations might also wish to specify that public assisted support for insolvent banks should follow a least cost criteria so as to avoid unnecessary fiscal outlays by the State. For example, under an equity takeover by the government, the eventual resolution of the bank should measure the options of an immediate depositor payout and liquidation (if the bank does not recover) against the options of selling partial balance sheet assets with deposits to healthy banks (thus avoiding the need for full depositor payouts). Given the almost blanket coverage of depositors under the new EU mandated limits, this may require building into the law a hierarchy of depositors (as creditors) starting with the smallest as first-covered creditors, to the largest, so as to be able to use a criterion for initially transferring limited numbers of deposits to healthy banks following a government takeover, using pre-established rules governing the treatment of depositors under a "limited transfer envelope."

55. ***Asset Conversion for Increased Market Trading.*** After a bank equity takeover by the government, the Stability Law may also wish to consider a non-complex, basic securitization of loan assets in the acquired bank to allow quicker sale of such loan portfolios to a wider range of banks or investors. The securitization (which can be overcollateralized to minimize defaults on the packaged securities) would allow the government to more quickly sell off assets once the bank's balance sheet recovers, with receiving banks or investors playing different roles. For example, some banks may wish to manage the underlying portfolio of loans (supporting a securitized bond) on a success fee basis but as an off balance sheet item for such bank. Other banks or investors may wish to purchase the bonds to place on their balance sheets along with matching deposits from the source bank. Such measures would also help to protect and minimize state fiscal outlays while transferring increased absorption of risks to private sector participants.

56. ***Role of Temporary Administrator.*** The Financial Stability Law may also wish to consider modifying the Banking Law so that appointment of a temporary administrator by BoL, in a private bank, may include more powers under a crisis situation (e.g.: to restructure or reorganize the bank and sell parts of its portfolio without shareholder consent if working under purview of Stability Law triggers that may involve State support). As well, the law may wish to specify (provided valuations of assets/capital are available) that the Temporary Administrator has the power to reorganize/restructure/sell parts of a bank if its equity value is shown to be zero or less (this obviates any property rights claims from shareholders). Alternatively, the law could

be modified to include a ‘special instance’ prior to moving toward the receivership phase, to conduct the above-mentioned functions while safeguarding the value of a bank’s assets as an operating entity, thus supporting the Stability Law powers.

IV. Liquidity Tools

57. While liquidity stresses were more prevalent in the fourth quarter of 2008 and currently credit risk development appears to be a greater emerging banking risk, the authorities nevertheless have enhanced their policy tool kit for tackling liquidity issues.

58. ***Debt Guarantees*.** As discussed the proposed Financial Stability Law permits the government to issue (for a fee) guarantees of bank debt (interbank loans, bonds) in case external third party liquidity suppliers are concerned about bank repayment/credit risks. One issue that may arise, however, is if third party banks or investors will supply liquidity supported by the Lithuanian government’s sovereign guarantee. In periods of liquidity stress, such a guarantee may also be seen as containing its own degree of sovereign credit risk. *The Government, therefore, may wish to consider whether a sovereign guarantee for bank debt requires its own wrap-around guarantee of the sovereign risk, which could potentially be structured/designed using a supranational guarantee provider*.

59. ***Covered Mortgage Bonds.*** Covered bonds are ***not*** securitizations (which carry less than an optimal reputation recently) but rather general pledges attached to bank issued bonds that back up such bonds’ cash flows with income earned on a bank’s mortgage portfolio in general, as well its total balance sheet. As such they are not structured securitizations and are fully on-balance sheet. Given the stability of mortgage loan portfolios, covered mortgage bonds would be a safe and reliable instrument for banks to obtain liquidity from either the domestic or the foreign market, and/or use such bonds as collateral for interbank or BoL borrowing, if approved for such. *Therefore, BoL and MoF should consider developing and implementing a legal and regulatory framework governing the requirements for issuing covered mortgage bonds, which would expand the potential liquidity sources for banks.*

60. ***Regulation on Time Deposits.*** Time deposits in banks which constitute 46% of all deposits, may according to the Lithuanian Civil Code Law, be withdrawn by customers at any time (including before maturity) without any penalty except for the loss of some interest. Such a practice increases the liquidity risk of banks significantly. *The Government and BoL, should consider, as part of the Financial Stability Law provisions to permit banks, in crisis or non crisis situations, to set disincentives for the withdrawal of time deposits that have not yet matured (e.g.: losing all accrued interest, or having penalty fees) so as to mitigate the risk of deposit runs, while at the same time avoiding outright deposit freezes which would send the wrong signals*. *As well, the Government should consider removing this banking-related aspect from the Civil Code.* Such a feature of the law and/or its changes, would need to be checked against the constitutionality of Lithuanian law.

61. ***Buyer of Last Resort.*** The government and BoL anticipate that if a liquidity crisis or a deposit run were to recur, many banks would be able to sell off liquid assets such as government

securities to the market in order to increase liquidity. However, in such an instance many financial institutions may not be willing to purchase securities in the secondary market as they may wish to remain liquid as well. BoL cannot act indefinitely as a buyer of last resort (or lender of last resort using the securities as collateral) given its limit under the currency board, of Litas 1.5 billion of freely usable liquidity. *The Government and BoL, therefore, may wish to consider entering into agreements with the strongest banks in the system, so that they may act as buyers of last resort (for a fee) of government securities being unloaded by other banks during periods of liquidity stress. Such agreements would specify amount limits to be absorbed by such 'market makers,' and included limited buyer-sharing agreements with BoL, either as stand-alone securities purchases, repos, or collateralized BoL lending.*

PART C: CREDIT RISK AND REGULATORY ISSUES

I. Loan classification and provisioning regime

62. ***Current Situation.*** As of March 31, 2009, non-performing loans (NPLs) at least 60 days overdue amounted to 8.23 percent of total loans,[4] including 10.45 percent of business loans, 3.23 percent of housing loans, 8.80 percent of consumer loans, and 3.96 percent of household loans. The table below presents NPL and impairment figures at the end of each quarter from June 2008 to March 2009 and shows the rising levels of NPLs and impairments.

Table 11. NPLs, Impaired Loans, and Provisions (%)

	6/30/2008	9/30/2008	12/31/2008	3/31/2009
Non-performing loans to total loans	2.45	2.65	4.55	8.23
o/w business loans	2.82	2.95	5.64	10.45
o/w housing loans	1.47	1.75	1.94	3.23
o/w consumer loans	3.03	3.70	5.23	8.80
o/w household loans	1.73	2.04	2.40	3.96
Impaired loans to total loans	1.66	1.90	3.41	5.32
o/w business loans	1.99	2.20	4.37	6.96
o/w housing loans	0.87	1.18	1.31	1.87
o/w consumer loans	1.72	1.98	2.66	4.14
o/w household loans	1.01	1.30	1.50	2.17
Non-impaired loans overdue more than 60 days to total loans	0.79	0.75	1.14	2.91
o/w business loans	0.82	0.75	1.27	3.49
o/w housing loans	0.60	0.58	0.63	1.35
o/w consumer loans	1.31	1.72	2.57	4.66
o/w household loans	0.72	0.75	0.90	1.79
Specific provisions (individual + common)	0.72	0.80	1.20	1.71

Source: Bank of Lithuania

[4] NPLs include both impaired loans and non-impaired loans overdue more than 60 days.

63. Despite rising NPLs, the capital adequacy ratio (CAR) on March 31, 2009, was 13.9 percent. At the same time, provisions are low at only 1.71 percent. Coverage is higher in foreign banks, with NPLs of about 7 percent (with main exposure to corporate) and with provisions of 1.7 percent, while NPLs in local banks are 17 percent (in large part due to loan non-accruals in SME portfolios) with provisions at 1.9 percent. The latter provisions remain low, as the loss period (e.g.: reflected in extended payment delays) has not yet occurred in the sense of an "incurred accounting loss," though it is expected that this would materialize shortly.

64. ***Legal and Regulatory Framework.*** Lithuania's banking laws and regulations have been revised in recent years to conform to EU Directives and be consistent with international standards. Per the Law on Banks (as amended, 18 January 2007), the Bank of Lithuania (BoL) is the banking supervisory authority. BoL regulation no. 114 "On Approval of Minimum Loan Assessment Requirements" (2005) establishes minimum requirements for loan assessment and provisioning and follows IAS 39. Per this regulation, senior management of a bank is responsible for establishing the principles and procedures for assessing the impairment of loans, including procedures for the recognition of loss events and the calculation of the loss from the impairment. Basel II regulations became effective on January 1, 2008, and cover credit, market, and operational risk, capital adequacy, public disclosure and large exposures. Banks establish their own internal risk-based (IRB) models to determine provisioning levels, and BoL assesses the validity of the models as part of its supervisory responsibilities. Banks must maintain a minimum capital adequacy ratio (CAR) of 8%.[5]

65. Under Article 67 of the Law on Banks, BoL may temporarily set a bank's individual prudential ratios or additional prudential requirements if BoL discovers infringements of legal acts or "shortcomings" in activities of the bank or if the activities of the bank pose a threat to the stability and soundness of the bank. Hence, under this Article, BoL would appear to have powers to set higher provisioning requirements for all banks (albeit individually) if it determines that current provisioning represents a shortcoming or threatens their stability and soundness in the context of the present challenging global financial environment. However, BoL does not set additional requirements for loan loss provisioning beyond those in IAS 39 and believes current IRB models and provisioning to be sufficient.

66. ***Recommendation***. BoL should consider exercising its powers under Article 67 of the Law on Banks to increase provisioning requirements, given the current global and local financial environment and the limited historical and macroeconomic time series data available for banks' IRB models. As has proved to be the case in other countries, there is a significant risk that banks' IRB models and other approaches do not capture the risk characteristics of the Lithuanian loan portfolios and therefore underestimate regulatory capital needs. BoL could establish a

[5] Following Lithuania's accession to the EU, the minimum capital adequacy ratio was reduced from 10% to 8% in 2005 in order to ensure a level playing field for Lithuanian banks in the European internal market. However, the effect of this change on banks' capital was partly mitigated by other recent measures taken by BoL, including redefining residential mortgages to limit eligible collateral and limiting the inclusion of current year's profits in capital. Every year since 2005, BoL has also requested banks to retain all profits in capital.

matrix of norms and risk factors for different types of loans as ‘reference criteria’, to set benchmarks, based on complete data for the banking sector.

II. Regulatory and supervisory issues for crisis management

A. Current powers applicable to the banking sector as a whole and to individual banks

67. ***No System-wide Instructions.*** The Law on Banks does not generally grant BoL powers to require the banking system as a whole, or all banks collectively, to undertake remedial measures in times of crisis. Instead, the Law provides BoL with broad powers to instruct ***individual*** banks to undertake remedial measures. Hence, if BoL wishes to issue instructions to the banking system as a whole (e.g.: to reduce foreign exchange credit exposure across the board), it must issue separate instructions individually to each bank.

68. ***Broad powers to intervene with individual banks.*** The Law on the Bank of Lithuania (as amended, 25 April 2006) authorizes BoL to grant loans to credit institutions if secured by adequate collateral (Articles 8, 25, 26, 27, and 35) and to freely set banks’ reserve requirements (Article 30). BoL’s discretionary powers under the Law on Banks appear to be quite broad. Article 67 appears to grant BoL carte blanche to issue instructions to a bank carry out actions (or not to carry out actions) in order to end any infringements of legal acts, to eliminate any “shortcomings” in a bank’s activities, or to ensure the stability and soundness of the activities of the bank, and to do so within a time limit set by BoL. Such instructions may include, but are not limited to the following:

- not to conclude certain transactions or to reduce the scope of such transactions;
- to carry out an audit of interim accounts of the bank; or
- to prepare and implement an action plan for the restructuring of activities of the bank.

69. Moreover, BoL may apply to the courts to declare a bank’s decisions void when such decisions pose a threat to the stability and soundness of the activities of the bank; and BoL may conclude agreements with audit firms to verify or determine, at the bank’s expense, the value of the bank’s assets or the financial situation of the bank or to assess the risks taken or verify other areas of the bank’s activities (Article 67).

70. ***No triggers requiring BoL’s intervention.*** At the same time, neither the law nor the regulations specify any triggers that require BoL intervention. Instead, BoL uses its discretion when to intervene. BoL has considered specifying triggers for remedial actions, e.g., if a bank’s capital falls below a specified level. However, BoL does not consider this to be necessary, given its broad discretionary powers and its obligation to carry out its duties in good faith. BoL believes that the small number of banks permit it to understand the risks and capital position of each bank. BoL is also confident that banks IRB/IRM models and its review and validation of them will ensure that all banking risks will be captured.

71. ***Powers to impose sanctions.*** The Law on Banks also authorizes BoL to impose sanctions on a bank including issuing warnings, temporarily removing of a member of the board or

management, temporarily prohibiting the provision of specified financial services or other activities, and suspending or withdrawing a license (Article 72). Although such decisions must be "substantiated" and may be appealed by the bank to a court, BoL appears to have wide latitude in imposing sanctions, including cases where "activities or the financial situation of a bank or a branch of a foreign bank pose a threat to public interests and/or interests of clients or the functioning of the banking system of the Republic of Lithuania." Moreover, BoL may impose penalties ranging from 0.1% to 2.0% of bank revenue.

72. ***Forced sale of bank shares.*** Article 27 of the Law on Banks allows BoL to apply to the courts requesting the forced sale of a bank's shares owned by a shareholder of the bank who, in the opinion of BoL, is exerting an influence which operates to the detriment of the sound management of the bank. Similarly, if a bank whose capital falls under the legal minimum does not restore the minimum capital within the time limit set by BoL (or if the general meeting of a bank's shareholders does not take the necessary decisions to restore the minimum amount of the capital), BoL may apply to the courts requesting the forced sale of the shares owned by all shareholders.

B. New powers under the draft Financial Stability Law

73. ***Types of intervention.*** Under a draft Financial Stability Law as mentioned earlier, four measures could be taken to strengthen financial sector stability. First, state guarantees could be provided on loans raised by a bank, with the maximum guarantee equaling the bank's capital. Second, the Government may purchase, manage, and dispose of bank assets. Third, the Government may get involved in bank capital by extending a subordinated loan, acquiring newly issued shares, and/or acquiring shares from the bank's shareholders. Fourth, the Government may adopt a decision to taking shares of a bank for public needs.

74. ***Grounds for intervention.*** The Government of Lithuania would be authorized to undertake such measures if (i) BoL concludes that a bank faces liquidity problems and BoL's current powers are insufficient for resolving the bank's liquidity problems, or BoL concludes that the bank may become insolvent, and (ii) the Government concludes that a significant threat to the stability and credibility of the banking system will arise if such measures are not applied. Applying any of the first three measures would require an agreement with the concerned bank, while the fourth may be applied by the Government without an agreement, but only in "exceptional cases" when the other measures are inappropriate or insufficient, and requires fair remuneration for the shares. Shares acquired (presumably under the third or fourth measure) must be sold "immediately when the Bank's financial position does no longer pose a threat to the stability and credibility of the banking system, or at the moment decided upon by the Government of the Republic of Lithuania in view of the situation in the financial sector … and other significant circumstances...".

75. ***Recommendation***. The preparation of the Financial Stability Law is a positive development, despite the fact that the present banking situation does not require its immediate application, but rather gives the Government powers to act if the situation so requires. The

Financial Stability Law, combined with existing powers, will ensure that the Government and BoL have considerable power and discretion to intervene in the banking sector in a timely and appropriate manner to inject liquidity, bolster confidence, and contain contagion. The authorities may wish to consider additional measures, such as the following:

(i) Amend the Law on Banks to authorize BoL to issue sector-wide instructions, rather than bank-by-bank, to ensure rapid sector-wide intervention when necessary;

(ii) Amend the Law on Banks to include triggers that require BoL to intervene, rather than leaving every case to BoL's discretion, to ensure a predictable remedial regime (this could include, for example adjusted C.A.R. measures below a given threshold) as "adjusted" by BoL, if needed;

(iii) Clarify in the proposed Financial Stability Law when the Government must sell shares. The current draft ranges from "immediately" after the bank no longer poses a threat to the stability and credibility of the banking system to "at the moment decided upon by the Government" in light of the financial sector situation. An obligation to sell "immediately" essentially imposes all the downside risks on the taxpayers, while greatly limiting their upside possibilities when the market and the bank's shares rebound. Imposing a fixed time limit (e.g., one or two years after the threat has passed) could provide some upside benefit to the taxpayers as a reward for the risk that they have incurred, while ensuring that bank shares are eventually returned to private ownership; and,

(iv) Link purchase of shares to deposit insurance to ensure least-cost resolution and payouts to insured depositors as discussed earlier and as per below).

III. Deposit Insurance

76. ***Legal basis and coverage.*** Deposit insurance is governed by the Law on Insurance of Deposits and Liabilities to Investors (as amended, July 21, 2009) which has been revised to conform to EU directives and covers 100% of deposits in LTL and foreign currency, up to the amount in LTL up to EUR 100,000. This covers 77% of deposits (i.e., 23% of deposits exceed the ceiling); 90% of depositors are fully covered. The required payout period is 20 business days from the day of the insured event (with a possible extension to 10 business days), in conformity with recent EU directives. The state-owned company Deposit and Investment Insurance (DII) collects premiums, manages the deposit insurance fund, and provides deposit insurance payouts.

77. ***Premium and funding levels.*** DII administers a deposit insurance fund, which amounts to LTL 1,143.5 million, as well as an insurance fund for liabilities to investors, which amounts to LTL 5.5 million. Its own capital is LTL 38.8 million, so total assets managed by DII are LTL 1,187.8 million. Some 74% of the assets are invested in LTL, primarily Government bonds,

while 7% are invested in USD and 19% in EUR. This largely reflects the structure of deposits in Lithuanian banks. Annual premiums are 0.45% of bank deposits, and the current ratio of the fund to insured deposits is 3.4%.[6] DII is authorized by the Law to borrow to cover its liabilities (Articles 20 and 21).

78. ***Role in bank workouts and least cost criteria for payouts.*** In the case of an insurance event, a list of depositors must be submitted to and approved by a court. After this happens, DII pays the full amount of insurance coverage to the concerned bank, which compensates depositors. There are no provisions to reduce costs to the insurance fund by, e.g., transferring deposits and good assets to another bank.

79. ***Recommendation.*** As discussed earlier, the authorities should consider amending the Law on Insurance of Deposits and Liabilities to Investors, or including in the draft Financial Stability Law or associated regulations, some provisions to ensure that least-cost criteria are considered in compensating depositors. This should include purchase and assumption transactions whereby a healthy bank purchases some or all of the assets of a failed bank and assumes some or all of the liabilities, including all insured deposits. The Stability Law should also consider allowing the deposit insurance fund to borrow from the government (and not just the market) if justified based on systemic and market conditions, and if the government approves of such based on fiscal considerations.

IV. Corporate Debt Restructuring Issues

Overview[7]

80. ***Current Status.*** Borrower distress is widespread and rising with non-performing loans standing at 8.23%, as discussed. While all categories of borrowers are experiencing some level of distress, it is most evident in the business and consumer categories. This increased distress is slowly being reflected in the increased number of bankruptcy and restructuring processes that are being filed. While still small in absolute numbers, bankruptcy cases filed during the first quarter of 2009 doubled from the same period in the prior year (446 vs. 215.) Approximately 80% of the businesses that filed were in the construction, wholesale and retail trade, manufacturing and transportation and storage sectors.

81. ***Legal Framework Adequate but Untested.*** Participants believe that the legal framework for creditor rights and insolvency is adequate and reasonably effective, although seldom used. The culture within Lithuania is to resolve cases out of court on a consensual basis and creditors are also able to enforce their claims against collateral in a reliable manner. This has meant that during the boom years, borrowers and/or banks could easily sell the collateral for a sufficient amount to cover the obligations. Thus, bankruptcy became the "last resort" for companies with most cases resulting in liquidation with very low recovery rates.

[6] Under the Law, the premium could have been lowered to 0.045% after the ratio exceeded 3% (and it could be lowered to 0.001% if the ratio exceeds 4%). However, the council of DII decided to maintain the current premium of 0.45% for now.

[7] A more complete discussion of this topic is elaborated in the next chapter, Part D.

82. While the process is viewed to be slow and abuses have occurred, the prevailing opinion is that the institutional or regulatory framework rather than the legal framework is at fault. Both judges and administrators are uniformly viewed as lacking substantive commercial knowledge and experience. This results in needless delays and appeals and additional costs.

83. ***Restructuring Process Slow and Cumbersome.*** The Enterprise Restructuring law has not proven to be an effective and efficient mechanism for the rehabilitation of distressed but otherwise viable companies. Since inception in 2001, 46 companies have used this process of which only 5 (11%) have successfully completed their restructuring plan. 46 (48%) cases have been terminated and bankruptcy proceedings instituted, 6 have been terminated, and 13 cases are currently pending. The provisions of the Enterprise Restructuring Law are generally consistent with international best practice and of a modern rehabilitation law.

84. ***Constraints and Institutional Limitations.*** The problems seem to be more centered in the flow of the process coupled with a general lack of understanding of the process on the part of the borrower and a weak institutional framework. Specific problems cited include: (1) the provision that a borrower must already be 90 days past due before being eligible to initiate the restructuring process; (2) an automatic four month payment moratorium while the final plan is being prepared regardless of the borrower's ability to repay; (3) the length of time required to obtain EU approval if state funds are being used in the restructuring; (4) the lack of commercial knowledge and skills of the judges and administrators, particularly in resolving disputes amongst the participants and identifying abusive or fraudulent transactions; (5) the possible close relationship between the borrower and administrator; and, (6) the conflict of interest when the owner of the business is also a major creditor. While each of these issues is troubling on its own, combined they have resulted in a view that the restructuring process is lengthy and subject to many abuses by borrowers who are merely seeking to delay repayment of their obligations.

85. ***Little Interest in Mediation.*** Many borrowers have more than one lender. The Scandinavian banks are experienced in working with other lenders to develop restructuring programs. In these cases, they generally leave the interests of the unsecured creditors untouched or provide sufficient accommodations so that these parties do not institute bankruptcy proceedings. It is, therefore, felt that an out-of-court mediation mechanism is unnecessary and serious reservations were expressed as to whether it would be workable within the Lithuanian culture. A previous attempt to introduce mediation under the Courts was unsuccessful. However, arbitration clauses are routinely included in the loan documents of some Scandinavian banks and they have proven to be an effective method of dispute resolution.

Recent Actions Considered

86. ***Loss Recognition in Early Stages.*** The Supervisors' continuing focus on capital adequacy is forcing banks to recognize losses though they still need to substantially increase their level of provisioning. Many are still in denial about a permanent impairment in collateral values and prefer to wait for the "good times" to return. But, further delays will only increase the losses. The quicker scarce financial resources can be freed up from the non-viable and

redirected to productive uses, the sooner economic recovery will begin. Thus, loss recognition is an absolute prerequisite for an effective asset resolution process.

87. ***Possible changes to Enterprise Restructuring Law.*** The mission has been made aware of possible revisions to the Enterprise Restructuring Law designed to make it easier for borrowers to initiate proceedings and gain approval of their restructuring plan. At present, an affirmative vote of creditors holding of two thirds of the claims is required to institute a restructuring proceeding and creditors holding three quarters of total claims must approve the restructuring plan.

88. Thought is currently being given to lowering these thresholds to one half and two thirds, respectively. In addition, it has been proposed that borrowers be granted an automatic two (2) year moratorium on payments and be allowed to initiate the restructuring process with minimal creditor rights during the process. As the mission did not receive a draft of proposed revisions, it was unable to provide specific comments on these efforts. In general, however, the benefits of any changes must be weighed against the costs incurred. As these changes will distort credit markets and result in increased costs and decreased availability of credit to all borrowers, we do not recommend their adoption.

Recommendations

89. ***Conduct a Limited Review of the Enterprise Restructuring Law.*** The law as enacted is generally consistent with international best practices but has not worked. As the primary goal of any distressed asset resolution process is to rehabilitate distressed but otherwise viable companies, it is essential that this vital component of the program be fully functioning. A limited review of the law should be undertaken to determine if the problem lies within the law or its application. Any revisions to the law should be limited to correcting the identified deficiencies rather than a broader rewrite of the law to accommodate political interests.

90. ***Creditor Rights.*** Some consideration should also be given to more clearly protecting creditors from the inherent conflicts that arise when the owner is also a major creditor. Weighting the claims of creditors (with the owner’s claim receiving the lowest weight, especially if equity based) may limit an owner’s ability to dominate the proceedings and provide greater protection for third party creditors. Other aspects to be considered include freezing of assets when a restructuring process is formally initiated, to avoid leakage (e.g.: asset “stripping”) and protect all creditors.

91. ***Strengthen the Institutional Framework for Insolvency.*** Participants uniformly mention the low level of commercial knowledge and experience of judges and administrators. Given that there is likely to be a surge of bankruptcy and reorganization cases in the coming months, thought should be given to quickly implementing an expedited training program for these officials. Donor or EU funding is available and can provide technical assistance for the design and implementation of such training programs.

92. ***Continue to force banks to recognize losses, restructure viable borrowers and liquidate non-viable borrowers.*** Global experience has demonstrated that the role of the government

should be limited to providing an appropriate framework for loss recognition and asset resolution. Asset resolution itself, however, is a private sector issue and is best left to the parties at risk, namely borrowers and lenders. Forcing banks and borrowers to work through their problems strengthens credit and lending skills within the banks while at the same time reinforces a strong payment culture within the borrowing community.

PART D: DESCRIPTION OF CORPORATE DEBT RESTRUCTURING PROCEDURES IN LITHUANIA

I. Current Status of Corporate Debt

93. ***Corporate Distress in Lithuania is widespread and rising.*** Lithuanian companies have been hard hit by the global downturn. In the third quarter of 2008, the percentage of non-profitable companies increased steadily. As of the first quarter of 2009, 55.4 percent of all Lithuanian companies were reporting losses. Amongst the hardest hit sectors were manufacturing; transportation and storage; wholesale and retail trade; and construction. Together these sectors account for 69 percent of the total number of enterprises and employ approximately 78 percent of all employees. While individual company results of course will vary, each of the sectors is highly leveraged with a debt/equity ratio ranging from a low of 73% for the mining sector to a high of 267 percent for hotels and restaurants. In effect, each of these sectors is relying heavily on their creditors for financing. In the current environment of an slowing of economic activity coupled with decreasing asset values, it is unlikely that creditors will recover all their funds.

Table 12.
Selected Enterprise Statistics
2009 Q1

Sector	% Companies unprofitable within Sector	Companies within sector as % of Total Enterprises	Employees within Sector as % of Total Employees	Sector Debt/Equity Ratio
Manufacturing	56.6	11.5	25.6	105.2
Transportation	58.2	3.8	3.8	81.6
Wholesale and Retail Trade	59.1	31.2	26.7	170.8
Mining	65.0	0.2	0.4	73.2
Construction	65.8	13.2	13.3	143.9
Hotels and Restaurants	74.2	4.1	8.4	266.9

Source: Ministry of Economy

94. ***Loss recognition is in the early stages.*** Non-performing loans have been increasing steadily since mid 2008 and stood at 8.23 percent of total loans as of 2009 Q1, with all categories of these loans reporting sharp increases.. The Bank of Lithuania's continuing focus on capital adequacy is forcing banks to recognize their losses, and substantially increase their levels of provisioning. Many, however, are still in denial about the level of permanent impairment in collateral values. While the actual loss events have taken place, banks and borrowers are slow in recognizing the losses embedded in the assets. This is particularly true in the real estate and construction sectors where owners have continued to support their projects from their savings and other sources of cash. As these resources are likely to be exhausted shortly, it is anticipated that losses will continue to rise.

Table 13.
Non-performing Loans

	6/30/08	**9/30/08**	**12/31/08**	**3/31/09**
Non-performing loans as % total loans	**2.45**	**2.65**	**4.55**	**8.23**
o/w Business Loans	2.82	2.95	5.64	10.45
o/w Housing Loans	1.47	1.75	1.94	3.23
o/w Consumer Loans	3.03	3.70	5.23	8.80
o/w Household Loans	1.73	2.04	2.40	3.96

Source: Bank of Lithuania

95. ***Bankruptcy cases are increasing.*** While still small in absolute numbers, bankruptcy cases filed during the first six months of 2009 increased significantly and exceeded number of cases filed during the total prior year. The number of cases is expected to continue to increase.

Table 14.
Total Number of Bankruptcy Cases Filed

Quarter	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
1	124	176	170	170	201	185	151	215	465
2	145	171	128	186	207	222	164	222	519
3	125	169	147	157	170	171	113	228	--
4	196	283	176	196	195	181	178	292	--
Total	590	799	621	709	772	759	606	957	984

Source: Department of Enterprise Bankruptcy Management under the MoE, Lithuania

96. Of the 445 cases filed during the first quarter, 380 companies filed traditional bankruptcy cases, 11 extrajudicial (out of court) proceedings and 55 Simplifed (no asset) bankruptcy cases. During the second quarter an additional 88 Simplified cases were filed. Comparable data for the other type of cases is not available.

Table 15. Total Number of Bankruptcy Cases Filed by Type									
Type	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009 Q1**
Normal	--	--	458	542	517	416	377	647	380
Extrajudicial	12	14	11	26	31	50	29	54	11
Simplified	--	--	152	141	224	293	200	256	55
Total	590	799	621	709	772	759	606	957	446

Source: Department of Enterprise Bankruptcy Management under the MoE, Lithuania

97. ***Approximately 80 percent of the businesses that filed, were in the construction, wholesale and retail trade, manufacturing, and transportation and storage sectors***. Real Estate activities accounted for only 39 cases or 4 percent of the total number of cases filed. This likely reflects the lag in recognizing losses in this sector or the willingness of the banks to work more closely with their larger borrowers to find a consensual solution.

98. Of the cases filed through June 30, 2009, 51 percent of the procedures were initiated by the company (either the owners or head of the administration of the enterprise) versus 33 percent for the same period in 2008. It is unclear if this reflects a greater awareness of the benefits of bankruptcy on the part of owners and administrators, or is merely an attempt to delay creditors' actions to collect debts. Major creditors initiating proceedings included the Board of the State Social Insurance Fund (15%), Employees (8%), and other creditors (23%).

Table 16. Initiators of Enterprise Bankruptcy Process				
Initiator	**2008 First Half**		**2009 First Half**	
	#	**%**	**#**	**%**
Head of Admin. of Enterprise	93	21	433	44
Owner(s)	52	12	70	7
State Tax Inspectorate	11	3	22	2
Social Insurance Fund	161	36	152	15
Employees	20	5	76	8
Other Creditors	73	17	224	23
Liquidator	27	6	7	1
Total	437	100	984	100

Source: Department of Enterprise Bankruptcy Management under the MoE, Lithuania

99. ***The restructuring process has been seldom used with only 64 cases having been filed since its institutionalization in 2001.*** In the first two quarters of 2009, however, 23 new cases were filed. Again, it is not certain whether this reflects a recognition of the benefits or restructuring versus liquidation, or simply a borrower delaying tactic. Of the 64 cases filed, only five (11%) have been completed successfully. Thirty one (48%) are pending and 22 (34%) have terminated in bankruptcy filings.

Table 17.
Number and Outcome of Restructuring Cases

Outcome	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
Completed	2	2	1	0	0	0	0	0	0	5
Bankruptcy	0	6	6	3	2	3	1	1	0	22
Terminated	0	2	1	0	0	1	0	2	0	6
Pending	0	0	1	1	3	0	2	1	23	31
Total	2	10	9	4	5	4	3	4	23	64

Source: Department of Enterprise Bankruptcy Management under the MoE, Lithuania

II. Legal Framework for Bankruptcy Proceedings

100. ***The legal framework for bankruptcy and restructuring is adequate but untested.*** The legal framework was modernized and substantially strengthened in 2001 with the adoption of the new Civil Code, a new insolvency law,[8] and the Enterprise Restructuring Law.[9] The priority of secured creditors[10] is established under the Civil Code and the realization of collateral is reliable. Participants believe that the framework for creditor rights and insolvency is adequate and reasonably effective, though they are reluctant to use it. The culture within Lithuania has been to resolve cases out of court on a consensual basis. This has meant that during the recent boom years, borrowers and/or banks could easily sell collateral for a sufficient amount to cover obligations. Thus, bankruptcy became the "last resort" for companies with most cases resulting in liquidation with low recovery rates.

101. ***The Enterprise Bankruptcy Law provides for three types of proceedings as well as procedures for a distressed company.*** Under the law, there are three main types of proceedings: (i) judicial (court supervised); (ii) extra-judicial (creditor-led); or (iii) simplified. If a company is unable to settle with its creditors, the owner/manager may request the creditors' consent to conduct the bankruptcy procedures out-of-court. To be eligible, however, judgments (claims) may not have been entered against the company, nor execution levied on the company under writs of execution.[11] Simplified bankruptcy is court ordered when it becomes apparent that the company's assets are insufficient to cover the legal and administrative costs of the proceeding. Once a proceeding has been filed, there are two possible outcomes (procedures): (a) composition or (b) liquidation. Composition refers to a type of borrower/creditor agreement/framework for resolving the debts. Only liquidation is to be used in simplified bankruptcy cases.

[8] Enterprise Bankruptcy Law, 20 March 2001 No IX-216 (Amended 15 April 2004, No IX-2129).
[9] Law on Restructuring of Enterprises, 20 March 2001 No IX-218 (Amended 25 October 2007 – X-1310).
[10] Almost all loans are secured with the primary form of collateral being real estate.
[11] Once the creditors have agreed to an extrajudicial procedure, it follows the same parameters as the judicial procedure with the exceptions that the actions undertaken by the court are performed by the creditors' committee.

102. ***If the grounds for filing a petition for bankruptcy are met, the owner(s), manager, or creditor(s)***[12] ***of the company may initiate a bankruptcy proceeding.*** A written petition may be filed with the county court of the locality in which the registered office of the business is located, if at least one of the following conditions is met:

- The enterprise fails to pay wages and other employment-related amounts when due;
- The enterprise fails to pay, when due, for goods received, work performed/services provided, defaults in the repayment of credits or does not fulfil other liabilities assumed under contract;
- The enterprise fails to pay, when due, taxes, other compulsory contributions required by Law, and/or awarded sums.
- The enterprise has made a public announcement or otherwise notified the creditors in any other manner of its inability or unwillingness to discharge its liabilities;
- The enterprise has insufficient assets or income from which to repay debt and therefore the bailiff has returned the writs of execution to the creditor.

103. ***A creditor must meet one additional test in order to be eligible to file a bankruptcy petition.*** Their debt must be three months (90 days past due) and they must have given the company/debtor written notice of the past due obligation. The notice must also contain a warning that if the obligation is not paid within the time specified (not less than 30 days), the creditor will file a bankruptcy petition.

104. ***The court or judge will within one month***[13] ***from the date of receiving the petition make a decision to either accept or reject the petition (investigation period).***[14] During this 30-day period the court will review the information submitted with the petition to determine if the enterprise is qualified to enter bankruptcy proceedings. The court may request any additional information it deems necessary to make its decision. And it may also summon the owners, manager, board members, chief financial officer and/or other executive officers, and creditors and demand written information regarding the circumstances surrounding the petition. At the conclusion of the investigation, the court will accept the bankruptcy petition if it finds that:

- The enterprise is insolvent, i.e., 30 days past due and the overdue liability amounts to over one half of the value of the assets on the company's balance sheet; or,
- Employee wages are 30 days in arrears; or
- The company has made a public announcement or in any other manner notified the creditors of its inability or unwillingness to pay its obligations.

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[12] Creditors are legal or natural persons who have the right under law to demand from the enterprise the discharge of liabilities and obligations including, *inter alia:* state institutions responsible for the collection of taxes, compulsory social and health insurance contribution; employees; an institution authorized by the Government in the event of transfer to the Sate of obligations for payment for damages arising from an accident at work or an occupational disease claim; the Ministry of Finance in the case of a loan or guarantee from the State; sellers of agricultural produce; and other creditors.

[13] The period may be extended for one additional month

[14] If during this period, the court receives a petition to initiate enterprise restructuring proceedings the investigation is suspended pending the court's decision to accept/deny the restructuring petition.

105. The bankruptcy petition is denied if: (i) the debtor has already satisfied the claim of the creditor filing the petition, or (ii) the court has made a sufficiently justified assumption that the enterprise has insufficient assets to cover legal and administrative costs.

106. ***The decision of the court becomes effective ten days after it is made unless it is appealed.*** The appeal must be heard by the Court of Appeals of Lithuania within two weeks of its being filed. If the Court of Appeals overturns the decision to deny a bankruptcy petition, the Court may not make a decision to institute proceedings. The Appeal Court's decision is final and is not subject to further appeal.

107. ***At the time that the bankruptcy petition is accepted, the court must appoint the administrator.*** The administrator must be a legal or natural person certified to provide administration services. Any of the parties eligible to file the petition may nominate a candidate for the post of administrator. The Court, however, is free to appoint any qualified administrator.

108. ***During the course of the proceedings, the administrator has broad powers to conduct/manage the affairs of the enterprise, including hiring and terminating employees, entering into or canceling contracts, compiling and verifying the list of creditors and their claims, contesting claims.*** He is also empowered to examine all contracts entered into within the three years prior to the filing and bringing actions to invalidate those which are not in the best interests of the enterprise and/or which could have led to the bankruptcy. He is also responsible for convening the creditors' meeting and keeping various parties of interest fully informed about the status of the proceedings. Under the Laws of Lithuania, he is also liable for all losses caused by his actions.

109. ***The Court must set the time period during which creditors must file their claims.*** This period must be 30-45 days in elapsed time from the effective date of the decision to institute the proceedings. The Court, for a valid reason, can accept claims not filed within this time period up until the day the Court makes a decision to terminate the proceedings or liquidate the company. Creditors have the right to a general or limited waiver of their claims and during the course of the bankruptcy, they may sell or assign their claims to another creditor or person without effecting the payment priority of the obligation.

110. ***The business may continue to operate during these proceedings provided it reduces creditor losses.*** It has the right to use the income generated to cover expenses related to its operation. However, the Law contains no provision for the extension of fresh funds on a super-priority basis. The enterprise shall pay taxes and cover other mandatory payments that arise in the due course of its operations.

111. ***Creditors also play an active role during the proceedings.*** The creditors meeting and/or the creditors committee, if one is formed, are charged with, *inter alia*:

- oversight of the administrator including fixing the terms of his remuneration and contract and requesting his removal;
- approving the estimate of administration costs;
- deciding on the continuity, restriction, or termination of the enterprise's operations;
- imposing restrictions on the disposal of assets; and,
- recommending to the Court that the company be placed in liquidation.

112. ***Resolutions by the creditors meeting are binding on all creditors.*** Resolutions are voted by open ballot and deemed adopted if voted in favor by the creditors holding qualifying claims accounting for over one half of the amount of the aggregate of all allowed claims. A creditor may notify the creditors meeting in writing of his vote – whether "for" or "against" – where such vote must be announced at the meeting and shall be included in the results. If the meeting fails to adopt a resolution due to an insufficient number of votes, a repeat meeting may be called within 15 days. The repeat meeting can consider only the resolutions on the agenda of the preceding meeting, except resolutions regarding extrajudicial bankruptcy and a framework with creditors. To be adopted, a resolution must be voted in favor of by creditors holding over one half of the total allowed claims present at the meeting.

113. ***A framework with the creditors may be concluded at any point prior to the effective date of the Court order to liquidate the company.*** The framework must be signed by all creditors, or their authorized representative, and the administrator, after the latter has received the written authorization of the owner(s) and/or the managing body which has the right to take a decision to liquidate or reorganize the company. The framework must specify the concessions made by the enterprise and the creditors; the liabilities of the enterprise; methods and schedule of satisfaction of claims; and the liability of the enterprise in case it fails to carry out the framework. The framework must be approved by the court and must be denied if any of the actions contemplated therein contradict the Law or infringe on any parties rights and interests provided by Law. After the effective date of the court order to approve the framework, bankruptcy proceedings against the company shall be discontinue.

114. ***The court declares the enterprise bankrupt and issues an order to put the company into liquidation if an order to conclude the framework with creditors is not issued within three months from the effective date of the order to allow the creditors' claims.*** The court may grant an extension of the deadline but only if so requested by the Creditors Meeting. If all of the property has not been appraised and sold or transferred to the creditors, and not all claims of the creditors have been satisfied within 24 months of the effective date of the court order to declare the enterprise bankrupt, the liquidation procedure shall be considered completed.

115. ***The remaining unsold property shall be written off as non-saleable assets upon the decision of the creditors whose claims have not been satisfied.*** The property that has been written off – except for immovable property – shall be used or destroyed in the manner established at the creditors meeting. Immovable property is to be transferred without payment to the municipality in which it is located, within 30 days from the date it was written off.

116. ***The sequence and procedure for satisfying creditors' claims preserves the seniority of secured creditors.*** Claims secured by a pledge and/or mortgage are paid first from the proceeds of the sale of the assets or by transferring the pledged assets. If the proceeds from the sale are in excess of the amount necessary to satisfy the secured amount, the balance is paid to the remaining creditors in two rounds[15] in the following sequence:

- employee claims (wages and compensation for injury, occupational disease or death on the job) and claims for payment for agricultural produce purchased for processing.
- taxes and other budgetary payments, also compulsory payments and claims relating to loans and/or guarantees given by the State.
- all other claims.

117. The claims of each successive sequence are paid after the full payment of the claims of the preceding sequence are completed. If the assets are not sufficient to pay all the claims of a sequence in full, the claims are distributed proportionally to each creditor.

118. ***Under the Simplified Bankruptcy Process this cannot not last longer than one year during which the company is liquidated.*** When a company's assets are insufficient to cover the legal and administration costs of the proceeding, the court requests that the creditors filing the petition pay into a deposit account of the court an amount not to exceed Litas 10,000. If the amount is deposited within five working days from the request, the case may proceed under the Simplified Process. The process must not last longer than one year from the effective date of the order to apply the Simplified Process.

119. ***The amounts so deposited shall be used to cover the legal and administration costs.*** The creditor advancing the funds is entitled to claim these funds from the manager or owner. Funds from the sale of the assets are allocated for covering legal and administration costs. If the sale proceeds, free of any encumbrances, exceed twice the amount necessary to cover these expenses, the court shall terminate the Simplified Procedure and order that the case be heard in accordance with the normal procedure. If the proceeds cover expenses but are less than twice the required amount, the excess is used to satisfy the claims of employees and then to reimburse the creditor who advanced the legal and administrative costs. Any remaining funds are transferred to the Guarantee Fund.

120. ***The speed and efficiency of the Law is improving.*** With the introduction of the latest law in mid-2001, both the number of cases and their speed of completion increased substantially. During the period from 1993 to the end of 2001, a total of 1,605 cases were filed, of which only 30% were completed during that timeframe. Between 2002 and March 2009, 5670 cases have been filed and 3,996 or 70% have been completed, with the bulk of these cases having been completed within two years of their filing. The "Doing Business 2010" issued by the World

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[15] First for claims not including interest and penalties and then to interest and penalties.

Bank reported that in Lithuania outperforms the region and OECD averages in speed, cost of proceedings, and returns to creditors.

Table 18.
Comparison of Selected Bankruptcy Indicators

Indicator	Lithuania	ECA Region	OECD
Average time to complete process	1.7 years	3.1 years	1.7 years
Average cost as % of debtors estate	7%	13.4%	8.4%
Average recovery rate as %	48.0	28.3	68.6

Source: "Doing Business 2010," The World Bank

III. Corporate Restructuring Mechanisms

121. ***The Law on the Restructuring of Enterprises allows an operating enterprise[16] experiencing temporary financial difficulties, to restructure[17] and settle its debts without resorting to bankruptcy.*** It broadly follows the rules and procedures established in the Bankruptcy Law and may be initiated or led by either the debtor or creditors. Once the creditors meeting has adopted a resolution to restructure the company by a vote of at least one half of all principal creditors present at the meeting, [18] the petition, together with a brief outline of the proposed restructuring and other required documentation is filed with the court.

122. ***The only grounds for denial of the petition are improper documentation, repayment of the obligations of the debtor applying for restructuring, or the initiation of bankruptcy proceedings.*** The order to initiate the proceedings becomes effective within ten days from its adoption, providing the decision has not been appealed. Creditors then have a 30-45 day period in which to file their claims.

123. ***The creditors have four months to approve a restructuring plan that must not last longer than four years.***[19] The requirements for the plan as set forth in the Law are quite comprehensive and include among other factors, a detailed business plan, an estimate of administration expenses, and a list of concessions to be made by both the debtor and its creditors. The Plan must also be accompanied by an opinion by in independent expert[20] as to its feasibility. Repayment of claims under the restructuring plan follows the order established in the

[16] The Law does not apply to banks, the financial companies or credit unions, other credit institutions, insurance companies, management companies, investment companies, closed-end investment companies and companies engaged in publicly trading securities.
[17] Restructuring is broadly defined and includes, *inter alia*: a change in business activities; upgrading production; rationalization of the workforce; sale of assets, in whole or in part; acquisition of other enterprises; and, a change in the amount or maturity of liabilities.
[18] Secured creditors and creditors holding claims representing at least 20% of the aggregate amount of all claims
[19] The Plan may be extended for one additional year upon the agreement of creditors.
[20] This expert is responsible for the correctness of his conclusion and liable for any damages incurred by the creditors due to an erroneous conclusion.

Bankruptcy Law. Once the Plan has been implemented, the court issues an order that the restructuring has been completed.

124. ***Creditors may vote for the Plan collectively or as groups***[21] ***and their decision is binding on all creditors.*** A collective vote requires the vote of creditors holding allowed claims, amounting to at least one half of the aggregate amount of allowed claims. When voting by groups, each group must approve the resolution by a vote of creditors holding at least two thirds of the aggregate amount of allowed claims within the group. And the total amount of votes in each group must amount to at least two thirds of the aggregate amount of all allowed claims. The final decision of the creditors is binding on all creditors. If the Plan is not approved, it must be returned to the company for amendment within 5 days and the company then has 15 days to submit a revised plan.

125. ***If the Plan contemplates the State granting a loan or guarantee, European Commission approval is required.*** In such cases, the Commission must be notified within 5 calendar days of the creditors having approved the Plan. Once the Court receives notice of such notification together with a request from the creditors, the proceedings are suspended until the decision of the Commission is received. If the Commission approves the Plan subject to additional conditions, the parties have 45 to 60 days in which to revise the Plan. If the Commission approves the plan or decides that the measures undertaken do not constitute state aid, the Court may make a decision to accept or reject the plan.

126. ***If the Plan is not adopted and approved by the Court within the required period, restructuring proceedings are terminated.*** The proceedings may also be terminated if it becomes evident that the Plan was based on incorrect information and/or that the Plan will not be implemented.

127. ***The Restructuring Law also provides for a simplified procedure akin to a "prepackaged bankruptcy."*** Under these provisions, a restructuring plan can be drawn up prior to the filing of the petition. This plan, however, must be approved by 100 percent of the creditors, and there are no provisions for a "cram down" on dissenting creditors.

128. ***The restructuring process is viewed as slow and cumbersome.*** While the provisions of the Enterprise Restructuring Law are generally consistent with international best practice and of a modern rehabilitation law, participants view the process as slow and cumbersome and its usage has been limited. Common problem areas cited are:

- the provision that a borrower must already be 90 days past due before being eligible to initiate the restructuring process. This results in debtors resorting to reorganization when the enterprise is no longer viable;

[21] Groups consist of secured creditors, employees and claims for purchase of agricultural produce; administrators of compulsory payments; creditors with unsecured long term debt not yet matured; and other creditors.

- an automatic four month payment moratorium while the final plan is being prepared regardless of the borrower's ability to repay;
- the approval threshold for the plan (75 percent of creditors) or simplified proceeding (100 percent of creditors) is too high;
- the length of time required to obtain EU approval if state funds are being used in the restructuring;
- the lack of commercial knowledge and skills of the judges and administrators, particularly in resolving disputes amongst the participants and identifying abusive or fraudulent transactions;
- the possible close relationship between the borrower and the administrator; and
- the conflict of interest when the owner of the business is also a major creditor.

129. ***There is little interest in introducing mediation as a means to speed up the resolution/restructuring process.*** The Scandinavian banks are the major lenders to most borrowers and they are experienced in working with other lenders to develop restructuring programs. In these cases, they generally leave the interests of the unsecured creditors untouched or provide sufficient accommodations so that these parties do not institute bankruptcy proceedings.

130. ***It is therefore felt that an out-of-court mediation mechanism is unnecessary***. Serious reservations were expressed as to whether such would be workable within the Lithuanian context. A previous attempt to introduce mediation under the Courts is viewed as having been unsuccessful. However, arbitration clauses are routinely included in the loan documents of some Scandinavian banks and they have proven to be an effective method of dispute resolution.

IV. Recommendations

131. ***Both the Enterprise Bankruptcy Law and the Law on the Restructuring of Enterprises could be improved.*** While both of these laws are generally consistent with international best practice, each could be strengthened to make the process more accessible and efficient. This is particularly true of the Restructuring Law, which is viewed as cumbersome and inflexible. Among the areas thus to be considered for improvement are:

- *Amending the simplified restructuring procedure to allow judicial approval of reorganization plans approved by a legally established majority of creditors even if unanimous consent of creditors had not been obtained.* At present, 100 percent of the creditors must give their consent to a so-called "pre-packaged plan." Obtaining the approval of all of the creditors is difficult under the best of circumstances and discourages the use of this important feature. A judicial proceeding provides for a properly adopted vote of the majority of to be binding on all creditors. Affording this right of "cram down" would provide the system with a valuable tool for the prompt and cost-effective resolution of a large number of insolvency cases likely to arise within the context of the current downturn.

- *Amending the restructuring law to provide greater flexibility for an enterprise to file a restructuring petition when the owner/manager has reason to believe that the company will not be able to pay its debts when due.* At present, the debt must be three months past due from maturity or demand and the borrower must obtain the consent of the majority of creditors before filing a petition. Increased flexibility would encourage debtors to enter restructuring discussions sufficiently early on, thereby increasing the chance of a successful rehabilitation

- *Amending the bankruptcy and restructuring laws to allow for the provision of "fresh money" on a super-priority basis.* Companies in the process of restructuring or otherwise entering into a settlement with their creditors frequently need additional working capital funds to ensure their continued viability. Lenders willing to extend such credit should be accorded a priority of payment in return for the use of their funds.

- *Amending the bankruptcy and restructuring laws to more adequately protect the interests of secured creditors during the proceeding.* The law should protect secured creditors from the erosion of collateral values during proceedings. This is particularly important during times of systemic crisis when collateral values are falling sharply. While their interests must be balanced against the needs of the enterprise to use the collateral, they should be allowed to request the lifting of stay or other monetary consideration on the grounds that they are not receiving adequate protection (compensation) for the use of the asset.

- *Consideration should be given to enacting the UNCITRAL Model Law on Cross-border Insolvency.* Lithuania as a member of the European Union conducts cross-border insolvencies involving other EU members under the EU Council Regulation 1346/2000. This regulation, however, only governs cross-border insolvencies where the enterprise's main place of business is within the EU. Adopting the UNCITRAL Model Law for Cross-border Insolvency would extend the regulation to cases involving countries outside the EU.

- *Amending the bankruptcy and restructuring laws to provide more protection to the creditors in cases where the owner is also a creditor.* The inherent conflict that arises when the owner is also a creditor provides an added layer of complexity to an insolvency/restructuring case. Additional care must be exercised to ensure that his claim is valid. The administrator and court should assure themselves that the funds were actually advanced and used for valid business purposes. In addition, consideration should be given to amending the voting rights to prevent the owner/creditor from dominating the proceedings and imposing a Plan which is mainly to his benefit.

V. Individual Bankruptcy Cases

132. ***Lithuania does not currently have a Law governing individual bankruptcy.*** Such a law was drafted in March 2009 with the intent of having it become effective by year-end. The exact status of this law is not known. Under the proposed law, an individual could file for bankruptcy if his/her obligations exceeded an amount in excess of twelve months of the Lithuanian approved minimum monthly wage. The petition would need to be accompanied by a Plan for the repayment of creditors. As presently drafted, the law does not clearly state the maximum length of the Plan.

133. ***The Law does, however, provide that the debtor must make monthly payments into the Trustee's account.*** Quarterly distributions are to be made to the creditors and for payment of administration expenses. It is also generally in line with the provisions of the Enterprise Bankruptcy Law with respect to the Trustee's duties, the role of the creditors, and the priority and sequence of repaying the individual's obligations.

134. ***The Court must approve or reject the Plan within two months***.[22] The petition may be rejected if the court finds that the individual is solvent; the individual has filed for bankruptcy within the past 5 years; or that the individual is a dependent, in custodial care, or drug or alcohol abuser and/or compulsive gambler. Once the case is approved, a trustee is appointed to implement the Plan. During the implementation period, the case may be dismissed if: the debtor fails to make a monthly payment; if it appears that the plan was based on false information; if the creditors waive all their claims; or if the individual becomes solvent, or dies.

VI. Conclusions

135. ***With corporate distress widespread and loss recognition in its early stages, the number of restructuring and bankruptcy proceedings will continue to rise.*** While the actual loss events have already taken place, many creditors and debtors remain reluctant to face their losses. And with signs that the global economy has stabilized and may even be improving, there will be a tendency to "wait and see" in hopes of avoiding further write-downs and increased provisions.

136. ***The Bank of Lithuania's continuing focus on capital adequacy should be helpful in continuing to force banks to recognize their losses, restructure viable borrowers, and liquidate non-viable borrowers***. Global experience has shown that the role of government should be limited to providing an appropriate framework for loss recognition and asset resolution. Asset resolution, however, is a private sector issue and is best left to the parties at risk, namely borrowers and lenders. Forcing banks and their borrowers to work through their problems strengthens credit and lending skills while at the same time reinforces a strong repayment culture within the borrowing community.

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[22] The court may also decide to allow the case to proceed on an extrajudicial basis if no claims have been lodged against the individual.

137. ***The Government should conduct a limited review of the Enterprise Bankruptcy and Restructuring Laws.*** While both laws as enacted are generally consistent with international best practices, this analysis has highlighted several areas that could be improved. This is particularly true for the Restructuring Law. Since the primary goal of any distressed asset resolution program is to rehabilitate distressed but otherwise viable companies, it is essential that this vital element of the program be fully functioning. The authorities may wish to consider undertaking a limited review of both laws to identify and correct deficiencies that are acting as impediments to an effective and efficient process.

138. ***What should be avoided is a broader rewrite of the laws to accommodate political interests or those that simply wish to avoid repayment by means of a lengthy moratorium on payments and undue restrictions on creditors' rights.*** In general, the benefits of any changes must be weighed against the costs incurred and precedents in terms of future incentives. In general, changes that will distort credit markets and result in increased costs and decreased availability of credit need to be avoided.

139. ***The institutional and regulatory framework for insolvency should be strengthened.*** Participants uniformly mentioned the low level of commercial knowledge and experience of judges and administrators. Given the likely surge in bankruptcy and reorganization cases in the coming months, consideration should be given to quickly implementing an expedited training program for these professionals. Donor funding is likely available and can provide technical assistance for the design and implementation of applied training programs.

140. ***An outreach program to heighten the awareness of all parties on the benefits of and proper use of restructuring should be considered.*** Experience has shown that many borrowers delay approaching their creditors about restructuring until it is too late to save the company. Many, particularly small borrowers, are intimidated. Others simply do not know how to proceed. Many countries have chosen to conduct a public awareness campaign to help educate both debtors and creditors on what is required of them. Most countries facing a systemic crisis have issued a set of principles modeled on the INSOL Statement of Principles for a Global Approach to Multi-Creditor Workouts.[23] These Principles, adapted for local conditions, set forth what is expected of borrowers and banks during restructuring negotiations.

[23] http://www.insol.org/pdf/Lenders.pdf