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of the Board of the Bank of Lithuania
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FINANCIAL ASSETS MANAGEMENT POLICY OF THE BANK OF LITHUANIA

CHAPTER I
GENERAL PROVISIONS

1. The objective of the Financial Assets Management Policy of the Bank of Lithuania (hereinafter – Policy) is to establish the key principles for the management of Bank of Lithuania's financial assets (hereinafter – financial assets), the requirements and restrictions applicable to the financial assets and operations, reporting requirements and other aspects of the management of financial assets. The Policy shall not cover the principles and procedure of the management, use and disposal of the financial assets related to monetary policy operations.
2. The provisions of the Policy shall apply to financial assets that are not acquired via monetary policy operations. Financial assets shall comprise official reserve assets[1] and investment in euros, as well as funds on the TARGET2[2] account.

CHAPER II
PRINCIPLES OF FINANCIAL ASSETS MANAGEMENT

3. The main objective of holding financial assets shall be to ensure the stability of the financial system in Lithuania and the euro area, create conditions for smooth implementation of monetary policy, ensure the financial independence of the Bank of Lithuania and provide a buffer against economic and financial shocks as well as other extraordinary circumstances.
4. Given the purpose of financial assets, financial assets management shall be based primarily on the principle of safety, which is prioritised over the principles of liquidity and profitability. Consistent with the principle of safety, financial assets shall be managed so as to ensure that the expected negative change in investment remains within the acceptable risk level. There is no absolutely risk-free investment in financial markets – all investments are exposed to risks that may materialise to a lesser or greater extent. Changes in the value of the invested financial assets can be driven by credit, market, liquidity or other types of risk. The objective of financial assets management shall be to identify and manage such risks so that the level of the total portfolio risk (negative change in value) is consistent with the acceptable risk level at a high degree of confidence. In this context, it is important to reiterate that investment risk (similarly as return) is to be evaluated with respect to the total portfolio rather than at the level of any single investment. An investment that is deemed risky on its own may reduce risk at the portfolio level if the implemented strategies are weakly correlated and ensure greater risk diversification.
5. Consistent with the principle of liquidity, financial assets shall be managed so as to ensure that a substantial portion of investments is mobilised quickly and without significant costs in order to fulfil the functions of the Bank of Lithuania and meet contractual obligations. As

[1] Official reserve assets comprise investment abroad denominated in foreign currency. Official reserve assets, according to the International Monetary Fund, are defined more narrowly as investments in the following currencies: US dollars, GB pound sterling, Japanese yen, Canadian dollars, Swiss francs, Australian dollars, Chinese renminbi and euro (the euro in Lithuania is not considered foreign currency).

[2] TARGET2 is the real-time gross settlement system for the central banks of the European Union. **TARGET2-LIETUVOS BANKAS** is the TARGET2 component system of the Bank of Lithuania.

investment liquidity is generally associated with lower returns, financial assets shall be managed based on reasonable assumptions with respect to the expected liquidity requirements.

6. The principle of profitability in financial asset management shall be subject to safety constraints. Nevertheless, profitability remains important as the Bank of Lithuania manages a substantial pool of financial assets, with the potential of generating substantial investment income both for the Bank of Lithuania and the Republic of Lithuania. The investment return depends on the size of financial assets under management, the market yields of individual financial assets, and the level of the risk assumed. Higher returns are generally associated with higher levels of risk, as measured by the annualised volatility of the market value of investments. Thus, implementing the principle of profitability shall imply finding an acceptable balance between the additional return associated with higher levels of risk or lower levels of risk at the cost of foregone return.

7. With respect to the profitability principle, the Bank of Lithuania shall seek to maximise investment return within the acceptable risk level expressed as the maximum tolerable expected investment loss. This risk tolerance, hereafter referred to as the ‘risk budget’, shall be established taking into consideration the ability of the Bank of Lithuania to absorb financial losses for a financial year through its accumulated provisions and capital reserves.

8. A portion of financial assets is comprised of approximately 5.8 tons of gold, which were accumulated in the interwar period in Lithuania. Gold is a low yielding asset with high price volatility, yet at times of global economic and political turmoil, it has the desirable characteristic of retaining its real consumption value and thus ensures high financial risk diversification. Gold reserves in the modern financial system meet the essential needs of the country during periods of global economic and political unrest. Taking this into consideration, the Bank of Lithuania shall not intend to change the amount of its gold reserves.

9. Financial assets management is an on-going process aimed at maximising expected return over a constant investment horizon, subject to the specified risk budget and the purpose of individual financial assets positions. For the purpose of financial assets management, the Bank of Lithuania shall adopt a constant (rolling and revolving) three-year investment horizon. The investment horizon differs from the accounting horizon as the latter is based on a calendar year, which declines to one day at the end of the year. The accounting cycle is thus not the appropriate investment management horizon for an on-going, continuous process. Moreover, efficiency of financial assets management should be based on the economic principle, i.e. with regard to the total financial asset portfolio, rather than financial accounting principles. In financial accounting, as set by the European Central Bank accounting and financial reporting guidelines, financial assets revaluation operations are recorded by applying the asymmetric method of their recognition.[3] Therefore, accounting income and expenses generated from the financial asset management and revealed on the income (loss) account of the annual financial statements of the Bank of Lithuania do not reflect the total return on investments, where valuations are based on market prices. The accounting results therefore do not reflect the long-term strategies and objectives of financial assets managements. The annual performance of financial assets investment (total return on investment) available at the year-end shall be reconciled with the financial reporting data, specifying the nature and reasons for any differences.

CHAPTER III
FINANCIAL ASSETS PORTFOLIOS

10. Financial assets of the Bank of Lithuania shall be divided into four portfolios: investment, reserve, short-term, and gold. Each portfolio shall be subject to individual investment strategies.

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[3]The essence of this method is that at the end of the year the revaluation gains of individual financial instruments are recorded in balance sheet revaluation accounts, and the unrealised losses are recognised as expenses.

11. The investment portfolio comprises investment in euros (including funds on the TARGET2 account) and foreign currencies. The objective of this portfolio shall be to maximise investment return over a three-year rolling investment horizon while diversifying risk and effectively using the risk budget set for a one year rolling horizon. The maximum and minimum size of the investment portfolio shall be established by the Board of the Bank of Lithuania.

12. The reserve portfolio is comprised of investments in US dollars. Its aim shall be to ensure a sufficient amount of official foreign reserves and liquidity. Given the objective of the reserve portfolio, the currency risk of the portfolio is not hedged, therefore, substantial fluctuations of this portfolio's value in euros are possible. The maximum and minimum size of the reserve portfolio shall be established by the Bard of the Bank of Lithuania.

13. The short-term portfolio comprises short-term investments and Lithuanian Government treasury funds in foreign currencies deposited at the Bank of Lithuania.

14. The gold portfolio includes gold reserves of the Bank of Lithuania. The gold shall be invested in gold deposits or temporarily swapped into euro or other currencies. Taking into consideration the specific purpose and management of this portfolio, investments shall be made so that the amount of gold does not change significantly and remains between 186–188 thousand Troy ounces.

CHAPTER IV
STRATEGIC STRUCTURE OF FINANCIAL ASSETS PORTFOLIOS

15. Only the strategic structure of the investment portfolio shall be established.

16. The strategic structure of the investment portfolio shall be conveyed by the strategic benchmark portfolio approved by the Board of the Bank of Lithuania, which is aimed at maximum diversification of risks of portfolio investments. The strategic structure of the investment portfolio shall be determined taking into consideration the principles of financial asset management, eligible asset classes, the risk budget and other constraints. It shall express the Bank of Lithuania's expectations regarding the return on the invested financial assets for the next three-year investment horizon.

CHAPTER V
INVESTMENT PORTFOLIO MANAGEMENT

17. Investment portfolio management shall comprise two distinct levels of decision making:

17.1. the strategic benchmark portfolio, established by the Board of the Bank of Lithuania, reflects primary expectations regarding the return on investments and the related risk over the three-year investment horizon;

17.2. active investment management which is allowed to deviate from the benchmark portfolio within the established risk budget.

18. The objective of active investment portfolio management shall be to achieve a higher investment return relative to the strategic benchmark portfolio by taking tactical positions consistent with the level of the allocated risk budget. The allocated risk budget shall be expressed as the maximum tolerable expected negative return possible by active investment portfolio management vis-à-vis the strategic benchmark portfolio over the specified horizon. Active management of the investment portfolio cannot significantly change the risk/return profile established by the Board of the Bank of Lithuania for the strategic benchmark portfolio. The results achieved by active management of the investment portfolio shall be evaluated in the context of the strategic benchmark portfolio and over the investment horizon no shorter than three years.

19. Active management of the investment portfolio comprises:

19.1. the tactical benchmark portfolio, oriented towards a one year investment horizon seeking to generate excess return relatively to the strategic benchmark portfolio;

19.2. investment decisions of portfolio managers, seeking to generate value added vis-à-vis the tactical benchmark portfolio.

CHAPTER VI
RISK BUDGET OF THE INVESTMENT PORTFOLIO

20. The total investment portfolio risk budget shall specify the acceptable level of investment risk at the portfolio level and shall be defined as the highest potential loss over a rolling one-year horizon at a 95 per cent confidence level.

21. The risk budget shall be allocated to the investment portfolio and the active management of the investment portfolio.

22. The risk budget of the investment portfolio shall be EUR 150 million, i.e. the total negative return of the investment portfolio over a rolling one-year horizon at a 95 per cent confidence level shall not exceed EUR 150 million.

23. The size of the risk budget allocated for the active management of the investment portfolio shall be determined by the Board of the Bank of Lithuania.

CHAPTER VII
DEVIATIONS FROM THE STRATEGIC BENCHMARK PORTFOLIO

24. The structure of the investment portfolio may deviate from the structure of the strategic benchmark portfolio within the allocated risk budget and the limits set by the Board of the Bank of Lithuania and the Risk Management and Reporting Division of the Banking Service.

25. The modified duration (MD) of the investment portfolio shall not exceed the MD of the respective strategic benchmark portfolio by more than 0.75 multiplied by the ratio of the size of the maximum investment portfolio to the size of the actual investment portfolio.

26. The equity share of the investment portfolio shall not exceed the equity share of the respective strategic benchmark portfolio by more than 0.5 percentage points. Limits shall not be granted for active investment positions in equities.

CHAPTER VIII
FINANCIAL INSTRUMENTS

27. Financial instruments eligible for investment shall be as follows:

Asset class	Eligible instruments or criteria (any of those listed below are eligible)
Money market instruments	treasury bills discount securities commercial paper (including commercial euro securities) money held in accounts time deposits (including gold) certificates of deposits transferable liabilities of the Bank for International Settlements repurchase agreement and reverse-repurchase agreement transactions (including try-party repurchase agreements) securities lending and borrowing
Bonds	<u>duration:</u> unlimited

	coupon definition: fixed, floating, index-linked structure of capital redemption: callable, puttable, extendible, amortising, sinkable, convertible, index-linked, etc. priority of capital redemption: explicit or implicit government guaranteed, not guaranteed, of any subordinate priority, based on the long-term credit rating of the issuer or/and issuance capital coverage: secured, unsecured, asset-backed, including mortgage loan-backed
Equities	exchange listed equity and equity funds
Currencies	currencies
Material	gold
Investment funds	investment funds (including index and exchange traded funds) as long as the funds' allowable investments fall within the universe of allowable financial instruments and operations.
Financial derivatives	futures (interest rate and bond) swaps (currency, interest rate, cross currency, inflation index, credit spread, total return, credit default) forwards (bond, interest rate, currency, exchange traded fund) options (bond, interest rate, currency, exchange traded fund) foreign exchange rate and gold derivatives

28. Financial derivatives shall be used for risk hedging purposes or efficient implementation of the chosen investment decisions, permissible within this Policy.

29. Investments in financial instruments shall become operational only when the Bank of Lithuania makes all necessary preparations: analysis of investment characteristics and information needs, identification and implementation of valuation methods, preparation of information systems, conclusion of necessary agreements with counterparties, accounting modalities, etc. A detailed list of eligible financial instruments shall be approved by the Risk Management and Reporting Division of the Banking Service.

CHAPTER IX
ELIGIBLE CURRENCIES

30. Financial assets may be transacted and invested (held) in euros, special drawing rights (SDR), gold and the national currency of countries with a credit rating not lower than the long-term investment grade rating.

31. The required currency composition of financial assets shall be ensured by investing in the eligible currencies or, if necessary, through currency swaps or other transactions hedging foreign exchange risk.

32. No limits on the open currency position shall be set for reserve portfolio investments.

33. The total open currency position shall not exceed 15 per cent of the predefined maximum size of the investment portfolio.

34. The open foreign currency position (except US dollar) shall not exceed 3 per cent of the predefined maximum size of the investment portfolio.

CHAPTER X
ISSUER AND COUNTERPARTY LIMITS

35. Financial assets shall only be invested in the bonds of, and transactions shall only be concluded with counterparties (including institutions where the Bank of Lithuania has correspondent, securities custody or clearing accounts) with a long-term investment grade rating. Spot purchase–sale transactions, which are settled on a DVP (delivery-versus-payment) basis, may be concluded with counterparties that do not have a long-term investment grade rating upon the evaluation of their eligibility by the Risk Management and Reporting Division of the Banking Service.

36. If a bond issue is not assigned a rating and the bond is not subordinated vis-à-vis other non-asset-backed debt securities, the issuer rating shall be applied.

37. If an institution and its parent company are separate legal entities, the rating of the parent company shall be taken into account only upon receiving its guarantee in writing.

38. If a national central bank is not assigned a rating, the country rating shall be applied.

39. The average investment rating of a debt securities fund shall not be below the investment grade.

40. The International Monetary Fund and the Bank for International Settlements shall be exempt from rating requirements.

41. Investments in equities, including indirect investments via funds, derivatives, etc., shall be exempt from rating requirements.

42. The total amount of investments with a long-term rating lower than A- (A3) shall not exceed 20 per cent of the predefined maximum size of the investment portfolio.

43. The exposure of the Bank of Lithuania to any single issuer or counterparty with a long-term rating lower than A- (A3) shall not exceed EUR 100 million.

44. The market value of investment in unsecured corporate debt securities (including indirectly exchange-traded or other investment funds, derivatives) shall not exceed 30 per cent of the predefined maximum investment portfolio.

CHAPTER XI
INVESTMENT MANAGEMENT UNDERTAKINGS

45. Financial assets management may be delegated to investment management undertakings. The risk assumed by investment management undertakings shall be included in the total risk budget allocated for financial assets. The Board of the Bank of Lithuania shall approve the size of assets to be delegated to investment management undertakings and the investment mandate. This requirement shall not apply to index and exchange-traded funds.

CHAPTER XII
INTERNAL GOVERNANCE AND CONTROLS

46. The Board of the Bank of Lithuania shall delegate the authority to the Banking Service of the Bank of Lithuania to manage, dispose and handle, within its competence, the financial assets of the Bank of Lithuania subject to the limits established in the Policy and the approved risk budget in line with the set strategic structure of investment.

47. The Risk Management and Reporting Division of the Banking Service shall inform the Board of the Bank of Lithuania if, since the start of the year, the negative return on the investment portfolio or its strategic benchmark portfolio exceeds the risk budget or if the risk assessment ex-ante exceeds the allowable risk budget. The Board of the Bank of Lithuania shall decide on the need to reduce the risks inherent in the strategic structure of investments.

48. In order to allocate responsibilities and ensure control, the Banking Service shall segregate the investment decision-making and implementation processes from the process of handling transactions and effecting payments for investment operations.

49. When managing investments, risk taking, i.e. active management of investments, shall be strictly segregated from risk management and control.

CHAPTER XIII
ACCOUNTABILITY AND REPORTING

50. The Risk Management and Reporting Division of the Banking Service shall provide to the Board of the Bank of Lithuania a quarterly report on the results of the investment of financial assets and positions thereof, risks assumed and incurred, return and sources of risk.

51. At least once a year, the Risk Management and Reporting Division of the Banking Service shall conduct and provide to the Board of the Bank of Lithuania an assessment of whether the financial assets management strategy and the risk level assumed are appropriate to achieve the financial assets management objectives.

52. In the management of financial assets, the principles of openness, transparency and accountability to the public shall be followed. To implement these principles, the Bank of Lithuania shall communicate to the public the key aspects of the Policy and periodically publish information on financial assets. The Bank of Lithuania shall present information on the management and accounting of financial assets in its Annual Report, which is published on the Bank of Lithuania website.

53. The investment portfolio's strategic structure of investments shall be presented on the Bank of Lithuania website.

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