LIETUVOS BANKAS
BANK OF LITHUANIA
FINANCIAL SERVICES AND MARKETS SUPERVISION DEPARTMENT

Heads of electronic money institutions and payment institutions on the list

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ON THE ENHANCEMENT OF OPERATIONAL MANAGEMENT, INTERNAL CONTROL AND COMPLIANCE CULTURE OF ELECTRONIC MONEY INSTITUTIONS AND PAYMENT INSTITUTIONS

Dear head of the electronic money institution and/or payment institution,

We are writing to you with regard to the enhancement of operational management, internal control and compliance culture in the electronic money institution and/or payment institution (hereinafter – the Institutions) managed by you.

The maturity of the financial technology (fintech) sector and the enhancement of the compliance culture continue to be a strategic direction of the Bank of Lithuania. Therefore, as part of our supervision of the Institutions, we would like to remind you that the expectations set out in the Bank of Lithuania's Letter No S 2021/(34.54.E-3402)-12-2676 of 14 May 2021 on the enhancement of operational management, internal control and compliance culture of electronic money institutions and payment institutions and Letter No S 2022/(34.54.E-3900)-12-939 of 17 February 2022 on the enhancement of operational management, internal control and compliance culture of electronic money institutions and payment institutions (hereinafter – the Dear CEO Letters) are still relevant.

We would also like to draw the attention of the Institutions once again to certain requirements laid down in the following legal acts which they are required to comply with in their day-to-day operations.

1. Ensuring proper governance requirements. A licence shall only be issued to a legal person who, taking account of the need to ensure sound and prudent management of the Institution, has put in place a comprehensive activity management procedure which is sound and adequate for the nature, scope and complexity of the Institution's activities (Articles 13(4), 14(4) of the Republic of Lithuania Law on Electronic Money and Electronic Money Institutions and Articles 5(4), 6(4), 7(3) of the Republic of Lithuania Law on Payment Institutions). The Bank of Lithuania is concerned about the management system of the Institutions, where the operational control and risk management mechanism of Institutions belonging to a group of undertakings is concentrated within the group of undertakings, while the Institutions themselves are responsible for the implementation of the supervisory requirements applicable to them as licenced institutions. This becomes particularly important when the activities of the Institution have reached a considerable scale. The Institutions must ensure that their operational control and risk management process, including the decisions adopted in this regard at the Institution level, is implemented within the Institution, i.e. the Institution must have sufficient and qualified staff that understands the requirements set out in the legal acts of the Republic of Lithuania, and the management body that devotes sufficient time for taking the Institution's management decisions. Members of the management bodies are required to be actively and effectively involved in the internal management system of the Institution and to

be able to adopt the Institution's independent, reasonable and objective management decisions.

The Institutions must ensure a proper separation of supervisory and management functions within the Institution. The body carrying out the supervisory function and the management bodies performing the management function must interact effectively. For the management system to function properly, a single person or a small group of persons must not dominate in the decision-making of the management bodies. Regardless of which management body, i.e. the Supervisory Board, the Board or the general meeting of shareholders, is given the discretion to carry out the functions of supervision of the Institution's activities, the Institution must assess whether the decision taken on the appointment of the supervisory body does not compromise the effectiveness of the supervisory function, enables proper functioning of a sound internal control system (Article 23 of the Republic of Lithuania Law on Financial Institutions, Article 28(6) of the Law on Electronic Money and Electronic Money Institutions, Article 22(6) of the Law on Payment Institutions, subparagraph 10.6 and paragraphs 14 to 25 of the Description of the Requirements for Electronic Money Institutions and Payment Institutions Concerning Governance Systems and Protection of Received Funds approved by Resolution No 247 of the Board of the Bank of Lithuania of 30 December 2009 on the approval of the description of the requirements for electronic money institutions and payment institutions concerning governance systems and protection of received funds (hereinafter – the Description) and adequate management of risks arising from conflicts of interest. There are still cases where, as the Institutions establish their management systems, the supervisory and management functions are concentrated in the hands of one or several persons within the Institution. The supervisory function includes, inter alia, supervision and monitoring of management decision-making, supervision of performance of the management bodies and their members, and supervision of the fulfilment of the Institution's strategy and objectives. Thus, the Institutions must assess whether or not the establishment of their management systems will lead to situations where the supervisors and supervised persons overlap, or to permanent conflicts of interest which (unlike the ones of one-off nature that can usually be managed by self-exclusion) will adversely affect the efficiency of performance of the functions, whether or not the independence and impartiality of the internal audit function will be prevented (whether or not the persons responsible for the internal audit function will be accountable to the same persons as the members of the supervisory body whose activities as members of the management bodies will be assessed through the performance of the internal audit function), and whether the Institution's bodies will be able to perform the functions set for them by legal acts in an impartial and objective manner in relation to other bodies or their members (see, for example, Article 20(1)(3) and 20(1)(4), Article 34(2) and Article 37(3) of the Republic of Lithuania Law on Companies; FAQ).

2. Implementation of the risk management requirements. The analysis of compliance with the reliability requirements of the risk management framework by the Institutions indicates only partial compliance. The main requirements for the risk management framework are laid down in the Description. The Bank of Lithuania recommends and encourages the Institutions to follow good practices of the risk management standards when drafting documents related to risk management and to indicate in the documents already prepared which risk management standards were used to compile the content of the documents. In the opinion of the Bank of Lithuania, not only must a risk management strategy and/or risk management policy be developed and approved by the Institutions, but it must also be consistently implemented by the Institutions. The Bank of Lithuania would consider it a good practice if the risk management documents prepared by the Institutions specified the scale of the risk, the limits for each type of risk and established internal procedures for identifying, assessing, monitoring, mitigating and controlling the risks. Also, if the roles, responsibilities and organisation of risk management were clearly defined i.e. the roles and responsibilities of the persons engaged in the risk management process were detailed, descriptions of the stages of risk management, the requirements for the information to be obtained and produced at each stage, and descriptions of the tools and techniques/methodologies to be used for each stage, as well as the templates were provided. Furthermore, the Institutions must ensure the timely preparation of quarterly risk maps, annual risk reports and annual risk management framework assessments as separate documents. The risk maps must indicate the impact (e.g. very high, high, medium, low, accidental) and likelihood (e.g. rare, unlikely, possible, likely, frequent) of the risks relevant to each of the Institutions, while incident registers must contain event records, risk assessment, the identified corrective actions and control of the status of implementation thereof, and the risks identified in the risk register should be further grouped within a certain risk category, the likelihood and impact should be assessed, a person in charge

of risk management should be assigned, the risk management plan, corrective actions, monitoring and status should be determined, and the magnitude of the risk before and after the corrective actions should be assessed. The risk management improvement plan should be drawn up periodically, at least once a year, specifying the category of the Institution's staff whose knowledge and behaviour is to be changed, an assessment of the current behaviour of the staff, a detailed description of the desired and/or target behaviour, the timeframe for the change, the mechanisms to be used, and the method of measuring the change in behaviour, in order to change understanding and behaviour. The risk communication plan should establish when and by what message communication is made, who is responsible for timely provision of information, how and through which channels communication is made within the Institution, feedback requirements and the periodicity of communication with stakeholders. The annual risk management report should contain a description of the overall assessment of the Institution's activities and incidents over the past year and provide an overall risk assessment, including information on the risks that the Institution encountered and what risk management measures were and/or are intended to be implemented. Establishing a separate position responsible for risk management (e.g. a Risk Manager) is considered good practice for risk management in the Institutions.

3. **Timely implementation of own funds requirements.** The Bank of Lithuania receives supervisory reports from the Institutions on a quarterly basis and, regardless of its expectation put forward in the Dear CEO Letter of 2021, the Bank of Lithuania has observed that some Institutions continue to ensure the fulfilment of the own funds requirements only after the reporting date and only carry out the verification of fulfilment of the own funds requirement at the end of the quarter. We would like to note that the Institutions themselves are responsible for forecasting and monitoring their own funds requirements as well as taking effective measures to ensure a continuous compliance with the own funds requirements. The market does not learn enough from its own and other Institutions' mistakes, and there is no significant change in the attitude of the Institutions in assessing the importance of compliance with this requirement. Therefore, in the future, the Bank of Lithuania sees the need to take into account all of the above considerations when deciding on the imposition of sanctions for failure to fulfil the own funds requirements.

4. **Requirements for applying the method for the calculation of own funds requirement.** As part of the supervision of the Institutions, the Bank of Lithuania continuously assesses the compliance with the own funds requirement. However, the appropriate level of the own funds requirement ensuring the sufficiency of the Institution's own funds, which must be sufficient for covering the Institution's risk appetite in relation to the provision of payment services, is of no less importance. Paragraph 7 of the Regulations for the Calculation of Initial Capital and Own Funds of Electronic Money Institutions and Payment Institutions approved by Resolution No 03-83 of the Board of the Bank of Lithuania of 24 May 2018 on the approval of the regulations for the calculation of initial capital and own funds of electronic money institutions and payment institutions and the forms of the report on the calculation of initial capital and own funds of electronic money institutions (payment institutions) (hereinafter – the Regulations) lays down that electronic money institutions that issue electronic money and provide related payment services should apply Method D for the calculation of its own funds requirement. Paragraph 7^1 of the Regulations provides that if an electronic money institution also provides payment services not related to the issuance of electronic money, the own funds requirement for such activities should be calculated in accordance with one of the following methods: A, B or C. When performing its supervisory activities, the Bank of Lithuania identifies cases where electronic money institutions, in addition to the mandatory Method D, also calculate the own funds requirement under Methods A, B or C, even though they only provide payment services related to the issuance of electronic money. It should be noted that an electronic money institution must comply with the requirements set out in the Regulations and constantly ensure that the method used to calculate its own funds requirement is adequate to the nature of the activities carried out (the payment services provided), and that by providing inaccurate information to the supervisory authority on the own funds requirement, it does not provide misleading information that could be used for judging on the nature of the services provided by the Institution. There are also cases where the own funds requirement is not calculated in accordance with the Regulations (e.g. payment transactions in payment services related to the issuance of electronic money are also included in the calculation under Method B), thereby increasing the own funds requirement and, consequently, the amount of own funds of the Institution. The Institutions should draw their attention to the fact that, upon individual assessment of their operational risks arising in practice and in order to have a higher level of own funds than the level calculated by the Institution in accordance with the compulsory

requirements for the calculation of the own funds set out in the Regulations, the Institutions may calculate the additional own funds requirement in accordance with the provisions for the calculation of such additional own funds requirement laid down in the internal procedures of the Institution. Such actions of the Institutions are considered by the Bank of Lithuania good practice, whereby the Institutions ensure adequate management of arising operational risks.

At the same time, we would like to draw the attention of the Institutions to the application of the own funds requirement under Method B: The European Banking Authority (EBA) (EBA's response to the European Commission's Call for advice on the review of Payment Services Directive (PSD2)) and the competent authorities of the Member States, including the Bank of Lithuania, are of the opinion that, in most cases, the calculation of the own funds requirement under Method B best addresses the risks arising from the activities of an Institution providing payment services that are not related to electronic money and thus ensures proper capitalisation of the Institutions. Please note that the calculation of the own funds requirement under Method B[1] is the most widely used method across the European Union and therefore the EBA recommends that electronic money institutions (providing payment services unrelated to the issuance of electronic money for the purposes of calculating the own funds requirement for these activities) and payment institutions should apply Method B for the calculation of their own funds requirement, while Methods A or C could only be used for calculating the own funds requirement if required by the supervisory authority on objective grounds. In light of the above, we believe that now, when preparing for the implementation of the Payment Services Directive (PSD3), it is appropriate for the Institutions to assess the level of their own funds requirement under Method B and to have substantiated evidence to demonstrate why, in the case of an Institution's choice of either Method A or Method C, they view Method A or Method C as a better representation of the risks arising in their activities.

5. Compliance with the equity capital requirements set forth in the Law on Companies. Article 38(3) of the Law on Companies stipulates that if the equity capital of an Institution falls below 1/2 of the amount of the capital as referred to in the articles of association, the board (if the board is not formed, the manager of the Institution) must convene the general meeting of shareholders within 3 months from the day on which it found out or should have found out about the existing situation. This general meeting of shareholders must consider the issues regarding the decisions referred to in Article 59(10)(2) and Article 59(11) of the Law on Companies. The situation existing in the Institution must be remedied within 6 months from the day on which the board found out or should have found out about the existing situation. If such a situation arises in a private limited company which has not been established for more than 18 months, the situation should be remedied within 12 months from the day on which the board found out or should have found out about the existing situation. When supervising the Institutions, the Bank of Lithuania still finds that the Institution's equity capital is less than 1/2 of the authorised capital, therefore, expressing its concern about the current situation, the Bank of Lithuania urges the Institutions to immediately take action to remedy the situation (to perform the actions referred to in Article 59(10)(2) and Article 59(11) of the Law on Companies), and to adopt the decision (to increase the authorised capital/to form additional reserves/to cover the losses by additional contributions, or to perform other actions).

6. Compliance with the requirements for safeguarding customer funds. Pursuant to Article 28(4) of the Law on Electronic Money and Electronic Money Institutions and Article 22(4) of the Law on Payment Institutions, an electronic money institution and a payment institution providing payment services referred to in Articles 5(1) to (6) of the Law on Payments, which are subject to a mandatory audit of financial statements and consolidated financial statements, must submit to the supervisory authority, together with the audited financial statements, a report on audit of financial statements disclosing separate accounting information on the correctness of segregation of electronic money issuance, provision of payment services and other business pursued and observations regarding the internal control mechanisms put in place by the Institution to ensure compliance with the requirements for safeguarding of funds of electronic money holders and payment service users as referred to in Article 25 of the Law on Electronic Money and Electronic Money Institutions and Article 17 of the Law on Payment Institutions. Detailed requirements for the safeguarding of the funds of electronic money holders and/or payment service users are set out in Chapter V of the Description.

Analysis of the audit reports submitted by the Institutions during the annual mandatory audit of financial statements led to the finding that the audit reports on the internal control

[1] It should be noted that in the application of Method B, the own funds requirement of electronic money institutions and payment institutions is calculated on the basis of the monthly average payment volume, i.e. the total amount of payment transactions carried out in the past 12 months and not related to the issuance of electronic money, divided by 12. It is important to note that according to the European Commission's explanation, both debit and credit transfers should be included in the scope of the calculation.

procedures applied by the Institutions designed to ensure the safeguarding of funds of electronic money holders and/or payment service users as defined in Article 25 of the Law on Electronic Money and Electronic Money Institutions and Article 17 of the Law on Payment Institutions, were often only limited to stating that the Institution has in place the approved written procedures (policies, rules, instructions, etc.) for ensuring compliance with the requirement for safeguarding the funds of customers, i.e. electronic money holders and/or payment service users, which are followed in practice; that separate accounts are used to account for the issuance of electronic money, the provision of payment services, and other activities; and that the Institutions hold customer funds in commercial banks of the EU Member States.

However, the Bank of Lithuania expects the audit report to disclose in more detail how, over the past financial year, the Institution, in accordance with the Institution's written internal procedures adopted to ensure compliance with the requirements for safeguarding of customer funds as set out in Article 25 of the Law on Electronic Money and Electronic Money Institutions and Article 17 of the Law on Payment Institutions, ensured the safeguarding of the funds of electronic money holders and/or payment service users. The audit report should disclose information and provide observations on compliance with the internal control procedures applied by the Institution, in view of the requirements set out in Chapter V of the Description. For example, where the Institution has chosen the method of segregation of customer funds (which is currently applied by many Institutions), the observations should include an assessment of the provisions of agreements entered into by the Institution over the past financial year for safeguarding customer funds and/or investment, permanent segregation of customer funds, reconciliations of funds carried out, internal control procedures, and any other areas, depending on the operating model chosen by the Institution (e.g. when operating through intermediaries).

Furthermore, the inspections have revealed that there are cases where the Institutions do not document the reasons why there was a surplus/shortage of funds in the account intended for safeguarding customer funds, i.e. electronic money holders and/or payment service users (hereinafter – the safeguarding account), failed to provide any evidence of the Institution's assessment of the amount of own funds in safeguarding accounts that should be transferred to the own funds account, the reconciliation process was not regulated in the Institution's internal written procedures, the Institution failed to transfer the amount of customer funds to be safeguarded from a payment account that was not in line with the requirements of legal acts set for a safekeeping account, to the safeguarding account by the next close of business. The Institution's procedures must specify the method and periodicity of reconciliation of funds where the amount of the safeguarding account balance at the end of a selected business day is compared with the amount of customer funds that have to be safeguarded, which should take place at least once per business day (if payment transactions have been carried out), decisions on discrepancies, and the periodicity of review of the procedures (once a year). The reconciliation must be carried out on internal account entries, bank account balances and amounts of obligations to customers, based on the data available at the close of the previous business day (where daily payments are carried out). The documents supporting the fact of reconciliation must show the date on which the reconciliation was carried out, the reconciliation activities performed and the results of the reconciliation. Reconciliation of the safeguarding account performed less frequently than daily raises the risk of non-compliance with the requirement of safeguarding of customer funds. The aforementioned cases of flawed practice and good practices have already been discussed at the training conducted in October 2022.
It is important to note that in addition to the annual mandatory audit of financial statements, it may be appropriate for Institutions to conduct additional audits (internal or external) as needed, e.g. upon a change in the Institution's business model (introduction of a new business activity, a payment service) or upon choosing a different method of safeguarding of customer funds, where such a material change may have an impact on the fulfilment of the requirements for safeguarding customer funds.

7. Outsourcing of operational functions. The Bank of Lithuania kindly reminds that the Institutions that have outsourced their operational functions to other persons remain fully responsible for compliance with the requirements set out in legal acts, including ensuring information security, incident management and business continuity. Regardless of whether the service provider is a group company or an external supplier, the Institutions are required to establish indicators for monitoring the level of quality of the outsourced operational functions, including unacceptable level of quality, data and system security requirements, and to continuously monitor compliance therewith.

The main focus of the Institutions must be on the control of important functions. To that end, the Institutions need to obtain appropriate reports from service providers, including quality reports, to use performance, control and risk indicators, to review reports on service providers' business continuity measures and testing, if applicable, to assess the effectiveness of the measures and processes in place for cybersecurity and for internal information and communication technologies security, and to take any other measures. The Institutions must also establish a reasonable strategy of exit from important operational functions.

The Institutions should exercise their audit rights more often, i. e. choose to carry out their own audits or arrange general audits. In the cases where external or internal audit reports provided by the service provider are used, the Institutions must make sure that the audit reports cover the key controls established by the Institutions and ensure compliance with the requirements set forth in legal acts.

When assessing the Institutions' compliance, the Bank of Lithuania will also pay attention to whether or not the Institutions have the characteristics of an empty shell, assess whether the management bodies are duly involved in the process of outsourcing, starting from the actions prior to the conclusion of the outsourcing agreement and then during the control and management of the agreement, as well as on the expiration or termination of the agreement. The Institutions must ensure that they are capable of terminating the outsourcing agreements without unreasonably disrupting the operations of the Institutions, without breaching the requirements set forth in legal acts and without adversely affecting the continuity and quality of provision of services to customers.

8. Notifications about members of management bodies of financial market participants and persons who have acquired a qualifying holding in the authorised capital and/or voting rights. It should be noted that paragraph 46 of the Guidelines for the Assessment of Members of the Management Body and Key Function Holders of Financial Market Participants Supervised by the Bank of Lithuania approved by Resolution No 03-181 of the Board of the Bank of Lithuania of 14 November 2013 on the approval of the guidelines for the assessment of members of the management body and key function holders of financial market participants supervised by the Bank of Lithuania stipulates that, unless otherwise specified in the legal acts regulating the activities of the respective financial market participant, the financial market participant must notify the Bank of Lithuania immediately, but not later than within 10 working days from the day when the member of the management body and/or key function holder has taken up or left their position, and indicate the name, surname and functions of the person who has taken up or left the position, as well as the date when the person took up or left the position.

Furthermore, paragraph 12 of the Rules for the Submission of Notifications on the Acquisition and Disposal of a Qualifying Holding of the Authorised Capital and/or Voting Rights in Financial Market Participants under Supervision of the Bank of Lithuania approved by Resolution 03-138 of the Board of the Bank of Lithuania of 12 September 2017 on the approval of the rules for the submission of notifications on the acquisition and disposal of a qualifying holding of the authorised capital and/or voting rights in financial market participants under supervision of the Bank of Lithuania lays down that a financial market participant must submit a notification of the disposal of a proportion of the authorised capital and/or voting rights held by it as soon as it becomes aware of the acquisition of the proportion of the authorised capital and/or voting rights or of the decision taken to dispose the proportion of the authorised capital and/or voting rights in the financial market participant or to reduce it to the size specified in the law regulating the activities of the financial market participant.

It should be noted that a decision of the Bank of Lithuania not to object to the candidature of the head of the financial market participant or to a transaction of acquisition of a financial market participant does not mean the appointment of the factual new manager or the acquisition of a qualifying holding of the authorised capital and/or voting rights, and therefore, upon receipt of a decision of the Bank of Lithuania not to object to the candidature of the head or to the proposed acquisition, it is necessary to specifically notify the Bank of Lithuania on the new head that has actually taken up the position or on the persons who have acquired authorised capital and/or voting rights in the Institution. The Bank of Lithuania kindly reminds you that non-compliance with the requirements set out in the legal acts referred to in this section of the Letter constitutes grounds for the imposition of sanctions on financial market participants or other persons.

9. Management of money laundering and terrorist financing risks. In its supervision of the prevention of money laundering and terrorist financing (AML/CTF), the Bank of Lithuania further draws the attention of the Institutions to the importance of complying with the AML/CTF requirements. The financial market supervision conducted by the Bank of Lithuania includes a

periodic analysis of the data submitted by the Institutions to it and a regular assessment of various AML/CTF risk factors, including newly emerging AML/CTF risks. Please note that the Bank of Lithuania's website (https://www.lb.lt/lt/rekomendacijos) provides guidance to financial market participants, including the Institutions, on a variety of relevant issues in the area of AML/CTF, including various recommendations, guidelines and explanations. Annual exhaustive Dear CEO Letters relating to the AML/CTF risks arising in the Institutions' sector and the need to take appropriate and proportionate measures to manage the AML/CTF risks, the implementation of which is to be assured by the heads of the Institutions, are also published in that section.