LIETUVOS BANKAS
EUROSISTEMA

Banking activity review
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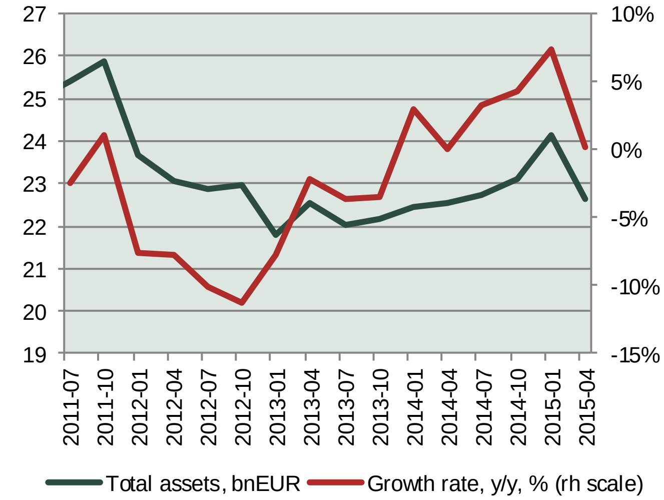
Banking activity review

The assets of banks operating in Lithuania contracted in Q1 2015 — at the end of the litas exchange into euro process, part of the funds naturally flew out of the banking sector. The change in the loan portfolio continued to be moderate, yet positive: loans, including housing loans, granted both to natural persons and enterprises, recorded growth. The favourable state of the economy and banks' prudent lending determined that the loan portfolio quality remained good. The amount of deposits with banks decreased for the first time after a prolonged period of growth, compared to all-time heights. At the end of the changeover, bank customers withdrew a smaller share of funds deposited in Q4 2014, and the overall amount of customer deposits was higher than a year ago or at the end of Q3 2014. The operations of banks were profitable, yet a negative impact of the low interest rate environment could be felt. Compared to the same period a year ago, banks' profits boosted by 7 per cent; the positive change stemmed from one system participant though, without which total profits would have declined somewhat.

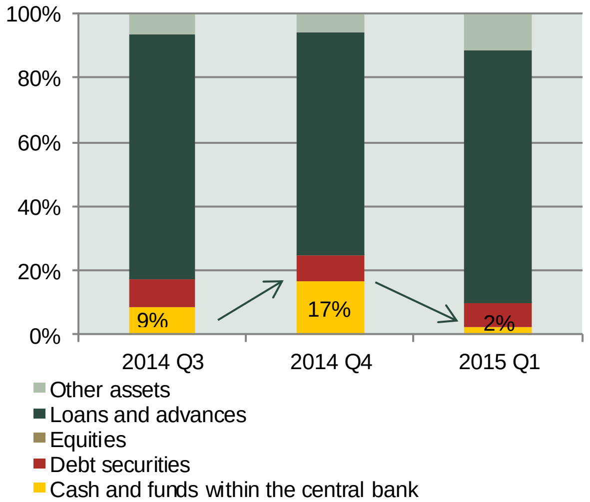
Assets and liabilities

After the adoption of the euro there was only partial outflow of deposited funds from the banking sector. In Q1 2015, 7 banks and 8 foreign bank branches operated in Lithuania. Bank assets amounted to EUR 22.6 billion at the end of the period, a decline of EUR 1.5 billion (6.2%) quarter on quarter. Year on year the assets of the banking system increased by EUR 58 million (0.3%). The decline in bank assets was due to a EUR 3.5 billion decline in the amount of cash and funds held with the central bank. Part of this amount flew out of the banking system; banks allocated slightly more than EUR 2 billion to other asset items though: part of this amount was transferred to deposits with parent institutions.

Assets of the banking sector



Asset composition



Source: The Bank of Lithuania.

The decline in bank liabilities was driven by a contraction in the liabilities to parent banks. Bank liabilities decreased by EUR 1.42 billion (6.5%) in Q1 2015 — to EUR 20.2 billion. Most of this decline stemmed from a contraction of EUR 1.36 billion in liabilities to credit institutions, a substantial portion of which consisted of liabilities to parent institutions, and of EUR 0.36 billion in customer deposits (i.e., the outflow of the share of previously deposited funds following the changeover process; for more information see the section “Deposits”). This contraction was offset somewhat by an increase in bank liabilities to the Bank of Lithuania, which grew by EUR 0.35 billion over the quarter as a result of the use by one bank of the Eurosystrem's monetary policy operations as a possibility to get financing on favourable conditions.

Key performance indicators of banks
(EUR)

No.	Indicator	01/04/2014	01/01/2015	01/04/2015	Change in Q1	Change over year
		Amount, EUR millions			%	
1.	Assets	22 565,3	24 129,5	22 623,1	-6,2	0,3
2.	Debt securities	2 165,7	2 077,1	1 920,5	-7,5	-11,3
3.	Leasing	991,3	993,2	992,0	-0,1	0,1
4.	Loans granted to customers	14 607,3	14 742,0	14 830,2	0,6	1,5
4.1.	Private enterprises*	6 713,7	6 524,6	6 587,5	1,0	_
4.2.	Financial institutions*	147,8	129,9	132,2	1,8	_
4.3.	Natural persons*	6 599,7	6 947,9	6 970,9	0,3	_
4,4	General government institutions*	1 146,1	1 139,7	1 139,6	0,0	_
4.3.1.	Housing loans*	5 621,1	5 731,4	5 743,4	0,2	_
5.	Loan impairment	618,0	522,0	497,6	-4,7	-19,5
5.1.	Loan impairment to granted loans ratio, %	4,1	3,4	3,3	_	_
6.	Depostis	13 873,5	16 271,8	15 912,3	-2,2	14,7
6.1.	Private enterprises*	4 554,1	4 962,3	4 832,0	-2,6	_
6.2.	Financial institutions*	265,1	356,1	364,6	2,4	_
6.3.	Natural persons*	8 031,7	9 796,0	9 652,8	-1,5	_
6.4	General government institutions*	1 022,6	1 157,4	1 062,9	-8,2	_
7.	Shareholders' equity	2 311,7	2 496,2	2 405,6	-3,6	4,1
8.	Profit (loss) of the current year	53,1	213,4	56,8	_	7,0
9.	Net interest margin, %	1,6	1,6	1,5	_	_

* As of 1 October 2014, the principles of classification of customer group categories were subjected to changes, thus the loan and deposit data by customer group are not directly comparable to the data of previous periods.

Source: *The Bank of Lithuania.*

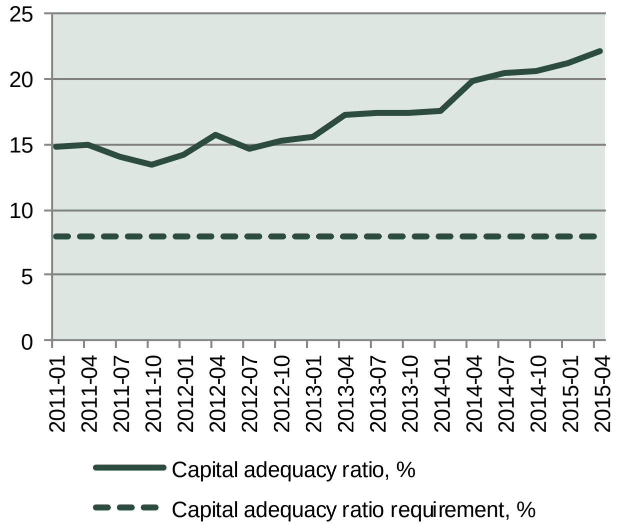
Compliance with requirements

All banks operating in Lithuania complied with all established requirements. As of 1 April 2015, the overall capital adequacy ratio of banks was 22.19 per cent (the requirement is 8%) and was higher than in the previous quarter (21.29%). All banks operating in Lithuania complied with the established capital adequacy requirement. The capital of Lithuania's banking system consists mainly (98%) of the highest quality common equity tier 1 capital (CET1), whose respective indicator stood at 21.78 per cent. The liquidity ratio, established by the Bank of Lithuania, is no more applicable to the monitoring of the liquidity condition of banks as of 2015; it is being replaced with the liquidity coverage ratio (LCR), which is calculated according to the provisions contained in the Capital Requirements Directive IV (CRDIV)[1] and the Regulation (CRR)[2]. The Bank of Lithuania, seeking to monitor banks' preparations for the implementation of the new liquidity requirements and ensure compliance with them, calculates the preliminary values of LCR, while the reporting on the LCRs calculated by banks themselves will start as of 1 October 2015. With the banks' sufficiently

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013
[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013.

large holdings of the reserves of liquid assets, the established ratios were complied with a large enough reserve.

The capital adequacy ratio of the banking sector



Source: The Bank of Lithuania.

The regulatory and economic environment

Lithuania — a member of the Single Supervisory Mechanism for banks in the euro area. Once Lithuania joined the euro area, the supervision of banks operating in Lithuania became part of the Single Supervisory Mechanism. The European Central Bank (ECB), which took over direct supervision of the three largest banks — *AB SEB bankas, Swedbank, AB*, and *AB DNB bank*as — carries it out in close cooperation with the Bank of Lithuania, while the supervision of smaller banks is further carried out by the Bank of Lithuania. The ECB only ensures indirect supervision of these market participants. Seeking that the supervision model is further effective and a constructive dialogue takes place with the ECB, the Bank of Lithuania has been adjusting its supervisory processes to the requirements of the Single Supervisory Mechanism.

An additional capital conservation buffer will be applicable to banks shortly. In March 2015 the Seimas adopted amendments to the Republic of Lithuania Law on Banks, which have legally enforced the provisions of the CRD IV in Lithuania. Beside other aspects, this Directive provides for five additional capital buffers: capital conservation buffer, special countercyclical capital buffer, global systemically important institution buffer[3], other systemically important capital reserve of financial institutions and the systemic risk reserve. The aim of these buffers is to regulate the economic cycle and protect the financial system. Based on the Republic of Lithuania legal acts[4], by which the provisions of the CRD IV have been transposed, as of 30 June 2015, the capital conservation buffer of 2.5 per cent requirement will be applicable beside the capital adequacy ratio of 8 per cent. The amount of the counter-cyclical capital buffer is to be published by the Bank of Lithuania in June and banks will have to accumulate it within one year starting from 30 June 2015. If the value of 0 per cent is established for the buffer, the decision is likely to come intro force on 30 June 2015. By the end of the year the Bank of Lithuania intends to publish the list of systemically important institutions together with the additional capital buffers established for them, which the financial institutions will have to accumulate by 1 January 2017.

Processes, related to the acquisition of the shares of two banks, have still been taking place currently in Lithuania's banking sector. The Bank of Lithuania has received and is processing the requests related to the acquisition of *AB bankas FINASTA* and *AB Citadele bankas.* Since Lithuania has been part of the Single Supervisory Mechanism, the final decisions on these transactions will be taken by the ECB. *AB Invalda INVL*, which, in 2014, acquired *AB bankas FINASTA* and affiliated undertakings, and related parties are going to sell their banking business to *AB Šiaulių bankas* in exchange for this bank's

[3] Since there are no global systemically important institutions in Lithuania, the appropriate reserve is not relevant.
[4] Including Resolution No 03-51 of the Board of the Bank of Lithuania “On the Approval of the Rules for the Formation of Capital Buffers” of 9 April 2015.

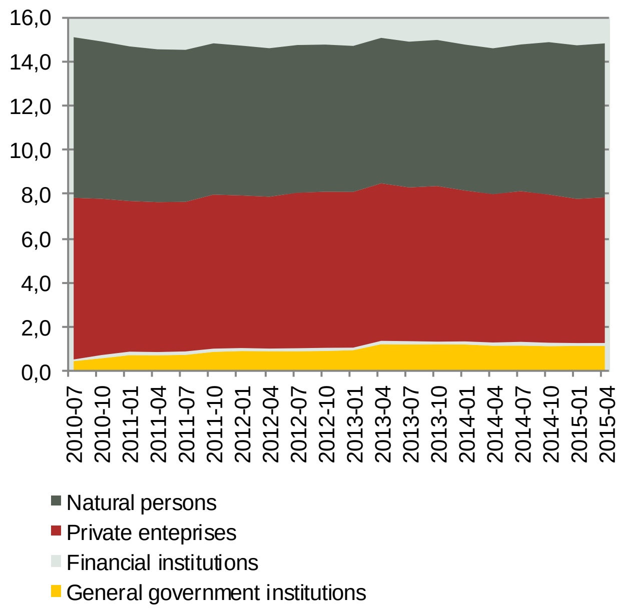
shares. In April 2015 the ECB permitted a group of US investors to acquire 75 per cent +1 of the shares of *AS Citadele banka* of Latvia. The latter owns 100 per cent of the shares of *AB Citadele bankas* operating in Lithuania, thus a decision on the indirect acquisition of the bank operating in Lithuania will also be taken shortly.

The loan portfolio

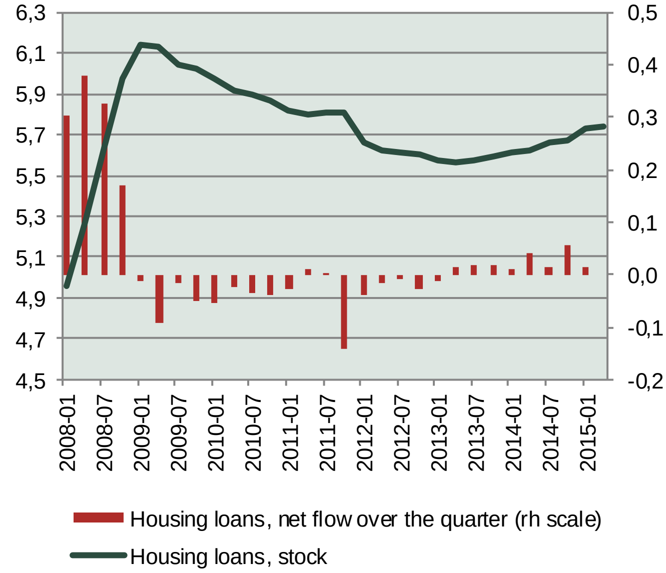
Developments in the loan portfolio

The developments in the loan portfolio (on a net basis) in Q1 2015 continued to be moderate. Despite the ultra-low interest rates, which have been holding for a few years, the banks' loan portfolio still lacks a more serious lunge, as the customers' demand for lent funds has been limited, while banks' risk tolerance has remained low enough. Nevertheless, marginal, yet positive developments in the loan portfolio were observed. At the end of Q1 2015 banks had granted to their customers EUR 88 million (0.6%) per cent more loans quarter on quarter, while their total loan portfolio amounted to EUR 14.8 billion. The share of loans granted to financial institutions grew the most (1.8%) over the quarter; credit to enterprises, which grew the most in the absolute value of EUR 63 million (1.0%) — to EUR 6.6 billion, should be noted as well. The developments in the loan portfolio of natural persons were moderate — this portfolio grew by EUR 23 million (0.3%) over the first three months of 2015 — to EUR 7.0 billion. Despite the improvements in the economic situation of households, residential mortgage loans followed a rather sluggish path — the residential mortgage portfolio expanded by EUR 13 million (0.2%) over this period to amount o EUR 5.7 billion.

The loan portfolio of banks
(EUR thousand)



Housing loans
(EUR thousand)



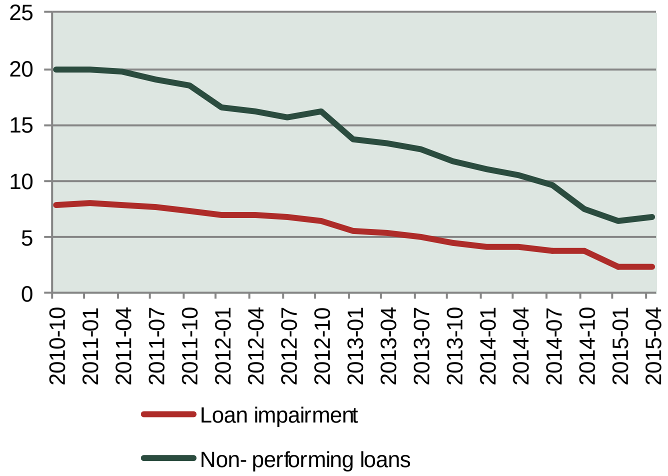
* As of 1 October 2014, housing loans also include loans granted to households designated for investment in one's house for one's own needs or rent, including construction and repair; therefore, the data are not fully comparable to the line of previous data.

Source: *The Bank of Lithuania.*

Quality of the loan portfolio

The quality of loans did not deteriorate significantly. In Q1 2015, the ratio of non-performing loans accounted for 6.7 per cent of the loan portfolio on a gross basis, while the specific provisions for loans formed — for 2.4 per cent. The ratio of specific provisions increased over the quarter, yet by an insignificant value (0.06 p.p.), while the ratio of non-performing loans deteriorated by 0.3 p.p. over the quarter. The latter ratio increased with most banks; the change in it, however, was basically driven by the change in the amount of funds with the central bank and credit institutions (the amount of these two, which improves the ratio of non-performing loans, contracted with banks by about EUR 2 billion). Excluding these two borrowers, which usually improve the ratio of non-performing loans, i.e., estimating the loans granted to general government, non-financial corporations and households, the ratio of non-performing loans improved by 0.3 p.p. — to 8.6 per cent.

Indicators of the banks' loan portfolio quality
(compared to the loan portfolio, %)



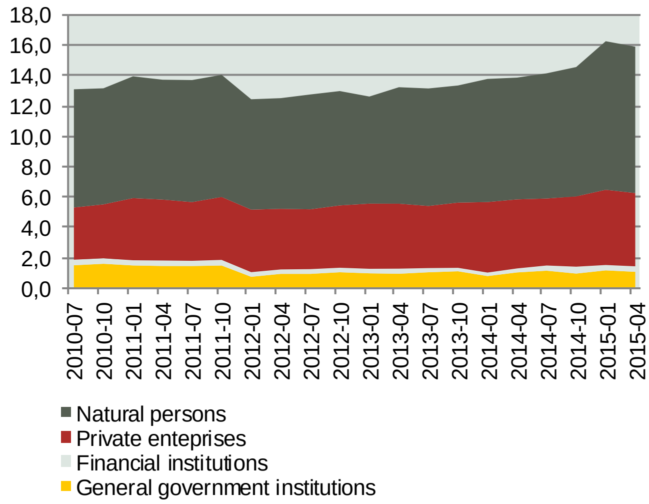
Note: From 2015 a new definition of non-performing loans is being applied in the European Union, thus the loan quality indicators of banks operating in Lithuania as of 1 October 2014 are already published according to new requirements and their values are not fully comparable to the previous ones. The loan impairment indicator methodology has been changed and therefore the values of this indicator, as of 1 January 2015, are not fully comparable to its previous values.

Source: The Bank of Lithuania.

Deposits

After the adoption of the euro customers withdrew from banks only part of their funds deposited at the end of 2014. The amount of deposits with banks, in Q1 2015, dropped from the highest levels reached at the end of 2014. This was the first time since the prolonged period of growth in deposits that the overall amount of deposits declined. As of 1 April 2015, customers held with banks EUR 15.9 billion of deposits, which was a decline of EUR 359 million (2.2%) quarter on quarter. The reason behind this decline is related to the changes observed at the end of 2014: in Q4 2014, the amount of deposits boosted significantly (by EUR 1.7 billion) — as a result of the upcoming euro adoption. Residents, wishing smooth conversion of their funds, put their holdings of cash on accounts with banks. After the changeover, customers withdrew part of these funds; however, the amount of deposits held with banks was larger than on 1 October 2014. Due to the changeover, residents transferred part of their savings, until then traditionally held as cash, to banks (i.e., chose a more secure saving instrument). Despite that banks offer very low or, in some cases, even zero-interest rates on deposits, customers continue to use this saving instrument as alternatives are uncommon.

The amount of deposits
(EUR billion)



Source: The Bank of Lithuania.

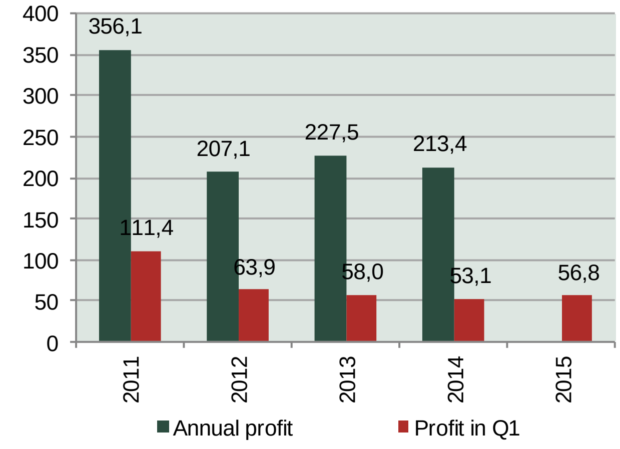
Profitability and efficiency of operations

The operations of the banking system were profitable in Q1 2015; however, the developments in the major sources of income followed an unfavourable path. The profits earned by banks and foreign bank branches operating in Lithuania in Q1 2015 amounted to EUR 56.8 million, an increase of EUR 3.7 million (7.0%) year on year, although the performance of the major sources of income — net interest income and fees and commissions — was worse. The greatest impact on the total profit change stemmed from one system participant, whose profit boosted by EUR 5.6 million from Q1 2014, to offset the total decline in the profits of the rest of the system. Having eliminated the above-named system participant, whose higher profit was driven mainly by technical reasons, the profit of the banking system would have declined by EUR 1.9 million. On an individual basis, in Q1 2015, compared to the same period a year ago, 8 banks increased their profits and 7 banks and foreign bank branches earned less. Over the first three months of 2015 only two members of the banking system incurred losses, while the others operated at a profit.

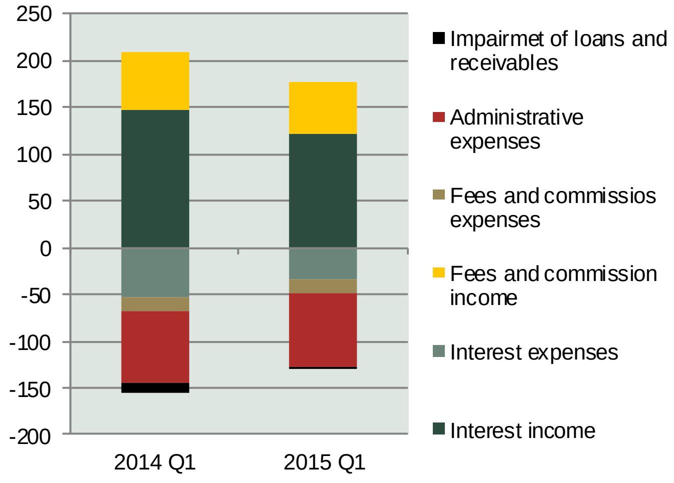
Net interest income of banks decreased. Particularly low market interest rates lead to bank interest income and interest expense decreases. The 3 month euro interbank interest rate EURIBOR crossed the zero per cent threshold in April 2015, while the 6 month ratio is very close to zero. It should be noted that a significant part of bank lending is related to these benchmarks. On the other hand, as interest rates have reached zero and demand deposits have been dominating the deposits with banks, the decreased flow of interest income from loans does not offset the lower deposit costs. Banks' interest income, compared to Q1 2014, contracted by a total of EUR 24 million (17%), while their expenses — EUR 19 million (36%), thus net interest income declined by EUR 5 million (6%).

Net income from fees and commissions followed an unfavourable trend; it was negatively affected by the loss of income from currency exchange and payment orders in euro. Income decreased less than expenses — by EUR 9.3 million (15%) and EUR 0.5 million (3%) respectively; hence net income from services and commissions shrank by EUR 8.7 million (18%) over the period.

Profit of the banking sector
(EUR millions)



Main items of income and expenses
(EUR millions)

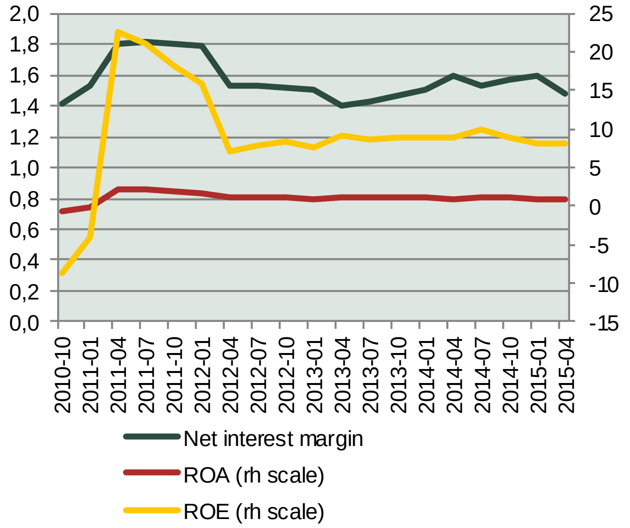


Source: *The Bank of Lithuania.*

The expenses of the banking system increased also due to the growing labour cost. In Q1 2015 banks incurred EUR 77.9 million of administrative expenses, which grew by EUR 1.9 million (2%) over the year and negatively affected the total profit of the banking system. According to the Statistics Lithuania, the annual growth rate of the average wage in the private sector of financial and insurance activities was 3.5 per cent in Q1 2015; thus it is likely that the improving situation in the country's labour market contributed to the higher expenses of banks. The contraction in the impairment costs of loans and receivables helped somewhat offset the influence of the negative factors: these costs declined by EUR 7.0 million (72%) compared to Q1 2014 — to EUR 2.6 million.

The profitability indicators of banks remained stable in Q1 2015. The return on assets of banks and foreign bank branches remained almost unchanged year on year (from 0.94 to 0.98%); the return on the equity of banks dropped from 8.85 to 8.05 per cent, mainly on account of the increase in the banking system's equity. Due to the larger decrease in interest income than in expenses, the net interest margin dropped somewhat over the year — from 1.60 to 1.48 per cent.

Profitability indicators of banks
(%)



Source: The Bank of Lithuania.

Banks will seek alternative solutions to maintain their profitability. The persisting environment of ultra-low (negative) interest rates creates unfavourable conditions for the profitability of Lithuania's banking system. It is complicated for banks to earn higher profits from their main activity, as the lending process is sluggish, while in terms of financing, the amounts of deposits held by customers are more than sufficient. Until the market conditions change, the banks operating in Lithuania will have to look for ways to ensure profitability. Some banks can undertake crediting projects involving higher risk they had avoided because of the lessons learnt during the crisis. However, the demand for loans in the market is limited and banks have to compete for clients. Given the deposit amounts held with banks, it is likely that banks may start developing alternative saving products more actively, by offering a wider range of saving instruments and providing investment banking services.

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