AUDIT OF BANK ANNUAL FINANCIAL STATEMENTS

The audit of 2004 financial statements in all banks was performed by international audit companies. The auditors expressed unqualified opinions in respect of the financial statements of all banks.

Pursuant to Paragraph 4, Article 61 of the Republic of Lithuania Law on Banks, banks have to publish audited annual financial reports and the opinion of the auditor within 4 months after the end of the financial year.

OVERVIEW OF BANK OPERATIONS

According to the audited financial statements for 1 January 2005, total assets of operating domestic commercial banks[1] made up LTL 29.2 billion, increasing over the year by LTL 7.1 billion, i.e. 32.3 per cent. Total loans granted to customers amounted to LTL 16.9 billion, increasing year on year by LTL 4.8 billion (39.7%).

Deposits held with domestic banks totalled LTL 17.9 billion on 1 January 2005, increasing over the year by LTL 4.3 billion (31.6%), of which deposits of individuals made up LTL 9.8 billion, up by LTL 1.9 billion (24.4%) over the year.

Development of some asset and liability items in the banking system
LTL million

No.	Item	1 Jan 2004	1 Oct 2004	1 Jan 2005	Change over Q4 (%)	Change year-on-year (%)
1	Assets	22,030.9	26,350.3	29,150.8	10.6	32.3
2	GS	2,618.9	2,620.2	2,721.3	3.9	3.9
3	Other debt securities	604.9	604.8	588.2	–2.7	–2.7
4	Loans to financial institutions	1,243.4	1,796.6	1,760.2	–2.0	41.6
5	Loans granted to customers	12,099.4	15,310.4	16,897.7	10.4	39.7
5.1	Of which loans to private companies	8,690.7	10,215.5	11,063.9	8.3	27.3
5.2	Of which loans to natural persons	2,405.9	3,858.8	4,448.5	15.3	84.9
5.2.1	Of which loans for house purchase	1,909.0	2,970.7	3,438.6	15.8	80.1
6	Specific loan provisions	67.8	108.5	120.5	11.1	77.9
7	Specific loan provisions/ granted loans, %	0.56	0.71	0.71	–	–
8	Deposits and letters of credit	13,573.9	16,004.2	17,859.5	11.6	31.6
8.1	Of which private companies	4,505.6	5,233.5	6,419.5	22.7	42.5
8.2	Of which natural persons	7,887.4	8,904.1	9,811.9	10.2	24.4
9	Shareholders' equity	2,105.4	2,419.9	2,508.1	3.6	19.1
10	Profit (loss) for current year	233.7	217.3	299.3	–	–

In the course of the year, the asset market share of the three largest banks (AB Vilniaus bankas, AB bankas Hansabankas and AB bankas NORD/LB Lietuva) contracted from 71.1 per cent to 67.6 per cent (AB Vilniaus bankas lost the largest part of market share when it contracted by 3.67 percentage points over the year). Among the banks that increased their market share most were Nordea Bank Finland Plc Lithuania Branch (1.61 percentage points), AB Sampo bankas (1.61 percentage points) and VEREINS–UND WESTBANK AG Vilnius Branch (1.53 percentage points). The rather fast expansion of assets held by Nordea Bank Finland Plc Lithuania Branch was influenced by the acquisition of the assets of Poland's AB Kredyt Bank S.A. Vilnius Branch.

LOANS

The bank loan portfolio retained a comparatively high growth rate in 2004. On the other hand, the fast rate of growth in the nominal loan portfolio of Lithuanian banks was also determined by the low initial base level of loans in comparison with other European countries. According to the data of 1 January 2005, the loan portfolio

[1] The concept of the banking system and operating domestic commercial banks includes all commercial banks and foreign bank branches operating during the period under review.

in Lithuanian banks[2] accounted for as little as 30 per cent of the GDP in 2004, while the same indicators were twice as high in Latvia and Estonia and even higher in other EU countries. As mentioned above, total loans granted to bank clients increased over the year by LTL 4.8 billion (39.7%). This rate of growth was considerably lower compared to 2003, when the rate of loan portfolio growth was 52.3 per cent (excluding the impact of methodological changes in 2003 loans to clients would have increased by approx. 49 per cent).

Bank credit obligations also experienced fast growth, albeit at a slightly lower rate than the expansion of the loan portfolio, in 2004, increasing by LTL 860 million (28%) over the year to LTL 3.9 billion on 1 January 2005.

By individual client groups, the highest increase of loans in 2004 (as in 2003) was loans to private undertakings (LTL 2.4 billion) and individuals (LTL 2 billion). Loans to natural persons (where loans for house purchase have been prevailing) have remained an item of banking assets characterised by most dynamic growth.

Loans granted to the population increased in 2004 by nearly 85 per cent. Loans for house purchase accounted for the largest part of these loans (77%), increasing over the same period by LTL 1.5 billion (80.1%). Loans for house purchase as a bank product has only recently gained popularity, and their volume and weight, in comparison to other countries of the region, has remained among the lowest (on 1 January 2005 loans for house purchase accounted for 5.6 per cent of GDP in 2004[3]), reflecting a high growth potential.

After the entry into effect of new rules for the classification of doubtful assets in Q3 2004, banks started presenting reports on the assessment of credit risk according to the rules on the assessment and classification of doubtful assets newly developed by banks themselves. The total amount of specific provisions on balance sheet assets increased in 2004 by LTL 43.6 million (35.7%), and the provisions on off–balance sheet items grew by LTL 9.7 million (3.7 times). Due to the said increase of specific provisions on loans, the ratio of specific provisions on loans to the loan portfolio went up over the year from 0.56 per cent to 0.71 per cent (unchanged in Q4).

COMPLIANCE WITH PRUDENTIAL REQUIREMENTS

The liquidity indicators in the banking system changed insignificantly in Q4 2004, and, on 1 January 2005, the liquidity ratio in the banking system was 41.7 per cent, exceeding the required minimum ratio set by the Bank of Lithuania by nearly 12 percentage points.

In September 2004 the Board of the Bank of Lithuania adopted a resolution thereby reducing the capital adequacy ratio applicable to banks from 10 per cent to 8 per cent, while the 10 per cent capital adequacy ratio was continued to be applied to AB VB Mortgage Bank. As at 1 January 2005, all domestic commercial banks complied with the capital adequacy ratio, and the overall capital adequacy of the banking system was 12.36 per cent.

In Q4 2004 all domestic commercial banks and foreign bank branches operating in Lithuania were in compliance with prudential requirements set by the Bank of Lithuania.

SHAREHOLDERS’ EQUITY

Shareholders’ equity increased in 2004 by LTL by 396 million (18.8%) and reached LTL 2.5 billion on 1 January 2005. The increase in Q4 2004 was LTL 85.1 million (3.5%). The registered bank share capital increased over the year by LTL 106.2 million (8.6%) to LTL 1.3 billion, of which in Q4 it went up by LTL 3.3 million..

Four domestic banks increased their share capital in 2004. AB bankas NORD/LB Lietuva increased its share capital by LTL 18.5 million to LTL 195.1 million, AB Bankas Hansabankas by LTL 50 million to LTL 485.3 million, AB Sampo bankas by LTL 30 million to LTL 118 million, and AB Šiaulių bankas performed two capital increased

[2] Including loans to financial institutions.
[3] According to the data for 1 October 2004, in Latvia loans for house purchase accounted for 11.5 per cent of GDP, and in Estonia for 15 per cent. In euro area countries (data for 2002) the ratio of loans for house purchase and GDP varied between 10 and 60 per cent.

during the year by the total amount of LTL 7.7 million to LTL 56 million.

In addition, banks used subordinated loans to strengthen their capital base in 2004. Thus AB bankas NORD/LB Lietuva renewed its subordinated loan agreement with the European Bank for Reconstruction and Development and increased the amount of the loan by LTL 11.5 million; AB Sampo bankas received an LTL 30 million loan from its parent bank, and AB Ūkio bankas received a subordinated loan of USD 1.5 million from the company Samsung U.K. Limited registered in the United Kingdom. The banks were permitted to include these subordinated loans in their Tier 2 capital.

The share of bank capital in Lithuania held by foreign investors declined by 2 percentage points in 2004 to 87 per cent on 1 January 2005.

PROFITABILITY AND BUSINESS EFFICIENCY

The expansion of the volume of banking operations was positively reflected in bank results. According to the audited financial statements for 1 January 2005, all domestic commercial banks and foreign bank branches were profitable in 2004. The total profit of domestic banks amounted to LTL 299.3 million, of which commercial banks earned LTL 293.2 million and two foreign bank branches LTL 6.1 million. In comparison, in 2003 the Lithuanian banking system posted a profit of LTL 233.7 million. The profit of the Lithuanian banking system grew for a third consecutive year, while the profit in 2004 was the largest from the restoration of the independence of the country.

Profitability of Operating Banks

No.	Bank	Profit for current year (LTL million)	
		1 Jan 2004	1 Jan 2005
1.	AB bankas NORD/LB Lietuva	15.5	19.4
2.	AB Ūkio bankas	4.9	6.0
3.	AB Vilniaus bankas	132.3	120.5
4.	AB Šiaulių bankas	4.2	6.5
5.	AB bankas Snoras	7.2	20.5
6.	UAB Medicinos Bankas	1.4	1.6
7.	AB Parex bankas	6.1	5.5
8.	AB bankas Hansabankas	60.9	111.1
9.	AB VB Mortgage Bank	0.9	0.9
10.	AB Sampo bankas	0.8	1.1
	TOTAL banks:	**234.2**	**293.2**
11.	Kredyt Bank S.A. Vilnius Branch (Poland)	–0.8	–
12.	VEREINS–UND WESTBANK AG Vilnius Branch (Germany)	1.2	3.0
13.	Nordea Bank Finland Plc Lithuania branch	–0.9	3.1
	Total foreign bank branches:	**–0.5**	**6.1**
	TOTAL:	**233.7**	**299.3**

The analysis of banking performance in 2004 allows distinguishing several main business segments, which, compared to 2003, had a positive effect on bank profitability. First, bank results reflected income from the rapidly expanding loan portfolio, which determined to a large extent the increase of net interest income of LTL 108.8 million (22%). It should be noted, however, that the real impact of net interest income on profitability was somewhat lower due to the adjustments from higher expenses on specific provisions and higher deposit insurance contributions. Second, the banking system earned LTL 42.3 million more in net income from services and commissions, determined by a higher volume of services and higher fees in some banks. The third factor to have a positive impact on the results was LTL 29.8 million (threefold) increase of income from equities most of which were accounted using the equity method.

The banks continued centralising certain functions, outsourcing certain operations and reducing the number of staff accordingly. In 2004 only, the number of employees in banks declined from 6,868 to 6,479 (5.7%).

On the other hand, fast growth of the loan portfolio in 2004 resulted in increased expenses on specific provisions. As a consequence, these expenses had the largest negative impact on bank performance in 2004, compared to previous years. The growing volume of deposits in banks resulted in higher expenses on deposit insurance contributions, while the amount paid by the banking system as profit tax increased as well. These factors slowed down net profit growth in the banking system.

The real interest margin that had been declined for several consecutive years went down further by 0.58 percentage points in 2004 and reached the lowest level over the recent years (2.83%).

The ratio of fixed expenses and the profit from the main operations which serves as the efficiency indicator declined (improved) over the year by 12.2 percentage points to 59.9 per cent on 1 January 2005, representing the proportion of the profit (net income) earned from the core operations to cover operating and amortisation expenses. Such a sizeable improvement in efficiency was not only determined by the higher profit from core operations but also by lower fixed expenses.

OPERATIONS OF THE CENTRAL CREDIT UNION OF LITHUANIA

The auditors of an international audit company which performed the audit of the financial statements of the Central Credit Union of Lithuania (CCUL) for 2004 expressed an unqualified opinion.

The assets of the CCUL, which showed the strongest growth in Q4 (LTL 12.6 million), increased by LTL 13.1 million (40.9%) in 2004 to the total of LTL 45 million on 1 January 2005. This resulted from the growth of deposits of credit union members, the main source of financing of the CCUL, of LTL 12.6 million.

In 2004 the CCUL helped credit unions to deal with liquidity problems on four occasions by providing loans from the Liquidity Support Reserve.

6 new credit unions joined the CCUL in 2004 and total membership increased to 53. As credit unions paid up their shares, the share of the Government of the Republic of Lithuania in the share capital of the CCUL continued to decline in 2004, while the share of credit unions increased. On 1 January 2005 the Government of the Republic of Lithuania held LTL 3.47 million of the LTL 5.3 million share capital of the CCUL, and 53 member credit unions held LTL 1.86 million of the share capital. As the membership of the CCUL increased and the volume of credit union operations expanded, the Liquidity Maintenance Reserve and the Stabilisation Fund increased further in 2004, and on 1 January 2005 made up LTL 1473 thousand and LTL 444 thousand, respectively.

According to the audited financial statements, the CCUL earned a profit of LTL 137 thousand in 2004, an increase of 3.3 times year on year. The major part of the income earned by the CCUL consisted of interest income accounting for 89 per cent of total income, while the largest share of expenses consisted of interest expenses and operating expenses, comprising 46.6 per cent and 45 per cent of total expenses, respectively.

In 2004 the LCCU complied with all prudential requirements.

OVERVIEW OF CREDIT UNION OPERATIONS

Credit unions. On 1 January 2005, there were 61 credit unions in Lithuania, with the total of 45 members. Four new credit unions were established in 2004.

Development of the main items of the consolidated balance sheet of credit unions

No.	Balance sheet item	Amount (LTL thousand)			Change over Q4 (%)	Change year on year (%)
		1 Jan 2004	1 Oct 2004	1 Jan 2005		
1.	Assets	122,983.9	161,308.9	185,222.7	14.8	50.6
2.	GS	1,903.4	2,705.1	2,962.8	9.5	55.7
3.	Loans granted	86,905.6	123,064.3	131,706.2	7.0	51.6
4.	Specific provisions on loans	445.1	1,012.5	939.0	–7.3	2.1 times
5.	Deposits	95,504.5	126,018.3	148,422.2	17.8	55.4
	Of which members and associated members of credit unions	93,295.9	124,106.7	146,491.1	18.0	57.0
6.	Share capital	13,428.8	18,621.7	20,215.8	8.6	50.5
7.	Profit (loss) for current year	820.9	628.0	907.5	–	–

The activities of credit unions expanded further last year. Over 2004:
- their assets increased by 50.6 per cent and on 1 January 2005 made up 0.64 per cent of total assets in the banking system; the assets of the largest credit union Ūkininkų viltis made up over LTL 20 million and accounted for 11.3 per cent of total assets of credit unions on 1 January 2005;
- granted loans increased by 51.6 per cent and made up 70.5 per cent of total assets. on 1 January 2004, 46 credit unions held specific provisions for loans (LTL 939 thousand);
- investment in Government securities increased by 55.7 per cent;
- deposits increased by 57 per cent, of which the largest share (98.7%) were deposits of members;
- the share capital of credit unions grew by 50.5 per cent.

45 credit unions earned a profit, while 16 credit unions incurred a loss in 2004.

According to the statements checked by inspectors (independent auditors) of credit unions and approved by general members meetings, the profit of LTL 907.5 thousand earned by credit unions in 2004 was higher in comparison with 2003 (LTL 820.9 thousand) and was the highest from 1995.

As in the previous years, the main source of income was interest income (88.8% of total income). Interest expenses and operational expenses accounted for the largest share of expenses, 42.7 per cent and 42 per cent, respectively.

SUPERVISION OF CREDIT INSTITUTIONS IN 2004

In 2004 the Bank of Lithuania continued work in implementing the supervisory system complying with the international practice, encouraged banks to improve the risk management process, assess the new risks and prepare properly for operation under unfavourable circumstances and streamlined accounting and reporting requirements. Following Lithuania's membership of the EU, considerable attention was focused on cross–border co–operation, the process of implementing European Union legislation was continued, and Bank of Lithuania representatives joined the working groups of various EU institutions and the European Central Bank as full members.

Domestic banks continued to strengthen their capital base last year, thus creating preconditions for their further development. The Board of the Bank of Lithuania registered changes in the Articles of Association of 4 banks related to the increase of the share capital. New share issues were distributed and the increased share capital was registered by AB bankas Hansabankas, AB bankas NORD/LB Lietuva, AB Sampo bankas and AB Šiaulių bankas. In addition, the Board of the Bank of Lithuania gave permission to include received subordinated loans into the bank capital to 3 banks. The capital base was increased in this way by AB Ūkio bankas, UAB Sampo bankas and AB bankas NORD/LB Lietuva.

In 2004 domestic banks started expanding to the CIS markets. The Board of the Bank of Lithuania authorised AB Ūkio bankas to open its representative office in the Ukraine (Kiiv) and later in Moscow. At the end of the year authorisation was granted to AB Vilniaus bankas to acquire a qualifying holding of the authorised capital and/or voting rights of the Ukrainian bank AGIO to the extent that bank AGIO becomes its associated undertaking, i.e. a subsidiary bank. Following its acquisition of the qualifying holding in the bank AGIO, AB Vilniaus bankas will draw up consolidated financial statements and supervisory reports for the whole financial group, and the Bank of Lithuania will perform consolidated supervision of AB Vilniaus bankas and its associated financial undertakings. In addition, the Board of the Bank of Lithuania authorised the Open Stock Company of the Republic of Belarus Djem–Bank to establish a representative office in Lithuania.

The process of the establishment of new credit unions continued in 2004: the Board of the Bank of Lithuania issued licences to 4 newly established credit unions (Savas rūpestis, Trakų KU, Alytaus KU and Gargždų taupa). At the start of 2005, same as last year, there were 10 banks with 118 branches and 2 foreign bank branches (in March 2004, on completing liquidation procedures, Norddeutsche Landesbank Girozentrale Vilnius Branch was removed from the Register of Legal Entities due to termination of its operations after the acquisition of the Agricultural Bank of Lithuania, currently AB Bankas NORD/LB Lietuva), 3 foreign bank representative offices, 61 credit unions and the Central Credit Union of Lithuania operating in the country.

After Lithuania became a member of the EU last year, simplified entry procedures for banks within the jurisdiction of other Member States were applied. In order to regulate the changed licensing procedures, in 2004 the Board of the Bank of Lithuania approved the Rules for the Implementation of the Right to Provide Financial Services in the Republic of Lithuania and Other European Union Member States. These rules define the procedure for the establishment of banks of the Republic of Lithuania and associated financial undertakings and/or the provision of financial services in another EU member state without establishing a subsidiary and the procedure for the implementation of the right to provide financial services in the Republic of Lithuania by foreign banks licensed in other EU Member States and financial undertakings controlled by them. To date the Bank of Lithuania has received 48 notifications from the financial services supervision authorities of various EU countries informing about the intentions of credit institutions supervised by them to take advantage of the freedom to provide services and to start their operation in Lithuania without establishing subdivisions (branches). These are mostly banks from the United Kingdom (18 banks), Austria (9 banks) and Germany (8 banks).

Following the entry into effect of the new Republic of Lithuania Law on Banks, the necessary legal acts for its implementation were drafted. A new revision of the Rules for Consolidation of Financial Statements and Consolidated Supervision of a Financial Group was adopted last year. They set out the conditions and methods for the preparation of consolidated statements of a financial group and the procedure for the submission of consolidated statements to the Bank of Lithuania and their publication. Among other things, the rules specify that the procedure of consolidated supervision performed by the Bank of Lithuania will depend on the jurisdiction of the parent bank / financial holding company within the financial group, i.e. whether it falls under the jurisdiction of a EU Member State or the jurisdiction of a third country. New Supervisory Rules for Foreign Bank Subsidiaries Operating in the Republic of Lithuania were approved; they establish different supervisory conditions for foreign bank subsidiaries licensed in the European Union Member States and foreign bank subsidiaries licensed in third countries, non–EU Member States. The rules also establish the procedure of submitting statements of foreign bank subsidiaries to the Bank of Lithuania and their publication.

Taking into account the changed conditions of bank operation after EU accession and the development of the banking sector, the Board of the Bank of Lithuania approved changes to the calculation of the capital adequacy ratio in 2004. In order to establish equal competitive conditions for the banks of Lithuania in the single EU environment, the capital adequacy ratio applied to the banks of the Republic of Lithuania was reduced from 10 per cent to 8 per cent and the maximum open position in foreign currency and precious metals was amended by establishing that the euro position held by banks would not be limited, since the banks do not experience foreign currency rate risk under the fixed litas exchange rate vis–ą–vis the euro.

The Bank of Lithuania continued to focus considerable attention on strengthening risk management processes in banks. Considering the recent trends in the operations of domestic banks related to abandoning certain activities (e.g. security, cash collection, information system maintenance, software development) and concluding agreements with third parties with regard to outsourcing bank ancillary services, and in order to ensure stability and reliability of bank operation after the conclusion of these agreements and to avoid obstacles for the supervision to perform its functions effectively, the Rules for the Outsourcing of Bank Ancillary Services, defining certain key principles to be followed by banks while entering into such agreements, were approved.

To ensure a more comprehensive reflection of operational risks faced by banks and following the practice of other EU Member States and the provisions of the Basle Committee on Banking Supervision, a new procedure for calculating the liquidity ratio was introduced as from the date of EU membership, whereby banks are encouraged to entrust their funds to the financial and credit institutions in more reliable and stable countries. The centrally managed Loan Risk Database was improved last year to start accumulating more comprehensive data on the financial status of the borrowers of banks and associated undertakings. In addition, the implementation of the concept of the further development of the Loan Risk Database was started in 2004 to create the conditions for using the accumulated data for the assessment of status of borrowers using internal rating methods.

Taking into consideration the progressive practice of foreign supervisory authorities and the recommendations of the Basle Committee on Banking Supervision, in 2004 the Bank of Lithuania reviewed its inspection procedures as one of the key tools of on–going supervision. The previous CAMELS rating–based inspection methodology was replaced by the risk–focused inspection system. The general inspection focuses on bank management and internal control, the efficiency of the risk management system in the key risk areas – credit, liquidity, market and operational, to allow timely identification, assessment, monitoring and management of the risks, while targeted inspections focus on particular areas requiring special attention.

One of the important tasks of the Bank of Lithuania in the area of supervision of credit institutions in 2004 was the preparation for the implementation of the New Capital Accord (Basel II) and the new EU Capital Directive (CAD III), which is still to be passed at the European Parliament, in the country. For this purpose, the Bank of Lithuania organised meetings with bank representatives in order to assess the level of preparation of banks for the implementation of the new capital requirements, especially in assessing credit and operational risk, to draw attention of banks to the essential aspects of these requirements and to identify the key problems and the intentions of banks to move to more complex capital requirement calculation methods in the future. Besides, domestic banks were requested to perform the analysis of the compatibility of their IT systems with the XML/XBRL data exchange format which will be used for the implementation of the common capital adequacy reporting system of EU banks and to carry out preparatory work on the parallel capital adequacy calculation on the basis of the old and new requirements yet to be implemented. At the end of 2004 the Bank of Lithuania started developing the procedure for the calculation of capital adequacy under the requirements of the new EU Capital Directive with respect to the planned parallel calculations in the transitional period.

The work of the Bank of Lithuania in the area of international co–operation continued in 2004. A co–operation agreement in the area of credit institution supervision was concluded at the start of the year with the Swedish financial supervisory authority whose representatives later paid a visit to the Bank of Lithuania to discuss issues in the application of the new capital requirements. At the invitation of the German Financial Supervisory Authority, representatives of the Bank of Lithuania participated in the working meeting in Bonn and discussed the topics related to the issue of a single European Union licence for banks. Members of staff of the Bank of Lithuania met with the representatives of the Finnish financial supervisory authority to exchange information on the supervision of Sampo and Nordea groups, discuss implementation of the new capital requirements and the renewal of the co–operation agreement. Representatives of the National Bank of Ukraine visited the Bank of Lithuania to get acquainted with the Lithuanian banking system, various aspects of the organisation of banking supervision and applied supervisory requirements.