LIETUVOS BANKAS

BANKING ACTIVITY REVIEW 2012

2012

BANK ASSETS AND LIABILITIES[1]

In 2012, there was a very rapid increase in deposits, and the loan portfolio significantly increased after a several year break. All banks, except for AB *Ūkio bankas*, were characterized by high capital adequacy and liquidity levels. It should be noted that from December 2012 to January 2013, after the inspection of AB *Ūkio bankas*, the results showed that the financial and supervision reports submitted by the inspected bank to the Supervision Service of the Bank of Lithuania, do not reflect the real situation of the bank (see more in section "AB *Ūkio bankas*"), therefore, in order for the data to be comparable, the data of AB *Ūkio bankas* is eliminated from the analysis of the banking sector indicators.

Changes in the main indicators of the banking sector

No	Indicator	Amount as at 01-01-2012, LTL millions (excl. *Ūkio bankas*)	Amount as at 01-01-2012, LTL millions	Amount as at 01-10-2012, LTL millions (excl. *Ūkio bankas*)	Amount as at 01-10-2012, LTL millions	Amount as at 01-01-2013, LTL millions (excl. *Ūkio bankas*)	Change in Q4 2012, % (excl. *Ūkio bankas*)	Change in 2012, % (excl. *Ūkio bankas*)
1.	Assets	74,750.2	78,970.6	72,850.6	76,945.0	74,259.3	1.9	–0.7
2.	Debt securities	4,779.0	5,664.1	4,850.2	5,674.1	5,180.6	6.8	8.4
3.	Loans granted to customers	51,815.8	54,009.4	52,160.3	54,308.2	52,875.0	1.4	2.0
3.1.	to private undertakings	23,509.5	25,114.9	24,067.1	25 813.2	24,005.5	–0.3	2.1
3.2.	to financial institutions	1,785.8	2,152.6	2,009.1	2,146.0	2,843.9	41.5	59.2
3.3.	to natural persons	23,393.1	23,499.1	22,962.0	23,068.0	22,775.2	–0.8	–2.6
3.3.1.	Housing loans	19,525.5	19,555.1	19,314.0	19,341.3	19,246.7	–0.3	–1.4
4.	Impairment of loan value	3,783.5	3,980.9	3,388.9	3,649.3	2,984.7	–11.9	–21.1
4.1.	Relation between the loan amount impairment and granted loans, in per cent	6.8	6.9	6.1	6.3	5.3	–	–
5.	Deposits and letters of credit	39,806.2	43,174.1	41,401.1	44,867.7	43,613.6	5.3	9.6
5.1.	of private undertakings	13,497.5	14,246.5	13,522.0	14,193.6	14,840.5	9.8	9.9
5.2.	of financial institutions	1,089.7	1,263.0	954.3	1,066.7	1,068.6	12.0	–1.9
5.3.	of natural persons	22,770.5	25,128.6	23,494.0	26,037.7	24,379.9	3.8	7.1
6.	Shareholders' equity	6,401.9	6,854.1	6,868.7	7,275.3	7,070.3	2.9	10.4
7.	Profit (loss) of the current year	1,120.8	1,116.2	531.7	483.9	721.5	–	–

In 2012, the bank assets declined a little, but compared to the previous year, the decrease was insignificant — merely LTL 0.5 billion (0.7%). On 1 January 2013, the bank assets totalled to LTL 74.3 billion.

The loan portfolio, comprising the major part of assets, which was declining during Q1, grew steadily for the next part of the year. In 2012, the bank loan portfolio increased by LTL 1.1 billion and on 1 January 2013 totalled LTL 52.9 billion (see more in section "Bank loan portfolio").

Bank investments in debt securities over the year grew by LTL 0.4 billion and on 1 January 2013 totalled LTL 5.2 billion. Investing in the Government Securities of the Republic of Lithuania during the reporting period amounted to LTL 3.3 billion, and securities of the governments of other countries owned by the banks — LTL 0.2 billion. In addition, banks have invested significant portion of funds (LTL 1.2 billion) in the bank

[1] Based on unaudited data submitted by the banks. The banking sector is comprised of seven commercial banks and nine foreign bank branches (*Pohjola Bank plc* Lithuanian branch had not yet been operational) currently operating in the country.

debt securities of the European Union countries with high ratings.

Nearly all equity securities portfolio held by the banks (LTL 1.1 billion) are comprised of investment in subsidiaries. In 2012, the existing equity portfolio increased by 36 per cent, or LTL 0.3 billion. Other equity securities held by the banks (other than subsidiaries), according to data of 1 January 2013, totalled to merely LTL 5.1 million.

In 2012, the banks' assets — cash and funds held in the Bank of Lithuania and other banks — fell by LTL 2.2 billion (to LTL 13.4 billion). Such a decrease was affected by a relatively high comparison base at the end of 2011, because after the start of the deposit insurance repayment process of AB *bankas SNORAS*, many new deposits were placed in the banks, therefore banks, being unable to invest them immediately, directed them to the accounts of the Bank of Lithuania or parent banks. Later, in order to efficiently utilize these funds, the banks invested them in more profitable instruments (loans, debt securities), also used them for covering liabilities of parent banks. While these funds declined, they still make up a large part of the banks' assets: as of 1 January 2013 — as many as 18.1 per cent.

Despite the prevailing very low interest rates, deposits in the banking sector increased significantly last year. According to data of 1 January 2013, bank deposits amounted to LTL 43.6 billion, and in AB *Ūkio bankas* — another LTLT 3.4 billion. So basically, as of 1 January, deposits in the banking sector (including AB *Ūkio bankas*) were as high as LTL 47 billion. This is a record amount in excess of even the former deposit levels before the suspension of AB *bankas SNORAS* activities. The annual deposit growth rate was as high as 8.9 per cent (after eliminating AB *Ūkio bankas* — 9.6%). The deposit growth last year mostly was due to the significant increase in resident deposits during the year, LTL 1.9 billion (excluding the figures of AB *Ūkio bankas*, resident deposits rose by LTL 1.6 billion). In the fourth quarter alone, these deposits grew by almost LTL 1 billion. The year 2012 also saw a significant growth in the deposits of private companies (LTL 1.2 billion), public authorities (LTL 0.7 billion) and state and municipal enterprises (LTL 0.2 billion).

From among the banks operating in Lithuania, AB *Ūkio bankas* was the most active in working with clients who are non-residents. When this bank was wound up, the scope of the activities of the Lithuanian banking sector with non-residents became minimal. According to the data of 1 January 2013, non-resident deposits in the banking sector accounted for only 3.8 per cent of total deposits.

Structural changes in the bank financing sources are observed for several years — formerly very strong funding from parent banks recently is in decline. Simultaneously, the banks seek to increase the financing attracted from the local market (deposits). Debts to parent banks in 2012 decreased by LTL 4.1 billion — to LTL 19.4 billion. Despite a consistent decline in the debt to parent banks, it is still noticeable — at the end of the 2012, parent bank funds financed a quarter of the bank assets. Net debt to parent banks (difference between liabilities to parent banks and funds in them) as of 1 January 2013 totalled LTL 12.6 billion.

The attempt of the banks is to refocus the financing to the local market shows a steady decline in loan-deposit ratio, which in 2012 decreased even by 8.9 percentage point and on 1 January 2013 was 121 per cent. It follows that the banking sector is becoming more balanced.

BANK LOAN PORTFOLIO

In 2012, as compared to 2011, the bank loan portfolio increased by 2 per cent and at the end of 2012 amounted to LTL 52.9 billion. Over the year, lending to private companies, financial and government institutions increased, while to natural persons and state and municipal enterprises — decreased. The positive growth of the loan portfolio is expected in 2013 as well — preconditions for further growth in the loan portfolio consists of moderate growth in the national economy, increasing lending commitments, as well as increased free cash volumes available to banks, that resulted when the Bank of Lithuania reduced the reserve requirement ratio.

As already mentioned above, in 2012 the banks were most active in crediting private companies and financial institutions. Loans during the year to the private companies' segment increased by LTL 0.5 billion (2.1%). The annual growth of loans to financial institutions amounted to as many as LTL 1.1 billion (59.2%), and the growth was due to a significant increase in lending to subsidiaries leasing companies in Q4. In addition, loans to authorities grew, which in 2012 increased by LTL 208 million (12.4%). Meanwhile, loans to residents were still decreasing — LTL 617.9 million (2.6%), of them, housing loans — LTL 278.8 million (1.4%).

Credit commitments during the year increased by LTL 453.8 million, or 7.1 per cent. This indicates that the loan portfolio will increase in the future.

In 2012, specific provisions for loans continued to decline in the banking sector (LTL 798.9 million, or 21.1%) and at the end of the year amounted to LTL 3 billion. But the main reason that led to the decline of special provisions in the last year, compared with 2011, was different: in 2011, the decline in special provisions was very significantly influenced by the improving financial condition of some of the banks' borrowers, and their ability to repay their loans, and the write-off of non-performing loans highly accelerated in 2012. This is explained by the fact that it has been a few years since the beginning of the country's economic crisis, when many borrowers were facing difficulties in continuing operations and meeting their liabilities, during which the banks have managed to complete the recovery procedures of a significant part of non-performing loans, and banks have written off part of loans which is unlikely to be recovered. It is likely that in the near future the non-performing loan write-offs will continue to be a key factor of quality improvement of the loan portfolio.

Due to the aforementioned decline in special provisions, as well as the growth of new loans, with the increasing portion of new (good quality) loans, the ratio between special provisions and the loan portfolio decreased by 1.5 percentage point during the year, to 5.3 per cent. Other indicators reflecting the quality of loan portfolio have also improved. The share of impaired loans during the year decreased to 11 per cent of the loan portfolio, or 2.8 percentage point, the ratio of loans and loan portfolio more than 60 days overdue (but not impaired) — to 2.1 per cent, or 0.4 percentage point, and the non-performing loan index[2] — to 13.1 per cent, or 3.1 percentage point (in 2010, when the maximum value of this ratio was recorded, the non-performing loan ratio was 19.6%).

The housing loan portfolio quality remains good, despite the fact that the mortgage loan quality has been deteriorating for slightly longer than in other segments of the loan portfolio. However, in the second half of 2012 the housing credit quality has stabilized and begun to improve moderately. This is illustrated by the changes in the mortgage quality indicators: the indicator of special provisions for housing loans in 2012 decreased by 0.2 percentage point to 3.1 per cent, and the non-performing mortgage loan rate during this period decreased by 0.5 percentage point — to 8.1 per cent.

Consumer loans in the banking sector are still of relatively lower quality — at the end of 2012, specific provisions for them accounted for 10 per cent of the consumer loan portfolio.

Last year, residents and businesses began to actively borrow in litas, rather than euro, as was customary in the past. Banks also started to encourage such lending; in addition, interest rates on borrowing in both litas and euro are basically the same. For these reasons, loans in litas increased by LTL 921.5 million, and the loan portfolio in foreign currency (mainly in euro) — merely by LTL 138 million.

During the year, loans to non-residents fell by 24.8 per cent and at the end of 2012 amounted to LTL 366.5 million, or 0.7 per cent of the total loan portfolio.

PROFITABILITY AND EFFICIENCY OF OPERATIONS

[2] Non-performing loans include impaired loans and loans overdue for longer than 60 days (but not impaired).

In 2012, the banks earned LTL 721.5 million of profit — a third less than in 2011. In 2012, six banks and six branches of foreign banks operated profitably, and one bank and two foreign bank branches operated at a loss.

Banking profit decline was primarily due to the loan value impairment. Last year, for the loan value impairment, the banks experienced LTL 49 million in costs and in 2011, because of previously recognized loan impairment reversals, banks received LTL 164.4 million in income. The annual result of the banking sector was also reduced by the fines imposed by the Lithuanian Competition Council to three banks (LTL 47.7 million) for the violations of the Law on Competition of the Republic of Lithuania (although the banks still have not paid these fines and, disagreeing, have challenged them in the courts, but according to the international financial reporting standards the banks have included such fines in the costs of 2012).

Major income of the banks is net interest income, that in 2012, as compared to 2011, declined by 124.1 million litas (9.8%) to LTL 1.1 billion. The decline in net interest income is mainly due to interest income from the loan portfolio, that decreased by LTL 284.5 million, while bank interest expense, although was declining, but not to the extent of the falling interest income. Bank assets and liabilities are now balanced so that the banks' net interest income is declining when interest rates are falling, and vice versa — net interest income is rising with the rising interest rates in the market, and in terms of profitability, low prevailing market interest rates currently are not highly favourable to the banks. It is clear from the bank net interest margin, showing the difference between the interest rate, that the banks earn on invested assets (loans, debt securities, money from banks etc.), and the interest rate that the banks pay to their creditors (depositors etc.). It is now extremely reduced and as of 1 January 2013 was 1.46 per cent.

Net fee and commission income of the banks in 2012, as compared to 2011, grew by 9.6 per cent and totalled LTL 0.6 billion. This growth was mainly due to the migration of former customers of AB *bankas SNORAS* to other banks: due to the increased volume of transactions, the banks' earnings from fees and commissions have increased. In addition, the banks have increased charges for some services.

Last year, the banks have significantly improved operating results by engaging in trading and other financial activities: compared with 2011, they have grown by more than 2 times — to LTL 207 million. This additional source of income is useful for the banks, especially in the current conditions, with the decline in the interest income earned by the loan portfolio, but this type of income is quite volatile, depending on the market structure and bank investment decisions.

Operating expenses in the banks in 2012, as compared to 2011, rose by 3.7 per cent — to LTL 1 billion, however, this increase was mainly due to the increased operating costs in one of the banks that were incurred in the implementation of a new information system. Some banks, in order to optimize the operating costs incurred, further reduced the number of employees. In 2012, average number of employees in the banking sector (excluding foreign bank branches) decreased by 237 employees, or 3.4 per cent.

Although the banks were profitable last year, but due to the lower profit, the indicators describing the operating efficiency of banks, according to data of 1 January 2013, were lower than in 2011: the banking cost to income ratio was 58.2 per cent, the annual banking sector index of return on assets — 1 per cent, return on capital — 8.7 per cent.

IMPLEMENTATION OF PRUDENTIAL REQUIREMENTS FOR BANKING ACTIVITIES

As of 1 January 2013, all banks, except for AB *Ūkio bankas*, complied with the prudential requirements for banking activities. The banking sector's capital adequacy ratio, except for AB *Ūkio bankas*, according to the data of 1 January 2013, totalled 14.4 per cent; in 2012 the banking sector's capital adequacy ratio increased slightly (0.5 percentage point).

The liquidity ratio as of 1 January 2013 totalled 40.8 per cent and was higher than 10 percentage points than is required. In addition, the banking sector had sufficient liquidity reserve to cover the financing gap: the banks' liquidity reserve amounted to LTL 17.6 billion, and the net financing gap — LTL 6.2 billion. Therefore, the banks have accumulated almost 2.8 times higher liquid reserve funds than required.

AB *Ūkio bankas*, according to the data of 1 January 2013, *de facto* did not comply with any of the prudential requirements for banking activities associated with capital. As the bank's liabilities exceeded the assets of the bank, the bank was declared insolvent and was unable to continue operations if the problem of the lack of capital is not solved immediately. It should be noted that even according to the bank's own statements, which do not account for all the relevant losses of the asset value impairment, the bank did not comply with the requirement of maximum loan amount per borrower.

AB *ŪKIO BANKAS*

At the end of 2012 –beginning of 2013 the inspection of AB *Ūkio bankas* revealed that the bank's assets have been significantly overvalued, the bank's liabilities exceed its assets, and the bank is *de facto* insolvent. Valuation of the bank's assets was also carried out, and significant recoverable amount mismatches were discovered by independent auditors. For more than a year, the Bank of Lithuania has been monitoring the transactions of AB *Ūkio bankas* very closely, applying various constraints, and has made a plan for AB *Ūkio bankas*, according to which the bank had to gradually reduce its credit risk. However, all these measures have failed, additional capital was required to ensure the bank's operations, yet the main shareholder of the bank failed to provide it. In addition, following the public comments of the main shareholder of the bank, some of the depositors started to withdraw from the bank, so there was a real threat to the bank to abandon their commitments. Given these circumstances, on 12th of February 2013 the Board of the Bank of Lithuania announced a moratorium on the bank's business, appointed a provisional administrator, and after six days the bank was *de jure* announced insolvent and its operating license was withdrawn. In his findings the provisional administrator proposed to the board of the Bank of Lithuania to divide AB *Ūkio bankas* into the good bank and the bad bank. This bank restructuring proposed by the provisional administrator was best in line with the bank's customer interests and was the cheapest for the state. Under the proposed plan, the good assets of the bank and all insured liabilities (deposits up to LTL 345 thousand or EUR100 thousand) had to be transferred to another already-operating bank, while the rest of the bank, the so-called bad bank, was announced bankrupt. On February 22 a tripartite agreement was signed between the provisional administrator of AB *Ūkio bankas*, AB *Šiaulių bankas* and the state enterprise *Indėlių ir investicijų draudimas* on the transfer of part of liabilities, assets, rights and transactions of AB *Ūkio bankas* to AB *Šiaulių bankas*. Under this agreement, to AB *Šiaulių bankas* was transferred LTL 2.7 billion in insured deposits and LTL 1.9 billion in good assets, and the funds of the state enterprise *Indėlių ir investicijų draudimas* will be used only for covering the difference between the good assets and the total insured liabilities (LTL 0.8 billion). The state enterprise *Indėlių ir investicijų draudimas* should become a creditor of AB *Ūkio bankas* and seek to recover these funds during the bank's bankruptcy process.

According to the unaudited reports of AB *Ūkio bankas* presented to the Supervision Service of the Bank of Lithuania, the bank's liabilities as of 1 January 2013 amounted to LTL 3.6 billion, of them, deposits — LTL 3.4 billion. Most of the deposits were the deposits of residents (LTL 2.6 billion), enterprise deposits (LTL 617 million), deposits of financial institutions (LTL 96.6 million) and deposits of government institutions as well as state and municipal enterprises (LTL 59.6 million). Lithuanian resident deposits totalled LTL 2.8 billion, non-resident — LTL 0.6 billion. Although, according to the bank's assessment, its assets as of 1 January 2013 were worth LTL 3.9 billion, according to information of the Lithuanian Bank Inspection Commission and the independent audit company UAB KPMG Baltics, the real value of the bank assets was at least a quarter less.

Suspension of AB *Ūkio bankas* activities had no systemic impact on the banking sector. The bank's interbank liabilities were insignificant, and deposits in banks remain stable.