1. AUDIT OF FINANCIAL STATEMENTS

The audit of 2000 financial statements in all commercial banks was carried out by international audit companies.

Independent auditors expressed a qualified opinion in relation to the financial statements of two commercial banks (the Lithuanian Savings Bank and the Lithuanian Agricultural Bank). In the case of the Lithuanian Savings Bank the auditors expressed doubts whether the book value of buildings and premises used by the Bank was not higher than the recoverable value and whether the value of this property has not declined. The independent auditor's report on the financial statements of the Lithuanian Agricultural Bank included reservations on deferred taxes of LTL 3660 thousand shown in the bank accounts, on which, in the auditor's opinion, provisions should be made.

2. COMPLIANCE WITH PRUDENTIAL REQUIREMENTS

In terms of the whole banking system, the operations of most commercial banks in 2000 were rather conservative, which is testified by their compliance with the prudential requirements with a sizeable reserve: according to audited statements for 1 January 2001, capital adequacy in the banking system was 16.33 per cent, which exceeded significantly the 10 per cent minimum capital adequacy requirement set by the Bank of Lithuania; the liquidity ratio was 49.7 per cent, against the established minimum of 30 per cent.

There were, however, violations in the course of the year. Twice the large exposure to a single borrower requirement and once the liquidity requirement were violated in 2000.

3. DEVELOPMENT OF THE MAIN INDICATORS IN THE ACTIVITIES OF BANKS

At the start of 2001, operating domestic commercial banks[1] posted the following results:
assets made up LTL 13.1 billion (increase in 2000 by LTL 1.85 billion (16.5%));
granted loans of LTL 5.5 billion decreased by LTL 50 million (0.9%) against 1 January 2000; however, but for the effects of changes in accounting (in July 2001 assets under management were introduced as a separate item, making up LTL 257 million on 1 January 2001 of loans managed by banks), the book value of granted loans year–on–year would have increased by LTL 207 million (3.7%); taking into account the scale of bad loan write–offs during the year, the growth of the loan portfolio would be even higher;
deposits made up LTL 8.6 billion, increasing year–on–year by LTL 1.7 billion (23.9%):
including *individual deposits* of over LTL 5 billion, or LTL 1.1 billion (26.5%) more than on 1 January 2000;
including *deposits in the national currency*of nearly LTL 4.5 billion (LTL 835 million (22.8%) increase in 2000);
including *deposits in foreign currencies* of LTL 4.1 billion (LTL 821 million (25%) increase in 2000).

4. LOANS

Although loans lost part of their share (loans[2] granted to clients last year declined from 47 per cent to 40 per cent of bank assets), they still remained the main part of bank assets. The trend of an increasing share of long–term loans has been evident for several years. Thus, the share of long–term loans in the loan portfolio was the following during the periods indicated below:
1 January 1996 – 31 per cent;
1 January 1997 – 35 per cent;
1 January 1998 – 41 per cent;
1 January 1999 – 51 per cent;
1 January 2000 – 57 per cent;
1 January 2001 – 60 per cent.

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[1] The concept of the banking system and the operating domestic commercial banks comprises all commercial banks and foreign bank branches operating during the review period.
[2] At book value.

To a certain extent this testifies that banks see prospects in long–term project financing; on the other hand, long–term loans imply higher credit risks, as it is more difficult to project the borrowers' financial standing over a longer period and the prospects of their business.

The fastest growth last year was recorded in the crediting of public and municipal enterprises.[3] As a consequence, the share of loans granted to public institutions and companies increased from 14.5 per cent to 17 per cent in the course of the year (loans granted to Sodra only stood at LTL 268 million (5 per cent of the loan portfolio) on 1 January 2001), and the quality of the bank loan portfolio became more dependent on the status of public finances.

The largest share of loans (approximately 72 per cent) consisted of loans to private companies, whose recovery after the Russian crisis was proved by the increased balances in their accounts last year, in contrast to the previous trend of declining funds. In 2000 the balances in the deposit accounts of private resident companies increased by LTL 493 million (28 per cent) and exceeded the average 1999 level by 14 per cent.

The development of loan portfolio quality in the operating banks is presented in the table below.

Development of Loan Portfolio Quality in the Operating Banks

Date	Loan provisions / granted loans, %	3, 4 and 5 category loans / total loans, %
1 January 1997	20.68	32.10
1 January 1998	18.52	28.25
1 January 1999	5.92	12.46
1 January 2000	4.47	11.92
1 January 2001	3.73	10.79

The improvement in the quality of the loan portfolio in 2000 was determined by a more conservative stance in crediting policies and the cleanup of loan portfolios.

Crediting remained the main income source and accounted for 48 per cent of income (58 per cent, including loans to banks and other credit institutions).

5. CAPITAL

The ability of banks to absorb possible losses primarily depends on the size and adequacy of their capital. As of 1 January 2001, available reserve capital allowed operating banks[4] to assume additional asset risk of LTL 4.4 billion or make additional provisions of LTL 445 million to cover loan losses. The capital base did not weaken following the general shareholders' meetings held at the start of the year, whereby over 92 per cent of the distributed profit was allocated to the capital, while approximately 8 per cent were distributed as dividends, tantiemes, etc.

On 1 January 2001, foreign investors held more than a half of the share capital in six out of ten operating commercial banks. In addition, negotiations are currently underway with the Estonian HANSAPANK on the sale of the publicly owned shares in the Lithuanian Savings Bank.

6. PROFITABILITY

The audit adjusted the results of commercial banks for 2000. While prior to the audit the posted net profit was LTL 62.6 million, after the audit it was reduced to LTL 52.7 million. The auditors reduced the profit of the majority of banks, with the exception of the Lithuanian Savings Bank, Vilniaus Bank and Hansabank, whose profit remained unchanged. The largest change was made in the reported profit of the Lithuanian Agricultural Bank, reducing the profit by LTL 4.6 million (38.5 per cent).

[3] Including Sodra.
[4] Excluding foreign bank branches.

Results of Operating Banks in 2000 (LTL million)

No.	Name of Bank	Profit prior to the audit	Profit after the audit
1.	Vilniaus Bank	82.2	82.2
2.	Lithuanian Savings Bank	–32.6	–32.6
3.	Lithuanian Agricultural Bank	11.8	7.3
4.	Bank Snoras	5.9	3.9
5.	Ukio Bank	4.2	4.0
6.	Hansabank	–3.7	–3.7
7.	Siauliu Bank	2.6	1.9
8.	Sampo Bank	2.3	1.3
9.	PAREX Bank	–4.5	–4.6
10.	Medicine Bank	1.5	1.4
	Subtotal	69.9	61.2
11.	Kredyt Bank SA Vilnius Branch	6.2	6.2
12.	Merita Bank Plc Vilnius Branch	–3.3	–3.3
13.	Nord/LB Vilnius Branch	–10.2	–11.3
	TOTAL	**62.6**	**52.7**

Interest income was the main source of income (70 per cent of total income). However, compared to 1999, the share of interest income slightly declined (from 71 per cent). Last year, compared to the year before, the banks earned more from operations in foreign exchange, equities, etc.

On the expenses side, operational expenses accounted for the largest share at 36.1 per cent. Yet the increase last year was only 1.9 per cent. Interest expenses, on the other hand, made up 34.7 per cent of total expenses, increasing by 19.1 per cent, which was determined by the growth of individual time deposits. Expenses on specific provisions accounted for 9.5 per cent of total expenses, showing a decrease of 15.8 per cent over the year.

7. FOREIGN CREDIT INSTITUTIONS IN LITHUANIA

Apart from a significant share of foreign investors in the management of domestic bank capital, foreign bank branches have been gaining weight in the domestic credit system. Merita Bank Plc Vilnius branch started operating in Vilnius in 2000, taking over the operations of Societe General Vilnius Branch. In addition, the representative office of Vereins– Und Westbank was opened last year. At the end of 2000, there were 3 foreign bank branches (Kredyt Bank S.A. Vilnius Branch, Norddeutsche Landesbank Girocentrale Vilnius Branch and Merita Bank Plc Vilnius Branch mentioned above) and four representative offices (Bank Polska Kasa Opieki, CA IB Investmentbank Aktiengesellschaft, Norddeutsche Landesbank Girocentrale and Vereins– Und Westbank AG; the fifth representative office, that of the Russian bank Kontakt, is about to be closed) in Lithuania.

Assets in foreign bank branches increased in 2000 from 3.1 per cent to 4 per cent of total banking system assets. The share of foreign bank branches grew in other segments as well. For instance, the loan portfolio increased from 4.5 per cent to 4.7 per cent, deposits from 1 per cent to 1.5 per cent of total deposits in the banks.

8. CREDIT UNIONS

6 new credit unions were registered in 2000, and 1 license was revoked. On 1 January 2001, 38 credit unions were operating, with over 6 thousand members.

Last year credit unions were rapidly expanding. Their assets increased by 49.5 per cent, and on 1 January 2001 amounted to LTL 15.3 million (0.12 per cent of the total banking assets). The assets of the credit unions "Ūkininko sėkmė", Pakruojis farmers and "Vievio taupa" exceeded LTL 1 million, and the assets of the credit union "Ūkininkų viltis" were over LTL 2 million.

In 2000, deposits in credit unions increased by 51.8 per cent, up to LTL 12.1 million, of which deposits of members accounted for the largest share (LTL 8.3 million).

Loans to members increased by 54.7 per cent, up to LTL 8.8 million. 17 unions had formed specific provisions (to the total of nearly LTL 0.2 million) by 1 January 2001.

Investment in Government securities declined by 51 per cent and on 1 January 2001 made up LTL 0.8 million. The decline was mostly caused by a smaller amount of securities held by "Vievio taupa", the largest holder of securities.

The total share capital of all credit unions on 1 January 2001 was LTL 2.5 million.

According to the financial statements audited by independent auditors and confirmed by general meetings of shareholders, in 2000 credit unions earned LTL 42.9 thousand of profit, which was LTL 63.9 thousand less than in 1999. The decline was brought up by increased expenses on specific provisions. Without the specific provisions of 17 credit unions, total profit would be LTL 306.3 thousand, i.e. LTL 71.5 thousand more than in 1999. 28 credit unions earned profits, while 10 credit unions bore losses.

On 1 January 2001, all credit unions complied with the prudential requirements set by the Bank of Lithuania. However, in the course of the year, two credit unions were in violation of these requirements and enforcement measures were applied.

Main directions in credit institution supervision in 2000

In 2000 the Bank of Lithuania continued to improve and strengthen the system of credit institution supervision, following the internationally accepted Principles of Effective Banking Supervision of the Basle Committee, the requirements of EU directives and taking into account the peculiarities in the development of the banking system.

The Bank of Lithuania further improved credit institution licensing and legal regulation procedures. In March 2000, the Law of the Republic of Lithuania on Commercial Banks was supplemented allowing foreign bank branches to establish other subdivisions in the country. To ensure better monitoring of such subdivisions, the Bank of Lithuania adopted a resolution "On the Branches and Other Subdivisions of the Banks of the Republic of Lithuania and/or Foreign Bank Branches", which ensures provision of more detailed information on their operations.

The Bank of Lithuania was an active participant in drawing up draft amendments to the Law of the Republic of Lithuania on Commercial Banks later approved by the Parliament. The draft amendments provided for a possibility for foreign natural and legal persons to take part in the establishment of banks in the Republic of Lithuania without restrictions as of the date of Lithuania's accession to the EU, and increased the allowed investment into the shares and capital of other companies by banks, which created the prerequisites for activating the capital market.

Additional proposals were drafted on improving bank bankruptcy procedures and accelerating liquidation. The draft introduced the terms for recognising the bankruptcy of a bank and initiating its bankruptcy procedure; it also included a possibility of selling the rights of claim in auction, etc.

The year 2000 saw a further increase in the number of credit unions that are supervised by the Bank of Lithuania. 6 new credit unions were registered and granted licenses. The Bank of Lithuania took part in designing legislation on credit unions, presented its comments on the draft amendments to the Law on Credit Unions and the Law on the Central Credit Union. It also simplified its requirements to credit unions that seek permission to perform foreign exchange operations.

In 2000 the Bank of Lithuania also focused its attention on improving other legislation regulating credit institution operations and tightening its requirements. In March the Bank of Lithuania reviewed the provisions of estimating country risk (i.e. the impact of adverse political, economic, social and other factors on the borrower's ability to manage its liabilities in the country of operation). Taking into account increasing liabilities of non–residents to domestic commercial banks, the Board of the Bank of Lithuania approved new criteria for establishing country risk with more weight attached to country ratings assigned by international rating agencies. The Bank of Lithuania also adjusted the rules on the classification of doubtful assets accordingly, and tightened the provisions on calculating specific provisions.

To ensure the compliance of risk management practices with international requirements and the efficiency of internal control systems, the Bank of Lithuania approved the general provisions on organising internal auditing in banks. These include a number of additional aspects facilitating the creation of a wide mechanism for managing new risks, including the role of the bank council in developing an effective internal control system.

The Bank of Lithuania also supplemented its prudential requirements by establishing that the total sum of large exposures (i.e. loans to a single borrower and connected persons equal to or in excess of 10 per cent of bank capital at book value) should not exceed 800 per cent of bank capital. The large exposure ratio shall be applied not only to the parent bank but also to the whole banking group. At the same time, the methodology of calculating the large exposure to a single borrower and the large exposure ratio were adjusted to include a wider concept of a borrower. The application of the new methodology will allow to achieve a better estimate of loan concentration in banks and impose certain limits on it.

As EU pre–accession negotiations are among the main priorities for the country, in 2000 the Bank of Lithuania focused on the harmonisation of the national legislation with EU directives. Last year, together with the international auditing company Arthur Andersen, the Bank of Lithuania completed the project of designing new Capital Adequacy Rules meeting the requirements of CAD I and CAD II. The project was financed by PHARE. The need for new rules was also prompted by the fact that domestic banks are becoming more active internationally in attracting financial resources and engaging in trade activities. The new Capital Adequacy Rules, approved in December, allow to estimate market risks (i.e. interest rate, equity, foreign exchange, country and commodity risks) and establishes capital charges (tier III capital) to offset them. In this connection the banks will have to identify and differentiate between their banking and trade activities and develop their trade policies, including risk management procedures. As the implementation of the new rules is a complex process that requires due preparation on the part of the banks, their application is due to start as of 31 December 2001.

In 2000 the Bank of Lithuania continued its co–operation with international auditing companies in other fields, such as accounting and accountability, especially concerning the treatment of the most recent international accounting standards and their implementation in banking.

The Bank of Lithuania continued to strengthen its relations with other financial sector supervisory authorities and the supervisory authorities of the home countries of banks establishing their subdivisions in Lithuania. At the end of the year the Bank of Lithuania signed a trilateral agreement on co–operation with the Securities Commission and the State Insurance Supervisory Authority under the Ministry of Finance, which will facilitate better co–ordination of their activities and exchange of information on the important developments in supervised institutions.

In 2000 the Bank of Lithuania signed new agreements on co–operation in credit institution supervision with the Bank of Latvia, the Financial Institution Supervisory Authority of Finland and the Bank of Poland. The agreements establish the principles of co–operation in performing joint supervision of internationally active banks, including licensing requirements and ownership control, examination, control of subsidiaries, application of prudential requirements, etc. With the development of international links between banks and new banks coming to the country, co–operation with foreign supervisory authorities will continue to be expanded in the future.