OPERATIONS OF CREDIT INSTITUTIONS IN LITHUANIA IN 2010 (AUDITED RESULTS)

AUDIT OF BANK ANNUAL FINANCIAL STATEMENTS

Pursuant to Article 61(4) of the Republic of Lithuania Law on Banks, banks have to publish annual financial statements and the auditor's report within 4 months from the end of the financial year.

Audits Audits of the annual financial statements of all domestic commercial banks[1] (with the exception of Scania Finans AB Lithuanian branch, which submitted its statements on 1 January 2011 for the first time therefore its annual financial statements have not been audited) for 2010 were conducted by independent audit companies. The opinion with the derogation was expressed concerning the annual financial statements of one foreign bank branch.

OPERATIONS OF BANKS

The performance of the banks in 2010 was better than in 2009. Although the scope of the activities of banks continued to reduce, the reduction of the amount of loans granted to customers was two or three times slower compared to the previous year and the amount of the deposits of clients held with banks grew more rapidly. Intensification of the activity of banks started in the second half of 2010 when growth of assets and loans was registered during different time periods. According to the audited financial statements for 1 January 2010, total assets of operating domestic banks [1] made up LTL 81.7 billion, i.e. they decreasing by LTL 2.5 billion over the year (3%).

Dynamics of some asset and liability items in the banking system

LTL million

Seq. No.	Balance sheet item	Amount 2010-01-01	Amount 2011-01-01	Change year-on-year (%)
1.	Assets	84,239.6	81 706.6	–3.0
2.	Debt securities	7,760.3	8 196.3	5.6
3.	Loans to customers	61,557.5	58 338.1	–5.2
3.1.	To private entities	31,097.3	27 842.4	–10.5
3.2.	To financial institutions	1,944.7	2 892.9	48.8
3.3.	To natural persons	26,939.7	25 035.9	–7.1
3.3.1.	Housing loans	20,341.3	19 847.6	–2.4
4.	Loan impairment	4,747.4	5 014.9	5.6
4.1.	Loan impairment/ granted loans, %	7,16	7.92	–
5.	Deposits and letters of credit	41,072.5	45 442.8	10.6
5.1.	Of private companies	11,404.4	13 403.3	17.5
5.2.	Of financial institutions	1,591.9	1 233.5	–22.5
5.3.	Of natural persons	24,746.3	26 081.8	5.4
6.	Shareholders' equity	4,992.3	5,912.4	18.4
7.	Profit (loss) for current year	–2,979.1*	–276.2	–

*Excluding bank's losses in 2009 which were covered by a shareholder of AB SEB (LTL 690.5 million), the loss of banking system activities amounted to LTL 3,669.6 million.

The loans to clients decreased by LTL 3.2 billion over the year, i.e. 5.2% and accounted for LTL 58.3 billion. It should be noted that the brunt of deterioration of loan portfolio was observed in the first quarter, i.e. by LTL 1.5 billion, meanwhile in the subsequent quarters that deterioration was less expressed.

Notwithstanding significantly lower interest rates offered by all banks, amount of the deposits held with banks continued to rapidly increase in 2010. Over the year, the deposits grew by LTL 4.4 billion to LTL 45.4 billion.

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[1] Concepts of the domestic commercial banks and the banking system apply to all domestic commercial banks and foreign bank branches which operated during the time period under consideration.

The deposits grew by LTL 2.4 billion (5.7%) in the fourth quarter and showed the strongest quarterly growth in deposits during the recent three years. The greatest contribution to the annual growth of deposits was made by the deposits of private enterprises which grew by LTL 2 billion.

In 2010, concentration of the three banks holding the biggest share of the market continued to gradually decrease in all main segments of the market. Asset market share decreased by 3.5 percentage points to 60.8%, deposit market share decreased by 2.2 percentage points to 63.5% and the loan market decreased by 1.9 percentage points to 64.1%.

In 2010, changes of the structure of assets were no longer that pronounced as in the previous year. Comparative weight of loans in the assets, which decreased considerably in 2009, started to stabilise in 2010. It decreased by 1.7 percentage points over the year and accounted for 71.4% of bank assets as at 1 January.

Bank investment in securities grew by LTL 849 million in 2010. A considerable part of that increment consisted of investment in subsidiaries. When expanding debt securities portfolio, the banks most often chose less risky investment in government bonds.

As deposits held with banks grew rapidly for two consecutive years reaching record heights of deposits ever held with banks, dependency of banks on the funding from foreign banks (parent banks among them) decreased rapidly. Comparative weight of debts to banks decreased by 7.2 percentage points over the year and accounted for 33.7% of total liabilities. Deposits of individuals which accounted for 34.4% of total liabilities as at 1 January 2011, was the main source of funding of the banking sector.

The bulk of the funds repaid to banks consisted of funds returned to parent banks. Lithuanian banks repaid to parent banks LTL 7.4 billion over the year. As the amount of funds held with parent banks also reduced, reduction in the net debt (i.e. the spread between debt to parent banks and the funds held with them) was less noticeable and accounted for LTL 6.4 billion.

The rise in deposits in litas (LTL 3.1 billion) exceeded the rise of deposits in foreign currencies (LTL 1.3 billion) therefore the share of deposits in litas grew to 66.5% of all deposits.

BANK LOAN PORTFOLIO

As specified before, shrinkage of loan portfolio was less noticeable in 2010 compared to 2009: loans decreased by LTL 3.2 billion over 2010 (cf. loan portfolio shrank by LTL 9.9 billion in 2009). Smaller changes in loan portfolio were mostly the result of more active bank crediting and less noticeable loan impairment. According to Loan Risk Database, banks granted new loans to the amount of LTL 9.6 billion in 2010 (i.e. LTL 2.8 billion more compared to 2009) and accounted for LTL 0.3 billion of specific provisions (cf. LTL 3.9 billion in 2009).

In 2010, banks were more active in crediting the public sector and subsidiary financial institutions. State Social Insurance Fund Board under the Ministry of Social Security and Labour borrowed about LTL 1 billion. The share of loans granted to public sector in the bank loan portfolio grew nearly two–fold over the year and accounted for 4.4% at the end of the year.

Loans to business decreased less markedly compared to 2009. In the last quarter of the year, decrease of such loans was the lowest over the last two years. The share of such loans in the loan portfolio remained the largest and accounted for 47.7% as at 1 January 2011.

In 2010, as the spread between the interest rates on interbank loans in litas (VILIBOR) and the interest rates on interbank loans in euro (EURIBOR) narrowed, incentives to borrow in euro also reduced. Due to this reason the share of loans in litas in the loan portfolio reduced at a slower pace compared to 2009. In the fourth quarter of 2010, loans in litas even increased by LTL 137.1 million (0.9%); their share in the loan portfolio increased by 0.6 percentage points. As at 1 January 2011, loans in litas accounted for 26% of the loan portfolio.

Some signs of recovery of the Lithuanian economy recently have been reflected in the tendencies of the loan portfolio quality. The loan portfolio quality did not deteriorate so rapidly in 2010 compared to its deterioration in 2009. This could be proved by the stabilisation of the indicators of loan portfolio quality.

In the third quarter of 2010, for the first time since the second quarter of 2004, specific provisions of banks on loans were somewhat smaller. They increased marginally again in the fourth quarter (LTL 53 million or 1.1%) and accounted for LTL 5 billion as at 1 January 2011. Specific provisions on loans to the loan portfolio ratio increased by 0.2 percentage points to 7.9%.

Same as during previous periods, relatively poorest quality indicators were those of consumer loan portfolio. In the fourth quarter of 2010, provisions on those loans reduced by LTL 2.8 million or 1.3% and accounted for 11.7% of the portfolio of those loans as at 1 January 2011. The quality of housing loan portfolio remained the best. Specific provisions on those loans accounted for 3% of the total housing loan portfolio.

Impaired loans to loan portfolio ratio increased by 0.8 percentage point in 2010 and accounted for 16.6% as at 1 January. Loans overdue by more than 60 days to loan portfolio ratio decreased by 0.6 percentage point and accounted to 3% at the end of the year.

Although the number of enterprises under bankruptcy or restructuring procedures began to decrease in 2010, liabilities of these enterprises continue to pose quite a huge problem to banks. As at 1 January 2011, bank liabilities of all companies which have gone bankrupt or are under restructuring procedures made up around LTL 3.5 billion or 12.7% of bank loans to resident private enterprises. Specific provisions made by banks on loans provided for the mentioned companies amounted to LTL 1.7 billion. The major share of these loans (around 70%) was comprised of loans provided for the enterprises undertaking real estate and construction activities.

Values of the ratio of the coverage of overdue and impaired loans by collateral fluctuated marginally in 2010 (from 70.3% to 76.5%). This shows what share of loans banks expect to recover solely from the collaterals provided by debtors.

COMPLIANCE WITH PRUDENTIAL REQUIREMENTS

In 2010, liquidity ratio was characterised by decreasing tendency due to intensified banking activity. Liquidity ratio decreased by 7.1 percentage points to 42.77%, however, it exceeded the minimum established by the Bank of Lithuania by nearly 13 percentage points (30%).

Over the year, liquid assets of the banking system reduced by LTL 0.2 billion while current liabilities increased by LTL 6.1 billion or 15.2%. As to current liabilities, most noticeable increase was registered in demand deposits (LTL 5.3 billion).

As at 1 January 2011, average liquidity ratio of the banks holding the major share of the market of the banking system, having foreign parent institutions and having a possibility to borrow from parent foreign institutions was 40.9%. Average liquidity ratio of banks having no parent institutions was higher and stood at 48.9%.

As at 1 January 2011, banks stated that they had sufficient reserves of liquidity to cover net funding gap. Liquidity reserves fixed by banks totalled to LTL 17.6 billion and net funding gap was LTL 7.3 billion, i.e. the banks built up 2.4 times huger reserves compared to the minimum requirement.

Capital adequacy ratio grew by 1.5% over the year and made up 15.6% as at 1 January 2011. Without breaching capital adequacy ratio, banks could compile LTL 2.9 billion additional provisions (i.e. increase their specific provisions by 57.9%) or to increase the risk–weighted assets by LTL 32.7 billion.

The banking system capital basis, which is used for calculation of capital adequacy ratio, accounted to LTL 7.3 billion as at 1 January 2011. The major share of that capital basis (LTL 5.7 billion) was attributed to Tier I capital. As at 1 January 2011, capital requirement accounted for LTL 4.4 billion of which capital requirement for capital risk amortisation totalled to LTL 3.8 billion. Capital for amortisation of market risk and operational risk made up only LTL 377 million and LTL 289 million respectively.

As to market risk, foreign exchange rate risk remained the most serious. It was alloted LTL 283 million or 75% of total capital required to cover market risk. Capital requirement for the euro position was LTL 282 million, i.e. 99.6% of total capital requirement required to cover foreign exchange rate risk. Open euro position increased marginally over the year and accounted for LTL 2.8 billion.

All banks complied with prudential requirements established by the Bank of Lithuania.

SHAREHOLDERS' EQUITY

Authorised capital of the banking system made up LTL 4.7 billion as at 1 January 2011. In 2010 the increment in the authorised capital was registered by AB Šiaulių bankas, AB bankas SNORAS and AB Ūkio bankas. Seeking to secure further safe operation, the banks intend to increase authorised capital also in 2011.

Same as in previous periods, the banking system of Lithuania was dominated by the Scandinavian capital. The share of authorised capital which is held by non–residents increased by LTL 133 million in 2010 and accounted for 87% of authorised capital as at 1 January 2011.

PROFITABILITY AND EFFICIENCY OF OPERATION

According to the data of the audited statements, the banking system earned no profit in 2010 however compared to 2009 the losses were considerably smaller. The losses incurred by banks last year totalled to LTL 276.2 million while losses of the operation of banks made up as much as LTL 3.7 billion in 2009. 2010 proved to be a turning point for the banking sector. The banking sector, which had suffered huge losses have started to operate profitably since the middle of 2010, i.e. profits were earned in the third and fourth quarters. Therefore losses incurred in 2010 were determined by losses sustained in the first half of the year while the profitable second half of the year started to offset losses incurred in the first half of the year.

Profit of operating banks

LTL million

Seq. No.	Bank	Profit
1.	AB DnB NORD bankas	–122.6
2	AB Ūkio bankas	–38.0
3	AB SEB Bank	–12.1
4	AB bankas "FINASTA"	0.06
5	AB Šiaulių bankas	–24.1
6	AB bankas SNORAS	9.9
7	UAB Medicinos bankas	–34.8
8	AB "Citadele" bankas	–41.5
9	"Swedbank", AB	–3.6
	Total banks	–266.8
10	*AS* "UniCredit Bank", Lithuania Branch	–47.2
11	MP Bank hf Baltic Branch	1.1
12	BIGBANK AS Branch	1.7
13	Allied Irish Banks, p.l.c.Lithuania Branch	0.2
14	Danske Bank A/S Lithuania Branch	5.7
15	Svenska Handelsbanken AB Lithuania Branch	–3.8
16	Skandinaviska Enskilda Banken AB,Vilnius Branch	–0.4
17	Nordea Bank Finland Plc Lithuania Branch	33.6
18	Scania Finans Aktiebolag Lithuania Branch	–0.3
	Total foreign bank branches	–9.5
	Total foreign bank branches	–276.2

Compared to 2009, the main factor enhancing the performance of banking activity last year was noticeably smaller expenditure on decrease in the value of assets. Such expenditure accounted for LTL 1.2 billion last year (cf. in 2009 it made up as much as LTL 4.9 billion). This expenditure is likely to continue to decrease as the economy of the country starts to recover.

Although net interest income earned by banks in 2010 were smaller by LTL 117.3 million (9.2%) compared to

2009, net earned quarterly interest income suggest that such income is increasing for the fourth consecutive quarter. Interest margin, which started to increase and reached 1.3% at the end of the year, made positive contribution on the growth of net interest income.

In 2010, banks received LTL 672.8 million net fee and commission income and such income was LTL 23.8 million (3.7%) higher compared to 2009. It should be mentioned that along with decreasing net interest income of banks, the impact of net fee and commission income on the income of banks increased markedly.

The key measures aimed at improving efficiency of the operation of the banks and offsetting at least in part increased losses and decreased income were taken already in 2009 therefore reduction in operational expenses was relatively marginal, i.e. it decreased by LTL 15.7 million (1.5%). Such reduction of expenses was affected by still decreasing number of employees in banks. In 2010, the number of employees in banking sector (excluding foreign bank branches) decreased by 457 employees, i.e. by 5.3%.

Return on assets (ROA) and return on equity (ROE) were negative. ROA was –0.3% and ROE was –5%. Owing to decreasing losses of the banking system, both indicators improved compared to the data of 1 January 2010 and to the data of the third quarter of the previous year.

CREDIT INSTITUTIONS SUPERVISION

The Bank of Lithuania, within the limits of the powers conferred on it, performs the supervision of credit institutions, i.e. it monitors and inspects whether credit institutions comply with the laws and requirements set by legal acts of the Bank of Lithuania, International Financial Reporting Standards and Basle Committee on Banking Supervision safe and reliable banking standards. The Bank of Lithuania also takes preventive measures ensuring efficient and reliable functioning of individual credit institutions and the entire system.

KEY TRENDS IN SUPERVISION OF CREDIT INSTITUTIONS

The main priority of the Bank of Lithuania in supervising credit institutions is the prevention of operational risk of banks. In 2010, the attention was focused on minimising different kinds of risks faced by banks and strengthening of bank capital (capital base) as the main source to cover losses inflicted by risks.

Seeking to improve risk management processes of banks and other credit institutions, additional requirements contributing to the strengthening of internal control and risk management were set. Attention was focused on the management of credit and liquidity risks. Moreover, new requirements were set for building up liquidity buffers and liquidity counterbalancing capacity, which reduce potential liquidity risk. Also, new requirements for the management of concentration risk were approved.

In 2010, the banks continued to conduct the internal capital adequacy assessment process (ICAAP): it assessed significant risk and capital requirement for its coverage, and provided information about possibilities to increase capital with due account to the projected performance of banks. When conducting ICAAP, the banks evaluate internal capital requirement not just for covering credit, market and operational risks but also for covering other risks that have not been assessed or have been assessed insufficiently according to General Provisions for the Calculation of Capital Adequacy when calculating regulation capital adequacy (concentration and strategic risks, interest rate risk defined in the banking book, large exposure risk defined in trade book, equity securities price risk, reputation risk, etc.). The internal capital adequacy requirements set by banks in Lithuania are higher than the internal capital level established by the Bank of Lithuania. If this level is approached, solutions are to be found how to increase the capital or reduce asset risk.

In its own turn, the Bank of Lithuania proceeded with the Supervisory Review and Evaluation Process (SREP). It checked whether the banks managed risk in a proper way and whether they had sufficient capital to cover that risk. It also identified probable and existing problems and shortcomings in the systems of internal control and risk management.

Together with SREP, the Bank of Lithuania conducted full–scope and target on–site inspections. During target

on–site inspections the attention was focused on the management of different risks and particular fields of activities. In 2010, particular attention was given to issues of credit and liquidity risk management and improvement of internal control. During full–scope inspections much attention was given to the fields of banking activities of highest risk. Apart from credit and liquidity risk management, the Bank of Lithuania also tested market and operational risk management and internal control. The Bank of Lithuania analysed comprehensiveness and effectiveness of risk management system, checked whether that system allowed to identify, monitor and mange risks, and whether banks duely comply with legal acts and internal requirements regulating their activities. It also checked the veracity of financial statements and of the reports for supervisory purposes submitted to the Bank of Lithuania.

There were a number of regular meetings organised with the Chairman of the Board of the Bank of Lithuania and some members of the Board, and the heads of banks operating in our country. These meetings were held with the aim to clarify the prospects of banks' activities, to present to their management the Bank of Lithuania's stance on issues it considers the most urgent, and discuss inspection results and other problems related to bank operations.

The liquidity of the banking sector has been continually monitored. The Bank of Lithuania continued to collect additional daily information about changes in asset and liability structure. In case any significant changes in the asset and liability structure are detected, banks were requested to give explanations and provide for the measures to be taken to cover potential liquidity risk.

Seeking to limit likelihood of emergence of liquidity risk, new requirements were imposed on banks for building up liquidity buffers and liquidity counterbalancing capacity. When fulfilling these requirements the banks started building up liquidity buffers for at least one–week and for at least one–month survival period. Banks estimated their counterbalancing capacity on the basis on the cash flow projections and in that way ensured adequate liquidity level.

To ensure more detailed regulation of risk and greater transparency of the supervisory process, the Bank of Lithuania legal acts, regulating ICAAP, SREP, requirements for consolidation of financial group financial statements and joint (consolidated) supervision, were supplemented and amendments were made to the requirements for the supervision of foreign bank branches and cooperation with supervisory institutions of other EU Member States during the branch supervision. Moreover, the definition of the new maximum exposure requirement and related persons was tightened. It is expected to impose more restrictions on bank lending to connected persons and thus reduce the loan portfolio dependence on interrelated borrowers.

To strengthen risk management processes in banks special attention was given to concentration risk. The new requirements approved by the Bank of Lithuania aim at reducing the loan portfolio concentration and dependence of credit risk on some particular clients, financial products, sectors of economic activity or geographical regions.

In order to tighten requirements that credit institutions have to comply with when specifying and paying out bonuses and other benefits assigned on the basis of performance results to employees whose professional activity and decisions taken may have a material impact on the risk assumed by the credit institution, the Board of the Bank of Lithuania approved new remuneration policy requirements for employees of credit institutions, which provide for some particular restrictions regarding the deferred and non–cash portions of variable pay and the term for deferment.

Taking into account the impact of the global financial crisis and recommendations of EU institutions to revise requirements for conducting stress testing in banks, the Bank of Lithuania updated and supplemented the General Regulations for Stress Testing. Requirements were set for banks following which they have to diversify the sources of liquid funds, perform liquidity risk testing taking into consideration probable unfavourable scenarios, and have business continuity plans prepared, which are revised on the basis of testing results. The banks are instructed to make macroeconomic scenarios which, apart from narrow aspects of banking activity, will have to cover different factors which are evolving at the moment or are likely to evolve independently from bank activities and which might have influence on bank's operation and its financial standing. Moreover, requirements for testing liquidity and concentration risks were improved.

Seeking to determine real resilience of the financial sector, all banks carried out stress testing according to general and rather strict scenarios of the Bank of Lithuania. Testing results as at 1 January 2010 and 1 July 2010 proved that the banking system of Lithuania is capable to withstand potential financial shocks.

Seeking to simplify conditions for operations of electronic money institutions and prompt the development of electronic money in the financial system of Lithuania, as well as to implement the provisions of the European Parliament and the Council directive on establishing electronic money institutions, experts of the Bank of Lithuania in cooperation with the working group formed by the Ministry of Finance of the Republic of Lithuania worked out a draft law of the Republic of Lithuania on electronic money and electronic money institutions, as well as amendments and supplements to other related laws.

As the Bank of Lithuania started to supervise payment institutions, the supervision infrastructure of these institutions was developed. It covers both the legal basis on the issues of licensing, calculation of ratios, internal control, reporting, etc. and technical means, ensuring adoption of supervisory and financial statements and performing of supervision.

As Lithuanian credit unions have been successfully expanding their services and introducing additional operations, the necessity for more detailed regulation of requirements regarding the financial accounting and preparation of financial statements emerged. With regard to the above the Board of the Bank of Lithuania approved Requirements for the Financial Accounting and Financial Reporting Policy of Credit Unions.

In implementing the provisions of the programme of the Republic of Lithuania Government for 2008–2012 on merging the financial market supervisory institutions, experts of the Bank of Lithuania drafted a number of legal acts and participated in the commission formed by the Ministry of Finance of the Republic of Lithuania to implement the conception of the merger of financial market supervisory institutions.

During their visit to Lithuania in May 2010, members of the IMF mission analysed macroeconomic and financial stability of Lithuania and gave their evaluation of the general economic projections and implementation of economic policy measures.