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FINANCIAL SECTOR ASSESSMENT

REPUBLIC OF LITHUANIA

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BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM UPDATE

This Financial Sector Assessment (FSA) summarizes the key findings and recommendations of the 2007 FSAP update report for the Republic of Lithuania.[1] The FSA, which focuses on developmental issues, should be read together with the Financial System Stability Assessment (FSSA) in order to get a full overview of the findings and recommendations of the 2007 Republic of Lithuania FSAP update. The FSAP update team noted progress since the 2002 banking sector vulnerability assessment[2], and evaluated regulatory and supervisory challenges for the banking and non-banking sectors; cross-border arrangements, safety nets, crisis management preparedness; the pension reform, and capital market development.

[1] The Republic of Lithuania FSAP update team, which visited the country in December 2007, gratefully acknowledges the excellent hospitality, cooperation and openness of the Lithuanian authorities and technical counterparts. The team consisted of May Khamis (Leader, IMF), Sophie Sirtaine (Deputy, World Bank), Luc Laeven, Thordur Olafsson, Miguel Segoviano (all IMF), Olivier Hassler, Michel Noel, Adolfo Rouillon, and Heinz Rudolph (all World Bank); and Jan Rein Pruntel (formerly De Nederlandsche Bank). Cristina Velazco-Weiss (World Bank) assisted the team. Its findings and recommendations were discussed with the authorities at the end of the mission. The diagnosis and assessment of the FSAP update, and hence this FSA, are based on information as of December 2007.
[2] See Appendix I for the status of the key recommendations of the 2002 assessment.

I. Overall Assessment

1. ***Stability assessment*. Lithuania's dependence on foreign financing, coupled with its macroeconomic imbalances and the banks' loan portfolios' sensitivity to the domestic economic cycle, leave Lithuania vulnerable to regional and global contagion risks**. Lithuania's catch-up, in terms of per capita income, toward the European average has been impressive. This success, however, has taken place in the context of emerging macroeconomic imbalances, accompanied by a significant rise in credit growth, a tripling in real estate prices, and an increased dependence on foreign parent banks' funding. Although the foreign banks are highly rated, these ownership linkages increase Lithuania's vulnerability to regional and global contagion risks, especially against the backdrop of the recent global turmoil in financial markets. The large share of loans contracted with variable interest rates and in euro increases credit risk related to domestic and foreign interest and exchange rate changes, since most borrowers are not hedged. Also, the concentration of real estate loans in banks' loan portfolios increases their vulnerability to a reversal in real estate prices. Helpfully, credit growth has slowed since mid-2006, as a result of the tightening of credit standards by banks.

2. ***Development issues*. The regulation and supervision of NBFIs, and the governance of pension funds, should be strengthened**. The banking sector regulatory and supervisory framework is in line with international standards, and the regulatory framework for non-bank financial institutions (NBFIs) is largely in conformity with European Union (EU) Directives. However, high staff turnover at the Lithuanian Securities Commission (LSC) affects its capacity to effectively supervise NBFIs. Thus, LSC must be able to pay market-based salaries to its staff and access an adequate and stable source of funding, including market fees. Also, market surveillance should be strengthened, deficiencies in IFRS implementation remedied, and the regulatory and enforcement framework for insider dealing revised. In addition, the governance structure of pension funds managed by banks and insurance companies should be strengthened to avoid conflicts of interest. Closer coordination is needed among LSC, the Insurance Supervisory Commission (ISC), and the Bank of Lithuania (BoL) to ensure adequate supervision of cross-sectoral linkages between financial institutions. The government's review of the overall financial sector supervisory structure is welcome in this regard.

3. **Opportunities to further develop the capital markets and improve the pension system should be seized.** MiFID offers opportunities for Lithuanian issuers but requires the development of regulation for missing financial instruments. The pension reform's efforts would benefit from revisions in portfolio investment and disclosure regulations, as well as to the pension system infrastructure. Further progress in the areas of lender of last resort, bank resolution, creditors' rights, insolvencies, and housing finance also would be helpful.

4. Appendix I follows-up on the status of implementation of the 2002 FSAP recommendations. Appendix II provides a summary of the main recommendations of this report. Priority recommendations are listed in Table 1. Appendix III provides a description of the financial sector in Lithuania and supervisory arrangements.

Table 1. Priority Recommendations

	Timeframe
Banking sector	
• In the process of IRB model validation under Basel II, ensure that banks' internal models adequately capture the risk characteristics of the Lithuanian loan portfolios. As needed, assess capital surcharges under Pillar 2 of Basel II, as needed, based on banks' individual risks not captured under Pillar 1	Short term
• Discuss further with banks, parent banks, and the home authorities contingency liquidity plans in case of a severe liquidity stress event	Immediate
Safety nets: Lender of Last Resort	
• Update procedures for emergency liquidity support in times of crisis and consider including guidelines for collateral valuation and approval to ensure an expedited process in emergency conditions	Immediate
Securities markets regulation and supervision	
• Modify status of LSC to enable it to pay market-based salaries to its staff and to have access to adequate and sustainable sources of funding, including fees from market participants	Short term
• Reform the regulatory and enforcement framework for insider trading by: ✓ Requiring companies to disclose their ultimate controllers as part of their listing application, and to disclose any change in ultimate controllership following their listing ✓ Requiring brokers to communicate black lists to LSC ✓ Revising the criminal code to exclude information shared by insiders with third parties from the concept of publicly known information	Immediate
Pension sector	
• Prepare new and complete regulation on the corporate governance and internal control systems for pension fund managers and enforce it	Immediate
Cross-sectoral issues	
• Improve supervisory structure to take into account cross-sectoral linkages, particularly those arising as result of a pension fund supervision by multiple supervisors	Immediate

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GLOSSARY

AIPTS	Association of Intermediaries of Public Trading in Securities
BoL	Bank of Lithuania
CBA	Currency Board Arrangement
EU	European Union
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
FSSA	Financial System Stability Assessment
GDP	Gross Domestic Product
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Organizations
IRB	Internal Risk-Based
ISC	Insurance Supervisory Commission
LoLR	Lender of Last Resort
LSC	Lithuanian Securities Commission
LTL	Lithuanian Lita
LTV	Loan-to-Value
MiFID	Market in Financial Instruments Directive
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MTF	Multilateral Trading Facility
NBFI	Non-Bank Financial Institution
NPL	Non-Performing Loan
S&P	Standard & Poor's
SMART	First North's Suspicious Transactions Detection System
SME	Small and Medium-Sized Enterprises
SODRA	State Social Insurance Board
SRO	Self-Regulated Organization
TRS	Transaction Reporting System
UCITS	Undertaking for Collective Investment in Transferable Securities
VSE	Vilnius Stock Exchange

II. Macro Setting and Stability Assessment

5. **Lithuania's catch-up in terms of per capita income toward the European average has been impressive, although imbalances have appeared**. Inflation has been on the rise since 2003 and has been above the Maastricht criterion since early 2005.[3] The current account deficit grew from 7.1 percent of Gross Domestic Product (GDP) in 2005 to 10.9 percent of GDP in 2006. Whereas in the early 2000s the external deficit was financed predominantly by net foreign direct investment, these represented less than half of the 2006 deficit and much of the deficit was financed by external debt, an increasing share of which is of short-term nature.[4]

Table 2. Select Macroeconomic Indicators

(In percent)	2002	2003	2004	2005	2006	2007e
Real GDP growth	6.9	10.3	7.3	7.9	7.7	8.8
General government fiscal balance 1/	–1.9	–1.4	–2.7	–1.3	–1.5	-1.9
Average CPI (year-on-year change)	0.3	–1.1	1.2	2.7	3.8	5.8
Current account balance (as share of GDP)	–5.3	–6.9	-7.7	–7.1	–10.8	-13.0
Gross external debt (as share of GDP)	43.9	44.9	46.5	48.8	63.7	65.8
Short-term debt (at original maturity, as share of GDP)	15.0	17.7	16.7	19.9	19.1	17.1
Reserve cover of short-term debt at original maturity	1.1	1.1	1.0	0.8	1.0	0.6

Source: Lithuanian authorities; and staff estimates.
1/ Including restitution payments.

6. **Credit growth has been significant since 2002 but more recently has shown signs of cooling down.** Credit grew at an average annual rate close to 50 percent since 2002. Lending for housing has been a driving force of the rapid growth of overall bank credit. At over 15 percent of GDP (compared to 5.5 percent at the end of 2004), it constitutes a major component (28 percent) of banks' total loan portfolios. Credit growth has slowed from its peak rate in mid-2006. Indications are that it will slow further in 2008 following a tightening of credit standards by banks. This slowdown seems to also reflect a recent negative sentiment in the real estate market.[5]

7. **Rapid credit growth in recent years has increased credit risk.** The rapidly rising indebtedness of households and enterprises has increased the economy's vulnerability to macroeconomic risks and developments in the real estate market. Between 2002 and 2006,

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[3] Lithuania meets by a wide margin the "Maastricht" cap on government debt, and is in compliance with the ceilings on long-term interest rates and fiscal deficits. Lithuania has been participating in the exchange rate mechanism, ERM II with a CBA.

[4] S&P lowered its outlook for all three Baltic States in the first half of 2007 from stable to negative citing increasing imbalances and inflationary pressures. Fitch changed its outlook from stable to negative in December 2007 reflecting rising inflationary pressures, a further prospective delay to euro adoption, a marked deterioration in Lithuania's external imbalances, and uncertainty over how the country will secure a gradual adjustment to a more sustainable growth path.

[5] Following several years of rapid house price appreciation, the housing market is now cooling, with house prices in Vilnius no longer rising and the volume of house sales declining.

household indebtedness as a share of GDP has grown from around 3 to 19 percent of GDP and corporate sector indebtedness from 12 to 28 percent of GDP.

8. **The characteristics of loan portfolios exacerbate the vulnerability to credit risk**. About 90 percent of household mortgage debt is contracted with variable interest rates and around 40 percent in foreign currency (largely in euro), increasing credit risk related to domestic and foreign interest rate and foreign exchange changes (pending euro area accession). Approximately 50 percent of all private sector loans are denominated in euros, and the banking system has a significant concentration in real estate loans (50 percent of the total loan portfolio).

9. **Lithuania's dependence on foreign capital leaves it vulnerable to the effects of spillovers from the rest of the region and global developments.** The banking sector is dominated by foreign banks (93 percent of the sector's assets), the majority of which are Swedish banks (62 percent of total assets). Until 2005, foreign parents financed close to 100 percent of bank net foreign borrowing. In 2006 and 2007, these proportions fell but remained significant, at about 40 and 60 percent respectively. The dominance of Scandinavian banks implies significant contagion risks: the effect of a regional shock on Lithuanian banks could be accentuated given ownership linkages. Spillover effects could manifest themselves in the form of the scaling back of new lending by parent banks, a downgrading of Lithuania's sovereign rating, and/or strain on the CBA.[6] At a minimum, such effects would increase funding costs and refinancing risks for Lithuanian banks. The recent global turmoil in financial markets implies potentially higher contagion risks for Lithuanian banks with internationally active parents.

10. **The banking system's financial soundness indicators (FSIs) are generally satisfactory, despite relatively low capital adequacy ratios** (Appendix III). Profitability has risen since the early 2000s, the return on assets more than doubled since 2002, and nonperforming loans are low. The system's capital adequacy has increased in the last two years thanks to action by the BoL, but remains low relative to other countries in the region and the EU.

11. **Capital buffers, defined as the difference between economic and regulatory capital, remain modest**.[7] Using a risk-based approach, the team and the BoL estimated the economic capital of the five largest banks for the fourth quarter of 2006. Results show that the average regulatory capital in the third quarter of 2007 surpassed economic capital in the fourth quarter of 2006 by an average capital buffer of only 1.6 percent, which seems insufficient to cover a potential increase in unexpected losses in the event that credit, market, liquidity or operational risks materialize.

[6] The team, however, considers the probability of a break in the CBA to be very low.

[7] Economic capital is defined as the amount of capital that is necessary to cover banks' ULs at the 99.95 VaR (conversely, this means there would be a 1 in 2000 probability of the bank becoming insolvent during the next 12 months).

12. **This assessment is supported by the results of stress tests.**[8] Under tests for credit risk, the minimum CAR of 8 percent would be breached for the system on average after the 11th quarter in a mild scenario and after the 5th quarter in a more severe scenario. Stress tests for market risk indicate considerably milder implications than those arising from credit risk – but the BoL should continue close monitoring of risks arising from these exposures. Despite the dependence of subsidiaries and branches of foreign parent banks on parent bank funding, stress tests for liquidity risk indicate that the prevalence of long-term parent funding and the high levels of liquidity banks maintain would enable these banks to withstand scenarios involving a reduction in parent bank financing. Large withdrawals of resident and nonresident deposits appear to have a more significant impact, although all systemic banks remain liquid. Liquidity positions might not be sufficient under more severe events where parent bank withdrawals are combined with deposit withdrawals. Although the probability of such a combination of events is low, given that the BoL's LoLR operations are limited by the CBA, the central bank should discuss its contingency plans (such as the availability of credit lines) with banks.

13. **Stress tests indicate that banks' regulatory capital might not provide an adequate buffer under severe events.** The BoL has taken action over the past years to encourage prudent credit risk management and strengthen banks' capital base.[9] In particular, where the Capital Requirements Directive (i.e. the EU transposition of Basel II) allows for national discretion, the BoL has chosen the more conservative option.[10] However, in view of the importance of real estate lending in banks' portfolios, it is unfortunate that the risk weight for residential mortgage loans with an LTV ratio below 70 percent was lowered in January 2008, with the implementation of Basel II, from 50 to 35 percent. The BoL may wish to reconsider this.[11]

14. **In the process of validating banks' IRB models, the BoL should encourage banks to capture risks under Pillars 1 or 2.** In view of the limited historical banking and macroeconomic time series in Lithuania, banks' IRB models might not capture the risk characteristics of the loan portfolios, thereby underestimating regulatory capital needs. Even if the BoL maintains the 50 percent risk weight for residential mortgages, uncaptured credit risk should also be accounted for under Basel II's Pillar 2. Guided by sensitivity and stress test analyses, capital surcharges based on each bank's individual risk should be considered.

15. **The BoL can also take additional measures to reduce the risks of real estate lending.** These include:

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[8] The FSSA provides a detailed description of the stress tests.

[9] Measures taken include a narrowing of the definition of residential mortgage loans, which effectively raises the risk weight, and the imposition of a 60 percent limit on the part of current year's profit that may count towards regulatory capital. Furthermore, the BoL has requested banks to fully retain profits made in 2005 and 2006, and intends to do so again in 2007.

[10] For example, for commercial real estate loans, the BoL has chosen to apply a 100 percent risk weight whereas a 50 percent risk weight would have been possible, and the maximum amount of a retail exposure has been set at 1 million litas (290,000 euro) instead of 1 million euro, limiting assets that receive a 75 percent risk weight.

[11] Discretion in this area is consistent with the EU's Capital Requirements Directive.

- enhancing the BoL's capacity to assess the real estate market and its implications for bank lending through: (a) using more diversified monitoring tools including early warning signals;[12] (b) identifying the riskiest loans (e.g. developer loans and equity withdrawals) as separate reporting categories; and (c) coordinating closer with the state mortgage insurer as defaults on the latter's loans would provide an early-warning signal;

- promoting the development of fixed rate loans through BoL surveillance (for example by ensuring that the credit risk resulting from variable rates is taken into account in lending parameters and pricing and in the banks' IRB models); and

- enhancing consumer protection and education, especially on risks linked to variable interest. In addition, the disclosure of information to borrowers should be improved, including through the provision of a standardized all-in rate and of stress scenarios in case of variable rates.

III. Regulatory and Supervisory Issues

Regulatory and Supervisory Framework for NBFIs

16. **The regulatory framework for NBFIs is in conformity with EU Directives, except for a limited number of missing regulations**. In particular, Lithuania has fully implemented MiFID, including detailed *know your client* rules. Two detailed regulations, which the LSC is preparing, are missing: (i) the risk-based supervision of market intermediaries, and (ii) the calculation of fair value for infrequently traded securities and derivatives.[13]

17. **The authorities need to redress LSC's staffing and funding situation as a matter of utmost urgency if this progress is to be maintained.** High staff turnover as a result salaries that are half those offered to qualified staff by the supervised sector robs LSC of its more experienced staff and leave it with weakened capability to effectively supervise securities markets. Between 2005 and 2007, 75 percent of LSC professional staff departed; they are being replaced by recent university graduates. The authorities must change the status of LSC to enable it to pay market-based salaries to its staff with relevant market experience, and provide it with adequate and stable sources of funding, including fees from market participants. Then LSC will need to implement a comprehensive staff recruitment, training and incentive plan, aimed at endowing it with a stable corps of supervisors experienced in licensing, surveillance, inspection, investigation, and enforcement. The ISC faces similar salary restrictions, but they have led to less acute staffing issues than those at LSC where competition from private employers has been stronger.

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[12] For instance, collecting information on the speed of sale of new units or the stock of unsold housing on the market.

[13] The methodology to determine the fair value of such securities should be specified in regulation, for instance on the basis of EVCA's rules.

18. **Market surveillance suffers from several deficiencies.** LSC should complete the ongoing implementation of its Transaction Reporting System (TRS) in collaboration with market intermediaries and extend its coverage to the First North alternative market.[14] The Vilnius Stock Exchange (VSE) expects its suspicious transactions detection system (SMART) to be operational at the beginning of 2008. LSC should request daily SMART reports from the VSE. LSC should also ensure that the Association of Intermediaries of Public Trading in Securities (AIPTS) performs its responsibility as a Self-Regulated Organization (SRO) in enforcing the Code of Ethics for market intermediaries and sanctioning offenders.

19. **There are deficiencies in IFRS implementation.** Adoption of IFRS should be mandatory for asset management companies and financial brokerages. Since LSC became responsible for overseeing IFRS implementation in January 2008, it should build its capacity by recruiting experienced accountants.

20. **The regulatory and enforcement framework for insider dealing suffers from serious deficiencies**. Companies should be required to disclose their ultimate controllers as part of their listing application, and also report any changes in ultimate controllership following listing. "Black lists" of the companies with which staff of financial brokerages maintain business relationships should be communicated to LSC. Finally, the Criminal Code should be revised to exclude information shared by an insider with related parties from the category of publicly known information.[15]

Monitoring of Pension Funds

21. **In 2003, the government implemented a successful pension reform** establishing a second pillar allowing individuals to voluntarily allocate part of their mandatory contributions to fully funded pension funds. The new pension system has received considerable support from intermediaries and the population: currently, 55 percent of the labor force participates in the second pillar and pension fund managers offer 32 different pension portfolios.

22. **Monitoring of the new pension system should be strengthened**. The second pillar – an essential component of future pensions – requires proper oversight, traditionally achieved through (i) the regulatory framework, (ii) the supervisory framework, (iii) safe pension fund manager governance principles, (iv) market surveillance, and (v) market contestability. In Lithuania, each of these areas suffers from weaknesses that leave second pillar pension funds vulnerable.

- **First, the legal and regulatory framework for pension funds needs clarification**. The law establishes the administrative rights of individuals precisely, but is followed by

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[14] Alternative market platform of the OMX group for small firms, in operation in the Nordic and Baltic countries.

[15] At the moment, courts interpret the definition of publicly known information as including information shared by an insider with related parties, which prevents the Prosecutor's Office from prosecuting cases of insider dealing.

general principles on pension fund management.[16] These could be challenged in courts, where judges may not be technically prepared to deal with such issues. Thus, the legal regime should better specify the rights and obligations of the asset manager and the powers and duties of supervisors.

- **Second, the supervision of pension funds needs strengthening.** Supervision by LSC and ISC is mostly compliance-based, which is insufficient for a system with flexible organizational structures and freedom for managing investments. Also, staffing problems at LSC have weakened its effectiveness in supervising increasingly sophisticated pension funds.

- **Third, corporate governance standards for pension funds need to be strengthened**. Pension management companies have strong operational links with their mother companies, breaching good principles of asset management. Key issues for pension funds managed by banks include their use of the depository and the broker of the mother bank, and their purchase of funds offered by the mother bank. In the case of pension funds managed by insurance companies, the key issue is the sharing of the same management team for pension and other activities of the insurance company. These conflicts of interest allow for the possibility that second pillar contributions could be managed in the interests of bank and insurance company shareholders rather than those of the pensioners. Therefore, an assessment of corporate governance arrangements for pension fund managers is needed. Supervisory agencies should clarify and ensure, through regulation, minimum standards of corporate governance and risk management, that pension funds' portfolio decisions are safeguarded from the interests of the mother company.

- **Fourth, a regulation should require that external auditors to conduct periodic assessments of the internal control systems of pension fund managers.** The pension law requires that auditors provide an opinion about compliance with pension fund rules, including internal controls, and violations of the law and other legal acts. However, since the supervisory commissions have not clarified these requirements, the auditing of pension funds is cursory.

- **Fifth, contestability in the market should be encouraged**. The large gap between the sophistication of products that the market offers and the population's understanding of them should be reduced. In addition, contributors face administrative obstacles should

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[16] For instance, the law says that pension fund management companies "should try to avoid conflicts of interest" and should manage, use and dispose of the pension funds under "fiduciary rights". No further explanation of these principles is provided. Similarly, the supervisory authority can impose sanctions and administrative penalties, but the law does not specify the circumstances under which that can be done, or the type of penalties that can be imposed.

they wish to switch pension fund managers.[17] The information clients receive should be streamlined and their ability to move between funds facilitated. The fees that pension funds pay to UCITS-type funds should be clearly disclosed.

Cross-sectoral Supervisory Issues

23. **The current supervisory structure does not ensure adequate supervision of all financial institutions and their inter-relations.** This results from two issues**:**

- **First, the supervision of pension funds requires closer coordination between ISC and LSC.** Pension funds are supervised by two different supervisory authorities depending on whether they are managed by banks or insurance companies. Despite coordination between these institutions, funds are subject to unequal supervisory rules and processes, opening the door to regulatory arbitrage. Significant coordination issues could emerge during the payout phase with respect to the supervision of annuity products.

- **Second, the governance structure of second pillar pension funds largely escapes oversight by supervisory authorities**. As mentioned above, the governance structure of pension funds managed by banks and insurance companies is fraught with conflicts of interest. Because of the separation of supervisory mandates across three institutions (the LSC, the ISC and the BoL) with little coordination, governance structures largely escape oversight by supervisory authorities. These weaknesses create strong reputational risk for the institutions involved, and thus also for the financial sector and pension reform.

24. **Resolving these issues requires an urgent review of supervisory arrangements for Lithuanian financial markets**. Future supervisory arrangements should be designed with the objectives to (i) strengthen capacity to supervise the interactions of banks with their related entities; (ii) improve systemic risk management by ensuring adequate monitoring of issues affecting the entire financial sector; (iii) facilitate harmonization of supervisory approaches and regulation; (iv) develop a unified risk-based approach; (v) increase the flow of information between regulators and supervisors of various institutions; and (vi) provide the supervisory institution(s) with sufficient resources including the ability to offer market-based incentives and salaries to staff. These objectives can be achieved through the implementation of various supervision models. The team commends the establishment in December 2006 of a parliamentary Working Group (WG) to explore various approaches including integrated supervision models.

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[17] Draft amendments of the Law on Pension Accumulation contemplate a simplified procedure to remove a pension manager.

Crisis Management, Safety Nets, Cross-border Cooperation, Bank Resolution, Creditors' Rights and Corporate Insolvency Framework

25. **The BoL should prepare procedures for a rapid implementation of LOLR operations.** The April 2006 amendment to the BoL Law provides the the central bank with the flexibility to accept various types of collateral against its lending. The BoL should prepare guidelines for the pre-approval of collateral (including for its valuation) to ensure an expeditious process in emergencies. It should also establish procedures for emergency liquidity support in case of crisis.

26. **The deposit insurance scheme, in line with the EU Directive, could be further improved,** in particular through risk-based insurance premiums. Also, an increase in the fund size to its target level would enhance its ability to cover a larger number of small bank failures.

27. **Efforts to enhance cross-border cooperation and strengthen the financial crisis management framework should continue**. The BoL has concluded bilateral MoUs with all foreign supervisory authorities who supervise parent banks of Lithuanian subsidiaries or branches, and multilateral agreements (including the EU-wide trilateral MoU of 2005 on crisis management cooperation). Recently the BoL signed a MoU between the central banks of the Baltic countries and Sweden on the management of a financial crisis in banks with cross-border subsidiaries or branches. The BoL participated in two multilateral crises management simulation exercises, and work on enhancing domestic crisis management is underway**.**

28. **The legal framework for bank resolution should be harmonized and strengthened.** The bank insolvency regime is embodied in different pieces of legislation (Law on Banks, Law on the Bank of Lithuania, Law on Financial Institutions, and other main acts). This could lead to conflicts in legislation and make it difficult to identify the proper sequence of a bank insolvency procedure. Thus, bank insolvency legislation should be consolidated in one comprehensive law. Also, the conditions for the recognition of a bank as insolvent should be defined more precisely and incorporated into the law. At a minimum, balance sheet insolvency (zero net worth) should be a strict condition for the recognition of a bank as insolvent and the withdrawal of its license.

29. **Creditor rights and insolvency systems can be improved.** Making the simplified restructuring procedure more flexible would enhance the reorganization regime**.** Given the practice of voluntary restructuring agreements (workouts), it could be complemented with an abbreviated reorganization procedure through which workout agreements could be converted into restructuring plans even if unanimity is not obtained. Also, specialization of some judges in large commercial centers would enhance the efficiency of insolvency proceedings and the capacity to deal with increasingly complex financial transaction cases.

IV. Developmental Issues

Capital Market Development

30. **The entry into force of MiFID creates challenges and opportunities for LSC.** MiFID creates an opportunity to deepen the market for large Lithuanian issuers. Acceleration in the integration between the Baltic and Nordic exchanges would provide large issuers with access to a deeper pool of liquidity. LSC will need to enhance supervision of financial brokerage firms to oversee their adoption of internal compliance processes in line with MiFID requirements. The launch of the First North market for the Baltic countries provides a market tier dedicated to SMEs. These developments create opportunities to increase the attractiveness of Lithuania for foreign investors but require improving the legal and regulatory framework for some market instruments (in particular, municipal bonds, corporate bonds to finance local infrastructure projects, covered bonds, and asset-backed securitization).

Pension Reform

31. **The pension system relies excessively on the capacity of individuals to make a proper selection for their savings options**.

- **First, the government should set "join the second pillar" as the default option for new entrants** while preserving the right of individuals to elect to remain in the first pillar only. The second pillar offers a diversified source of income for retirement and long-term fiscal benefits.[18]

- **Second, regulation should impose limits to maximum portfolio risk exposure and require adequate disclosure of portfolio benchmarks**. Due to market conditions, returns of pension funds have been relatively low, and pension fund managers are pressured to find higher returns through riskier investments. This should be limited by regulation. Also, regulation should require disclosure of portfolio benchmarks as homogeneous point of comparison for clients and impose penalties for moving away or not tracking the benchmark. In order to align the interest of the pension fund manager with those of pensioners, the reserve requirement (capital) of pension fund managers should be required to be invested in the same assets as the pension fund as in Chile and Estonia.

- **Third, lifecycle benchmark portfolios should be designed** to provide incentives to pension fund managers to invest in portfolios aligned with the long term interests of contributors[19] and maximize the future value of pensions at different stages of a

[18] However, such a change should only take place once the governance issues of the second pillar have been solved.
[19] For information on lifecycle portfolios, see *How to Invest over the Life Cycle, A Review*, Wallmeier, Martin and Zainhofer, Florian, December 2006.

pensioner's lifecycle. These benchmarks may be used as default options for individuals who do not feel comfortable taking a decision about portfolio allocation. It would also facilitate comparisons among funds. In order to reduce marketing expenses by pension funds, a lottery process to allocate new entrants to pension fund managers could be introduced as in Poland. Alternatively, the government may define a benchmark portfolio under a "no lose" strategy.[20]

32. **An upgrade in the IT system of SODRA is recommended, as well as moving to an electronic system of contributions.** SODRA's contribution collection system, which is entirely paper-based, is significantly less efficient than in other countries of the region, including Poland, the Slovak Republic, and Estonia. In these countries the lag between the collection of contribution and deposits in individual accounts is less than two weeks, while in Lithuania it takes up to three months. Also, the current delay to effectively join the system should be revised.

Housing Finance

33. **Revitalizing the covered bond framework could support fixed-rate lending**. While today the use of floating rate loans is common, fixed rate loans should become more attractive as interest rates are no longer declining. This should be an opportunity to develop domestic funding instruments such as covered bonds.

34. **Financial markets could help fill social gaps in the housing market.** A growing share of families is excluded from the housing market because of price increases, without being eligible for social housing. Also, the social and financial efficiency of public assistance is not optimal. A better coverage of housing needs in the moderate income segment can be achieved by leveraging the government's housing policy with market finance by (i) developing a policy to foster a rental sector, (ii) promoting the channeling of financial resources towards it through innovative instruments and the extension of the state owned insurer's business to rental products; (iii) leveraging municipal spending in the social rental sector through structured finance solutions; and (iv) better focusing the state mortgage insurance on moderate income groups.

[20] Feldstein (2005) and Poterba Rauh, Venti and Wise (2006) have proposed a "No Lose" strategy as an alternative to the Lifecycle one. The "No lose" strategy does not involve rebalancing portfolios at each step of an individual lifecycle, but rather to link equity investments with historical pattern of TIPS yields, which in turn determine the amount available for stock investment, and with the historical returns on equity assets. Poterba et al simulate these portfolios for the 401k plans in the US and conclude that in some cases the "No lose" strategy dominates the "Lifecycle" one. See Poterba Rauh, Venti and Wise, *Lifecycle Asset Allocation Strategies and the Distribution of 401K Retirement Wealth*, Working Paper 11974, National Bureau of Economic Research NBER, January 2006.

APPENDIX I. FOLLOW-UP ON KEY RECOMMENDATIONS OF THE 2001 FSAP

2002 FSAP Recommendation	Assessment of implementation
Banking Supervision	
Require greater accountability of bank directors for risk management within their banks.	Since 2006, banks are required to publicly disclose information on their risks and risk management practices.
Revise loan classification and provisioning rules to better reflect the economic value of a bank's loan portfolio.	The 2005 Minimum Loan Assessment Requirements follow IFRS and assign responsibility for proper provisioning to a bank's board.
CP 1(5) Make provision for the legal protection of members of the board of the BoL and banking supervision staff, while retaining robust accountability arrangements.	The BoL Law was amended to include a new [Article 46(1)] that explicitly provides for legal protection of BoL board members and supervisory staff.
Define collateral acceptable for LoLR operations more broadly so as not to constrain BoL's ability to adequately conduct these operations.	The new BoL Law provides for a wider range of collateral.
Strengthen the legal powers of the BoL to intervene in, and quickly resolve the failure of banks experiencing financial distress or insolvency.	The framework has been substantially strengthened and gives the BoL ample powers to intervene an ailing bank. One stringent definition of an insolvent bank is recommended to be included in the regulatory framework.
Strengthen cooperation with home country supervisors of Lithuania banks.	The policy of the BoL is to conclude MoUs between all financial supervisory authorities from jurisdictions with cross-border banking activities with Lithuania as well as all neighboring countries. This has been done. The BoL has participated in cross-border multilateral crisis management simulation exercises based on multilateral MoUs with Sweden, the other Baltic countries and EU and will continue to do so.
Insolvency and Creditors' Rights	
Strengthen the insolvency system: • Most insolvency proceedings were liquidation cases, averaging more than 3 years and yielding little benefit to creditors. • Insufficient experience with the then newly enacted Enterprise Restructuring Law prevented proper assessment of its effectiveness. • The insolvency system in general was weak and fragmented because three different insolvency laws – entered into force in 1993, 1997 and 2001– governed insolvency proceedings (according to the initiation date of cases).	The following reforms were introduced: • A new Code of Civil Procedure which, among other reforms, introduced a so-called "simplified court order procedure" • Application of the Civil Code rules to mortgages and pledges, which in the past were governed by a Mortgage Law and Pledge Law • Actual use of restructuring proceedings under the new restructuring of enterprises system
Strengthen the institutional framework for creditor rights and insolvency: • Court efficiency was found to be stifled by a lack of specialization among judges. • Low standards for licensing, as well as over-licensing, inadequate training and inconsistent performance of insolvency administrators, affected the implementation of the insolvency system.	The following reforms were introduced: • Reforms to the Law on Courts • New rules regulating the insolvency administration profession
Capital markets	
The 2002 FSAP reported that Lithuania's conformity to IOSCO principles was high.	Since 2002, the government has completed a number of legal reforms to reflect key EU directives[1] concerning the capital markets. Particularly, it passed a new Law on Markets in Financial Instruments and a revised Securities Law in January 2007.

[1] The Prospectus Directive, Transparency Directive, Directive on MiFID, Directive on UCITS, the Collateral Directive and the Clearing and Settlement Code of Conduct.

APPENDIX II. DETAILED RECOMMENDATIONS OF THE FSAP UPDATE

Recommendations	Timeframe
1) Mitigation of risks: Regulatory and Supervisory Issues	
a) Banking sector	
• In the process of IRB model validation under Basel II, ensure that banks' internal model capture the risk characteristics of the Lithuanian loan portfolios adequately. Otherwise, assess capital surcharges under Pillar 2 of Basel II, as needed, based on banks' individual risks not captured under Pillar 1	Short term
• Discuss further with banks, parent banks, and the home authorities contingency liquidity plans in case of a severe liquidity stress event	Immediate
• Strengthen the analytical cooperation between the BoL's Banking Supervision and Financial Stability Departments to enhance financial stability analysis	Short term
• Clarify to banks that open euro positions are included in the capital adequacy calculations for market risks	Immediate
b) Securities markets regulation and supervision	
• Complete missing regulations under EU Directives ✓ risk-based supervision rules ✓ valuation of fair value of infrequently traded securities and derivatives rules	Short term
• Broaden the coverage of IFRS to financial brokerages and asset management companies	Short term
• Modify status of LSC to enable it to pay market-based salaries to its staff and to have access to an adequate and sustainable source of funding, including fees from market participants	Short term
• Prepare and implement a comprehensive staff recruitment, development and incentive plan for LSC	Short term
• Strengthen market surveillance by: ✓ Completing the ongoing implementation of TRS in collaboration with market intermediaries ✓ Extending TRS coverage to alternative market (First North) ✓ Carrying out enhanced market surveillance through TRS and through SMART reports to be provided daily by VSE ✓ Imposing fines on AITPS in cases it does not enforce the Code of Ethics for market intermediaries, in addition to fines imposed on offenders	Short term
• Reform the regulatory and enforcement framework for insider trading by: ✓ Requiring companies to disclose their ultimate controllers as part of their listing application, and to disclose any change in ultimate controllership following their listing ✓ Requiring brokers to communicate black lists to LSC ✓ Revising the criminal code to exclude information shared by insiders with third parties from the concept of publicly known information	Immediate
• Sign MoU with Russian and Ukrainian supervisory authorities	Medium term
c) Pension sector	
• Specify the rights and responsibilities of pension fund managers and supervisors in the pension law	Short term
• Move supervisory approach towards risk-based supervision	Short term
• Prepare a new complete regulation on the corporate governance and internal control systems for pension fund managers and enforce it	Immediate
• Specify in the regulation the responsibility of external auditors in auditing internal control systems of pension funds	Short term
• Consolidate LSC and LIC databases and enhance disclosure of information to public	Short term
d) Cross Sectoral issues and other non-bank activities	
• Improve supervisory structure to ensure adequate supervision of cross-sectoral inter-	Immediate

relations in the financial sector	
• Change status of ISC to ensure independence from Executive branch of government	Short term
2) Crisis Management, Safety Nets, and Cross-Border Cooperation	
a) Safety nets: LOLR and deposit insurance	
• Update procedures for emergency liquidity support in case of crisis situations and consider including guidelines for collateral valuation and approval to ensure an expedited process in emergency conditions	Immediate
• Consider a risk-based approach to insurance premiums	Medium term
b) Cross-Border cooperation and crisis-management	
• Continue to enhance cross-border cooperation and to participate in cross -border crisis management simulation exercises	Ongoing
• Finalize the domestic crisis management arrangements that the authorities are currently working on	Short term
c) Banking sector resolution framework	
• Define the condition for the recognition of a bank as insolvent more precisely in the regulations (at a minimum as zero net worth), and preferably include this into the law	Medium term
d) ICR framework	
• Amend mortgage legislation to: (1) allow creation of security interests related to future obligations, (2) eliminate the role of judges at registration of mortgage and pledges, and (3) simplify creation formal requirements • Review bailiffs fee structure • Amend Law on Restructuring to allow simplified restructuring procedures for out-of-court plans approved by a majority of creditors • Specialize a number of judges to deal with insolvency cases	Medium term
3) Developmental issues	
a) Capital market	
• Implement MIFID: ✓ Maintain TRS system ✓ Exercise increased oversight over implementation of client suitability and appropriateness rules	Ongoing
• Broaden the supply of Lithuanian securities ✓ Establish the conditions for risk pricing of municipal bonds, including market-based regulation of municipal borrowing, municipal bankruptcy law, and no-bailout policy ✓ Adopt revised Law on Investments to enable PPPs both at the national and municipal corporations level; ✓ Design and implement the legal and regulatory framework for securitization, including possibility to register SPVs as trusts ✓ Improve regulatory framework for covered bonds	Medium term
b) Pension sector	
• Finalize legislation about payout phase	Ongoing
• After strengthening the governance structure of pension funds, change the default option from “not to join the second pillar” to “join the second pillar” • Create a Presidential Commission for the definition of the default benchmarks • Specify in the law or regulations the maximum exposure to risk by category of pension fund portfolios • Develop a regulation to optimize decisions of default contributors, including the use of lotteries for selecting pension managers and allocation of contributors to different portfolios	Medium term
• Upgrade SODRA’s IT systems and eliminate restrictions for enrolling in the second pillar	Short term

c) Housing finance	
• Enhance BoL's capacity to assess real estate market risk	Medium term
• Ensure that the credit risk resulting from variable rates, high LTV and debt to service ratios is taken into account in lending parameters and pricing and in the banks' risk models	Ongoing
• Promote structured finance tools to channel resources to rental investments, including by municipalities	Medium term
d) Other developmental issues	
• Strengthen the consumer protection framework for financial services, focusing on mortgage and consumer loan borrowing and pension investments	Immediate

APPENDIX III. THE LITHUANIA FINANCIAL SYSTEM: STRUCTURE AND SUPERVISORY FRAMEWORK

1. **The Lithuanian financial system is centered on the banking sector and dominated by three foreign-owned banks**. The banking sector comprises nine banks - of which six are subsidiaries of foreign banks - and two branches of foreign banks. Foreign entities account for around 93 percent of the sector's assets; Swedish banks together account for around 62 percent of sector assets. The three largest banks (SEB Vilniaus Bankas, Hansabankas, and DnB NORD Bankas) account for around 69 percent of banking sector assets and have a substantial share of non-bank financial sector assets. The three banks generated three quarters of the 2006 credit growth. All three banks are owned by foreign banks with A+ Standard and Poor's credit ratings.

2. **Until recently, leasing has been the largest segment of the non-bank sector.** There are 12 leasing companies, all subsidiaries of banks, with a total portfolio as of July 1, 2007 of 8.4 billion litas or around10 percent of GDP, growing at an average rate of 48 percent a year over the last six years. Two of the largest leasing companies, Hansa Leasing and SEB Leasing, dominate with 42 and 36 percent of the market respectively. Leasing companies are funded by the direct parent company up to a limit of 75 percent of the capital of the parent company, and by their foreign parent, where applicable, up to 20 percent of the capital. The funding for the two largest companies is mostly in euros. Financial leasing is the most used form of leasing (95 percent of all contracts) largely to the corporate sector. The main categories of leased objects are: (i) heavy vehicles for commercial transport (37 percent); (ii) industrial equipments (30 percent); (iii) cars (18 percent; and 4 percent private/family cars), and (iv) commercial real estate (15 percent).

3. **The non-bank financial sector is still very small but has been growing in recent years.** Since their introduction in 2004, second pillar pension schemes accumulated assets at a rapid rate. The third pillar, however, has attracted less enthusiasm, but the government has introduced recently tax advantage for all third pillar savings. Currently 16 second pillar and six third pillar pension funds operate with total assets of around 280 million litas (81 million euros). Compulsory motor third-party liability insurance, introduced in June 2001, and the introduction of UCITs in November 2004 have also contributed to the growth of the NBFI sector. Finally, the rapid growth of mortgage loans has spurred the growth of mortgage insurance.

Supervisory Framework

4. **The BoL is the banking supervisory authority.** It has the mandate to conduct both individual and consolidated supervision of banks and their financial groups, including domestic banks' foreign subsidiaries. The BoL also has the right to conduct consolidated supervision if the parent company in the financial group is a controlling (holding) company where the group includes a bank licensed by the BoL. The leasing sector is not regulated or supervised except where leasing companies are subsidiaries of banks.

5. **Securities market intermediaries are regulated and supervised by the Lithuanian Securities Commission (LSC)**, including financial brokerage firms, departments, and brokers;

management companies, collective investment undertakings, pension funds, stock exchanges, the Central Securities Depository, as well as listed and non listed public and private issuers, and EU cross-border firms. In 1996, the Securities Commission joined the IOSCO.

6. **The Insurance Supervisory Committee is responsible for the supervision of insurance companies.** However, in line with EU Directives, financial supervision of insurance undertakings of other EU member states, providing their services in Lithuania, or of branches of such undertakings established in the Republic of Lithuania is carried out by a competent authority of this EU member state.

Table 3. Total Assets of Financial Market Participants, 2003-06

In LTL million	2003	2004	2005	2006 1/	Growth (2005-06) (in %)
Commercial banks	22,031	29,151	44,849	52,577	17.2
Credit unions	155	230	379	462	21.8
Leasing companies	2,976	4,399	5,930	…	…
UCITS	…	161	398	602	51.3
Life insurance	401	595	838	1,059	26.4
Non-life insurance	1,010	1,090	1,233	1,409	14.2
Second pillar pension funds 2/	0	127	410	770	87.8
Third pillar pension funds 3/	0	11	37	47	28.7
Stock brokerage enterprises	…	79	111	143	29.1
Management enterprises	…	25	33	45	35.8

Source: Statistics Lithuania
1/ End of Q3 data.
2/ Pension funds accumulating a part of social security contribution.
3/ Pension funds accumulating supplementary voluntary pension contribution.

Table 4. Number of Financial Intermediation Enterprises, 2003–06

Institutions	2003	2004	2005	2006 1/	Growth (2005-06) (in %)
Commercial banks	13	12	12	11	-8.3
Credit unions	58	62	65	67	3.1
Leasing companies	20	18	15	16	6.7
Collective investment undertaking	0	10	19	24	26.3
Life insurance companies	9	9	8	8	0.0
Non-life insurance companies	19	19	17	15	0.0
Pension funds	0	34	34	36	5.9
Stock brokerage enterprises	…	16	14	12	-14.3
Management enterprises	…	9	10	13	30.0

Source: Statistics Lithuania, and ISC.
1/ Provisional data.

Table 5. Ownership of the Banking System, end-2006

Bank	Owner	Legal form	Share in total banking sector assets (%)
DnB NORD Bankas	Bank DnB NORD A/S (Denmark); ultimate owner: DNB NOR Bank ASA (Norway)	Subsidiary	12.7
SEB Vilniaus Bankas	Skandinaviska Enskilda Banken AB (Sweden)	Subsidiary	32.4
Hansabankas	Hansapank (Estonia); ultimate owner: Swedbank AB (Sweden)	Subsidiary	23.9
Parex Bankas	Parex banka (Latvia)	Subsidiary	1.3
Sampo Bankas	Danske Bank (Denmark))	Subsidiary	7.2
Snoras Bankas	Conversgroup (Luxembourg) Holding Company (49.9 percent); ultimate owner: ZAO Conversbank (Russia)	Subsidiary	7.2
Siauliu Bankas	EBRD (16.1 percent)	Domestic	2.3
Ukio Bankas	Mr. Vladimir Romanov (33.0 percent)	Domestic	5.1
UAB Medicinos Bankas	Mr. Saulius Karosas (55.8 percent)	Domestic	0.7
Bayerische Hypo- und Vereinsbank AG	Bayerische Hypo- und Vereinsbank AG (Germany); ultimate owner: Unicredito Italiano Spa (Italy)	Branch	1.7
Nordea Bank Finland Plc Lietuvos skyrius	Nordea Bank Finland Abp (Finland); ultimate owner: Nordea Bank AB (Sweden)	Branch	5.5

Source: Bank of Lithuania.

Notes: The following changes in ownership structure occurred since end-2006. First, in February 2007, Mr. V. Antonov, Chairman of the Supervisory Board of Snoras Bankas and major shareholder of the international financial group Conversbank, acquired 68.65 percent of the registered share capital of Snoras Bankas, becoming the controlling shareholder of the bank. Second, Danske Bank Group's purchase of Sampo Bank from Sampo Group was completed. Danske Bank is now the sole owner of Sampo Bank, and the ultimate owner of Sampo Bankas.

Table 6. Financial Soundness Indicators for the Banking Sector 2002-2007

	2002	2003	2004	2005	2006	June 2007
Capital adequacy						
Regulatory capital to risk-weighted assets [1]	14.7	13.2	12.4	10.3	10.7	10.5
Regulatory tier I capital to risk-weighted assets [1]	12.1	11.1	10.2	8.9	7.8	8.2
Capital to assets [2]	10.5	9.8	8.7	7.2	7.1	7.5
Asset quality						
Nonperforming loans net of provisions to capital [2, 3, 11]	21.1	11.7	12.6	5.7	9.7	8.7
Nonperforming loans to total (non-interbank) loans [11]	5.3	2.4	2.2	0.6	1.0	0.9
Sectoral distribution of loans to total loans [12]	0.0	0.0	0.0	0.0	0.0	0.0
Agriculture, hunting, forestry	2.0	1.8	2.0	2.0	1.9	1.7
Fishing	0.2	0.1	0.1	0.1	0.1	0.0
Mining and quarrying	0.4	0.3	0.2	0.2	0.1	0.1
Manufacturing	21.4	21.8	17.5	15.2	11.9	10.6
Electricity, gas and water supply	7.3	7.6	6.4	4.2	2.5	2.1
Construction	4.0	3.2	2.9	3.9	5.7	5.2
Wholesale and retail trade; repair of motor vehicles, motorcycles; personal and household goods appliances	20.2	19.2	15.7	13.0	12.8	11.0
Hotels and restaurants	1.6	1.7	1.6	1.5	1.6	1.5
Transport, storage and communication	5.0	2.9	2.3	2.6	2.5	2.5
Financial intermediation	10.6	10.7	10.8	14.6	7.3	6.7
Real estate, renting and other business activities	6.8	7.6	9.8	12.5	14.5	15.3
Public administration and defence; compulsory social security	4.3	2.4	4.1	3.3	1.5	1.7
Education	0.2	0.1	0.1	0.1	0.0	0.0
Health and social work	0.4	0.6	0.8	0.5	0.3	0.3
Other utilities, social and personal services	1.4	1.1	0.9	0.7	0.9	0.9
Other types of economic activities	0.0	0.0	0.0	0.0	0.0	0.0
Loans not attributed to economic activities	14.4	18.9	24.9	25.8	36.4	40.4
Residential real estate loans to total (non-interbank) loans	11.2	14.3	18.4	21.2	24.7	26.8
All large exposures to regulatory capital [1, 5]	194.7	213.1	199.6	239.0	189.6	165.6
Earnings and profitability						
Return on equity (Net income to average capital) [2, 4]	9.1	11.8	13.5	13.8	21.4	28.5
Return on assets (Net income to average total assets) [4]	0.9	1.2	1.3	1.1	1.5	2.1
Interest margin to gross income	51.3	49.1	51.0	53.8	54.6	56.1
Noninterest expenses to gross income	82.7	81.6	70.9	66.6	58.7	52.1
Trading and foreign exchange gains (losses) to gross income	14.1	10.3	8.1	7.8	8.5	9.0
Personnel expenses to noninterest expenses	42.0	38.3	37.3	37.4	37.6	40.2
Spread between reference lending and reference deposit rate [6]	5.2	4.2	3.6	3.3	3.5	3.9
Liquidity						
Liquid assets to total assets [7]	29.3	27.7	28.3	26.9	24.1	21.3
Liquid assets to current liabilities [7, 8]	42.0	42.4	41.7	42.9	41.9	38.9
Spread between highest and lowest interbank rate [9]	9.0	3.9	1.7	3.3	2.8	3.9
Customer deposits to total non-interbank loans	132.1	101.7	95.7	83.3	72.5	66.6
Foreign exchange risk						
Foreign-currency-denominated loans to total (non-interbank) loans [10]	51.5	54.6	58.3	65.8	52.8	48.7
Foreign-currency-denominated liabilities to total liabilities [10]	44.5	46.1	45.6	51.6	52.0	53.7
Net open position in foreign exchange to regulatory capital [1, 13]	-1.5	10.8	-1.9	-1.0	-1.4	0.5
Equity risk and exposure to derivatives						
On balance (assets) position in equities to capital [2]	11.7	12.2	12.2	14.9	13.2	9.9
Gross assets position in financial derivatives to capital [2]	0.3	0.5	0.8	1.2	4.5	7.7
Gross liabilities position in financial derivatives to capital [2]	2.0	2.1	0.8	0.7	4.9	6.2

Source: Bank of Lithuania.
1/ Without foreign bank branches.
2/ Capital is defined as banks shareholders' equity and foreign bank branches funds received from the head office.
3/ From end-2005 FSI is Nonperforming loans to capital.
4/ Net income before extraordinary items and taxes.
5/ Large exposure - means loans granted to the borrower the net value of which equals to, or exceeds, 10 per cent of bank capital that is calculated having regard to the national Rules for Calculating Capital Adequacy. In this particular case Loan - means all bank's monetary claims to the borrower, acquired shares (contributions or other portions of equity), reflected in the bank balance-sheet and off-balance sheet items, also monetary obligations of the bank recognised in the bank's off-balance.
6/ Excluding loans and deposits to / from credit and financial institutions.
7/ Composition of liquid assets is defined in the Liquidity Ratio Calculation Rules approved by Resolution No. 1 of the Board of the Bank of Lithuania of 29 January 2004.
8/ Composition of current liabilities is defined in the Liquidity Ratio Calculation Rules approved by Resolution No. 1 of the Board of the Bank of Lithuania of 29 January 2004.
9/ Information is based on interbank deals of all maturities (mostly overnights) made between resident banks in national currency Litas within the last quarter of the period.
10/ From 2005 the major part of foreign currency loans and foreign currency liabilities are in Euros. Due to the Currency board arrangement and pegging Litas to Euro this does not represent such foreign exchange risk as it would be in the other cases.
11/ From end-2005 NPLs are loans with regular payments overdue more than 60 days. Untill 2004 NPLs are loans in Substandard, Doubtful and Loss loans categories.
12/ Credit Registry data from 2005 for sectoral distribution of loans to domestic market.
13/ As defined in Rules for Calculation of Capital Adequacy approved by Bank of Lithuania Board Resolution No. 172 of 21 December 2000.

Note: The 2006 increase in nonperforming loan is related to a bankruptcy of one electronics manufacturer and does not reflect a systemic trend.

Table 7. Financial Sector Indicators, 2002-07 (in percent, unless indicated otherwise)

	2003	2004	2005	2006	Sep-07
Private sector credit (year-on-year change) 1/	56.6	40.3	56.1	51.4	45.8
Claims on private enterprises (in billions of litas)	9.1	11.3	16.1	22.7	28.2
of which: share of foreign currency loans	61.9	64.8	67.9	58.2	54.3
Claims on private enterprises (year-on-year change)	47.9	24.6	42.6	41.1	34.4
Share of claims on private enterprises in total private sector credit	78.0	69.2	63.2	58.9	55.1
Claims on individuals (in billions of litas)	2.6	5.0	9.4	15.8	22.9
of which: share of foreign currency loans	29.2	42.8	54.7	43.9	43.2
Claims on individuals (year-on-year change)	97.8	96.0	86.6	69.2	62.7
Share of claims on individuals in total private sector credit	22.0	30.8	36.8	41.1	44.9
Share of foreign currency loans	54.7	58.0	63.1	52.3	49.3
Official risk indicators					
Nonperforming loans to total gross loans 2/	2.4	2.2	0.6	1.0	0.9
Regulatory capital to risk-weighted assets 3/	13.2	12.4	10.3	10.7	11.3
Liquid assets (Core) to short-term liabilities 4/	42.4	41.7	42.9	41.9	38.9
Financial sector risk factors of deposit money banks					
Share of foreign currency private sector credit in total private sector	54.6	58.0	63.1	52.3	49.3
Share of foreign currency deposits in total deposits	27.1	27.0	28.0	22.4	22.7
Short-term private sector credit in percent of total private sector credit	76.9	81.1	84.5	86.2	87.4
Demand deposits in percent of total deposits	45.1	43.3	38.3	40.7	46.1
Bank profitability 5/					
Return on Assets	1.2	1.3	1.1	1.5	2.1
Return on Equity	11.8	13.5	13.8	21.4	28.5
Market assessment					
Net open position in foreign exchange to capital 6/	10.8	-1.9	-1.0	-1.4	0.5
Total private sector credit (in billions of litai) 7/	11.6	16.3	25.5	38.5	51.1
Total resident deposits (in billions of litai) 7/	13.8	17.2	23.4	28.6	32.3
Average annual interest rate on litas loans to enterprises 8/	6.5	5.7	5.0	5.0	7.1
Average annual interest rate on litas loans to households 8/	7.0	6.4	5.8	5.2	7.6
Average city centre residential prices in Vilnius (annual return) 9/	14.3	37.5	45.5	50	25

Sources: Bank of Lithuania and National Stock Exchange of Lithuania.

1/ Includes credit to private enterprises, households, and nonprofit institutions by monetary authorities, deposit money banks, and other banking institutions.
2/ Includes foreign bank branches. Includes loans overdue for 31 or more days. Unconsolidated data. 2007 data for June.
3/ Foreign bank branches are excluded.
4/ Core liquid assets comprise currency and financial assets available on demand or within 3 months or less. 2007 data for June.
5/ Net income before extraordinary items and taxes. 2007 data for June.
6/ Excluding foreign bank branches. Since June 1, 2000, maximum in foreign currency and precious metals is 25 percent of a bank's capital. Maximum in each currency is 15 percent. 2007 data for June.
7/ From banking survey, including monetary authorities, deposit money banks, and other banking institutions.
8/ Average annual interest rate on 1-3 month loans in litai. From 2005, average annual rate on new 0-1 year loans in litai.
9/ Data for 2007 are for Dec-Aug.

Table 8. Indicators of External and Financial Vulnerability, 2002–07

	2002	2003	2004	2005	2006 Est.	Latest Actual	Date of Observation
Financial indicators							
Broad money (year-on-year change in percent)	19.4	19.4	21.4	31.9	21.5	25.3	Dec. 2006
Broad money in percent of gross official reserves	196.7	196.7	249.4	268.7	239.7	250.1	Dec. 2006
Private sector credit (year-on-year change in percent)	28.3	56.6	40.3	56.1	51.4	45.4	Dec. 2006
External indicators							
Current account balance in percent of GDP	-5.2	-6.9	-7.7	-7.1	-10.9	-13.8	Q1 2007
Exports of GNFS (in millions of U.S. dollars)	7,510	9,536	11,749	14,880	17,747	4,475	Q1 2007
Exports of GNFS (year-on-year change in percent)	24.2	27.0	23.2	26.6	19.3	15.0	Q1 2007
Imports of GNFS (year-on-year change in percent)	24.0	28.0	25.3	25.7	24.4	22.7	Q1 2007
Capital and financial account balance in percent of GDP	4.2	6.0	6.8	7.3	11.6	16.8	Q1 2007
Gross official reserves (in millions of U.S. dollars) 1/	2,413	3,450	3,594	3,816	5,773	5,645	Q1 2007
Gross official reserves/short-term debt 2/	0.8	0.8	0.7	0.5	0.6	0.5	Q1 2007
Gross official reserves/short-term debt 3/	1.1	1.1	1.0	0.8	1.0	1.0	Q1 2007
Gross official reserves/reserve money	151.8	143.2	128.0	122.8	140.2	137.2	June 2007
Gross official reserves in months of imports of GNFS over the following	2.7	3.1	2.6	2.2	2.9	3.8	Q1 2007
Total gross external debt (in millions of U.S. dollars)	6,199	8,338	10,472	12,560	18,918	20,645	Q1 2007
in percent of GDP	43.9	44.9	46.5	48.9	63.5	56.6	Q1 2007
of which: Public sector debt (in millions of U.S. dollars)	2,429	2,793	3,136	2,879	3,995	3,991	Q1 2007
in percent of GDP	17.2	15.0	13.9	11.2	13.4	10.9	Q1 2007
of which: Short-term external debt (in millions of U.S. dollars) 3/	2,123	3,277	3,766	4,872	5,709	5,689	Q1 2007
in percent of gross international reserves	88.0	95.0	104.8	127.7	98.9	100.8	Q1 2007
in percent of GDP	15.0	17.7	16.7	19.0	19.2	15.6	Q1 2007
of which: excluding short-term liabilities of commercial banks	1,379	1,829	1,999	2,241	2,525	2,509	Q1 2007
Total net external debt (in millions of U.S. dollars) 4/	4,463	6,202	7,112	8,198	12,902	14,459	Q1 2007
in percent of GDP	31.6	33.4	31.6	31.9	43.3	39.7	Q1 2007
of which: Public sector debt (in millions of U.S. dollars)	2,429	2,793	3,136	2,879	3,995	3,991	Q1 2007
in percent of GDP	17.2	15.0	13.9	11.2	13.4	10.9	Q1 2007
Total net external short-term debt (in millions of U.S. dollars) 5/	740	1,452	1,431	2,150	2,501	2,449	Q1 2007
in percent of GDP	5.2	7.8	6.4	8.4	8.4	6.7	Q1 2007
Real effective exchange rate (year-on-year change in percent, "+" = appreciation) 7/	4.8	3.4	0.9	3.6	1.5	1.5	2006
Financial market indicators							
Stock market index, end of period 8/	85	174	289	449	493	520	Aug 16, 2007
Foreign currency debt rating 9/	BBB	BBB+	A-	A	A	A	Aug 16, 2007
Memorandum item:							
Nominal exchange rate (litai/U.S. dollar, end-of-period)	3.3	2.8	2.5	2.9	2.6	2.5	Jul. 2006
Nominal exchange rate (litai/euro, end-of-period)	3.5	3.5	3.5	3.5	3.5	3.5	Aug 16, 2007

Sources: Bank of Lithuania, Ministry of Finance, Department of Statistics, National Stock Exchange of Lithuania, Bloomberg, Information Notice System, and IMF International Financial and Trade Statistics.
1/ Gross official reserves reported here differ from the monetary table due to valuation differences.
2/ On an remaining maturity basis, estimated as short-term debt at year-end plus amortization of medium- and long-term debt of the following year.
3/ On an original maturity basis.
4/ Gross external debt minus debt securities held abroad and other investments abroad.
5/ Short-term gross external debt excluding trade credits and currency and deposits held abroad.
6/ Debt service comprises interest and repayment on external loans, and interest and repayment on debt securities.
7/ CPI-based REER against the 17 major trading partners in 2000.
8/ VILSE index.
9/ S&P investment grade rating.