



LITHUANIA: REVIEW OF THE FINANCIAL SYSTEM

November 2017

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

FOREWORD

This review of the financial system in Lithuania was prepared by the OECD Committee on Financial Markets (CMF) as part of the process of Lithuania's accession to the OECD.

On 9 April 2015, the OECD Council decided to open accession discussions with Lithuania and on 8 July 2015, the Council adopted the Roadmap for the Accession of Lithuania to the OECD Convention [C(2015)92/FINAL], which sets the terms, conditions and process for accession to the Organisation. In the Accession Roadmap, the Council requested a number of OECD Committees including the CMF to carry out an evaluation of Lithuania in their area of expertise.

The CMF reviewed Lithuania's financial system, including its market and regulatory structure, to assess whether it is market-oriented and sufficiently open, efficient and sound, based on high standards of transparency, confidence and integrity.

This report was finalised on the basis of information available as of 30 June 2017.

TABLE OF CONTENTS

I. Financial infrastructure.....	6
A. Monetary policy framework.....	6
B. Payment Systems.....	6
II. Banking system: structure and operations.....	7
A. Financial institutions and financial groups.....	7
B. Concentration of the banking system.....	9
C. Credit Unions.....	10
III. Capital markets: structure and operation.....	13
A. Recent developments.....	13
B. Capital market intermediaries.....	13
C. Custody, clearing and settlement.....	15
IV. Financial supervision and regulation.....	16
A. Institutional arrangement for supervision and regulation of financial market and intermediaries.....	16
B. Supervision of financial institutions.....	19
C. Financial stability oversight and macroprudential surveillance.....	24
D. Financial consumer protection and education.....	30
E. International surveillance assessment (2008).....	33
V. International financial integration.....	34
A. Market access for foreign institutions and investors.....	34
B. Securities and other financial market instruments.....	37
VI. Compliance with the OECD legal instruments on financial markets.....	37
ANNEX.....	39
I. Overview.....	39
A. Macroeconomic context.....	39
B. Recent trends in financial markets.....	40
II. FSAP Recommendations.....	43

Tables

Table 1.	Lithuanian Banking Sector: Loan and Deposit Market Shares.....	9
Table 2.	Issuance of private sector bonds by domestic and foreign entities in Lithuania.....	14
Table 3.	Domestic and foreign institutional investors in Lithuania.....	14
Table 4.	Macroprudential Instruments in Lithuania.....	24
Table 5.	Breakdown of Lithuanian banking system assets.....	34

Figures

Figure 1.	SEPA MMS Transaction Volume.....	6
Figure 2.	KUBAS Payment System Transaction volume.....	7
Figure 3.	Lithuanian financial system: breakdown of assets.....	8
Figure 4.	Banking sector market shares by total assets.....	10
Figure 5.	Composition of Credit Union assets in Lithuania (EUR m).....	11
Figure 6.	Bank of Lithuania Organisation Chart.....	17

Figure 7.	Capital adequacy ratio of larger banks in Lithuania	20
Figure 8.	Capital adequacy and liquidity ratios based on stress testing scenarios	25
Figure 9.	Financial products risk map.....	31
Figure 10.	Private sector debt and house prices in Lithuania	40
Figure 11.	Capital adequacy and asset quality in Lithuania.....	41
Figure 12.	Bank profitability ratios and net interest margins.....	41
Figure 13.	Lithuanian banking sector: liabilities to parent banks and deposits	42

Boxes

Central Credit Union of Lithuania	12
Bank failures in Lithuania.....	27
The Deposit Insurance Fund of Lithuania (Lietuvos Indėlių draudimo fondas).....	28

I. Financial infrastructure

A. Monetary policy framework

On 1 January 2015, Lithuania joined the euro area and Lietuvos bankas (Bank of Lithuania, BoL) became a member of the Eurosystem. The Law on the BoL forms the legal basis for BoL and its operations, prescribing its status, structure, functioning and governance. The Law on the BoL prescribes that the Government and State institutions must respect the independence of the BoL and must not seek to influence the BoL and its staff in the discharge of their duties. The Law on the BoL provides legal protection to the Board and its staff in carrying out their duties in financial market supervision, unless it is proven that they undertook an illegal action and damage was caused through intent or gross negligence.

After the introduction of the euro, the structure of the BoL's balance sheet has been adjusted in accordance with the requirements defined by accounting and reporting guidelines adopted by the Governing Council of the ECB (ECB/2010/2 (2011/68/EU) under Article 26.4 of the Statute of the ESCB, as applicable to all Eurosystem central banks for the purpose of financial reporting.

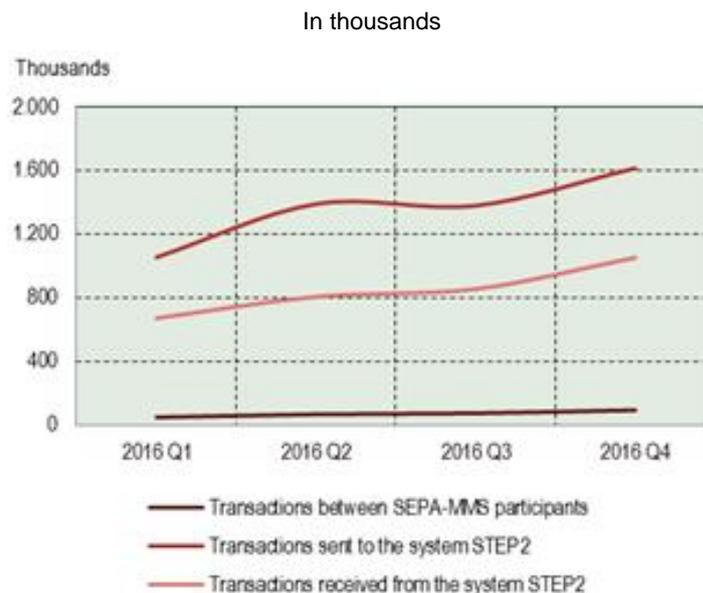
B. Payment systems

There are three payment systems operating in Lithuania, two of them operated by the BoL (TARGET2-Lietuvos Bankas and SEPA-MMS) and a third one operated by the Lithuanian Central Credit Union (KUBAS). More than 95% of retail domestic interbank payments are, however, processed in the pan-European retail payment system, STEP2 operated by EBA Clearing.

TARGET2-Lietuvos Bankas is a real-time gross settlement system in euro and is a component system of the Eurosystem's TARGET2 payment system.

In 2016, Lithuania joined the Single Euro Payments Area (SEPA). SEPA-MMS is a retail payment system owned and operated by the BoL in line with SEPA requirements. Risk management measures are in place to ensure the system's stability and to address credit, liquidity and operational risk.

Figure 1. SEPA MMS Transaction Volume



Source: Lithuanian Authorities.

BoL oversees SEPA-MMS and together with the Eurosystem participates in the oversight of TARGET2. The oversight of payment systems by the BoL is performed according to ECB regulation. Also, in accordance with the CPSS-IOSCO Principles for Financial Market Infrastructures. Importantly, in accordance with the framework, separate structural units of the BoL operate and oversee the payment systems.

KUBAS is a secondary payment system for credit unions, owned and operated by the Lithuanian Central Credit Union. The system is currently under review to evaluate whether it meets the definition of a payment system in accordance with the ECB requirements.

Figure 2. KUBAS Payment System Transaction volume
In thousands



Source: Lithuanian Authorities.

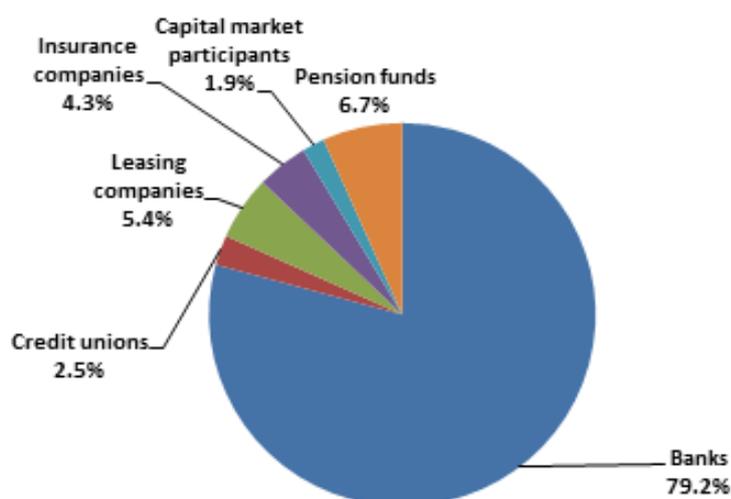
II. Banking system: structure and operations

A. Financial institutions and financial groups

The Lithuanian financial system is dominated by banks offering basic retail banking services, leasing, and insurance services. All six Lithuanian banks are retail banks that do not engage in cross-border activities. Eight branches of EU banks are registered (seven of them already operate and one is preparing to launch its operations) in Lithuania and specialise in corporate loans, leasing, or have a retail business model. Bank assets account for 79.2% of the financial system as of 2016. Credit unions provide retail financial services (loans, transaction banking) to their members and account for 2.0% of total financial system assets as of December 2016 (2.5% including the Central Credit Union).

The BoL has been the single supervisory authority for all financial markets and institutions in Lithuania since 2012, supervising credit institutions, insurance and securities, payment and electronic money institutions, and most of other financial institutions operating in Lithuania. The supervision of the financial system is performed according to the Law on the BoL, the Law on Banks, the Law on Financial Institutions, the Law on Payment Institutions, the Law on Electronic Money and Electronic Money Institutions, the Law on Credit Unions, The Law on Central Credit Unions, the Law on Insurance, the Law on Consumer Credit, and the Law on Markets in Financial Instruments.

Figure 3. Lithuanian financial system: breakdown of assets, 2016



Source: Bank of Lithuania, as of end 2016. Capital Market Participants comprise of financial brokerage, collective investment undertakings, investment holding and management companies.

While services such as commodity derivatives are available from Lithuanian banks, retail banking services represent the bulk of their operations. The majority of Lithuanian banks' income comes from loans (68%), while deposits account for the largest share of liabilities (80%, mostly current accounts).

Loans to small and medium-sized enterprises (SMEs) represent 43% of total loans to non-financial corporations, or 20% of the total loan portfolio of banks. Non-financial corporations receive 47.7% of total loans, while 44.6% of total loans are extended to private persons, out of which 79.6% are residential mortgages. Lending to SMEs is of greater importance to smaller banks, for which loans to SMEs represent 87% of their total non-financial corporation loan portfolio. The majority of SME credit products are term loans, credit lines and overdrafts.

The Lithuanian banking sector comprises six privately held domestically chartered banks and eight branches of EU banks, along with 73 credit unions. Three of the subsidiaries of foreign-owned banks are owned by Nordic parent groups (SEB, Swedbank, DNB) and AB "Citadele" bankas is also a foreign subsidiary fully-owned by the parent bank. The bank subsidiaries and branches belonging to Nordic parent groups account for 89.5% of total banking sector assets and 91.4% of total system lending, as of end of 2016. AB Šiaulių bankas is listed on the NASDAQ Vilnius market, with the EBRD (18.2%), AB Invalda Invl (6.8%) and Mr. Gintaras Kateiva (5.8%) as the main investors. The largest shareholder of UAB Medicinos Bankas is Mr. Saulius Karosas, holding an 89.9% stake.

Leasing services in Lithuania are provided by the banks directly or by leasing companies owned by banks or by other companies that are not supervised by the BoL. A few banking groups in Lithuania have simplified their structure by taking over the assets of their own leasing companies (AB SEB bankas in 2013 and AB DNB bankas in 2015). Almost all subsidiaries are fully owned and most of them provide either financial (leasing, venture capital, investment management services, insurance) or auxiliary services (property management). Investments in subsidiaries are insignificant for Lithuanian banks, representing a total investment of EUR 268 million or 1.4% of total bank assets.

There are no restrictions on bank cross-sector investments in the financial sector, although Lithuanian banks are prohibited from engaging in non-financial activities. The local interbank market is not active, and as such, the level of interconnectedness between domestic banks is low. In terms of cross-sector activities, bank groups are extensively engaged in the statutory private pension savings market, the leasing market and the insurance market, either directly or through companies belonging to the parent company.

Other market participants include insurance, credit providers, payment institutions, e-money institutions and brokerage firms, which are mainly engaged in the provision of specialised financial services. Financial brokerage and investment management companies represent a very small part of the institutional investment market. In terms of broker/dealer services, six financial brokerage firms operated in Lithuania in 2015, of which only one was allowed to deal on its own account. Over 2015, one financial brokerage firm license was issued and three licenses were terminated: MRC Markets terminated based on a shareholder request, AB Finasta following its merger with AB Šiaulių bankas and UAB FMĮ FINVESTA following a number of violations (precluding the BoL from effectively supervising the financial brokerage company, failure to ensure the protection of entrusted client assets, provision of misleading information to clients by unqualified managers).

The private pension funds sector is becoming an increasingly important part of the system, accounting for 6.7% of total financial sector assets (as of end-2016); the share of pension funds has been growing steadily since the establishment of the pension fund system in 2003. The total assets of insurance companies have been growing at a slow pace in recent years, reaching 4.3% of total financial system assets in end-2016. Collective investment undertakings comprise less than 1% of the system.

B. Concentration of the banking system

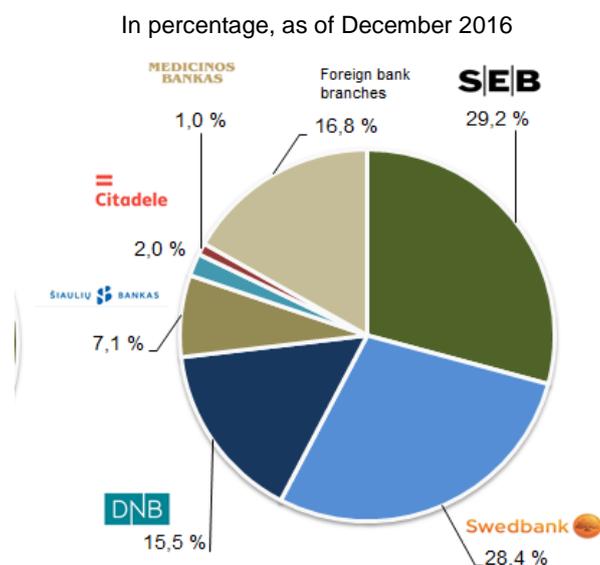
There is some concentration of the banking sector, with three dominant banks accounting for almost ¾ of the entire sector in terms of assets: AB SEB bankas, “Swedbank”, AB and AB DNB bankas account for a combined 73.1% of assets, 71.3% of loans and 75.2% of deposits as of Q4 2016. In Q2 2016, Swedbank finalised the acquisition of the Danske branch retail business.

Table 1. Lithuanian Banking Sector: Loan and Deposit Market Shares

	SEB bankas	Swedbank, AB	AB DNB bankas	Nordea Bank AB Lithuania Branch	AB Šiaulių bankas	Danske Bank A/S Lithuania Branch	OP Corporate Bank plc Lithuania Branch	AB "Citadele" bankas	UAB Medicinos bankas
Loans & advances	5.4	4.6	2.9	2.3	1.0	0.7	0.6	0.3	0.1
<i>% of total</i>	29.5%	25.7%	16.1%	12.6%	5.8%	4.0%	3.1%	1.5%	0.8%
Deposits	5.2	6.5	2.5	1.3	1.6	1.0	0.1	0.4	0.2
<i>% of total</i>	27.5%	34.5%	13.2%	6.6%	8.3%	4.7%	1.3%	2.2%	1.2%

Source: Bank of Lithuania

Figure 4. Banking sector market shares by total assets



Source: Bank of Lithuania.

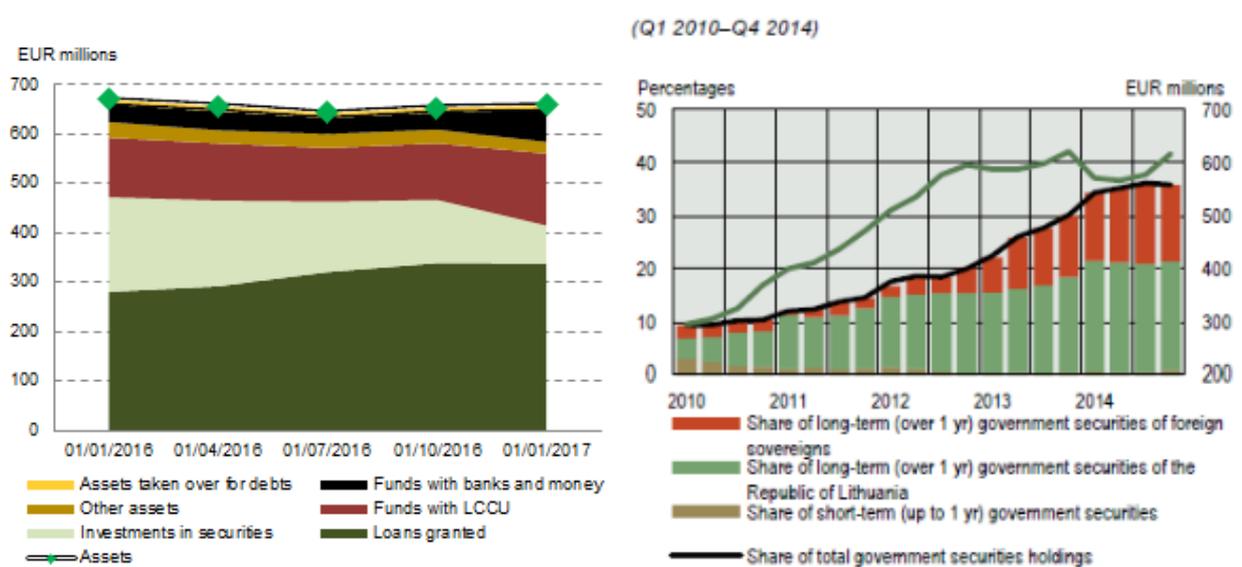
Given the bank-centric financing of Lithuania, the Government launched an initiative in 2015 to increase access to alternative financing and strengthen competition in the financial sector. The BoL, the Ministry of Finance and the Ministry of Economy have submitted a set of proposals and amendments of legal acts covering crowdfunding, public offerings and private placements, regulation concerning the protection of interests of limited liability companies' bondholders, and improvement of the regulatory framework for collective investment funds as well as stock options for employees. The laws on the protection of interests of limited liability companies' bondholders and public offering of private limited liability companies' bonds were approved by the Seimas in June 2016 (effective from 1 November 2016) which will enable more diverse alternative financing sources.

C. Credit Unions

Credit unions represent a small part of the Lithuanian financial system, with 2.6% of the banking system's total assets (about EUR 658.5 million as of Q4 2016), and are focused on financing local SMEs and individuals. They provide loans and retail deposit services and are largely funded by deposits (89.7% of assets funded by deposits as of 1 January 2017). Members are attributed to a credit union based on their residence (employed or studying within the territory of a municipality of Lithuania), on the type of economic activity performed, or on their membership in a trade union/association.

The number of credit unions has grown from 65 to 73 and total assets have increased almost 770% in the past 10 years. Total membership has risen to 163,100 members. The growth is mainly concentrated among the top ten largest credit unions, which account for almost half of total credit union assets. Of the 73 credit unions in operation as of 1 January 2017, 61 are members of the Lithuanian Central Credit Union, while 12 operate independently. In 2016, credit union assets decreased by 1.8% and, as of 1 January 2017, amounted to EUR 658.5 million, or 2.6% of the banking system's assets (vs. 2.8% as of 1 January 2016). The annual change in the credit union sector assets was driven by the suspension of operations of *AMBER* credit union from the market.

Figure 5. Composition of Credit Union assets in Lithuania and investment in government securities (EUR million)



Source: Bank of Lithuania, Review of the activities of Lithuanian credit unions, 2017.

Although small in absolute terms, the credit union sector has nonetheless posed risks to the financial sector, with a credit underwriting policy that was not robust, poor risk management practices and inappropriate governance of certain credit unions. These weaknesses have increased the volumes of non-performing loans and have led to significant asset depreciation. Six credit unions have gone bankrupt since 2013, resulting in insured deposit payments of EUR 134 million. Additionally, in 2016, insolvency concerns led to the withdrawal of the license and suspension of operations of the *AMBER* credit union.

Reflecting these failures, the Law on Credit Unions was amended in July 2014, aimed at strengthening the capacity of Lithuanian credit unions to absorb losses by strengthening their capital base, as well as improving their risk management. In 2015, the Parliament’s Committee on Budget and Finance approved the “Sustainable concept of credit unions”. It analyses the reasons why the credit union sector should be restructured, the objectives and expected results of such restructuring and the principles for its implementation. The Ministry of Finance and the BoL drafted legislation necessary for the implementation of the sector’s fundamental reform, which was approved by the Seimas in June 2016.¹

The revised Law on Credit Unions (effective from 1 January 2017 with some articles effective from 1 January 2018), establishes a clear mission for credit unions’ activities, promotes the effective functioning of a cross-guarantee system, and strengthens cooperation and integration of credit unions, regulates their capital and enhances management and self-regulation. According to the new Law on Central Credit

¹ In December 2016, a comprehensive independent review of the credit unions’ assets was completed with the assistance of audit companies. The objective of the review was to assess the financial situation of credit unions prior to the implementation of the changes proposed in the structural reform of the credit union sector, ensuring that the new credit union system starts its operations having addressed legacy problems, and to encourage mutual trust between the credit unions. The review concluded that some credit unions had overly risky loan portfolios and deteriorated asset quality. Credit unions have managed to improve their capital positions following the review, by either providing additional information for loans with insufficient documentation, or by securing additional collateral for riskier loans.

Unions, it will be possible to establish additional Central Credit Unions (Central Organisations Uniting Credit Unions or COUCUs) and all credit unions will be required to either join one of the central credit unions or convert into a specialised bank by January 2023 (see Box 1).

Box 1. Central Credit Union of Lithuania

Membership in the Lithuanian Central Credit Union (LCCU) by individual credit unions is voluntary, and LCCU currently has 61 member credit unions (as of 1 January 2017). The LCCU's management bodies are composed of representatives of credit unions (LCCU members). Its objective is to protect the interests of its members, represent and promote their activities, and in certain circumstances provide financial support. LCCU proposes legal acts regulating the activities of credit unions, consults with members, organises trainings, provides methodological assistance, and establishes necessary forms and rules for standardised document processing, information systems and financial statements.

The LCCU's main function is to ensure liquidity and solvency for its members and to maintain the stability of the credit unions' system. To that end, LCCU has formed the Liquidity Maintenance Reserve and the Stabilization Fund which can be used for liquidity and solvency support of LCCU members, when necessary. Loans are granted to credit unions when their liquidity falls below the established liquidity ratio or there is a mismatch between assets and liabilities. The Stabilization Fund of Credit Unions acts as the lender of last resort for credit unions with impaired solvency positions and is formed by LCCU members' contributions (proportionate to their credit rating/risk). In practice, the funds accumulated in the Liquidity Maintenance Reserve and the Stabilization Fund are insufficient to address larger issues in the credit unions system.

LCCU also provides software to its members, including a unified accounting and reporting system for reporting to the BoL. Payments among credit unions are made through the LCCU payment system.

LCCU is also responsible for the monitoring of its members, carrying out onsite inspections and providing information, suggestions and recommendations to the BoL on potential irregularities and non-compliance with prudential requirements. Unfortunately, this function has not always been performed properly: By being both the supervisor (identifying and reporting issues to the BoL) and the authority responsible for resolving issues arising in the sector, the LCCU faces potential conflicts of interest. The self-regulation mechanism applying to LCCU was deemed ineffective by the BoL, as it supervises credit unions while it is itself a group of credit unions.^a The non-mandatory character of membership introduced added complexity, while the exclusive right of LCCU to engage in such activity restricted market competition. A comprehensive systematic reform of the credit union sector was prepared and was approved by the Seimas on 30 June 2016.

Following the implementation of the amended Law on Central Credit Unions, it will be possible to establish additional central credit unions (COUCUs) and membership of credit unions to a CCU will be required unless the credit union chooses to convert into a specialised bank by January 2023. The BoL will supervise the COUCUs and ensure the adequacy of the COUCU-coordinated self-regulation of the sector.

a. Bank of Lithuania discussion paper on the reform of the credit union system (2015).

Credit unions are governed by a Board of Directors and a Chief Executive Officer, the General Meeting of their members and a Supervisory Board (optional), as prescribed by the credit unions statutes, the Civil Code, the Law on Financial Institutions, the Law on Credit Unions and the Law on Co-operative Societies. Under the revised Law on Credit Unions, each credit union must have in place a standing Internal Audit Committee. The credit unions' internal controls systems are required to have adequate internal information systems, internal regulations on responsibilities and competencies of staff, internal controls for operating processes, and management information, risk control and risk management systems.

III. Capital markets: structure and operation

A. Recent developments

The Ministry of Finance plans government securities auctions in the domestic market, performed through weekly auctions, syndication, private placement or retail intermediation (savings notes). The auctions are carried out via AB NASDAQ Vilnius. Only banks and financial brokerage companies that meet the requirements set by the Ministry of Finance and sign Auction Participant Agreements with the Ministry of Finance can participate in the auctions. At the end of 2016, nine banks had signed the Government Securities Auction Participant Agreements, of which 6 were resident in Lithuania. The funds borrowed on behalf of the State are obtained and repaid through the BoL, the fiscal agent of the State.

Short and medium-term (up to 10 years) sovereign borrowing is raised in the domestic market and medium and long-term borrowing in the international capital markets. Municipalities do not issue bonds.

In 2016, EUR 900 million was raised at government security auctions in the domestic market (approx. EUR 18 million raised in each auction). At the end of 2016, the outstanding value of bonds issued in the domestic market (at nominal value and excluding savings notes) was EUR 3.04 billion. Savings notes are distributed via a specialised site (www.vtl.lt), Lithuanian post offices (until September 2015), and Lithuanian banks (AB DNB Bankas, SEB Bankas AB and Swedbank AB). In 2015, EUR 0.2 billion of savings notes (nominal value) were distributed and EUR 0.4 billion of savings notes (nominal value) were outstanding (representing 18.3% of total funds borrowed on the domestic market for the year 2015 and 13.3% of outstanding domestic government securities as of year-end 2015).

B. Capital market intermediaries

AB NASDAQ Vilnius is the only regulated market in Lithuania, offering trading, listing and information services, and is part of the NASDAQ Baltic Market. NASDAQ Vilnius provides trading on the regulated market in equities, debt securities and investment fund units and conducts primary placement auctions of Lithuanian Government bonds. In 2015, NASDAQ Vilnius launched the alternative market First North, which has a multilateral trading facility status.

The market capitalisation of AB NASDAQ Vilnius Stock Exchange was EUR 6.8 billion (17.6% of GDP) as of 30 December 2016, with a total turnover of shares traded in 2016 of EUR 86.9 million. However, the financing of companies through share offerings has been limited and bank lending remains the main source of corporate financing. As of January 2017, 28 issuers were listed on AB NASDAQ Vilnius, out of which 23 issuers are domestic companies (5 of them state-owned) and 5 are foreign-owned. The Main List consists of 13 companies, the Secondary List consists of 14 issuers, and 1 company is listed on the Bond List. Five open-ended funds are also listed on the AB NASDAQ Vilnius Fund list.

Since 2011, three Lithuanian companies have successfully listed their shares in the Warsaw Stock Exchange (AviaAM Leasing AB, AB Inter RAO Lietuva and AB Avia Solutions Group) raising a total of EUR 69 million.

No restrictions apply to foreign legal entities and individuals wishing to invest in stock companies of Lithuania, except for investments in strategic or high importance national security companies where special security measures apply to both foreign and domestic investors.

Over the last six years, 304 corporate bond (bond and structured securities) issues were issued by banks. The issuance of bonds has declined in the past 6 years, with only one bank issuing short-term bonds for an amount of EUR 7 million in 2016, compared to EUR 337 million raised by seven listed companies

in 2011. The outstanding level of bonds was EUR 25 million as of year-end 2016, held by two foreign-owned banks.

Table 2. Issuance of private sector bonds by domestic and foreign entities in Lithuania

Year	Number of issues	Attracted funds, EUR million
2011	113	335.0
2012	60	210.8
2013	63	191.4
2014	48	122.6
2015	18	32.7
2016	2	7.0

Source: Bank of Lithuania.

The role of domestic and foreign institutional investors in the Lithuanian economy has been growing. The assets of the statutory supplementary pension funds and personal pension funds² have grown as a result of the increase in the number of members, the rise in global asset prices, increased contributions, and the decrease in the amount of deduction from contributions paid on behalf of participants. Membership growth in the voluntary personal pension funds is expected to continue at a rapid pace given the growth in household income, the decline in interest rates offered by credit institutions and further improvements in financial education at the household level.

Table 3. Domestic and foreign institutional investors in Lithuania

Institutional investors	Investments as at 31 December 2016 (in EUR million)	% of GDP	Year-on-year % change
Banks	1 845.7	4.8%	-10.7%
Domestic	650.2	1.3%	1.8%
Foreign	1 195.5	3.1%	-16.3%
Credit unions	76.8	0.2%	-59.9%
Insurance companies	1 194.3	3.1%	19.5%
Domestic	43.5	0.1%	6.3%
Foreign	1 150.8	3.0%	20.1%
Statutory supplementary pension funds	2 487.2	6.4%	17.3%
Personal pension funds	79.5	0.2%	29.2%
Collective investment undertakings	189.5	0.5%	-16.3%
Collective investment undertakings for informed investors	372.1	1.0%	150.1%

Source: Bank of Lithuania, Ministry of Finance of Lithuania.

Assets managed by collective investment undertakings (CIU) (mutual funds, UCITS, unit investment trusts, etc.) have followed a downward trend for several years, owing in part to the funds' performance falling short of participants' expectations, funds merging and a number of them exiting the market. At the

² Statutory supplementary pension funds in Lithuania consist of statutory private pension savings in individual accounts; occupational pensions are non-existent. Otherwise, there are the social assistance-based minimum retirement benefits and contributory earnings-related social insurance pensions.

same time, assets managed by CIUs for informed investors increased threefold in 2015, supported by the Law on Collective Investment Undertakings for Informed Investors and favourable tax regime applicable to these CIUs.

There is limited use of derivatives in Lithuania. Those contracts that do exist are mostly serving hedging purposes. Derivatives are usually provided by banks to clients or used for their own risk management purposes, but the amounts outstanding are rather small (EUR 134 million or 0.6% of the total bank balance sheet). A derivative position concluded with a client is closed by a mirror transaction with the parent entity of the bank. Pension funds can invest in derivatives solely for risk management purposes. Management companies can use derivatives only where the pension fund rules specify which derivative can be used by the management company and for what purposes. Each derivative must be based on a concrete investment transaction/investment position.

C. Custody, clearing and settlement

Trading and settlement of shares listed on NASDAQ Vilnius takes place in euros. NASDAQ Vilnius uses the INET technology for trading of equities (INET trading system) and fixed-income products (Genium INET system).

The Securities Settlement System (SSS) operated by the Central Securities Depository of Lithuania (CSDL) is the only SSS in Lithuania. The CSDL is a public company operating in accordance with the Law on Markets in Financial Instruments, the Company Law and its by-laws. The CSDL is 100% owned by Latvian Central Depository, which belongs to the NASDAQ Nordic Ltd. The CSDL is supervised as an institution and its SSS is overseen by the BoL. The CSDL has bilateral links with the Estonian and Latvian CSDs and unilateral links with the international CSD Clearstream Banking Luxembourg and the Polish CSD.

The SSS of the CSDL was launched in 2004; it is designated under the Law on the Settlement Finality in Payment and Securities Settlement Systems and operates under the Rules of the Securities Settlement System of the CSDL approved by the board of the CSDL. The SSS provides settlement services both for securities transactions executed on the Stock Exchange and over-the-counter. Government securities auction, public sales of shares, tender offer and public offering of shares related transactions are settled in the SSS as well. In the SSS, securities transactions are settled on a delivery-versus-payment (DVP) basis with intraday finality in central bank money. Real time settlement of free-of-payment (FOP) transactions is offered in the SSS as well.

The SSS, together with the TARGET2-LIETUVOS BANKAS payment system operated by the BoL, provide facilities to settle securities transactions in real time. It applies the DVP principle to all securities transfers against payment. The securities and cash legs of securities transactions, except automatically matched trades concluded on the Stock Exchange, are settled on a gross basis (DVP Model 1, BIS Report) in real time. The cash leg of automatically matched trades concluded on the Stock Exchange is settled on a net basis and the securities leg on a gross basis (DVP Model 2, BIS Report). The latter type of transactions is settled once a day.

IV. Financial supervision and regulation

A. Institutional arrangement for supervision and regulation of financial market and intermediaries

The BoL has been the single supervisory authority for the financial market in Lithuania since January 2012, following the merger of three institutions supervising banking, insurance and capital markets. It is the supervisor of credit institutions, insurance and securities markets, payment and electronic money institutions, and most of other financial institutions operating in the country.

The BoL is managed by its Board, and governed by the Treaty on the Functioning of the EU (TFEU), the Protocol on the Statute of the European System of Central Banks and of the ECB annexed to the TFEU and other relevant EU legislation. The BoL is also governed by national legislation in as much as it is in compliance with the abovementioned Treaty. As of 2014, the Lithuanian Constitution, the BoL Law and the Law on the National Audit Office are fully compatible with Articles 130³ of the TFEU that legislate the independence of central banks.

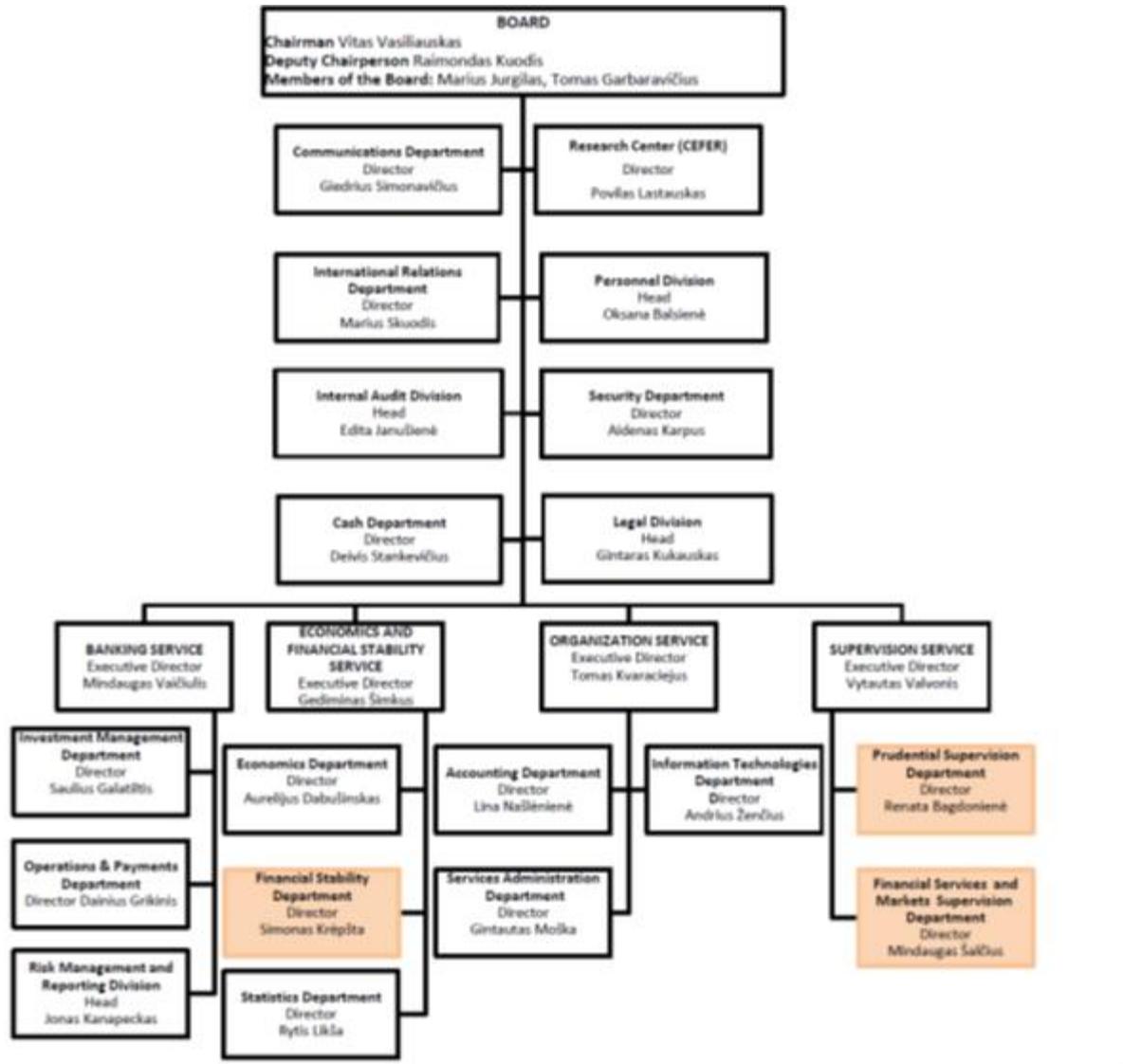
The operations of the BoL are conducted by four services: (i) Supervision; (ii) Economics and Financial Stability; (iii) Banking; and (iv) Organisation. There are four additional departments and three autonomous divisions: (i) International Relations; (ii) Security; (iii) Legal; (iv) Personnel; (v) Communications; (vi) Cash and (vii) Internal Audit.

Macroprudential supervision is performed by the Financial Stability Service department of the BoL, which falls under the Economics and Financial Stability Service.

The Supervision Service of the BoL performs both prudential and market conduct supervision of financial markets. It consists of two separate departments: the Prudential Supervision Department (PSD) conducting prudential supervision and the Financial Services, and Markets Supervision Department (FSMSD) responsible for market conduct supervision. Both departments are directly accountable to the Director of the Supervision Service. Each of the two departments is led by its own director and follows detailed internal regulations on their mission, functioning, organisational principles, rights and responsibilities focusing on prudential or market conduct supervision, respectively.

³ When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks.

Figure 6. Bank of Lithuania Organisation Chart



Source: Bank of Lithuania, as of 16 January 2017.

The Governor of the BoL is accountable to the Seimas and as such is required to submit audited annual financial statements to the Seimas. In addition, the Governor presents reports to the Seimas biannually on the implementation of the objectives of the Bank, the performance of its functions and developments in financial markets. The BoL reports its activities to the public via its annual report. Pursuant to a 2014 amendment to the Law on the National Audit Office, the latter may perform an audit on the activities of the BoL, with the exception of the execution of tasks of the European System of Central Banks and the Eurosystem.

The Board of the BoL comprises a Chairperson (the Governor), two Deputy Governors and two Members of the Board. Only citizens of Lithuania that have not reached the age of 65 may be appointed Governor, Deputy Governor or Member of the Board of the BoL.

The Governor is appointed for a term of five years by the Seimas (Parliament) of Lithuania, on the recommendation of the President of the Republic. The Governor might be dismissed by the Parliament

prior to expiration of his term in office, on the recommendation of the President of the Republic. Deputy Governors and Members of the Board of the BoL are appointed for a term of six years and might be dismissed prior to the expiration of their term of office by the President of the Republic on the recommendation of the Governor. The Governor, deputy Governors and members of the Board can be dismissed prior to the expiration of their term of office only if they no longer fulfil the conditions required for the performance of their duties or if they have been found guilty of misconduct.

The Governor of the BoL may be appointed to his/her position for an unlimited number of terms of office, provided the age limit is not breached (age of 65), while the Deputy Governors and Members of the Board may be appointed to their respective positions for no more than two consecutive terms. According to the Law on the BoL, the Governor's salary can be equal to five average monthly salaries of the employees of monetary intermediation institutions announced by the Department of Statistics to the Government of Lithuania. The salaries of the Deputy Governor and Board Members are established by the Board of the BoL and cannot exceed 90% of the Governor's salary. The Governor and the Board Members of the BoL are entitled to a severance pay of a maximum of 5 average monthly salaries upon the expiration of their term of office.

Financial market supervision performed by the BoL is financed by supervisory fees levied on financial institutions and by funds of the Bank of Lithuania. The activities of the financial sector resolution authority (BoL) are financed by mandatory contributions of financial market participants.⁴ Supervised financial market participants are required to pay contributions based on calculations set out in Annex 1 of the Law on the BoL. The level of contributions for a particular year is established by the BoL following consultation with the financial market participants, taking into consideration risk-based supervisory activities. The detailed methodology of the calculation of contributions and the relevant payment procedure is established by the legal acts of the BoL.

Upon joining the euro area in January 2015, Lithuania became a member of the ECB Single Supervisory Mechanism (SSM), and the banking supervision model was adapted to SSM requirements. A number of supervisory responsibilities and decision making powers were moved to the ECB. Three Lithuanian banks (AB SEB bankas, Swedbank, AB and AB DNB bankas) fall under the direct supervision of the ECB and participated in the 2014 comprehensive assessment⁵.

Information exchanges between domestic and foreign supervisory authorities are undertaken through the exchange of MoUs. The supervision of financial groups is performed through supervisory colleges, on the basis of MoUs. The BoL is a signatory to the IOSCO MMoU for cross-border cooperation.

⁴ If in a given year the sum of contributions paid by financial market participants is insufficient to cover the expenses of the BoL related to the functions of the financial sector resolution authority, the BoL may temporarily cover the shortfalls with other funds, however, it must increase by an appropriate amount the contributions planned for coming years to finance activities of the financial sector resolution authority (without exceeding maximum annual contributions set in Annex 2 to this Law) with the purpose of recovering the used funds of the BoL.

⁵ ECB'S Comprehensive Assessment comprises an asset quality review and a stress test. SEB bankas, Swedbank and DNB bankas successfully passed capital adequacy and stress tests in the 2014 Comprehensive Assessment of ECB. For detailed results of Lithuanian banks see the website of the ECB www.bankingsupervision.europa.eu/banking/comprehensive/2014/html/index.en.html and the BoL www.lb.lt/en/news/european-central-banks-test-lithuanias-banks-are-classified-as-being-highly-secure-and-reliable

The Ministry of Finance formulates policy regarding financial markets, financial institutions and their supervision, central bank activity, financial services, insurance, reinsurance and insurance mediation, financial sector stability, financial crisis prevention and management, restructuring of financial institutions, insurance of deposits and liabilities to investors. In the area of financial markets, legal acts are often prepared in cooperation with the BoL. In addition, it is often carried out through a public consultation with other relevant state bodies and private entities.

All draft laws are published in the official online public database where stakeholders can submit comments, while electronic/fax copies of draft laws are also sent out to stakeholders who might not use the database on a regular basis (industry associations). The minimum consultation time is 10 working days for draft laws of less than 10 pages and 15 working days for longer legal acts. Following the public consultation stage, draft laws are sent to the Ministry of Justice so as to confirm compliance with legislative rules, and then submitted to the Government. The preparation of legislation is subject to general legislative rules set in the Law on Legislative Framework, which requires an ex-ante impact assessment. The extent of the ex-ante assessment is proportional to the expected scale of impact, and an assessment of the impact on administrative burden is also required where relevant. Inter-institutional working groups are established for the preparation of legal acts in cross-sector areas and the use of external experts and/or commissioning of specific studies/analyses/research is also envisaged.

B. Supervision of financial institutions

The capital requirement framework for Lithuanian financial institutions (banks, central credit union and brokerage firms) is based on the Basel III requirements which were transposed into the national legislation through the CRD IV (Capital Requirements Directive 2013/36/EU). The BoL may, however, decide on Pillar II capital levels (for risks which are not covered by the minimum capital adequacy requirements) depending on risk-relevant situations in specific institutions. The majority of Lithuanian banks apply the standardised approach for credit, market and operational risks for regulatory purposes; one third of Lithuanian banks use internal models for credit and operational risks.

Lithuanian financial institutions (banks, central credit union and brokerage firms) must, at all times, satisfy the following capital requirements: (i) total capital ratio of 8%; (ii) Common Equity Tier 1 (CET1) capital ratio of 4.5%; (iii) Tier 1 capital ratio of 6%.

While the minimum required CET1 ratio of the banks for Pillar I risks is 4.5%, an additional 2-4% of CET1 capital is required for Pillar II risks, and a capital conservation buffer of 2.5% of CET1 has been a binding requirement for institutions since mid-2015. A capital buffer for other systemically important institutions (0.5–2.0%) and a countercyclical capital buffer (currently at 0%) are also added. This leads to supervisory CET1 ratios of 9-11% and total capital ratios of 12.5-14.5%.

All banks in Lithuania comply with established capital requirements. The overall capital adequacy ratio of banks, as of end of 2016, stood at 19.4%. The capital of the Lithuanian banking system consists mainly (98.5%) of CET1 capital. The CET1 ratio for Lithuanian banks stood at 19.1%. Capital adequacy ratios have been improving since 2010 given the profitability of Lithuanian banks. The overall capital adequacy ratio of the banking sector decreased by 5.5% in 2016 on a year-on-year basis, however, this was not due to a deterioration of banks' capitalisation in general, but due to the dividends paid out by Swedbank, AB at the beginning of the year. In late 2015, Swedbank's capital adequacy ratio stood at 40.0%, dropping to 22.1% as of 31 December 2016, and remaining the largest among the banks in operation in Lithuania.

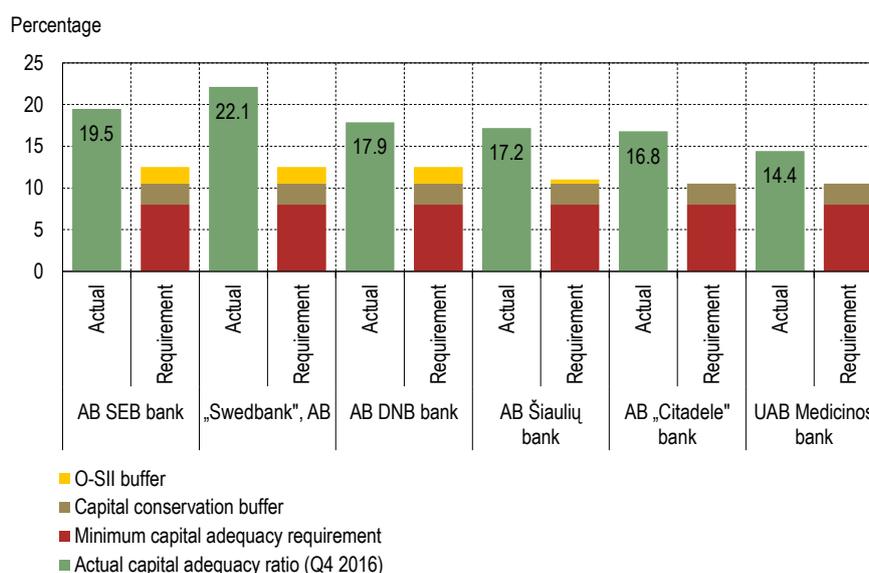
On 19 June 2015, the BoL established a unified capital adequacy ratio of 13% for all credit unions, which entered into force on 30 September 2015. Credit unions with significant loan portfolios to associate

members calculate additional capital requirements for credit risk. These requirements allow a more accurate assessment of credit risk faced by credit unions.

According to CRD IV requirements and national legislation, asset management companies and certain financial brokerage firms are required to calculate their minimum capital requirement based on the higher of the risk exposure amount, calculated taking into account the relevant risks (credit, market, credit valuation adjustment, counterparty, operational risk), or ¼ of fixed overhead of the preceding year. Asset management companies and financial brokerage firms are also subject to requirements for initial capital.

Figure 7. Capital adequacy ratio of banks in Lithuania

In percentage, as of Q4 2016



Source: Lithuanian Authorities. Excluding Pillar II add-ons. O-SII buffer requirements came into force in December 2016.

Both public and private financial market participants in Lithuania are required to keep accounts in compliance with laws of Lithuania and in conformity with IFRS accounting standards, with the exception of credit unions. According to the *Accounting Law of Lithuania*, credit unions report under business accounting standards due to the local character of their operation (Such business accounting standards are broadly in line with IFRS). Banks and credit unions are required to report interim and annual financial statements to the public and to submit supervisory financial reports to the BoL on a quarterly basis.

Capital requirements for payment institutions and electronic money institutions are based on respective requirements under EU legislation, and own funds of respective institutions must at all times be no less than the larger of the following two indicators: set initial capital requirement (minimum own capital) or the own funds requirement calculated by one of the methods established by a Resolution adopted by the Board of the BoL. On the basis of the assessment of the risk management process, quality of the data collection of risk-related losses and the system of internal control, the BoL may set for the electronic money institution an individual own capital amount which can be up to 20% smaller or larger than the own capital requirement.

Loan loss provisioning is regulated by EU regulation No 575/2013 on prudential requirements for credit institutions and investment firms (CRR), which is directly applicable since 1 January 2014. Provisioning and recognition of losses is performed under international accounting standards (IAS 39). The

detailed methodology used for calculation of impaired loss on loans as well as impaired loss over the period and balance of loan loss provisions should be publicly disclosed in annual (and to a lesser extent in interim) financial reports. The Technical Standards on Supervisory reporting developed by the European Banking Authority (EBA) and endorsed by the European Commission oblige all banks and investment firms to submit comprehensive information on loan loss provisioning to the Supervision Service of the BoL as part of the prudential framework.

Banks build reserve capital to enhance their financial stability through additional shareholder contributions or via retained earnings. The annual general meeting of the shareholders may also make a decision on the use of the reserve capital of the bank to cover losses of activities of the bank in the case referred to in subparagraph 6 of Article 41 of the Law on Banks.⁶ Other bank reserves shall be the reserves whose formation and use has been provided for in the articles of association of the bank and/or by Regulation (EU) No 575/2013.

The effectiveness of banks' internal governance frameworks is monitored and assessed by performing mandatory self-assessments at least annually.⁷ An initial self-assessment of the effectiveness of the bank's internal governance framework is performed on the basis of a questionnaire provided by the BoL. The assessment covers three main aspects: (i) the institution's internal governance framework (including key control functions such as risk management, internal auditing, and compliance); (ii) its risk management framework and risk culture; and (iii) its risk infrastructure, internal data and reporting. The Supervision Service of the BoL reviews the results of such initial self-assessments and highlights general and specific issues which are then discussed with the bank's management. Banks are obliged to communicate annually to the Supervision Service the results of their self-assessment and their developed action plan for improvement.

Supervision of credit unions

The supervision of credit unions has been reinforced through more stringent requirements applying to credit unions' top management, aiming at enhancing risk management. New prudential requirements (liquidity, capital adequacy, large exposure requirement) have also been set. The supervision of systemically important and the riskiest credit unions was tightened. In particular, the BoL issued a number of resolutions by which it introduced new prudential requirements (liquidity, capital adequacy, large exposure requirement), tighter supervision of systemically important (the largest) credit unions and more stringent requirements for top management. The main changes introduced were as follows:

- a uniform liquidity ratio of 30% for all credit unions came into force as of 31 December 2016;
- a uniform capital adequacy ratio of 13% applied to all credit unions. Credit unions which have significant loan portfolios to associate members calculate additional capital requirements for credit risk;
- a new liquidity coverage ratio requirement which obliges credit unions to forecast more accurately cash flows which can act as a safety cushion in case of financial distress;
- tighter maximum exposure to a single borrower ratio (the lesser of 25% of credit unions capital or EUR 144 800);

⁶ Taxes should be paid before the establishment of reserves.

⁷ Requirement for self-assessment introduced on 1 January 2013 through the *General Guidelines on Internal Governance of Banks* approved by Resolution No 03-176 of the BoL.

- new rules to becoming a credit union manager (stricter qualification and experience requirements, exams for management bodies);
- new requirements on public disclosure;
- new requirements on establishment;
- regulations for the assessment of credit union loans (came into force from 1st January 2014);
- new provisions for organizing the internal control and governance of credit union risk;
- the market risk associated with aggressive investment in debt securities is limited by regulation⁸;
- asset quality reviews for the assessment of balance sheet assets by the BoL and independent external valuers.

A working group established by the Board of Seimas agreed on the Conception for the Sustainable Operation of Credit Unions in March 2015 (Decision No.109-S-1). The objectives and principles under this framework aim at the consolidation of the credit union sector, more sustainable credit union capital formation, better risk management and more effective supervision. The legal acts implementing the Concept of the Sustainable Credit Union Operation were approved by the Seimas in June 2016.

Fitness and propriety

The legal acts regulating activity of financial market participants set forth the fitness and propriety requirements for managers and major shareholders.⁹ Resolution No 03-181 of 2014 of the Board of the BoL set forth guidelines for the assessment, and criteria for the evaluation, of reputation, qualification and experience of managers and/or key function holders of financial market participants supervised by the BoL. The initial assessment of managers and major shareholders is performed upon licensing of the financial market participant as well as following the granting of authorisation insofar as changes to initial information provided to the BoL at the stage of applying for a license occur. In case of material changes to a person's information, which might affect the outcome of the initial assessment, the financial market participant is obliged to provide all relevant information to the BoL in order to allow for a reassessment.

Fitness and propriety requirements are also applied to the heads of credit unions as regards (i) reputation: data on convictions, sanctions and penalties, personal financial obligations, operating results of legal entities governed by the candidate; and (ii) qualification and skills: the chairman and at least one member of the supervisory council should have higher education, at least 1 year of managing experience in the last 5 years and at least 2 years of lending experience. In the absence of the above qualifications and skills requirement, a qualification and experience exam is required. Reassessment of managers can be performed as required by the BoL.

Large exposures and related party transactions

Article 48 of the Law on Banks of Lithuania foresees limits for large exposures and their calculation, in line with EU regulation (EU)575/2013. Large exposures to a client or group of connected clients are subject to a limit of 25% of the eligible capital of the institution, after taking into account the effect of credit mitigation. Where that client is an institution (i.e. credit institution or investment company) or where

⁸ Credit unions' investment in government securities has been growing steadily since 2008. In 2014, the ratio of investment in government securities to total assets increased 5.7% over the year to 35.8%. Most of the government securities acquired in 2014 had a maturity of more than one year, suggesting a search for higher yield rather than liquidity management.

⁹ In particular: Law on Banks – Art. 34 (2), 25 (8)(1); Law on Insurance – Art. 11 (2)(2); Law on Markets in Financial Instruments – Art. 9(1), 10(1); Law on Credit Unions – Art. 30(2); Law on Collective Investment Undertakings – 10(8), 11(4).

a group of connected clients includes one or more institutions, that value should not exceed the higher of 25% of the institution's eligible capital or EUR 150 million, provided that the sum of exposure values to all connected clients that are not institutions does not exceed 25% of the institution's eligible capital, after taking into account the effect of the credit risk mitigation.

Related party transactions and relevant lending limits for Lithuanian banks are set up in Article 51 of the Law on Banks of Lithuania. The limits applied to lending to single or connected counterparties, as required by the CRR, are also applicable to banks' internal lending and lending to related parties. Any lending to related parties as well as the relevant terms must be approved by the bank's supervisory board. Similar requirements apply to internal lending (lending to bank managers and their relatives) as per Article 52 of the Law on Banks of Lithuania. The Supervisory Board of an institution is responsible for setting additional limits and internal procedures and limits for internal lending or lending to related parties¹⁰.

Exposures incurred by an institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries are exempted from the large exposures regime insofar as those undertakings are supervised on a consolidated basis (in accordance with CRD 2013/36/EU, Regulation (EU) 575/2013, Directive 2002/87/EC or with equivalent standards in force in a third country). The same applies to covered bonds complying with criteria in line with EU regulation 575/2013 and central bank claims in the form of required minimum reserves.

The Law on the prevention of money laundering and terrorist financing (AML Law) requires the identification and verification of customers and beneficial owners before establishing a business relationship and before carrying out monetary operations or transactions equal or exceeding EUR 15 000, whether the operation is carried out in a single operation or in several operations which appear to be linked, currency exchange (cash) operations exceeding EUR 6 000 or post remittance operations exceeding EUR 600, before performing and accepting money transfers in compliance with the provisions of EU Regulation on the payer accompanying transfers of funds, or when there are doubts about the veracity or authenticity of previously obtained customer or beneficial owner identification data and in any other case where suspicion of money laundering and/or terrorist financing occur.

Financial institutions and other entities must take all relevant, targeted and proportionate measures in order to establish whether the customer operates on its own behalf or is controlled and, if so, to establish the beneficial owner. The transposition of EU Directive 2015/849 of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing to national legislation is underway and the processes and requirements prescribed by the AML Law will be adapted accordingly.

Laws regulating the activities of financial institutions in Lithuania impose line-of-business restrictions, with insurance companies not permitted to provide any other financial services, except for insurance and related services, and banks not allowed to provide insurance services. In addition to the provision of financial services, a bank may pursue only such other activities as those in the absence of which financial services cannot be provided, which assist in the provision of the financial services or are otherwise directly related to the provision of the financial services. However, no regulation is imposed on ownership linkages among financial institutions in Lithuania; thus, banks have the ability to establish insurance subsidiaries and vice versa. Significant investments in financial entities (over 10% of CET1 and/or close links with the entity and ownership of CET1 instruments) are nevertheless subject to deductions from eligible capital for the calculation of own funds for capital adequacy purposes, according

¹⁰ As set up by the General Guidelines on Internal Governance of Banks approved by Resolution No 03-176 of the Board of the BoL.

to the CRR (Article 43). There are no limits on cross-shareholdings between financial and non-financial institutions in Lithuania and corporate groups can establish or own banking or insurance subsidiaries.

Although financial institutions in Lithuania are not prohibited from establishing non-financial entities or corporations and/or entering into strategic alliances with non-financial entities or corporations, the BoL limits qualifying holdings of institutions regulated by the CRR (Article 89(3)(b)) to a maximum of 15% of eligible capital of the institution in a single entity and the total investment in non-financial entities cannot exceed 60% of the eligible capital of the institution.

C. Financial stability oversight and macroprudential surveillance

In 2009, the Seimas of the Republic of Lithuania adopted the Law on Financial Sustainability of Lithuania. In September 2014, the BoL was granted an explicit mandate to conduct macroprudential policy, as prescribed by the Law on the BoL. In March 2015, the Board of the BoL approved the Strategy of the Macroprudential Policy (Resolution No. 03-31).

The BoL sets out the framework for macroprudential policy instruments: countercyclical capital buffer, buffer for other systemically important institutions, loan-to-value (LTV), debt-service-to-income (DSTI) and loan maturity requirements for borrowers (natural persons) are instruments already in place. In 2016 the BoL evaluated the need and has taken the decision not to implement a systemic risk buffer yet. The evaluation of the need for the systemic risk buffer will be repeated once more information is available on the impact of upcoming regulatory changes, such as IFRS 9, MREL requirements and changes in the setting of Pillar 2 capital add-ons.

Table 4. Macroprudential Policy Instruments in Lithuania

Measure	Level	Description	Valid from
Loan-to-value (LTV)	85%		Nov 1, 2011
Debt-service-to-income (DSTI)	40%	Limit the excess credit risk assumed by financial institutions and form a responsible borrowing practice by not allowing households to become over-indebted, thus creating conditions for sustainable credit growth	Nov 1, 2011
Loan maturity	30 years		Nov 1, 2015
DSTI with interest rate sensitivity test	50%		Nov 1, 2015
Countercyclical capital buffer	0%	Secure the banking system against possible losses, when too rapid credit growth results in the formation of systemic risk	March 31, 2017
Other systemically important institutions buffer	0.5%–2.0%	At the country level, increase the resilience of systemically important institutions to shocks and decrease the possibility of bankruptcy	Dec 31, 2016
Capital conservation buffer	2.5%	Obligate banks to accumulate additional capital to cover unexpected losses	June 30, 2015

Source: Bank of Lithuania.

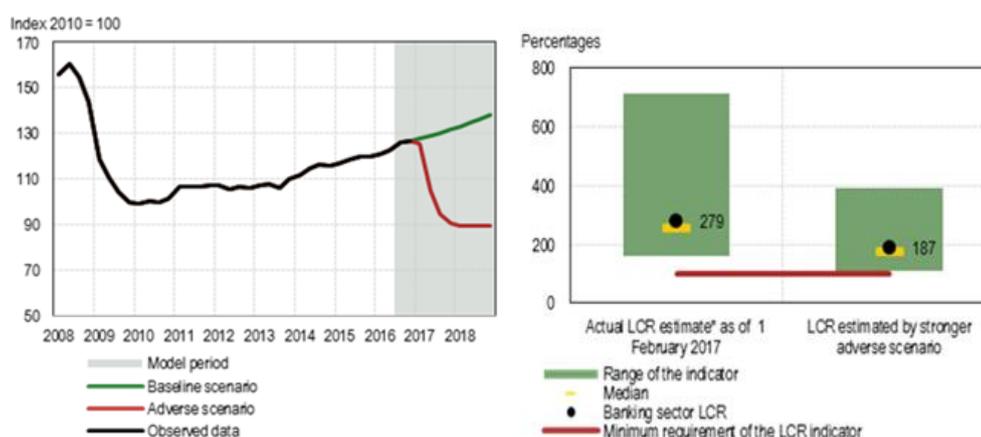
After the main provisions of CRD IV were transposed into Lithuania's law in April 2015, new capital buffer requirements for banks have been applied to target structural and cyclical systemic risks to the

Lithuanian financial system. Given the general absence of cyclical imbalances in the Lithuanian credit market, the countercyclical capital buffer rate has been set at 0%, but this level can be increased when necessary to increase the resilience of the banking sector and contain excessive credit growth and financial leverage.

In December 2015, the BoL identified and declared systemically important institutions in Lithuania, which were made subject to additional capital buffer requirements. From end-2016 onwards, an additional capital buffer of 2% has been applied to AB SEB bankas, Swedbank AB and AB DNB bankas, and a 0.5% buffer to AB Šiaulių bankas.

In order to promote responsible lending practices, the BoL introduced a LTV cap of 85% for new mortgage loans in 2011 alongside a DSTI limit of 40%. In 2015, the regulations were amended and in addition to the DSTI limit of 40%, credit institutions are now required to ensure that the DSTI ratio does not exceed 50% when an interest rate of 5% is used to calculate the interest payment. The maximum mortgage credit maturity was shortened from 40 to 30 years. Amendments to the Responsible Lending Regulations which are in line with the national implementation of Mortgage Credit Directive come into effect as of 1st of July 2017.

Figure 8. Capital adequacy and liquidity ratios based on stress testing scenarios



Source: Banks' data and Bank of Lithuania calculations, Financial Stability Review 2017.

The BoL conducts regular top-down solvency and liquidity stress tests in order to assess the domestic banking system's resilience to adverse shocks, using an in-house methodology. Solvency stress testing is focused on the assessment of the banks' credit loss and profitability under an adverse macroeconomic scenario over a two-year horizon and on a quarterly basis. Liquidity stress testing involves sensitivity analysis. Aggregate results of the solvency and liquidity stress tests are made public once a year in the BoL's Financial Stability Review.

The BoL has also developed a methodology for household stress testing based on micro data. It conducts additional stress-testing exercises on an *ad hoc* basis, including stress testing of the insurance sector, market risk stress testing for credit unions etc. The three largest Lithuanian banks were subject to the restricted bottom-up EU-wide stress testing in 2014, based on the methodology developed by the EBA.

Resolution framework

In December 2015, the BoL was designated to become the resolution authority of the country (Bank Recovery and Resolution Directive 2014/59/EU). From 2016, when the Single Resolution Mechanism

fully entered into force, the BoL shares its resolution responsibilities with the Single Resolution Board, as prescribed in the Single Resolution Mechanism Regulation (806/2014). For financial institutions the failure of which would not pose risks to financial stability, the regular liquidation/insolvency procedure is available and depositors receive payouts from the Lithuanian Deposit Insurance Fund as required.

Resolution tools/options available to the resolution authority are:

- i) sale of business, based on prior valuation and without the need to obtain the consent of the institution under resolution, its shareholders, creditors or debtors;
- ii) bridge institution, whereby some or all of the shares/assets/rights/liabilities of the institution under resolution are transferred to a newly-established temporary bridge institution. Transferred shares, rights, assets and liabilities have to ultimately be sold or wound down in an orderly fashion;
- iii) asset separation, whereby assets/rights/liabilities of an institution under resolution are transferred to a recipient established or controlled by the resolution authority. Transferred shares, rights, assets and liabilities have to ultimately be sold or wound down in an orderly fashion; and/or
- iv) bail-in, whereby the resolution authority writes down and converts some of the institution's liabilities, causing shareholder dilution, changes management and applies haircuts to creditors.

The Law on Financial Sustainability of Lithuania sets the framework for the preparation of recovery and resolution plans by banks. Banks that do not belong to a group subject to consolidated supervision are required to draw up and maintain an individual recovery plan. If a bank belongs to a group with the parent undertaking located in a EU Member State, it should be included in the group recovery plan prepared by the parent undertaking and approved by the supervisory college headed by the consolidated supervisor using the joint decision procedure for plan approval, in line with Bank Recovery and Resolution Directive 2014/59/EU (BRRD). If deemed necessary, the supervisory authority can demand certain subsidiaries to prepare individual recovery plans. Recovery plans must be updated annually and submitted to the supervisory authority for their assessment.

At the 2016 assessment of significant institutions' (SIs) recovery plans, which included relevant recovery information at subsidiary level, no material deficiencies were identified. Domestic banks (AB Šiaulių bankas and UAB Medicinos bankas) provided their individual recovery plans where no material deficiencies were identified either. The first resolution plans were prepared at the end of 2016, and the national resolution authority further cooperates closely with the Single Resolution Board which is directly responsible for the resolution of banks directly supervised by the ECB (i.e. SIBs). The second version of resolution plans for SIBs are expected to be finalised by the end of 2017.

Bank resolution may be financed by the European Single Resolution Fund while large investment firms remain covered by the national resolution fund. In certain circumstances, the Deposit Insurance Fund may be required to contribute to the financing of bank resolution by an amount equal to the losses that covered depositors would have suffered had they not been protected and excluded from resolution. The national resolution fund and the Deposit Insurance Fund are administered separately by the same designated authority, the state company "Deposit and Investment Insurance", but decisions regarding their usage during resolution are made by the national resolution authority.

Box 2. Bank failures in Lithuania

During the past 6 years, two domestic banks, AB bankas Snoras in 2011 and AB Ūkio bankas in 2013, were subject to bank bankruptcy proceedings, following excessive risk-taking, and breaches of law and deficiencies in these institutions' operations.

AB bankas Snoras failed to recognise losses from investments in securities of CIS countries after the Russian crisis of 1998. Revocation of the bank's license was subsequently considered but not implemented due to insufficient funds at the Deposit Insurance Fund to cover the bank's insured depositors. In 2003, the bank was acquired by the twice smaller Russian bank Konversbank, related to the family of the largest former shareholder Vladimir Antonov. Since then, it inappropriately applied the BoL's guidance, violated provisions of legal acts, avoided provisioning for risky assets and intensified its business with non-resident customers. The concentration of funds in the Russian market accelerated (both deposits and financing of non-transparent projects). The bank's balance sheet expanded by 43% over the period 2009-11, and onsite inspections by the BoL in 2010 revealed that investment in securities reported by the bank were held by AB bankas Snoras' private connected persons. Having confirmed a real threat of insolvency, the BoL decided to suspend AB bankas Snoras' activities, and bankruptcy procedures were instituted against the bank in December 2011.

Over the period 2005-10, AB Ūkio bankas had been extending loans to companies controlled by or related to its major (64.9%) shareholder, Vladimir Romanov, for which it had failed to perform proper risk assessment. The BoL's inspection in 2013 revealed that the value of the bank's assets were lower than reported, while the liabilities would exceed its assets after making provisions against bad loans. Related party loans extended to the major shareholder made up for the majority of the bank's misrepresented assets.

The failure of these two domestic banks have not had systemic repercussions. Deposits with AB bankas Snoras were guaranteed by the Deposit Insurance Fund, while a large share of AB Ūkio bankas assets and all insured deposits were transferred to AB Šiaulių bankas. In order to cover the deposit insurance guarantees, the Ministry of Finance provided loans to the state company "Deposit and Investment Insurance", of 2.8% and 0.7% of annual GDP, to support the underfunded deposit guarantee fund. The loan dedicated to deposit insurance pay-outs for AB bankas Snoras' clients was fully repaid by Q2 2015 from the recovered assets, while by end-2016 73% of the loan due to AB Ūkio bankas' insolvency has been repaid.

The proceeds from the insolvency procedures have not been finalised yet; the recovered amount by the Deposit Insurance Fund stood at EUR 0.9 billion in end-2016 (including all insolvency procedures). The deposits of AB bankas Snoras were compensated by the Deposit Insurance Fund, while in the case of AB Ūkio bankas a large share of bank assets and all insured deposits were transferred to AB Šiaulių bankas. The transfer of insured deposits to another bank was considered to best safeguard the continuation of provision of services and banking operations to the clients of AB Ūkio bankas with the minimum possible distortion to the banking system, while at the same time avoiding an insured event under which the Deposit Insurance Fund would need to compensate deposit holders for an amount of EUR 782 million.

Source: Bank of Lithuania, *The Bank of Lithuania revoked the licence of AB bankas SNORAS and will apply to court regarding bankruptcy* (24 November 2011), BoL, 2012 Financial Stability Review.

Deposit Insurance and State Guarantees

Lithuania has an explicit deposit insurance scheme regulated by the Law on Insurance of Deposits and Liabilities to Investors of Lithuania, in compliance with Directive 2014/49/EU on Deposit Guarantee Schemes. The deposit insurance scheme is managed by a separate state company "Deposit and Investment Insurance" established by the Government of the Republic of Lithuania (whose rights and responsibilities are implemented by the Ministry of Finance). The state company "Deposit and Investment Insurance" administers the insurance of deposits held by residents in banks, non-EU bank branches and credit unions. It is responsible for the collection of contributions paid by insured institutions and the distribution of funds via a paying agent in case of an insured event.

The deposit insurance scheme is mandatory for all credit institutions (banks and credit unions) established in Lithuania as well as to the branches of banks from non-EU countries if the level of their respective depositor protection is lower in their home country.

Box 3. The Deposit Insurance Fund of Lithuania (Lietuvos Indėlių draudimo fondas)

The Deposit Insurance Fund (the Fund) guarantees aggregate deposits of each depositor in each deposit-taking institution up to EUR100 000. In certain specific cases, such as deposits resulting from real estate transactions relating to private residential property, inheritance and other specific cases, the coverage level is higher (EUR 200 000–300 000). The Deposit Insurance is required to reimburse depositors within 20 working days from the day the deposit-taking institution is declared insolvent by the supervisor, and will be gradually shortened to reach 7 working days by 2024.

Participants of the deposit insurance system are required to make regular (*ex-ante*) and special (*ex post*) deposit insurance contributions to the Deposit Insurance Fund. Regular (*ex-ante*) and special (*ex post*) deposit insurance contributions are calculated and paid based on the amount of covered deposits held with bank being insured: *Ex-ante* contributions are calculated each year based on the objective of reaching the target Fund level of 0.8% of covered deposits by the middle of 2024 and 2% of covered deposits by the middle of 2028. *Ex-post* contributions will be collected should the Fund's available resources not suffice to disburse all relevant deposit compensation in the insured event. Calculation of both *ex-ante* and *ex-post* contributions to individual credit institutions is based on three main criteria: 1) the riskiness of the institution (defined by the BoL for each credit institution); 2) the target level; and 3) the amount of covered deposits.

The compensation of EUR 1.2 billion (3.8% of GDP) for state-insured deposits of AB bankas SNORAS in December 2011 proved that the deposit insurance system operating in Lithuania at that time was suboptimal. In September 2011, the assets accumulated in the Deposit Insurance Fund covered 4.4% of the insured deposits (vs. 1.5% indicated by the EU¹¹), nevertheless the compensation of AB bankas SNORAS' covered deposits in a tight timeframe was challenging; the amount of deposits to be compensated exceeded the accumulated deposit insurance fund more than twice and the government had to finance the pay-out of covered deposits through a loan to the Deposit Insurance Fund.

In 2013, following the agreement on the transfer of assets and liabilities of AB Ūkio bankas to AB Šiaulių bankas, the funds of the Deposit Insurance Fund were used to cover the difference between the good assets and total insured liabilities, which amounted to EUR 0.2 billion, following which the Deposit Insurance Fund became a creditor of AB Ūkio bankas. In order to cover this amount, the Deposit Guarantee Fund received a government loan with an annual interest rate of 2.801%, and is expected to repay the loan by 1 February 2019. The loan will be repaid by using the funds recovered during the bankruptcy proceedings and the funds collected as the deposit insurance contributions by credit institutions.

In the period from 2013 to the end of 2016, insolvency concerns led to the suspension of operations of six credit unions, including Vilniaus Taupomoji Kasa, which was the largest in the sector. As a result of these developments, the Deposit Insurance Fund paid EUR 134 million in deposit insurance claims.

The new Law on Amending the Law on Insurance of Deposits and Liabilities to Investors implements the provisions of the EU Directive on Deposit Guarantee Schemes. The law sets the minimum target level of the deposit insurance fund at 0.8% and the national target level of the deposit insurance fund at 2% of the amount of covered deposits of all the insurance system participants. The minimum target level should be attained before 3 July 2024, and the national target level before 3 July 2028.

¹¹ Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes, COM (2010), 368.

The state company “Deposit and Investment Insurance” is managed by a Council comprised of three members nominated by the Ministry of Finance and two members nominated by the Chairman of the BoL. Representatives of other stakeholders can participate in Council meetings as observers, if necessary.

The state company “Deposit and Investment Insurance” is a member of the Committee of Creditors, whose main role is to supervise the bank bankruptcy process and the activities of the bankruptcy administrator. It represents the funds’ creditors claim in bankruptcy proceedings, dealing with 215 active legal cases as of 31 March, 2017. It manages three separate funds which are administered and controlled independently:

- i) the Deposit Insurance Fund: for the insurance of deposits up to EUR 100,000 in credit institutions and credit unions. The Fund has accumulated a reserve of EUR 98.2 million as of 31 March, 2017. The Deposit and Insurance Fund may be required to contribute to the resolution of a credit institution for the amount of payouts it would have to incur in case of the institution’s bankruptcy. .
- ii) the Liabilities to Investors Insurance Fund (LIIF): for the insurance of liabilities up to EUR 22,000 in the form of financial instruments or cash for facilitating transactions to investors. Current size is EUR 2.62 million.
- iii) the Resolution Fund: for the financing of large investment firm resolution procedures, as defined by Article 103 of the Lithuanian Law on Financial Sustainability. Current size is EUR 2,000.

According to Article 39 of the amended Law on Financial Sustainability of Lithuania, which entered into force on 3 December 2015, public financial support is available to solvent financial institutions to ensure stability of the sector when there is a systemic liquidity shortage. The following forms of public financial support are available: (i) state guarantees; and (ii) purchase of capital instruments. These cannot cover any actual or expected losses, and are only granted by the Government to requesting institutions that have proved to suffer liquidity problems or risk of insolvency that may jeopardise the stability of the financial sector.

Financial crisis prevention and management

Effective cooperation among financial market supervisors and other institutions for crisis prevention and management has been in place since 2008 as prescribed by the Financial Crisis Prevention and Management Plan (Plan) Resolution No. 1253 of the Government of Lithuania. A Standing Commission for Crisis Prevention and Management was established, comprising the Vice-Minister of Finance, responsible for financial markets, the Advisor to the Prime Minister and a high-ranking official of BoL (member of the Board) or the Head of the structural unit of BoL.

The Plan sets out a framework for the Ministry of Finance, BoL and other institutions in the area of financial crisis prevention and management, and for decision-making and application of appropriate measures in the area of financial stability, crisis prevention and crisis management. In 2009, as a follow-up measure, the BoL and the Ministry of Finance signed the Cooperation Agreement, which sets out the detailed procedures on exchange of information and initiation of the Standing Commission’s meetings in situations determined by the Plan. The Ministry of Finance serves the work of the Standing Commission, while BoL is responsible for the assessment of risk factors. The Plan establishes three stages of financial crisis according to the level of risk as calculated by the BoL in its monthly assessment.

D. Financial consumer protection and education

Financial consumer protection in Lithuania is established under a set of laws: Civil Code of Lithuania, Law on Consumer Protection of Lithuania, Law on Prohibition of Unfair Business-to-Consumer Commercial Practices of Lithuania, Law on Advertising of Lithuania (and relative Guidelines on Financial Services Advertising by the BoL) and laws regulating the provision of certain types of financial services (e.g. payments, consumer credit, financial instruments, insurance, etc.).

The State Consumer Rights Protection Authority coordinates the activities of state institutions in protecting consumers. The BoL is responsible for investigating and handling disputes between consumers and financial services providers. As a supervisory authority, the BoL also monitors the compliance of financial market participants with the laws and requirements set by legal acts.

Complaint handling and redress are both carried out by the Bank of Lithuania. Alternate dispute resolution is carried out by a panel of BoL staff members.

Financial services in Lithuania are supervised applying risk-based supervision principles for consumer protection and resources are allocated to financial services and products that pose the greatest risk to consumers. Every year the BoL creates a financial products risk map, based on the financial product risks to consumers and the significance of the product (size of the market). The risk evaluation is based on results of inspections, thematic reviews, product analysis carried out by the BoL, data of disputes and complaints and covers areas such as the corporate culture of the suppliers, product design, oversight, governance and distribution processes, information disclosure, flexibility and other characteristics of the product.

The main risk areas in recent years have consisted of private pension funds, unit-linked life insurance and consumer credits. A number of regulatory changes, supervisory actions or changes in supervision processes have been initiated in these areas:

- Supervision of consumer credit providers has been tightened, with 84 cases investigated by the BoL since 2012 (sanctions were imposed in 78% of the cases, out of which 47 fines for a total of EUR 281 000 were assessed, while one credit provider was suspended). Incorrect creditworthiness assessment and incorrect advertisement were the most common infringements identified;
- Amendments to the Law on Consumer Credit were adopted and entered into force on 1 February 2016: new regulations on advertising, creditworthiness assessment, total cost of the credit to the consumer, cooling off period, restrictions of credit agreements, registering of natural persons that cannot receive credits, and peer2peer lending were included;
- Regulatory amendments initiated in pension fund legislation, where the principle of life-cycle as a default option was introduced;
- Regulatory initiatives in the field of unit-linked life insurance were introduced, driven by the results of dedicated inspections, research and mystery shopping by the BoL, which indicated issues of information asymmetry and regulatory arbitrage. Draft amendments of regulations will be incorporated in the legislation implementing the Insurance Distribution Directive (IDD).

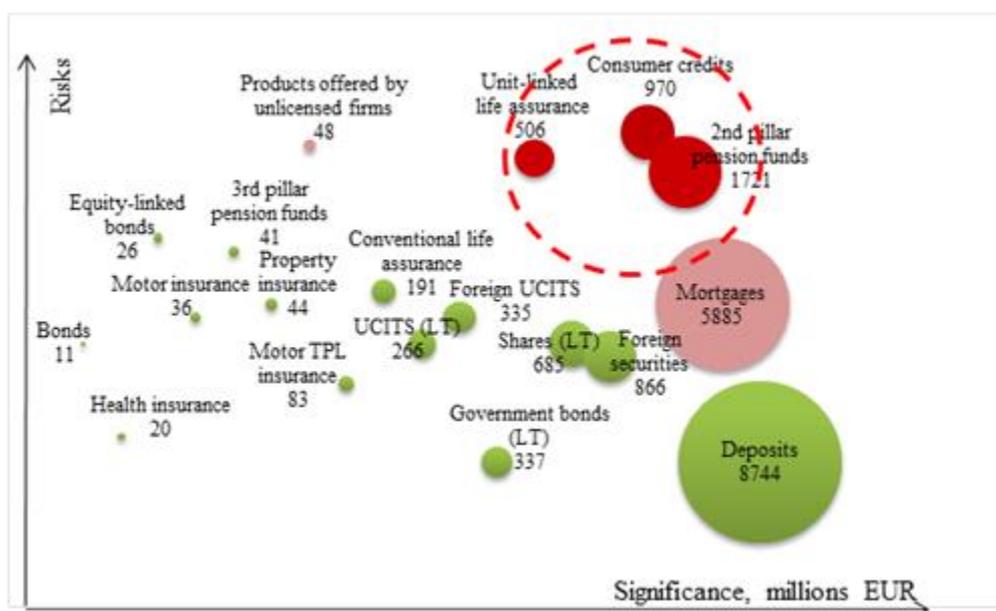
A revision of the existing supervision processes and documentation around financial services was initiated in 2015 and approved in the end of 2016. The supervision process is amended according to the

Concept of Risk Assessment System approved by the BoL's Committee of the Supervision Service, as follows:

- all financial products and services will be assigned to one of four categories (F1-F4) according to the risks they pose for consumers;
- the evaluation of product/service risks will be based on qualitative and quantitative criteria according to the preassigned risk score for each type of risk. The more risk points the product/service receives, the riskier it is for the customers.
- the intensity of supervisory actions and/or regulatory changes initiated will depend on the product risk category.

Figure 9. Financial products risk map

As of June 2014



Source: Lithuanian Authorities.

In accordance with the ECB's recommendation on the security of internet payments, the BoL adopted rules for payment service providers, governing minimal security requirements for internet payments (Resolution No. 03-172 of 30 September 2014, which came into force on 1 January 2016). Requirements focus on the security of the platform supporting the internet payment service, specific control and security measures for internet payments, customer awareness, education and communication. BoL's website dedicated to financial education (<http://www.pinigubite.lt>) provides the most common aspects of techniques used in crimes related to the provision of financial services by electronic means. In 2016 the Supervision Service of BoL performed a survey of market participants on potential shortcomings of the regulation covering the provision of financial services by electronic means. An action plan of possible improvements was prepared following the examination of responses received around shortcomings. . The Law on Advertising sets prohibitions on the use of misleading (Art. 5) and unlawful comparative advertising (Art. 6) in B2B and B2C cases (these are also prohibited as unfair competition (Art. 15(1) (7) of the Law on Competition)). Following the enactment of the Law on Prohibition of Unfair Business-to-

Consumer Commercial Practices, Lithuania has implemented the Unfair Commercial Practices Directive which sets a common standard for consumer protection.

Financial market participants are required to provide the Supervision Service of the BoL with information on new financial products intended for distribution to consumers. This allows the BoL to identify potential risks to consumers and take action at an early stage, if necessary. The power of the BoL will be expanded to allow it to prohibit or set limits on the product design or marketing of certain financial products, after the appropriate amendments of the laws regulating financial markets and implementing Regulation on key information documents for Packaged Retail and Insurance-based Investment Products (PRIIPs)¹² and Regulation on Markets in Financial Instruments (MiFIR)¹³ are passed (expected by the end of 2017).

According to the Market Abuse regulation introduced in July 2016, a fine up to EUR 5 million applies to insider trading and market manipulation cases for natural persons. A fine up to EUR 15 million or 15% of annual turnover applies to legal entities. In addition, the criminal code stipulates sanctions (restriction of liberty, fines or custodial sentence of up to four years) for market manipulation and insider trading that causes property damage exceeding EUR 9,500. The BoL identifies cases of market abuse through notifications from market participants, notifications in the dedicated website and through a market abuse detection system developed in-house.

The BoL has the power to terminate activities in accordance with the Law on Markets in Financial Instruments of Lithuania (implementing the MiFID), to prevent substantial or irreparable damage to investor interests. It has also the power to prohibit or suspend admission or trading of financial instruments on a regulated market (or another trading venue), as well as suspend or terminate the distribution or marketing of the financial instrument. Similar powers are set forth in the Law on Collective Investments Undertakings of Lithuania (implementing UCITS directive 2009/65/EC).

Responsible lending regulations, introduced in November 2011, oblige credit institutions to fully assess the ability of borrowers to repay credit in the long term, define the maximum allowed LTV and DSTI ratios, the highest possible repayment duration and other parameters of responsible lending. Regulations originally included a legally binding LTV cap of 85%, a DSTI cap of 40% and 40 year maximum maturity requirement.

In November 2015, the Responsible Lending Regulations were further revised and amendments were adopted by the BoL in order to ensure responsible lending in a low interest rate environment. The amendments stipulate that loan terms cannot exceed 30 years and the DSTI limit applied does not exceed 50% of sustainable household income based on an interest rate of 5%. At the same time, and so as to avoid a negative impact on lending volumes, the BoL allowed credit institutions to grant 5% of new loans (in value terms) by applying the DSTI of up to 60% over the calendar year, when such exceeding of the limit is recognized by the credit institution as reasonable and justified.

¹² The Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPs) introduces a key information document (KID – a simple document giving key facts to investors in a clear and understandable manner) covering not only collective investment schemes but also other 'packaged' investment products offered by banks or insurance companies.

¹³ Regulation (EU) No 600/2014 (commonly referred to as 'MiFIR') together with Directive 2014/65/EU ('MiFID II') replace Directive 2004/39/EC (MiFID I). MiFIR and MiFID II provide an updated harmonised legal framework governing, amongst others, the requirements applicable to investment firms, trading venues, data reporting services providers and third country firms providing investment services or activities in the Union. MiFIR is due to become applicable on 3 January 2017.

Financial education

In 2013, the Board of the BoL approved the Framework of Financial Education for 2013-16¹⁴ with the goal of improving financial literacy of the country's residents. The BoL has also introduced the financial education initiative 'Money Bee' (Pinigų bitė) and created the financial education website (www.pinigubite.lt) which provides unbiased information, calculators and other instruments related to effective personal finance management.

In 2015, the BoL became a full member of the International Financial Education Network (OECD INFE). The BoL and the Ministry of Education and Science of Lithuania signed an agreement of collaboration and initiated Lithuania's participation (2015) in the PISA financial literacy assessment of students. The general results of PISA 2015 were published in December 2016. The results of the financial literacy option were published in May 2017. The BoL will work with the Ministry of Education and Science and other related governmental institutions (Ministry of Social Security and Labour, Ministry of Finance and etc.) to address upcoming findings. Lithuania will participate in PISA 2018 as well.

A household survey has been conducted, the questionnaire for which was based on the methodology prepared by INFE and tested internationally in 2015. Results of the survey's 1012 respondents revealed that while the population assesses its ability to manage its finances favourably and is aware of most financial products, it does not use them actively. The most popular means of saving is holding cash at home or the cash balance accumulated in a bank account. A third of the survey's participants do not consider alternative options before choosing financial products, and only one fifth considers proposals by the same provider. The data obtained during the survey has been forwarded to the OECD for comparison on an international scale, and the insights have been used in preparing the BoL's financial education framework and further updates

In 2017 the BoL, the Ministry of Finance, Ministry of Science and Education and other institutions prepared a Plan for the Financial Education of Public (2017-21), which was approved by the Government in May 2017. Participation in the PISA 2015 measurement exercise is particularly important given the need for reliable baseline data and developing of this Plan for the Financial Education of Public. It defines long-term directions, measures and tools that will allow for the introduction of financial literacy into school curriculum (pupils from age 3 to 19) as well as measures to improve the financial competencies of adults. Financial education has already been integrated in school curriculum as part of a subject of economics and entrepreneurship lessons. The pupils in the 9th or 10th grade have one economics and entrepreneurship lesson per week.

The Ministry of Finance also develops projects aimed at raising public awareness on financial education ('Economics by the Labučiai', budget games organised in cooperation with Delfi) and other campaigns (on the euro introduction, on the 2016 public finances, on the budget, debt management, EU financial assistance and other relevant information).

E. International surveillance assessment (2008)

The IMF carried out a Financial Sector Assessment Programme (FSAP) in 2008, with key recommendations made to Lithuania (Annex I). It was stated that the BoL had addressed most of the Recommended Actions to improve compliance with the Basel Core Principles for Effective Banking Supervision from the previous FSAP performed in 2002.

¹⁴ [/www.lb.lt/n21049/conception_of_financial_education.pdf](http://www.lb.lt/n21049/conception_of_financial_education.pdf)

The BoL has strengthened the analytical cooperation between the Banking Supervision and Financial Stability Departments, as is the case for banking sector stress testing. In addition, the BoL has set up a cross-departmental committee that monitors national and international market developments, and reassesses the cooperation needs between its departments on an annual basis.

Capital needs' assessment and additional capital requirements have been established under the solvency framework for Lithuanian financial institutions based on the Basel III requirements which were transposed into the national legislation through the CRD IV (see Section IV.B).

In regards to the new loan assessment and classification methodology adopted in 2005, losses regarding loan value reduction are accounted for only in case they are actually incurred, in compliance with IFRS. The BoL has stated that additional reporting in order to establish the effect of the change in methodology on the level of reserves would constitute an unjustified burden for the banks.

V. International financial integration

A. Market access for foreign institutions and investors

The bank market in Lithuania is dominated by three Nordic banks, representing 73.1% of the system's total assets at the end of 2016 (AB SEB bankas, Swedbank, AB and AB DNB bankas). Eight branches of EU banks operate in Lithuania and specialise in corporate loans, leasing, with some of them having a retail business model (AS Meridian Trade Bank, Bigbank AS, Danske Bank A/S, Nordea Bank AB, OP Corporate Bank plc, Scania Finans Aktiebolag, Svenska Handelsbanken AB and TeliaSonera Finance AB).

Table 5. Breakdown of Lithuanian banking system assets (in EUR million)

	AB SEB bankas	Swedbank, AB	AB DNB bankas	AB Šiaulių bankas	AB "Citadele" bankas	UAB Medicinos bankas	Total Banks	Total foreign bank branches (7 branches)	Total Banking Sector
Total assets	7 521	7 325	3 989	1 832	502	260	21 430	4 323	25 754
% of total	29.2%	28.4%	15.5%	7.1%	2.0%	1.0%	83.2%	16.8%	100.0%

Source: Bank of Lithuania

According to the Law on Banks, foreign banks may establish banks in Lithuania, acquire an unlimited proportion of the authorised capital and/or voting rights of the banks in operation and establish branches and representative offices. A branch of a foreign bank may commence the provision of financial services in Lithuania only upon obtaining of a licence.

The general requirements of Article 9 of the Law on Banks are applied to the establishment of a bank and acquisition of a bank licence in Lithuania. Article 9 requires, in addition to the legal requirements applied to domestic institutions, an authorisation by a foreign supervisory institution (home supervisor) to a foreign bank wishing to establish a controlled bank in Lithuania is required, or alternatively a confirmation that the supervisor in question does not oppose such establishment. Moreover, the supervisory institution should seek advice from the home supervisor of another EU Member State, responsible for supervision of foreign banks, financial brokerage firms or insurance undertakings, before granting an authorisation to a bank wishing to establish: 1) an undertaking controlled by a foreign bank, a financial brokerage firm or an insurance undertaking licensed in another EU Member State; 2) an undertaking controlled by the parent undertaking of a foreign bank, a financial brokerage firm or an insurance undertaking licensed in another

EU Member State; 3) an undertaking controlled by the same persons who control a foreign bank or a financial institution or an insurance undertaking licensed in another EU Member State.

According to the Law on Financial Instruments of Lithuania, no non-EU/EEA financial brokerage company may establish a branch in Lithuania and provide investment services. In the context of MiFID II implementation, a draft Law on Financial Instruments of Lithuania includes the possibility for third-country financial brokerage firms to establish branches in Lithuania.

Non-EU/EEA investment firms have to establish a subsidiary in Lithuania. No prior authorisation is required for EEA investment firms.

Some financial institutions (payment institutions and e-money institutions holding waiver licenses) may provide services in Lithuania only. Under the Payment Services Directive, in order for non-EU/EEA payment institutions to provide services in the EU, such companies must establish specific legal entities within the EU. Thus, according to the Law on Payment Institutions, payment services in Lithuania can be provided by EU/EEA payment institutions through a branch, an agent or on a cross-border basis. Accordingly non-EU/EEA payment services providers need to be established in the EU in order to provide payment services in Lithuania.

According to the Law on Markets in Financial Instruments of Lithuania (Article 4 para. 1), the following institutions can provide investment services in Lithuania on a professional basis: (a) financial brokerage firms holding the licence of a financial brokerage firm as issued by the BoL or the supervisory institution of another EU/EEA Member State, (b) credit institutions licensed in Lithuania or another EU/EEA Member State, where the licence of a credit institution grants the right to provide investment services, (c) financial adviser undertakings holding the licence of a financial adviser undertaking as issued by the BoL.

According to the Law on Credit Unions of Lithuania (Article 10 para. 1) only legally capable natural persons can be members of a credit union provided they meet one of the following criteria for membership selected by credit unions: (i) reside, be employed or study within the territory of a municipality of Lithuania where the registered office of the credit union is located and within the territory of other municipalities indicated in the articles of association of the credit union and bordering on this municipality; (ii) work in enterprises, undertakings engaged in the same type of economic activities; or (iii) belong to a trade union or an association of the relevant branch of economic activity.

No discriminatory measures apply to foreign providers offering banking and other financial services, limit the activities of foreign providers, or otherwise adversely affect the ability of foreign providers to operate, compete, or enter the domestic market. In addition, Art. 4 of the Law on Competition requires public administration entities to ensure freedom of fair competition in Lithuania not only for national, but for foreign economic entities as well.

The participation of foreign banks is prominent, with eight foreign (EEA) banks' branches operating in Lithuania as of end of 2016, representing 16.8% of total banking sector assets. Provisions related to the supervisory activities of these branches are envisaged in CRD IV/CRR legislation.

There are no differences in treatment of foreign entities and domestically incorporated providers as regards the timeframe for the review and approval process, fit and proper tests required or capital requirements.

According to Article 13 of the Law on Banks, commercial banks established in Lithuania have the right to establish a bank in a foreign country, acquire a qualifying holding in the authorised capital and/or

voting rights of a foreign bank or increase it so that the foreign bank would become controlled by it or establish a branch in a foreign state upon obtaining an authorisation of the supervisory institution.

Lithuania has been a member of the World Trade Organisation (WTO) since 31 May 2001 and has made commitments under the WTO's General Agreement on Trade in Services (GATS), including specific commitments in financial and banking services. The only horizontal requirement in Lithuania's Schedule on Specific Commitments on Services is for providers of banking and other financial services to have at least one manager who is a Lithuanian citizen. Accordingly, the Law on Banks (Article 34(3)) stipulates that at least one head of the bank's administration must speak the Lithuanian language and permanently reside in Lithuania. Taking into account development of communication technologies it is planned to abolish the residency requirement by the end of 2017.

There are no additional rules or regulations restricting cross-border financial transactions. Domestic laws and regulations on AML/CFT processes do not discriminate between domestic and cross-border activities. Transactions are only differentiated into domestic and cross-border when it comes to common applicability of the risk-based approach and the implementation of international sanctions regime (prevention of money laundering and/or terrorist financing).

The laws regulating the insolvency of financial institutions and investor rights (compensation under the investment and deposit guarantee scheme and rights of creditors of financial institutions) do not differentiate between national and foreign investors and ensure the same rights and treatment.

Table 6. Lithuania's proposed reservations to the E items of the Code of Liberalisation of Current Invisible Operations

[Draft as of 30.06.2017]

E/1	<p>Payment Services <i>Remarks: The reservation applies to the provision of payment services in Lithuania by non-residents other than:</i> <i>i) credit institutions established in the EU;</i> <i>ii) payment institutions established in the EU, provided a notice from the other country supervisory authority has been received ;</i> <i>iii) electronic money institutions established in the EU.</i></p>
E/2	<p>Banking and investment services <i>Remarks: The reservation applies only to:</i> <i>i) the provision of underwriting and broker/dealer investment and banking services in Lithuania other than by licensed EU service providers;</i> <i>ii) the extent that financial advisor companies are allowed to transmit orders of clients only to EU licensed financial brokerage firms and credit institutions, and branches of financial brokerage firms and credit institutions established in third countries.</i></p>
E/4	<p>Asset Management <i>Remark: The reservations applies only to the provision of pension fund management services provided in Lithuania by non-residents, other than licensed EU service providers.</i></p>
E/5	<p>Advisory and agency services <i>Remark: The reservation applies only to the provision of investment research and advice in Lithuania by non-EU residents.</i></p>
E/7	<p>Conditions for establishment and operation of branches, agencies etc. of non-resident investors in the banking and financial services sector. Annex II to Annex A, paragraph 1 <i>Remarks: The reservation on paragraph 1:</i> <i>i) concerns the fact that under EU Directive 85/611/EEC, a depository of an undertaking for collective investment in transferable securities (UCITS) must either have its registered office in the same EU country as that of the undertaking or be established in the EU country if its registered office is in another EU country;</i> <i>ii) applies to the provision of investment services by branches of non EU resident financial brokerage firms</i></p>

B. Securities and other financial market instruments

As of 31 December 2016, seven management companies, supervised by the Bank of Lithuania, had established 14 CIUs (13 IFs and one investment company with variable Capital. Also, 11 management companies managed 39 Collective Investment Undertakings for informed investors (three of them had no assets and participants).¹⁵

VI. Compliance with the OECD legal instruments on financial markets¹⁶

Lithuania accepts all legal instruments under the Committee's purview. In the accession review, Lithuania has demonstrated a willingness and ability to implement these legal instruments.

C(2012)102: Recommendation of the Council on High-Level Principles on Financial Consumer Protection

Lithuania accepts this Recommendation.

C(2009)125: Recommendation of the Council on a Policy Framework for Effective and Efficient Financial Regulation

Lithuania accepts this Recommendation.

C(2009)62: Recommendation of the Council on Good Practices on Financial Education and Awareness Relating to Credit

Lithuania accepts this Recommendation.

C(2005)55/REV1: Recommendation of the Council on Principles and Good Practices for Financial Education and Awareness

Lithuania accepts this Recommendation.

C(75)198/FINAL: Recommendation of the Council concerning the Minimum Disclosure and Procedure Rules to be Complied with before Securities may be Offered to the Public

Lithuania accepts this Recommendation.

¹⁵ Consist of five equity, five mixed investment, three real estate, and one private equity CIU. In addition, three umbrella CIUs, assigned to mixed investment funds, had eight sub-funds: four equity, two mixed investment and two debt security. In Lithuania, nine special and ten harmonised CIUs have been established. Out of the funds that operated at the end of 2016, one CIU (real estate fund) did not invest and had no participants.

¹⁶ Lithuania's complete position on all the legal instruments can be found in Lithuania's Initial Memorandum to the CMF.

C(74)157: Recommendation of the Council concerning Regulations for the Public Offer and for Stock Exchange Listing or Quotation of Foreign Securities

Lithuania accepts this Recommendation.

C(74)156: Recommendation of the Council concerning Disclosure Requirements and Procedures to be Applicable to all Publicly Offered Securities

Lithuania accepts this Recommendation.

C(74)61/FINAL: Recommendation of the Council concerning the Review of any Restrictions which Member Countries Impose on Portfolio Investment in Unlisted or Unquoted Securities

Lithuania accepts this Recommendation.

C(71)234/FINAL: Recommendation of the Council concerning Standard Rules for the Operations of Institutions for Collective Investment in Securities

Lithuania accepts this Recommendation.

C(71)176/FINAL: Recommendation of the Council on International Security Issues

Lithuania accepts this Recommendation.

ANNEX

I. Overview

A. Macroeconomic context

In 2015, Lithuania's GDP grew by 1.8%, driven by strong household consumption and gross fixed capital formation. Investment had a positive contribution to growth, and Lithuania received substantial EU funds supporting public and private sector investment.

Import growth outpaced export growth in the same period, with subdued exports to some extent attributed to the Russian embargo imposed on certain European Union (EU) food products as well as the prolonged recession in Russia, one of Lithuania's key trade partners. Efforts to diversify Lithuania's export base, currently pursued, are bearing fruit and together with energy supply diversification (e.g. gas and electricity links) are expected to cushion the impact of demand fluctuations in export markets and reduce vulnerability to the economic performance of Russia in particular.

Table 7. Lithuania: selected macroeconomic indicators

	2013	2014	2015
GDP	3.5	3.5	1.8
Private consumption	4.3	4.3	4.1
Government consumption	0.7	0.3	0.9
Gross fixed capital formation	8.3	3.7	4.7
Residential	11.5	16.9	13.9
Final domestic demand	4.5	3.9	5.4
Stockbuilding ¹	-1.1	-0.1	3.4
Total domestic demand	3.2	3.4	7.1
Exports of goods and services	9.6	3.5	-0.4
Imports of goods and services	9.3	3.3	6.2
Net exports ¹	0.3	0.2	-5.2
GDP deflator	1.4	1.0	0.2
Harmonised index of consumer prices	1.2	0.2	-0.7
Private consumption deflator	1.0	0.1	-0.9
Unemployment rate	11.8	10.7	9.1
Output gap ²	0.1	0.7	-0.5
General government financial balance ³	-2.6	-0.7	-0.2
General government gross debt ³	48.0	52.7	53.4
General government gross debt, Maastricht definition ³	38.7	40.5	42.7
Current account balance ³	1.5	3.6	-2.3

Source: OECD Economic Outlook 98. Notes: 1. Contributions to changes in real GDP. 2. As a percentage of potential GDP. 3. As a percentage of GDP.

Inflation was negative in 2015, standing at -0.7% as a result of decreasing energy and food prices. Inflation is expected to return to positive territory in 2016, with a gradual recovery of energy prices, stronger demand and rising price levels in Lithuania's main export market, the EU.

Unemployment has followed a constant downward trend for several years, dropping from almost 20% during the financial crisis to 9.1% in 2015 but remains above the OECD average. Growing labour demand

and a moderate decline in supply and the lack of skilled labour force, partly attributed to the emigration of skilled labour to other EU countries, are expected to drive real wages upwards in the medium term.

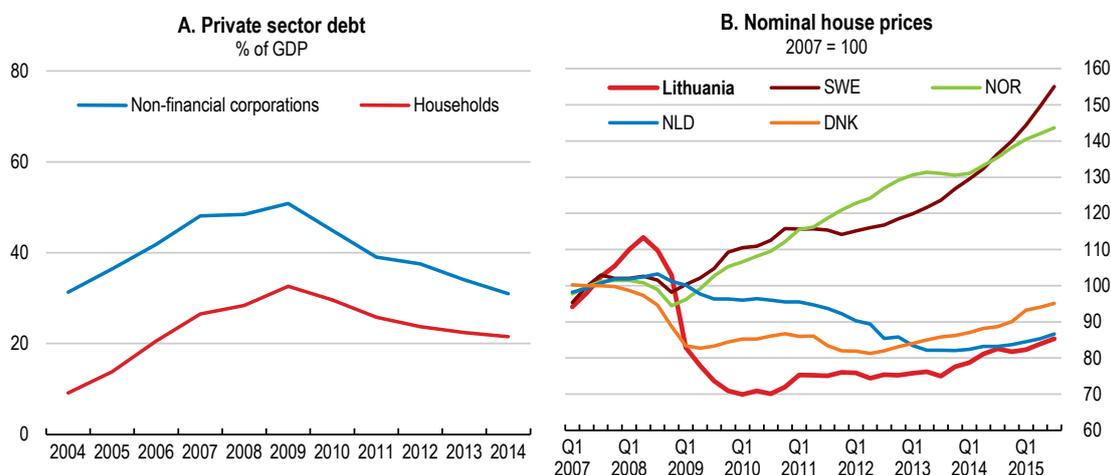
The BoL's balance sheet changed following the introduction of the euro in 2015, creating a break in the balance of payments data. As a result, the net investment position was still negative (-45% of GDP), but assets rose to 63% from 54% of GDP and liabilities to 108% from 100% of GDP in a single year.

B. Recent trends in financial markets

Lithuania has a small financial system dominated by deposit taking institutions, with banks comprising 79.2% of the financial system's assets and credit unions another 2.5% of total assets, as of year-end 2016. All six Lithuanian banks are universal retail banks, not engaged in cross-border activities. In addition, there are eight branches¹⁷ of EU banks established in Lithuania, specializing in corporate loans and leasing, with some of them also running a universal retail business model. Credit unions are specifically engaged in the provision of retail financial services (loans, transaction banking) exclusively to their members.

The Lithuanian banking sector is dominated by Scandinavian-owned banks, with three of them accounting for 73.1% of the sector's assets as of 2016: AB SEB bankas, Swedbank, AB and AB DNB bankas. In the run-up to the crisis, external financial conditions and easy access to low-cost funding resulted in an excessive credit cycle and a housing boom, with private debt rising to 85% of GDP in 2009. The financial crisis and the substantial decline in house prices created a strong deleveraging need, particularly for the subsidiaries of those three foreign-owned banks. Although these institutions had contributed to the excessive pre-crisis credit growth, they acted as a source of stability post-crisis by providing liquidity through the parent institutions and absorbing asset losses, thereby limiting the reversal of capital flows.

Figure 10. Private sector debt and nominal house prices in Lithuania



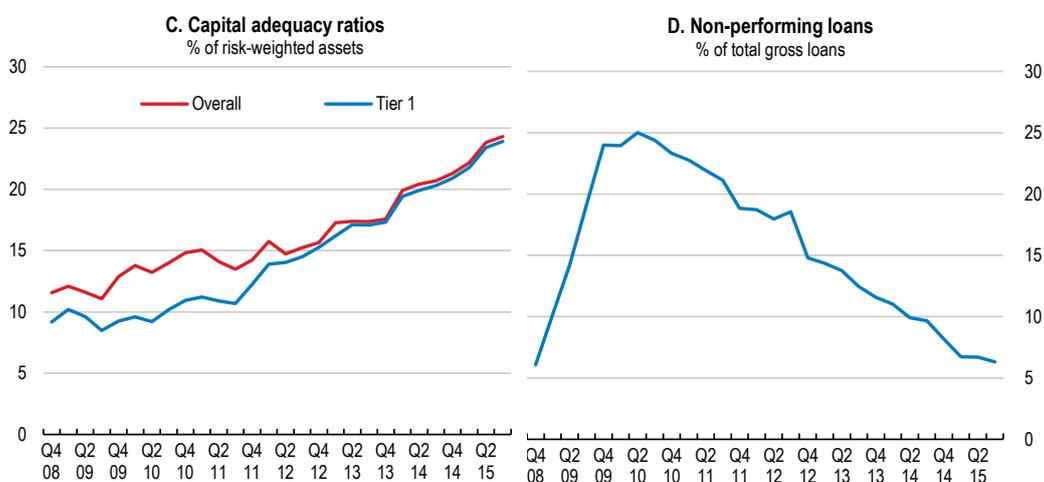
Source: IMF, Financial Soundness Indicators (FSI) database and Eurostat tables on EU policy; OECD Housing Prices database.

¹⁷ Danske bank has concluded a deal with Swedbank AB for the sale of its Lithuanian consumer retail portfolio (pending approval by the State Competition Council). The biggest share of Danske's activity in Lithuania was mortgage lending.

The Lithuanian financial sector recovered swiftly from the crisis, private sector debt dropped to less than 60% in 2013 and the loan-to-deposit ratio of Lithuanian banks declined from a peak of 170% in 2009 to 96% in 2016. Asset quality improved with non-performing loans standing at c. 4% from 20% levels in the aftermath of the crisis, driven by recoveries of previously impaired loans and write-offs of 2009-2010 crisis legacy loans.

The Lithuanian banking sector is well-capitalised with the average capital adequacy ratio standing at 20.0% as of Q1 2017 (including the capital conservation buffer of 2.5%) and the three Scandinavian-owned banks covered by the European Central Bank’s (ECB) asset quality comprehensive assessment have passed the latest review. According to the BoL’s stress tests, no Lithuanian bank is expected to breach the minimum capital requirement under a severe shock scenario.

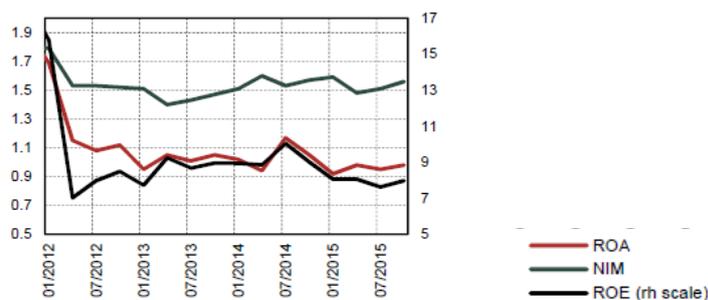
Figure 11. Lithuanian banking sector: capital adequacy and asset quality



Source: IMF, Financial Soundness Indicators (FSI) database and Eurostat tables on EU policy; OECD Housing Prices database.

Bank profitability has been hit by the persistent low interest rate environment and the decline in fees and commissions following the introduction of the euro in early 2015, as banks lost income from currency exchanges and transfers as a result of the adoption of the common currency. However, banking activities remain overall profitable with the sector posting a EUR 251.8 million profit in 2015 (17.0% increase year-on-year) and profitability is increasing due to significantly decreased interest expenses and increase in efficiency despite the above headwinds. The operations of 11 banks and foreign bank branches were profitable, while 2 market participants operated at a loss.

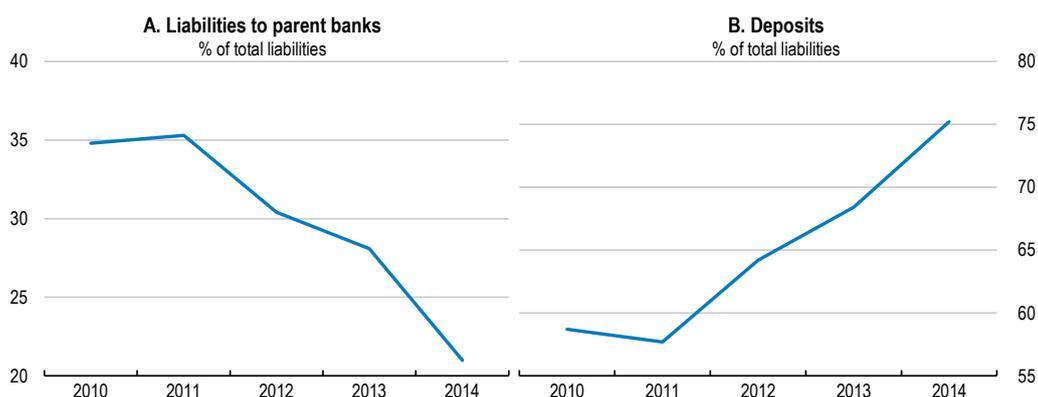
Figure 12. Bank profitability ratios and net interest margins (in percentages)



Source: Bank of Lithuania.

Funding through liabilities to parent banks has declined from 34.8% in 2010 to 16.8% in 2016, as a percentage of total liabilities. Deposits as a percentage of total liabilities have risen from 58.7% in 2010 to 79.8% in 2016. Such reduction in funding from parent banks, coupled with the parallel rise in deposits in the same period, suggest lower vulnerability to external financing conditions than in the past. It should be noted that civil code provisions prohibit the application of negative interest rates on deposits, which are the main source of bank funding, thus also limiting the potential for interest expense reduction.

Figure 13. Lithuanian banking sector: liabilities to parent banks and deposits



Source: Bank of Lithuania, Financial Stability Review 2015, Statistical annexes.

During the last 5 years, bankruptcy procedures were initiated against two domestic banks, AB bankas Snoras in 2011 and AB Ūkio bankas in 2013, following excessive risk-taking by these institutions. The failure of these two domestic banks has been dealt with adequately and without negative systemic repercussions and with a small impact on the share of the banking sector's assets in the financial system. Crisis resolution procedures were invoked; AB bankas Snoras deposits were compensated by the Deposit Insurance Fund, while a large share of AB Ūkio bankas assets and all insured deposits were transferred to AB Šiaulių bankas. In order to cover the deposit insurance compensations, the Ministry of Finance provided loans to the state enterprise 'Deposit and Investment Insurance', corresponding to 2,8% and 0,7% of annual GDP. The loan dedicated to deposit insurance pay-outs for AB bankas Snoras' clients was fully repaid by Q2 2015 from the recovered assets, while by end-2016 around two-thirds of the loan due to AB Ūkio bankas' insolvency has been repaid.

II. FSAP Recommendations

Figure 14. Recommended Action Plan to improve observance of Basel Core Principles

2006 Basel Core Principles (BCP)	Recommendations
Objectives, independence, powers, transparency, and cooperation BCP 1	Consider incorporating the objectives of banking supervision in the Law on the BoL on a basis consistent with the Law on Banks. Continue to advance the depth of staff expertise and skills.
Licensing and structure BCPs 2–5	
Prudential regulation and requirements BCPs 6–18	Ensure that the credit risk ensuing from client borrowing at variable interest rates or denominated in euros is fully captured in Pillar 1 and/or Pillar 2. Clarify to banks that open positions in euros enter into the capital adequacy calculations. Closely monitor banks' open positions in euros. Include, at a minimum, a balance sheet insolvency condition (zero net worth) in the Law as a trigger for compulsory license withdrawal.
Methods of ongoing banking supervision BCPs 19–21	Consider giving more guidance to banks on an individual basis, making use of more frequent contacts with on-site supervisors. Enhance the interaction between the Financial Stability Department and the Credit Institutions Supervision Department.
Accounting and disclosure BCP 22	Encourage the banks to make public simplified information, which should be comprehensible and accessible to a wide public, alongside with the obligatorily disclosed information.
Corrective and remedial powers of supervisors BCP 23	
Consolidated and cross-border banking supervision BCPs 24–25	Continue the close cooperation with the home country supervisory authorities of Lithuanian banks with foreign parents.

Source: IMF Financial Sector Assessment Program Update, Republic of Lithuania, Technical Note - Basel Core Principles of Effective Banking Supervision Assessment, IMF Country Report No. 08/246, July 2008.