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Republic of Lithuania: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Insurance Regulation, and Payment Systems

The Financial System Stability Assessment on **the Republic of Lithuania** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **December 21, 2001.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Republic of Lithuania** or the Executive Board of the IMF.

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REPUBLIC OF LITHUANIA

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and European II Departments

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December 21, 2001

The Financial System Stability Assessment (FSSA) is based on the work of the joint World Bank (WB)-IMF mission that visited Vilnius from November 5 to November 15, 2001, in the context of the Financial Sector Assessment Program (FSAP). Preparatory missions visited Vilnius from July 6 to July 13, 2001 and from September 10 to September 21, 2001; these were supplemented by stand-alone visits by experts to assess standards and codes. The missions met with senior officials and staff of institutions and agencies involved in the supervision and regulation of the Lithuanian financial system, including the Minister of Finance and the Governor of the Bank of Lithuania (BoL). Mission members also met with the Credit Institutions Supervision Department and the Settlements Center (both at the Bank of Lithuania), the Lithuanian Securities Commission (LSC), the State Insurance Supervisory Agency (SISA), and with representatives of commercial banks, insurance companies, accounting firms, credit rating agencies, auditors, and lawyers.

The FSAP team was led by Marie-Renee Bakker (Head, WB, ECA) and Karl Habermeier (Deputy Head, IMF, MAE) and included: Martin Cihak, Anne Kester, and Jodi Scarlata (all IMF); John Hegarty, Robert Gourley, Gregorio Impavido, Gordon Johnson, Cally Jordan, Peter Modeen, Marius Vismantas, and Walter Zunic (all WB); Tomas Hladek (Czech National Bank); Geoffrey Mortlock (Reserve Bank of New Zealand); and Alessandro Portolano (Bank of Italy). An IMF Article IV consultation and program review mission led by Patricia Alonso-Gamo (IMF, EU2) overlapped with the November FSAP mission. The mission was assisted by Mark Horton (IMF Resident Representative) and Mantas Nocius (Head of World Bank Office in Vilnius), who also joined some of the discussions.

There appear to be no immediate threats to the stability of the bank-dominated financial system, owing to sound macroeconomic policies in the context of the currency board arrangement (CBA), vigorous structural and legal reforms in preparation for accession to the European Union, and strong banking regulation and supervision. The two main banks are foreign-owned (and the authorities are seeking to sell the third largest and still state-owned bank to another foreign bank) and are liquid and well capitalized. The exposures related to the planned repegging of the litas from the U.S. dollar to the euro in February 2002 appear to be manageable. Against this background, recommendations focused mainly on the legal and regulatory framework for the financial system, based inter alia on the assessment of Lithuania's observance of international standards and codes. Areas that may warrant attention include bank intervention and failure resolution and the regulation and supervision of nonbank financial institutions and markets. The authorities agreed to participate in an assessment of their anti-money laundering policies, which was carried out during the mission. The assessment found that while policies in this area were generally sound, there were some issues that merited further attention.

This report is divided into two sections. The first section provides an overall stability assessment of the Lithuanian financial system. The second section reports on the observance of standards and codes in the areas of banking supervision, insurance supervision, payments system, and transparency in monetary and financial policies.

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SECTION I—REPORT ON FINANCIAL SYSTEM STABILITY

I. OVERALL STABILITY ASSESSMENT AND KEY RECOMMENDATIONS

1. **There appear to be no immediate threats to financial system soundness in Lithuania.** Macroeconomic policies are centered around a currency board arrangement (CBA) supported by fiscal discipline and a Fund program. International capital flows have been liberalized for some years with beneficial effects. Both domestic and foreign indebtedness are low, with the current account deficit financed largely by private foreign direct investment inflows. Banks have adopted a conservative approach to lending and risk management, and their capitalization and loan quality are generally adequate. Securities and insurance markets are not large enough to pose a significant systemic risk in the near term. The payment and settlement system handles only a limited number of transactions and has shown itself to be robust in previous periods of stress. Regulation and supervision of banking and securities markets are well-developed, and there is a high degree of transparency in monetary and financial policies. There are, however, significant weaknesses in insurance regulation and supervision.

2. **There is at present ample liquidity in the Lithuanian financial system.** This is particularly important in view of the constraints imposed by the CBA on Bank of Lithuania (BoL) lender of last resort operations. The foreign exchange reserves of the BoL exceed reserve money by about 50 percent; and the foreign exchange reserves are overwhelmingly invested in highly liquid instruments. Commercial banks, too, hold considerable liquid assets, both in domestic and in foreign currency.

3. **Lithuania is firmly committed to EU accession by the beginning of 2004**, and has made considerable progress in adopting the *acquis communautaire*. Following EU accession, the authorities would like to join the euro-zone as soon as possible (after a minimum of two years following EU accession and entry into the ERM), and as an important step in this direction, will repeg the litas from the U.S. dollar to the euro on February 2, 2002.

4. **Stress tests indicate that the Lithuanian financial system should be able to cope with most shocks.** Shocks considered in the stress-testing exercise, both individually and in combination, included swings in interest rates and exchange rates (such as the euro-dollar cross rate), declines in interest margins, and a downturn in real economic activity. In particular, absent unusually and unexpectedly large movements in the euro-dollar rate between now and the repegging date, there appear to be no significant risks to financial system stability from the repegging of the litas, which will entail no devaluation or revaluation relative to the market rate. Only a very major shock, such as a financial crisis in the countries of origin of the institutions that own the Lithuanian banks, could materially affect bank solvency in Lithuania through foreign ownership linkages.

5. **Some measures could be taken to more effectively address the impact of hypothetical large shocks to the financial system.** These include, most importantly,

expanding the legal powers of the BoL to intervene in, and quickly resolve the failure of, banks experiencing financial distress or insolvency, strengthening supervisory cooperation with the home country supervisors of Lithuanian banks' parent institutions, and establishing sufficiently stringent limits on domestic banks' exposures to their parent institutions. Other measures include improving the quality of borrower and bank financial statements, strengthening accountability of bank directors for risk management, and revising loan classification and provisioning rules to better reflect borrower creditworthiness and the fair value of collateral. There may also be a case for modifying the present arrangements for the management of the assets of failed banks, which have proven less than fully effective.

6. **Financial activity is likely to grow markedly in years to come, but a large share of the intermediation of saving and investment will not take place locally, but will instead involve a specific pattern of domestic and cross-border financial activity**. Notably, domestic banks and leasing companies are likely to intermediate demand for finance from SMEs, households, and to some extent larger corporates, using domestic deposits. By contrast, large enterprises will probably continue to rely more heavily on foreign sources of financing, as they have done to date. Demand for insurance and nonbank saving products is likely to expand, but given the small size and lack of liquidity of domestic securities markets, and the difficulty of adequately diversifying risks in a small market, insurers and other institutional investors are most likely to place a large portion of these funds abroad, all the more so as the barriers between domestic and foreign financial markets will continue to diminish in the course of European integration.

7. **These anticipated developments would need to be supported by changes in the regulatory, supervisory, and market infrastructure.** It may be desirable to consolidate the insurance industry, improve consumer protection for policyholders, and strengthen the independence and the capacity of the insurance supervisory agency in connection with the planned overhaul of insurance legislation. The further development of the market for Lithuanian equity and debt securities will most likely involve some form of cooperation or merger between the NSEL and other exchanges in the region, coupled with measures to significantly improve issuer disclosure, the quality of issuer financial statements, and the protection of minority shareholders. More generally, there is a need to address the regulatory and market implications of increasing international integration of financial markets and the growth of domestic and foreign financial conglomerates providing a wide range of different financial services.

8. **As requested by the authorities, an assessment of anti-money laundering policies was undertaken**, based on the preliminary methodology developed by the Fund and the World Bank. This assessment found the legal and regulatory framework to be largely in line with international standards, but it also identified areas for improvement in the examination and cooperation practices of supervisory agencies involved in preventing money laundering.

II. Financial System Overview

A. Institutions and Markets

9. **Institutions in the Lithuanian financial system comprise banks, securities firms, insurance companies, and leasing companies** (Table 1). The system is dominated by banks, which at end-June 2001 accounted for 87 percent of total financial system assets (93 percent, when consolidated with their subsidiaries).

10. **Overall, the financial system is relatively small**, with total assets equivalent to about 30 percent of GDP.[1] Monetization of the economy, as measured by the ratio of broad money to GDP, increased from 18 percent in 1998 to 21 percent in 2000, reflecting higher confidence in the banking system, but it still remains low compared with other countries (Figure 1). The money multiplier increased from 2.0 in 1998 to 2.6 in 2000, reflecting both a reduction in required reserves and a substitution away from cash in transactions (Figure 2). However, credit to the private sector has until recently grown much more slowly than money; and financial intermediation in Lithuania is among the lowest in the region.

11. **The Lithuanian banking system has undergone substantial consolidation and restructuring since the banking crisis of 1995–96.** Following the crisis, some banks had their licenses revoked and were liquidated, while some merged. As a result, the number of licensed banks declined from 27 in the mid-1990s to 14 in mid-2001 (10 domestically incorporated banks and 4 branches of foreign banks).[2] The system is now highly concentrated, with the three largest banks accounting for about 85 percent of total banking system assets. The two largest banks have been recently privatized and are part of Swedish-owned banking groups. The authorities are seeking to privatize the third largest and still state-owned bank, the Agricultural Bank of Lithuania.

12. **The nonbank financial sector has grown in recent years, but remains small.** The further development of nonbank institutions and markets will be strongly influenced by efforts to achieve greater integration between the Lithuanian economy and other European economies. Foreign institutions and investors appear likely to play an increasing role, acting either directly or through local subsidiaries and branches.

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[1] The calculation of total assets of the financial system for the purpose of this report includes the assets of securities firms, but not the securities that are traded in the securities market (see Table 1).

[2] This figure includes a state-owned asset management institution (Turto Bankas), which was classified under "other banking institution" until mid-2001.

Table 1. Lithuania: Financial System Structure, 1997-2001

	Dec-97			Dec-98			Dec-99			Dec-00			Jun-01			
	Number	Assets (M litas)	Pct of assets	Number	Assets (M litas)	Pct of assets	Number	Assets (M litas)	Pct of assets	Number	Assets (M litas)	Pct of assets	Number	Assets (M litas)	Pct of assets	Pct of GDP
Banks	13	8,393	91.3	13	10,689	86.5	14	11,358	86.7	14	13,213	86.3	15	13,305	87.1	27.7
Private	9	4,265	46.4	10	5,871	47.5	11	6,537	49.9	11	8,007	52.3	13	11,473	75.1	23.9
Domestic 1/	8	4,241	46.1	8	5,645	45.7	8	6,186	47.2	8	7,479	48.9	9	10,693	70.0	22.2
Foreign 2/	1	24	0.3	2	226	1.8	3	351	2.7	3	528	3.5	4	780	5.1	1.6
State-owned	3	4,062	44.2	2	4,680	37.9	2	4,706	35.9	2	5,088	33.2	1	1,734	11.3	3.6
Other banking institutions 3/	1	66	0.7	1	138	1.1	1	115	0.9	1	118	0.8	1	98	0.6	0.2
Institutional investors	22	273	3.0	53	911	7.4	49	926	7.1	45	946	6.2	46	967	6.3	2.0
Insurance companies	-	-	-	32	616	5.0	32	749	5.7	33	828	5.4	33	859	5.6	1.8
Life	...	...	...	4	28	0.2	5	55	0.4	6	100	0.7	7	127	0.8	0.3
Nonlife	...	...	...	28	588	4.8	27	694	4.5	27	728	4.8	26	732	4.8	1.5
Pension funds	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Investment companies	22	273	3.0	21	295	2.4	17	177	1.4	12	118	0.8	13	108	0.7	0.2
Investment holding companies	22	273	3.0	21	295	2.4	17	177	1.4	12	118	0.8	12	107	0.7	0.2
Collective investment schemes	-	-	-	-	-	-	-	-	-	-	-	-	1	1	0.0	0.0
Other nonbank	82	460	5.0	82	621	5.0	149	701	5.3	151	1,026	6.7	150	911	6.0	1.9
Leasing companies	8	450	4.9	10	602	4.9	17	660	5.0	17	944	6.2	15	833	5.5	1.7
Securities firms	51	7	0.1	44	11	0.1	38	22	0.2	27	53	0.3	25	55	0.4	0.1
Brokerage companies	47	...	...	39	...	...	32	...	...	23	50	0.3	21	52	0.3	0.1
Investment management 4/	4	...	...	5	...	...	6	...	...	4	3	0.0	4	3	0.0	0.0
Mortgage institutions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Credit unions and cooperatives	23	3	0.0	28	8	0.1	33	10	0.1	38	15	0.1	39	23	0.1	0.0
Insurance brokers	...	...	...	...	...	...	61	9	0.1	69	14	0.1	71	...	...	...
Microfinance institutions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Other	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Total financial system 5/	118	9,193	100.0	149	12,359	100.0	213	13,100	100.0	211	15,303	100.0	212	15,280	100.0	31.8
Memorandum items:																
Branches of domestic banks	204	-	-	175	-	-	171	-	-	159	-	-	160	-	-	-

Sources: Bank of Lithuania, Ministry of Finance, Department of Statistics, and staff calculations and estimates.

1/ Domestically incorporated private commercial banks, including subsidiaries of foreign banks.

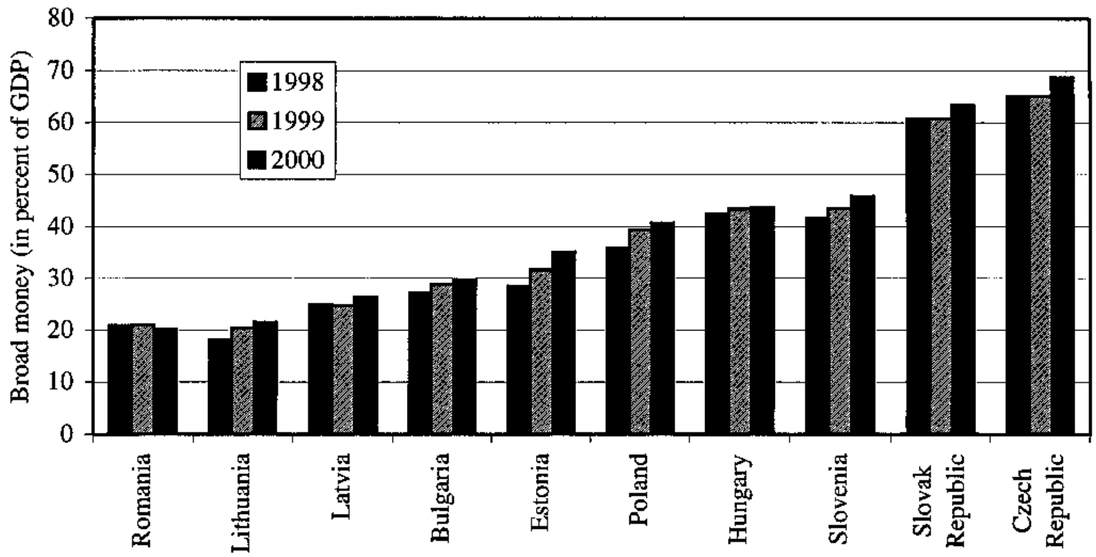
2/ Branches of foreign banks.

3/ Includes a state-owned loan workout company (Turto Bankas). Data adjusted for assets entrusted for management by the state.

4/ Includes investment consulting and management companies, and investment management companies.

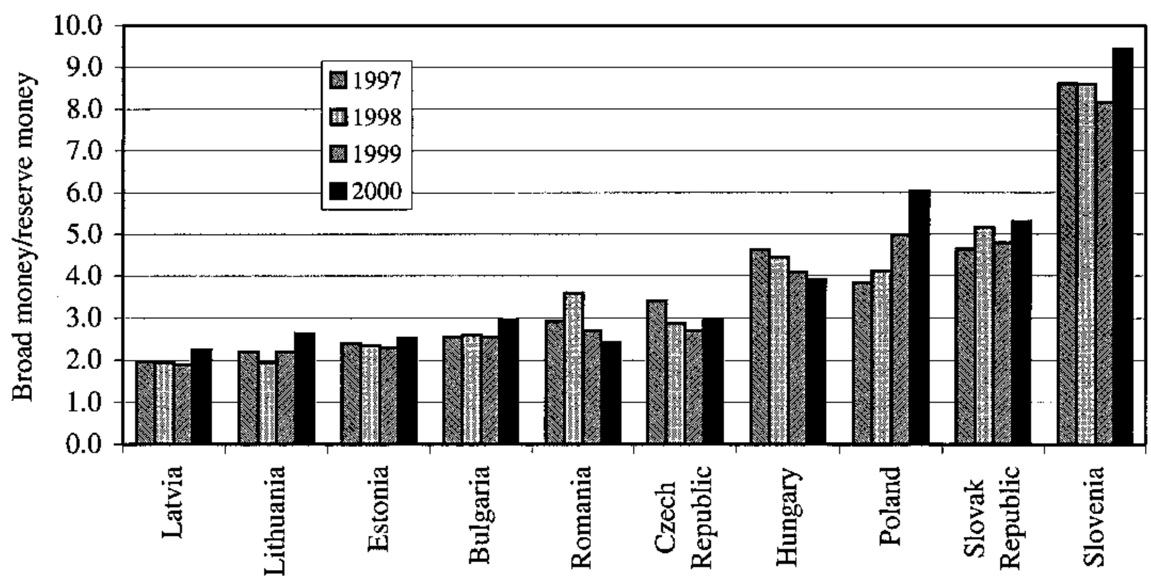
5/ Does not include the capitalization of the stock market.

Figure 1. Cross Country Comparison: Broad Money, 1998–2000[1/]



Source: IMF, International Financial Statistics, and staff calculations.
1/ The average of broad money at the end of the current and the previous year, as a percentage of the current year's GDP.

Figure 2. Cross Country Comparison: Money Multiplier, 1997–2000[1/]



Source: IMF, International Financial Statistics, and staff calculations.
1/ The ratio of broad money to reserve money.

13. **The securities market is not highly developed, with total market capitalization of about 25 percent of GDP, and very little trading and liquidity**. Lithuanian government debt securities represent sixty percent of trading on the NSEL, the rest being shares.[3] Capitalization is concentrated in a few large enterprises; and only 6 enterprises are actively traded, while perhaps 40 other listed enterprises trade sporadically. Other large enterprises are closely or privately held and do not trade at all. There are no significant institutional investors, only one index mutual fund, and virtually no retail investor base.[4] There are no private pension funds as of yet, although a new law for a voluntary scheme—third pillar—was passed last year (a draft law for compulsory schemes—second pillar—is currently being discussed). Brokerage firms and brokerage departments of commercial banks provide intermediation in the capital markets. In December 2000, there were 27 such intermediaries with about 200 licensed financial brokers, probably too many in view of the small size of the market; and consolidation is ongoing.

14. **The insurance sector is small but likely to develop significantly in the years ahead**. Gross insurance premiums amounted to only 1 percent of GDP in 2000 (of which 0.8 percentage points was nonlife insurance and 0.2 percentage points life insurance), and insurance sector assets amounted to less than 1.8 percent of GDP. On a per capita basis, nonlife insurance premiums totalled only LTL 106.4 million (US$26.6 million),[5] and life insurance premiums LTL 20.6 million (US$5.2 million). Starting from this low base, there is considerable potential for growth. Notably, it is expected that nonlife gross premium income will increase by 30 to 40 percent per year for 2 to 3 years following the introduction of compulsory motor insurance in 2002.

15. **The insurance market is highly concentrated, with banks and foreign investors playing a growing role**. At the end of 2000, there were 6 life insurance companies and 27 nonlife insurance companies, with the three largest companies writing 63 percent of nonlife

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[3] Moreover, the government draws significant financing from eurobonds traded in London, Frankfurt, and Luxembourg (equivalent to about 9 percent of GDP, compared with total public debt of about 30 percent of GDP).

[4] Wealthy individuals often invest in foreign markets. The general public does not participate in capital markets, reflecting low levels of wealth but also a lack of confidence in the wake of the voucher privatizations of the early 1990s, which marooned many households in illiquid and nonperforming investments. In December 2001, about 800 companies comprised the NSEL's "Unlisted Sector," which consists mainly of the residue of voucher privatization, with 300 or more companies having simply "vanished."

[5] Major nonlife insurance activity comprises automobile (about 27 percent), property (about 22 percent), and automobile liability (about 16 percent).

insurance policies and 94 percent of life insurance policies in 2000.[6] Insurance is also becoming more integrated with other financial services as banks are entering the market by establishing insurance subsidiaries. At the end of 2000, banks controlled four of the 27 nonlife insurance companies and two of the six life insurance companies. Foreign investment in the Lithuanian insurance market is continuing to increase. At the end of 2000, foreign investors held almost half of the equity in Lithuanian insurance companies, with investors from Germany, Finland, and Denmark playing the largest roles.

16. **Leasing and factoring have increased rapidly in importance in the last two years,** with outstanding balances equivalent to 2 percent of GDP. This market is dominated by the largest domestic bank and by a Swedish-owned bank in Estonia and their leasing subsidiaries. There are as yet no separately incorporated factoring companies. Leasing and factoring are especially important sources of financing for SMEs. Adaptations in the legal and regulatory framework for this market should help to further stimulate its growth.

B. Liquidity Infrastructure and Safety Nets

17. **Systemic liquidity policies are constrained by the CBA**. Against this background, the authorities have given the strongest possible emphasis to establishing sound and sustainable macroeconomic conditions and strengthening the institutional and regulatory infrastructure of the financial system in an environment of almost entirely liberalized international capital flows.

18. **Interbank money markets for litas are not highly developed**. The monthly volume of transactions in the domestic interbank market averaged only about LTL 600 million in January–September 2001. Market development has in the past been constrained by cumbersome legal arrangements for collateral, though steps were taken recently to simplify these.[7] High minimum reserve requirements may have reduced banks' use of the interbank market to manage liquidity. Also, some foreign-owned banks have preferred to place excess liquidity with their parent institutions instead of in the domestic money market.

19. **The shallowness of the interbank market manifests itself in high interest margins and volatile interest rates.** The BoL no longer enters the money market to smooth liquidity, but has instead moved in November 2000 to increase market transparency by beginning to publish daily data on liquidity in the financial system. There are no direct regulatory limits on

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[6] In 2000, the three largest life companies accounted for 80 percent of total assets and the three largest nonlife companies for 71 percent of total assets in their respective sectors.

[7] In early October 2001, parliament passed an amendment to the Law on Public Trading in Securities to allow market participants to avoid complicated collateral registration procedures for overnight loans and similar instruments.

interbank exposures, but commercial banks have established internal limits with respect to other banks, in line with the expectations of bank supervisors. The transfer of treasury accounts from commercial banks to the central bank in mid-2001 was smooth and did not create problems for liquidity management.[8] A deeper interbank money market, which is gradually developing, would help to improve liquidity conditions, raise the efficiency of banks' treasury management, reduce the volatility of domestic interest rates, and lower the costs of financial intermediation.

20. **There is at present ample liquidity in the Lithuanian financial system.** The foreign exchange reserve coverage of reserve money increased from 122 percent at end-1999 to 152 percent at end-June 2001; and official reserves are overwhelmingly invested in highly liquid instruments. The reserve coverage of gross short-term debt improved from 65 percent in 1999 to 79 percent in 2001.[9] The government held about US$91 million of liquidity abroad in a highly rated fund. The private sector's liquid assets are mainly held in the form of deposits with domestic and foreign banks, bonds, and money market instruments. The private sector's main short-term liabilities are trade credit and borrowing from banks. The former exposure is manageable (US$717 million at end-June 2001), while the latter could be easily rolled over given the abundance of liquid assets held by banks. Minimum reserve requirements now stand at 8 percent of deposits; and banks hold the equivalent of about another 6 percent of deposits in excess reserves and cash. However, the eventual convergence of reserve requirements to the much lower level in the European System of Central Banks will reduce the scope for further reductions in reserve requirements in periods of diminishing liquidity. Liquidity could also decline in years to come if, for example, demand for bank loans increases rapidly.

21. **The payment system handles only a limited number of transactions and has shown itself to be robust in previous periods of stress**. There is only one payment system in Lithuania (TARPBANK), which is a designated time net settlement system. Compliance

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[8] In the three months following the shift, average daily volume in the domestic interbank market increased by almost 60 percent compared with the 18 months preceding the shift; and both the standard deviation and the coefficient of variation of interbank market rates declined substantially (so interbank rates became less volatile). This occurred even as the average daily change in central government accounts with the BoL changed sign and more than doubled in absolute value.

[9] This occurred because gross official reserves increased, despite a reduction in the reserve requirement ratio from 10 to 8 percent in 2000, while short-term external debt declined. A relatively low reserve coverage of short-term debt should be considered in the context of the availability of high quality liquid assets of the private and public sectors. At end-June 2001, Lithuania had a positive net short-term asset position.

with the CPSS Principles for Systemically Important Payment Systems is generally good.[10] The payment system was developed by the BoL, which is also its owner and operator. The system is capable of processing both high value and low value payments (although low-value payments are preponderant at present); and it is also used to perform the settlement of the cash leg of securities transactions. Users are mainly domestic banks, branches of foreign banks, and participants in the securities market.[11] Equipment, communication standards, and security arrangements put in place by the central bank and commercial banks in the area of payments are modern. Cash is still widely used for payments in Lithuania, but noncash means are growing in importance.[12] There have been no apparent attempts to violate payment system rules, nor attempts at or complaints of fraud. The payment system was able to weather, without any significant failure or gridlock, the domestic banking crisis of 1995 and the Russia crisis of 1998, both of which caused major economic and financial disturbances in Lithuania. Even though two large banks were short of liquidity during the 1995 crisis and it was necessary to reject a number of transactions from the input queues, these rejections did not cause a failure of the system. In connection with EU accession, the authorities are working to develop a real-time gross settlement system (RTGS) by 2004 and to establish an interface with the EU's TARGET system.

22. **A deposit insurance fund has been established**, with assets of presently about 1 percent of GDP. EU standards in this area will require significantly increased depositor and security investor protection amounts to be implemented by 2008.[13] A small investor protection scheme, with similarly increasing coverage to reach compliance with applicable EU standards over the medium term, will also have to be introduced.

C. Regulation and Supervision

23. **The Bank of Lithuania (BoL) is responsible for licensing and supervising banks and credit unions**. The formal exercise of most banking supervision powers is vested in the Board of the BoL, but the operational responsibility for banking supervision rests with the Credit Institutions Supervision Department (CISD). The objectives of banking supervision are clearly set out in law, the BoL has a wide range of powers to license and supervise banks and credit unions, and to manage their exit from the system when necessary. A comprehensive framework of prudential regulation and supervision has been established that

[10] See Section II of this report for details.

[11] I.e., the Central Securities Depository of Lithuania (CSDL), brokerage departments of commercial banks, and brokerage companies licensed by the LSC.

[12] Wages are transferred to bank accounts, payment cards usage and ATM networks are growing rapidly, and e-money schemes are in place. The use of checks is not widespread.

[13] A full discussion of deposit insurance is found in Chapter IV.

either fully or largely conforms to the Basel Core Principles in most respects, with the most notable weakness being a lack of legal protection for banking supervision staff. Staffing is adequate, and CISD staff possess the necessary skills to carry out their responsibilities.[14]

24. **In the last year or two, further progress has been made in developing the supervisory arrangements for banks**. The BoL has taken steps to bring the supervision regime into line with the recommendations of the Basel Committee and directives from the European Union. In particular, the BoL has implemented the EU directives on capital adequacy—CAD I and CAD II. Supervisory coordination has been strengthened, including through memoranda of understanding (MOU) between the BoL, the Lithuanian Securities Commission, and the State Insurance Supervisory Authority, and between the BoL and the banking supervision authorities in a number of countries with a banking presence in Lithuania. Important steps have also been taken to strengthen the regulatory arrangements applicable to credit unions.

25. **The legal basis for the sound, transparent, and efficient functioning of the securities market is provided in the Law of the Republic of Lithuania on Public Trading of Securities (LPTS)**, which aims to protect the interests of investors and ensure competition among participants in the market. The LPTS allocates responsibility for the supervision of the securities market to the LSC, a government agency accountable to parliament and whose funding comes from the state budget. The LSC consists of a chairman and four commissioners appointed to a five-year term. The LSC oversees the compliance with laws and regulations governing public trading in securities, by conducting routine and for-cause inspections of public trading intermediaries, public companies, and investment companies. Inspections are initiated in response to investors' complaints or suspicious transactions. Upon detecting a violation, the LSC may warn a violator to remedy the situation, impose a pecuniary penalty, or suspend or revoke licenses.

26. **The Law on Insurance regulates the activities of insurance companies and brokers and establishes the framework for the supervision of the sector**. Responsibility for insurance supervision rests with SISA, an agency of the Ministry of Finance (MoF).[15] SISA is charged with the protection of the interests and rights of policyholders, the insured, beneficiaries, and third persons. SISA issues licenses for insurance activity, insurance products, insurance brokers, and company branch establishments. It also approves minimum

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[14] See Section II of this report for the details of compliance with the Basel Core Principles for Effective Banking Supervision.

[15] The organizational structure of SISA is specified in the Law on Insurance and includes a director, a board, and a staff. The director is appointed by the Minister of Finance (MoF). The board of SISA is appointed and dismissed, on the proposal of the director, by the MoF. The director serves as the chairman of the board.

rates for insurance premiums, amendments to insurance terms and conditions, methods for calculations under insurance technical provisions, solvency margins, reinsurance and other activities. Subject to the resolutions of its board, SISA's director can impose sanctions—warning or penalty—on insurance companies, their managers, and insurance brokers. In addition, SISA can revoke licenses for insurance activities, exercise oversight of insurance companies and brokers to ensure compliance with financial and accounting practices, and monitor adherence to insurance rules and regulations. Supplementary regulations are established by orders of the MoF and resolutions of the Board of SISA. There are, however, some weaknesses in insurance regulation and supervision, as noted in the assessment of compliance with the IAIS Insurance Core Principles.[16]

III. Financial System Stability: Macroeconomic Factors

A. Macroeconomic Environment

27. **Macroeconomic management in Lithuania improved markedly in the last two years.** After the fiscal deficit reached 8.5 percent of GDP in 1999 (Table 2) and the government's access to financial markets became constrained, Lithuania adopted a stabilization program under a stand-by arrangement with the IMF.[17] Measures to substantially reduce the fiscal deficit were central to this program. Fiscal adjustment restrained demand, economic activity and exports strengthened, and the current account deficit declined sharply in 2000. Increasing productivity allowed exporters to remain competitive despite a real appreciation of the litas. Monetary aggregates continued to grow quickly as the monetization of the economy increased and substitution from currency to deposits raised the money multiplier.

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[16] Details are provided in Section II of this report.

[17] An IMF Stand-By-Arrangement was approved on March 8, 2000 and expired on June 7, 2001 (EBS/00/28, EBS/01/19, and EBS/01/63). A new 19-month precautionary Stand-By Arrangement was approved by the IMF Executive Board on August 30, 2001, in an amount of SDR 86.52 million or 60 percent of quota (EBS/01/160). The authorities have indicated their intention not to make purchases under the arrangement.

Table 2. Lithuania: Selected Macroeconomic Indicators, 1997-2001

(As of December 12, 2001)

Total population (end-2000, million)	3.7
GDP per capita (2000, in U.S. dollars)	3,027

	1997	1998	1999	2000	2001 Est.
Real sector					
GDP (percent change, in constant prices)	7.3	5.1	-3.9	3.9	4.5
GDP (in millions of U.S. dollars)	9,585	10,748	10,664	11,314	12,022
Consumer price index (percent change, end of period)	8.4	2.4	0.3	1.5	2.0
Non-government national savings (percent of GDP)	15	13	15	15	14
Monetary and credit data (percent changes, end of period)					
Reserve money	32.4	28.8	-4.0	-3.3	5.5
Money (M1)	41.5	9.0	-5.3	7.5	...
Broad money (M3)	34.1	14.5	7.7	16.5	15.8
Domestic credit	37.6	16.8	24.5	1.7	...
Private sector credit 1/	18.9	16.9	13.8	-1.2	9.8
Yield on government bills (percent, end of period) 2/	10.7	12.7	11.1	5.9	4.6
Yield on government bonds (percent, end of period) 3/	...	...	18.0	9.0	6.1
Reference bank lending rate (percent, annual average) 4/	14.4	12.2	13.1	12.1	...
Spread of benchmark bonds (basis points, end of period) 5/	105.0	359.0	268.0	228.0	...
Stock market index	40.3	-41.6	0.0	-3.9	...
Public finance (in percent of GDP) 6/					
Central government financial balance	-2.3	-4.4	-5.4	-2.2	-1.6
General government financial balance	-1.5	-4.4	-6.2	-2.1	-1.7
Municipalities	1	0	-1	0	0
General government fiscal balance	-1.8	-5.9	-8.5	-2.7	-1.7
External sector (millions of U.S. dollars, unless otherwise indicated)					
Litas per U.S. dollar (end of period)	4.0	4.0	4.0	4.0	4.0
Current account	-981	-1,298	-1,194	-675	-695
in percent of GDP	-10.2	-12.1	-11.2	-6.0	-5.8
of which: Trade balance	-1,147	-1,518	-1,405	-1,104	-1,036
Foreign direct investment (net)	328	921	478	375	433
Portfolio investment (net)	188	-53	506	265	318
Gross official reserves (end of period)	1,063	1,460	1,242	1,359	1,565
Reserve cover (months of imports of GNFS)	2.0	3.3	2.6	2.6	2.6
Reserve cover (short-term external debt)	0.6	0.8	0.7	0.5	...
Total external debt, gross 7/	3,759	3,741	4,528	4,856	...
in percent of GDP	39.2	34.8	42.5	42.9	...
Total external debt, net 8/	...	2,243	2,818	2,948	...
in percent of GDP	...	20.9	26.4	26.1	...
of which: Public sector debt	...	1,687	2,392	2,364	...
of which: Banking sector debt	...	473	577	569	...
Central bank short-term foreign liabilities (end of period) 9/	0.7	0.7	0.8	0.7	...
External interest payments to GNFS exports (in percent)	...	3.2	3.7	4.2	4.5

Sources: Data provided by Lithuanian authorities; and Fund staff estimates.

1/ December 2000 is adjusted for reclassification of LTL 270 of DMB's claims on private sector to government lending funds, which were removed from balance sheets in July 2000.

2/ End-year average yield on 6-month government bills. The 2001 figure relates to November 26, 2001.

3/ End-year average yield on 2-year government bonds. The 2001 figure relates to December 3, 2001.

4/ Average annual interest rates on bank loans in litas on total maturities.

5/ Monthly average spread of 5-year Eurobond (US$200 million) issued in July 1997 above the rate on a synthetic U.S. treasury bond with the same maturity, as reported by DataStream.

6/ Financial balance equals revenues minus expenditures. Fiscal balance equals revenues minus expenditures minus net lending.

7/ External liabilities minus foreign equity investment in Lithuania.

8/ Total external liabilities minus total external assets, excluding foreign direct investment, equity invesetment, and reserve assets.

9/ Remaining maturities of 1 year or less. The sum of repurchase agreements and non-residents deposits.

28. **Improved economic policies have also enhanced the credibility of the CBA,** which remains the cornerstone of macroeconomic and financial stability in Lithuania. The authorities decided to repeg the litas from the dollar to the euro, given the increased integration with the euro area and the intention to join the European Union, possibly as early as the beginning of 2004. Lithuania could join the euro area a minimum of two years following EU accession and participation in the ERM; and the authorities hope to reach this important milestone by 2006 or 2007. The authorities announced in June, 2001 that the repegging would take place on February 2, 2002. The advance notice was meant to afford private agents adequate time to restructure their portfolios and thus limit the exchange risk arising from the repegging.

29. **Macroeconomic performance has remained good thus far in 2001**. Real GDP grew by 5.1 percent in the first half of 2001, with a gradual recovery in domestic demand adding to the contribution from strong export performance. Inflation remained relatively subdued, consistent with wage moderation and the lagged effects of the appreciation of the litas against the euro, with the consumer price index increasing by 2.1 percent in the 12 months to September 2001. The external current account deficit narrowed to 5 percent of GDP in the first half of 2001, reflecting the brisk growth in exports. The completion of major privatization projects and higher reinvested earnings resulted in an increase in foreign direct investment of 76.8 percent year-on-year in the first half of 2001. Broad money grew by 17.2 percent year-on-year through August 2001, reflecting sustained confidence in the banking system. While the increased monetization has mainly resulted in a further accumulation of net foreign assets by banks (LTL 302 million between end-year 2000 and August of 2001), growth of credit to the private sector turned around in early 2001, growing by 9.5 percent in September year-on-year.

30. **The main fiscal targets for the first half of 2001 were met**. The fiscal deficit was 1.5 percent of GDP, much lower than programmed; and it is expected that the authorities will meet their target for the year as a whole under the Fund program. However, continued revenue shortfalls point to the need for tax reform, including the elimination of loopholes in VAT and the improvement of tax administration. Progress is being made in other fiscal structural areas, especially in policies to increase the financial accountability of municipalities.

31. Lithuania has already liberalized most international capital movements; and further liberalization is expected in connection with preparations for accession to the EU.[18] In particular, Lithuania imposes no restrictions on credits related to commercial transactions or the provision of services, nor on financial loans and credits. Residents may open accounts in foreign banks, and nonresidents may open accounts in Lithuanian banks. Foreign direct

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[18] Moreover, Lithuania has since May 1994 accepted the obligations of Article VIII and has eliminated all restrictions on current payments and transfers.

investment, both inward and outward, is largely unrestricted.[19] There are no restrictions on cross-border portfolio investment by resident and nonresident individuals. Some restrictions on the activities of financial institutions remain in place, particularly on insurance companies, investment funds, pension funds, and other institutional investors. For example, pension funds are presently not permitted to invest more than 30 percent of their assets in foreign securities. Although these limitations are mainly of a prudential nature, a few are not compatible with the *acquis communitaire* and will need to be revised prior to accession to the EU.

B. Macrofinancial Risks and Exposures

Domestic and external macroeconomic risks

32. **At present, there are no significant risks to financial system stability from domestic macroecononomic conditions and policies**. However, the continued stability of the CBA and financial markets in Lithuania depends on sound fiscal policy. Gradual progress towards the government's objective of a budget balance over the cycle (excluding the cost of the pension reform) would strengthen the credibility of the CBA, help hold the current account deficit to a sustainable level, and improve Lithuania's credit standing.

33. **External competitiveness does not raise strong concerns**. Provided the euro/dollar rate remains within historical ranges ahead of the repegging, the repegging of the litas from the U.S. dollar to the euro would not undermine the competitiveness of the economy. Even if the euro were to appreciate after the repegging, the effect on Lithuania's competitiveness would be limited since 75 percent of its trade is with EU and EU-accession countries.

34. **Medium-term growth prospects are good**, as the economy is projected to grow at 5 to 6 percent in the medium term. However, a slowdown in Europe and other trading partners sensitive to a downturn in the EU could have a temporary negative impact.

35. **The balance of payments position appears to be sustainable**. The gross external debt and net debt-to-GDP ratios declined to 42 and 25 percent, respectively, at end-June 2001, which does not warrant particular concern. Moreover, the share of FDI and equity portfolio investment (EPI) in the financing of the current account deficit increased from one third in 1999 to two thirds in 2000 and in the first half of 2001. Another major source of financing of the current account deficit was government borrowing through eurobonds,

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[19] Foreign investment is prohibited in the national security and defense sectors, except for investment made by foreign entities meeting the criteria of European and Transatlantic Integration, and subject to the approval of the State Defense Council. Foreign investment in lotteries and land are also restricted, although these restrictions are to be liberalized prior to accession to the EU.

syndicated bank loans, and IFIs to finance the budget deficit. Banks and nonfinancial corporates relied only to a limited extent on foreign borrowing in 1999, 2000, and the first half of 2001. The maturity structure of external debt improved significantly, as the share of short-term debt in total debt declined from 42 and 54 percent in 1999 and 2000, respectively, to 37 percent at end-June 2001.

36. **The sensitivity to financial strain emanating from emerging markets has recently declined**. The Asian and Russian crises were associated with a substantial increase in Lithuania's money market and deposit and lending rates, and with higher yield spreads of eurobonds over U.S. treasuries. This could have been partially explained by fundamentals—a significant exposure to trade with Russia and an unsustainably large fiscal impulse contributing to a high current account deficit, but also by indiscriminate international investors and contagion in the wake of the Asian crisis. However, by 2000–01, Lithuania had redirected a large share of its exports to the EU (almost 50 percent compared with 33 percent in 1997) and established a distinct and credible policy track record. Stronger fundamentals, a reduced role of short-term foreign portfolio investment, and greater country risk differentiation by foreign investors led to a gradual ebbing of contagion to Lithuania against the background of continuing turmoil in other emerging financial markets. Even so, the possibility of contagion cannot be ruled out.

Financial system soundness and resilience to shocks

37. **Available quantitative indicators suggest that the banking sector faces no immediate risks to its stability** (Table 3). The soundness of the banking system has improved significantly since the 1995–96 banking crisis. Banks have adopted a conservative approach to lending and risk management, and their capitalization and loan quality are generally adequate. Risk-weighted capital adequacy ratios have declined from 24 percent in 1998 to about 17 percent in the third quarter of 2001, still remaining well above the 10 percent minimum established by the authorities.

38. **The quality of banks' assets has improved considerably, with nonperforming loans falling steadily**. The share of nonperforming loans in total loans declined from 22 percent in 1997 to 9 percent in the third quarter of 2001. This is a substantial improvement, all the more so as the definition of nonperforming loans was tightened, and the scrutiny of loan quality became more thorough.[20] Reflecting the decline in nonperforming loans, specific provisions also declined. The distribution of loans by countries seems prudent. As regards the distribution of loans by economic sectors, banks indicate an increased focus on retail banking, and have started to lend more to households. Although households' default ratios are generally low now, this could change as household indebtedness grows.

[20] More generally, the data on non-performing assets can be regarded as reliable owing to the conservative approach to loan classification enforced by banking supervisors in Lithuania.

Table 3. Lithuania: Financial Soundness Indicators for the Banking Sector, 1997-2001
(In percent, unless otherwise indicated)

	Dec-97	Dec-98	Dec-99	Dec-00	Mar-01	Jun-01	Sep-01
Capital Adequacy							
Regulatory Tier-1 capital / risk-weighted assets	12.7	19.0	13.0	12.7	13.4	13.5	13.7
Total regulatory capital / risk-weighted assets (CAR)	15.3	23.8	17.4	16.3	16.4	16.5	16.82
Total regulatory capital / total assets	8.7	13.9	9.9	9.2	9.6	9.6	9.9
Number of banks with CAR<15 %	5	0	1	1	3	2	3
Asset Quality							
Sectoral distribution of loans to total loans							
Manufacturing	28.6	24.5	29.7	28.6	28.8	27.5	25.7
Wholesale and retail trade	22.4	22.1	23.9	23.7	21.6	23.4	19.1
State admininstration and defense, obligatory social security	...	...	6.8	8.6	10.0	9.9	8.3
Financial intermediation	3.8	7.6	8.0	7.6	8.5	9.9	10.1
Electricity, gas, and water supply	2.2	4.8	10.3	8.9	7.3	7.6	6.4
Transport, communication, hotels, and restaurants	4.1	4.4	5.7	7.2	7.3	6.7	7.4
Real estate and leasing	4.5	3.7	2.8	4.3	6.3	5.8	5.3
Construction	3.3	2.7	3.5	3.7	3.5	3.2	3.3
Agriculture, hunting, forestry, and fishing	7.2	5.3	4.4	3.4	2.1	1.7	1.6
Geographical distribution of loans to total loans							
Group A countries 1/	...	...	...	99.4	99.4	99.4	99.7
Group B and C countries 1/	...	...	...	0.6	0.6	0.6	0.3
Foreign exchange loans to total loans	36.9	52.2	59.2	65.1	63.2	65.2	62.4
Foreign exchange liabilities to total liabilities	42.0	45.4	52.9	52.6	51.9	49.7	50.9
Nonperforming loans to total gross loans	22.2	12.9	12.5	11.3	12.0	11.0	9.9
Nonperforming loans net of provisions to total capital	54.4	22.8	38.8	34.0	35.0	32.3	26.5
Loan loss specific provisions/total loans	12.4	6.2	4.7	3.9	3.5	3.2	3.3
Large exposures to capital	...	...	...	0.0	0.0	0.0	0.0
Number of banks with credit exposures above 25 percent of capital	3	2	2	0	0	0	0
Connected lending / total capital	2.2	3.1	2.5	2.4	2.6	2.3	3.1
Gross asset position in derivatives to capital	94.7	57.7	27.0	123.2	162.3	169.3	136.0
Gross liability position in derivatives to capital	97.0	55.6	25.9	126.3	163.4	168.9	136.2
Spread between highest and lowest interbank rate LTL	...	8.8	16.5	9.3	8.0	7.1	3.5
Spread between highest and lowest interbank rate FX 2/	...	4.5	0.6	2.6	0.7	1.1	3.7
Spread between reference lending and deposit rates LTL	6.4	6.0	8.1	8.1	7.1	6.9	6.9
Spread between reference lending and deposit rates FX	6.5	6.0	7.1	6.2	5.6	5.1	4.8
Trading and foreign exchange gains / total income	9.6	9.4	4.6	6.9	2.4	4.3	5.2
Customer deposits / total non-interbank loans	154.9	128.7	124.3	152.8	160.3	162.4	165.7
Total loans / total assets	44.7	44.2	48.8	41.9	41	41.9	40.2
Management							
Expenses to revenues	97.6	91.8	98.0	95.3	88.6	90.1	98.4
Personnel expenses / non-interest expenses	41.4	42.2	36.5	37.1	38.3	40.4	33.8
Earnings per employee (thousands of Litas)	79.5	115.9	138.3	154.8	37.0	74.1	108.8
Earnings and Profitability							
Return on average assets	0.3	0.9	0.2	0.5	1.2	1.0	0.2
Return on average equity	3.9	11.9	1.3	5.0	11.3	9.8	1.4
Interest margin to gross income	37.3	34.9	41.7	36.8	35.5	35.1	35.7
Noninterest expenses to gross income	38.8	40.1	29.3	30.5	32.5	33.5	33.4
Liquidity							
Liquid assets to total assets	45.7	36.6	27.5	32.3	33.7	29.5	33.5
Liquid assets to short-term liabilities	61.6	51.0	37.6	41.0	41.7	36.4	40.9
Funding volatility ratio (volat.liab.-liq. assets/illiquid assets)	39.8	40.9	47.1	49.6	51.9	55.0	54.2
Demand deposits to total liabilities	50.2	44.0	38.1	38.2	37.1	38.7	39.2
Sensitivity to Market Risk							
Net open position in foreign exchange / total capital	-13.9	-3.8	6.0	3.8	4.1	3.8	8.6
Net open position in equities / total capital	22.3	13.1	17.8	15.7	15.4	...	...

Source: Bank of Lithuania, staff calculations.

1/ Group A (lower risk) includes in general countries with a rating of at least Aa3 by Moody's Investor Service or at least AA by Standard & Poor's, FitchIBCA, or Thomson BankWatch. Groups B (medium risk) and C (high risk) include other countries.

2/ Only transactions in euros (since 1999) and U.S. dollars.

39. **Reflecting the cautious approach of banks to lending, their profitability continues to be modest**, with average return on total assets being below 1 percent. A source of concern is banks' dependency on interest income, which could shrink significantly as competition intensifies.

40. **As discussed in Chapter II, liquidity in the Lithuanian banking sector is ample at present**. Commercial banks' liquid assets in domestic and foreign currency are well in excess of the required minimum 30 percent ratio of liquid assets to current liabilities. This partly reflects continuing caution by banks in granting loans.

41. **The aggregate prudential indicators mask large differences in the financial situation and performance of individual banks**. Some banks still carry substantial amounts of nonperforming loans on their books, which will adversely affect their profitability for some time.[21] Also, the maturity and currency mismatches vary substantially from bank to bank, and there are differences in the structure of income and in return on assets and equity. The financial data for some of the smaller banks raise questions about the nature and sustainability of their operations. However, these banks are too small to pose a systemic risk; and some may exit the market in due course.

42. **Direct exposure of banks to market risks appears limited**. In general, banks maintain only small open foreign exchange positions and try to avoid large mismatches in the maturity of their assets and liabilities. Banks' net open position in equities is about 15 percent of their capital. The vulnerability of the Lithuanian banking system to movements in interest rates and exchange rates (such as the euro-dollar cross rate) appears to be relatively low (see below).

43. **The indirect impact of changes in exchange and interest rates on banks via the credit risk of corporate sector borrowers is likely to be more significant**. Available information suggests that the corporate sector has large foreign exchange exposures, although comprehensive data are not available. Bank lending is highly dollarized, with about two thirds of loans denominated in foreign exchange (of which about 80 percent in U.S. dollars and 20 percent in euros). Some bank customers have naturally hedged positions, in the form of income denominated or effectively priced in foreign currency, but formal hedging via derivative instruments is uncommon in the corporate sector. Banks have begun to offer hedging products to their clients, but the demand for them is very low. The extent of the indirect risk is not comprehensively monitored at this stage. The authorities are aware of the need to improve the compilation and presentation of statistics and analysis in this area.

[21] The reported ratios of non-performing loans to total loans vary from 0 to 16 percent.

44. **Stress tests suggest that banks are sufficiently capitalized to withstand a wide range of shocks.** Banks were found to be sufficiently well capitalized to absorb the increase in nonperforming loans that could follow an acceleration in loan growth, or a large swing in interest and exchange rates. Capital also seems to be sufficient to cover a combination of large shocks to exchange and interest rates and to the loan portfolio. The calculations include both the direct effects on banks' balance sheets and the indirect effects on borrowers' economic condition, including the currency risks stemming from borrowers' mostly dollar-denominated debt. The most serious combination of shocks would cause the CAR for several banks to fall below the regulatory minimum (Table 4). However, none of the assumed combinations of interest rate, exchange rate, and credit portfolio shocks yielded a decline of a bank's CAR below zero.

Table 4. Lithuania: Multivariate Stress Testing[1/]

(In percent, unless noted otherwise)

Scenario	I	II	III	IV	V
EUR/USD appreciation	20	20	20	20	20
Interest rate increase by (percentage points)	10	15	10	10	15
Loans deteriorating by one category	0	0	10	15	15
Impact on CAR (percentage points relative to June 2001)	-3.4	-4.4	-4.7	-5.5	-6.8
Number of banks with CAR below 10 percent	1	1	3	4	4
Number of banks with CAR below 8 percent	0	0	0	0	2

Source: Staff calculations; and data provided by the Bank of Lithuania and individual banks.

[1/] Calculations are based on data for end-June 2001. The estimates include both direct balance sheet effects and the indirect effects of changes in borrowers' economic condition, including those owing to currency risk.

45. **The solvency of the Lithuanian banking system could be compromised, however, by a banking crisis in the countries of origin of the parents of the domestic institutions.** The shock facing the Lithuanian banking system in such a case could be very large. In the event such problems were to occur, they could be compounded by asset stripping and other problematic actions by parent banks. Despite the generally good quality of banking supervision in Lithuania, such activities might not be detected in time.

46. **Other factors do not present a significant risk to bank stability at present, but will need to be closely monitored as the market develops.** As banks now have only small exposures to securities, and make only limited loans against such collateral, the impact of a declining stock market on their portfolios would be modest. Other risks, such as exposure to the real estate market through mortgage lending or holdings of real estate, or exposures in off-balance sheet positions, also are small at this stage. The stress testing also identified a potential risk in the banks' dependency on interest income. If interest margins narrowed substantially due to increased competition, most banks would have to cut costs or find other

sources of income in order to avoid losses. The growing role of banks in the insurance market may also pose some risks in the future.

47. **Given their small size in comparison with banks, nonbank financial institutions and markets do not seem to pose any significant systemic risks at this stage.** In 2001, the nonbank financial institutions accounted for only about 14 percent of total financial system assets (about 4 ½ percent of GDP).

48. **The opening of the capital account has not exposed Lithuania to major risks,** as it has been supported by sound macroeconomic policies and steps to strengthen financial institutions, markets, and the overall financial infrastructure. The bulk of capital inflows has consisted of foreign direct investment, including stock purchases in connection with privatization, reinvestment, and greenfield investment. Private debt-creating inflows and short-term inflows have been very limited. Even so, Lithuania remains highly reliant on foreign capital inflows to finance domestic investment and the current account deficit. A rapid exogenous diminution or partial reversal of these capital inflows would require adjustments in the Lithuanian economy, but would probably not threaten financial system stability.

IV. Financial System Stability: Sectoral and Infrastructure Issues

A. Overview

49. **The Lithuanian financial system is likely to undergo significant further development and change, driven mainly by stepped-up domestic financial system reform and the increasing integration among financial markets in Lithuania and other countries in Europe.** Preparations for accession to the EU will provide an important impetus to this process; but the anticipated changes will require a more general and continuing adaptation of the regulatory and institutional infrastructure to facilitate the orderly and stable development of the financial system. Overall, the gap between financial system development in Lithuania and the most advanced transition economies in the region is expected to narrow.

50. **Over the medium term, Lithuania is expected to invest more than it saves; and this will be reflected in a current account deficit. Saving and investment will not be fully intermediated locally, but will involve a particular pattern of domestic and cross-border activity that will influence the development and stability of the financial system.** Domestic banks and leasing companies are well placed in both the short and medium term to intermediate demand for finance from SMEs, households, and to some extent larger corporates, using domestic deposits. The small number of very large enterprises has often found it more efficient to tap foreign sources of financing owing to the small size and concomitant high costs of raising funds in the domestic financial system. Moreover, the government has issued only small amounts of debt securities. These factors have limited the development of an active domestic securities market. As saving increases over the medium

term, domestic and foreign insurance and private pension funds will attract a considerable portion of this saving. Given the limited availability of suitable domestic instruments and markets, and the inability to fully diversify risks in a small market, insurers and other institutional investors will tend to place many of these funds abroad. This is likely to continue in the future as the distinction between domestic and foreign financial markets diminishes in the course of European market integration.

B. Banking and Leasing

51. **Bank credit to the private sector has grown slowly since the banking crisis of 1995, but this does not raise immediate concerns**. Several factors have probably contributed to this phenomenon. On the demand side, many corporate borrowers have had recourse to foreign direct investment or foreign bond markets, while borrowing for housing has until recently been dampened by low household income. Bank restructuring and privatization, cautious risk management by banks reinforced by forceful prudential regulation and supervision, weak competition among the major banks, and shortcomings in accounting, auditing, disclosure, corporate governance, and the insolvency regime, may have reduced banks' appetite to lend. In the short run, slow growth in bank credit to the private sector is likely to be more conducive to stability than excessively rapid growth. In the medium-term, however, a retarded development of bank lending could hamper economic growth, especially if it left the SME sector without adequate access to finance. In the meantime, it appears that at least some of the structural factors that have in recent years inhibited the growth of bank credit to the private sector are being overcome; and recent developments suggest that bank credit will in future develop more closely in line with deposits and nominal GDP.

52. **A successful privatization of the Agricultural Bank of Lithuania would strengthen competition in the banking sector and facilitate sound credit growth**. The Agricultural Bank is the last state-owned bank in Lithuania and accounts for 15 percent of total banking system assets. The authorities are now making the third attempt to privatize the Agricultural Bank.[22] The local subsidiary of a German bank has submitted the only bid for the 76 percent stake that the Lithuanian state still holds.[23] Negotiations on the terms and conditions began in December 2001.

53. **Residential mortgage lending is growing rapidly from a low base**. Although the market is still small, accounting for just 5 percent of banks' lending to residents in January–September 2001, it has for some years been among the fastest growing segments of the

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[22] Previous attempts ended unsuccessfully in 1998, when the only bidder offered an amount regarded as too small, and in 2000, when the sole participant in the auction unexpectedly pulled out.

[23] Vilniaus Bank and the EBRD each own 11 percent of the shares of the Agricultural Bank.

lending market. The growth of mortgage lending has been driven of late by declining benchmark interest rates for litas, euro, and U.S. dollars, to which mortgage interest rates are tied; by the growing ability of financial institutions to assess and price the risks involved; and by government subsidies. Two subsidized lending programs presently cover about 80 percent of new mortgage lending. In addition, a state-owned and subsidized insurance company sells generous mortgage insurance (covering 100 percent of the principal risk); and there are widespread expectations that this insurer would be bailed out by the government in the event it became insolvent.[24] Despite the rapid growth in mortgage lending, real estate prices have thus far remained stable; and the size of the mortgage loan portfolios is still too small to pose a systemic risk. Even so, caution and a reorientation of policies are warranted in view of the role that real estate markets have played in triggering banking problems in many other countries. Additionally, government support for housing finance as currently structured runs the risk of undermining lender and borrower discipline, and also could be costly to the budget.

54. **Policies to foster mortgage lending should aim for a stable, predominantly private sector-led development of this market; and there are signs that the government is moving in this direction**. The government has decided to phase out interest rate and mortgage insurance subsidies; and it has capped spending on these programs at LTL 27 million in the 2002 budget. More generally, social housing policy should be implemented by providing targeted subsidies outside the financial system, while mortgage lending should be based on commercial considerations. The government and the BoL should nevertheless stand ready to work with private market participants to develop and implement proposals for new housing finance instruments that may aid in risk management (for example, there is no secondary mortgage market at present). The creation of specialized mortgage finance institutions may not be advisable, as it would risk further fragmenting an already small financial system.

55. **Unsecured bank lending to municipal governments gives rise to risks and costs and should be ended**. Although Lithuania is in the process of reforming its municipal finance arrangements, there is a legacy of shortfalls in municipal funding that have resulted in a buildup of arrears and unsecured commercial bank debt. Since end-1999, bank claims on municipalities increased by 33 percent, reaching LTL 282 million in September 2001 (about 0.6 percent of GDP). The state-owned Agricultural Bank has played the dominant role in such lending since the other major banks were privatized.[25] In view of the bailout of the

[24] Moreover, at least one of the new mortgage lending initiatives proposed by the private sector calls for substantial government subsidies to support borrowers and new specialized mortgage banks.

[25] In the past, the Lithuanian Savings Bank (now privatized) also played an important role in providing loans to municipal governments.

municipalities by the central government in 1997 and the more recent discussions of debt relief for municipalities, there is a considerable potential for moral hazard.[26] Although bank lending to municipalities does not at present pose a systemic risk, the practice is unsound.[27]

56. **Financial system stability and development would be enhanced by additional steps to reinforce the prudential regulation and supervision of banks**. Although the regulatory and supervisory system is generally strong, the following areas merit attention:

- Requiring greater accountability of bank directors for risk management within their banks would enhance both self-discipline and market discipline in the banking sector.

- The BoL's loan classification and provisioning rules provide a conservative basis for assessing asset quality and determining provisioning in the banking sector. However, the existing standardized rules can lead to some arbitrary provisioning outcomes that may not accurately reflect the economic value of a bank's loan portfolio.

- While considerable progress has been made in developing memoranda of understanding between the BoL and foreign banking supervisory authorities, it would be important for the BoL to implement cooperation agreements with all remaining supervisory authorities and to build close working relationships and regular dialogue with these authorities.

- It would desirable for the BoL to further tighten limits on banks' exposures to their parent banks and to consider other means for ensuring that foreign banks' operations in Lithuania are managed in such a way as to adequately protect the interests of the Lithuanian banking system and its creditors.

- Supervision staff should ensure that the risks within banks' subsidiaries and the systems employed by the banks to monitor and control their subsidiaries' risks are subject to particular scrutiny as part of the annual on-site examination process. This will become a more important aspect of supervision as banking groups become more complex.

- Legal protection for the members of the Board of the BoL and staff involved in supervision needs to be strengthened to adequately protect them from legal claims

[26] Lending to municipalities may reflect an implicit guarantee by the central government to bail out the municipalities if they become unable to repay. Alternatively, banks may lend (and have lent) to municipalities at excessive interest rates, thereby increasing the debt burden of municipal governments and the potential debt burden of the central government.

[27] Bank lending to the social security fund (SoDra), by contrast, has been virtually eliminated; and the nonguaranteed debt of SoDra declined to LTL 5 million at end-September 2001.

arising from a lawful exercise of their supervision powers, while preserving effective accountability and transparency.

57. **The leasing market has grown rapidly, and may offer a useful complement to bank finance**, especially for SMEs without a longstanding debt service track record and access to high quality collateral. To encourage the further development of leasing and factoring, it would also be desirable to eliminate the elements of the VAT charge on leasing contracts and factoring interest and fee income that disadvantages these forms of financing relative to bank loans. Also, following some further strengthening of consolidated supervision of banks and their leasing subsidiaries, consideration could be given to eliminating the limit on a parent bank's lending to these subsidiaries, which would facilitate the development of the leasing market.

C. Capital Market

58. **Regional integration and cross-border transactions will play an increasingly important role in the development of Lithuania's capital market.** Lithuania is well on its way to harmonizing its legal framework for capital markets with the EU's *acquis communautaire*. Moreover, it appears likely that the National Stock Exchange of Lithuania will merge or enter into a cooperative arrangement with one or more other stock exchanges in the region.

59. **The development of the market for Lithuanian equity securities might benefit from some changes in privatization policies and improvements in corporate governance**. Current rules require investors with a stake of more than 50 percent to bid for all outstanding shares to protect the interests of minority shareholders; and the government has routinely sold 100 percent stakes in strategic assets to foreign investors.[28] As a result, major Lithuanian equities are increasingly privately held and no longer publicly traded. In future privatizations, the government may wish to consider retaining a minority stake for future sale to small investors, coupled with measures to significantly improve disclosure, the quality of financial statements, and the protection of minority shareholders. Also, in the interest of market efficiency and integrity, the aftermath of voucher privatization should be dealt with, by removing the nontraded companies from the NSEL and creating an equitable mechanism for rationalizing their ownership structure.

60. **The government's plans for pension reform provide an opportunity to develop private pension funds.**[29] However, the prospects for domestic private pension funds will

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[28] These rules have been inspired inter alia by a desire to protect small shareholders following the experience in the early years after independence with voucher privatization.

[29] A pension reform that will create a three-pillar pension system will start in 2004 comprising: (i) a pay-as-you-go pillar; (ii) a mandatory contribution second pillar financed by

(continued…)

remain limited unless the tax advantage that life insurance now enjoys is abated; and a sufficiently large mandatory second-pillar pension scheme is in place. It is likely that foreign providers will capture a significant share of the market for third-pillar schemes, which would require a substantial upgrading in the capacity of LSC to supervise this type of activity.

61. **Regulation and supervision of capital markets are generally strong, as are the associated systems**. Dematerialization, trading, clearing and settlement, electronic communications between market and regulator are modern and compatible with major European systems. In the absence of issuer activity (there have been no initial public offerings), the LSC focuses on regulation of intermediaries. It would be desirable to develop a more substantive approach to supervision, as the present formalistic approach has in some instances led to a misplaced regulatory focus, e.g. on the brokerage industry, which is rapidly declining in significance. LSC staff should have legal indemnity for actions taken in the normal discharge of their duties; and the LSC needs to recruit adequate staff with skills in areas such accounting and auditing.

D. Insurance

62. **In the insurance sector, there appears to be a need for consolidation to foster both financial stability and development**. Many of the smaller insurance companies now active in Lithuania may not be viable in the medium term. Their cost ratios are high and their loss ratios low, possibly because they do not pay some legitimate claims. Exit could be encouraged by tightening licensing rules, adopting a file and use approach for new products to promote innovation, speeding the liquidation procedure for insolvent companies, and strengthening consumer protection to make it more difficult for insurers to withhold payment of claims.

63. **A high priority attaches to harmonizing the regulatory framework with that in the EU in order to create a level playing field for domestic and foreign market participants and potential entrants**. Lithuania closed the "Freedom to Provide Services" chapter, which includes insurance services, with the EU on June 11, 2001. Lithuania has adopted or plans to adopt changes to its legal and regulatory framework for insurance in order to bring it fully into compliance with the *acquis communautaire* in 2003.

64. **In connection with the planned legal changes in the insurance sector, weaknesses in regulation and supervision should be addressed**. Particular importance attaches to increasing the independence of the insurance supervisory agency (SISA), introducing stronger fit and proper tests and improving corporate governance, establishing asset valuation standards, supervising derivatives activity (which is still limited), fully implementing

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a diversion of a least 5 percentage points of the payroll tax for the younger generation; and (iii) a voluntary, privately funded pillar.

consolidated supervision, and developing a more predictable approach to the imposition of sanctions. Insurance supervision in Lithuania also needs to give more emphasis to issues like corporate governance and internal controls, rather than just formal compliance with regulations. In addition, consumer protection is weak in the insurance sector, and could be improved by requiring insurance companies' boards of directors to safeguard policyholders interests, for example by establishing principles for the fair treatment of customers and creating an equitable process for dealing with customers' complaints. Compliance with consumer protection provisions would need to be closely monitored by SISA.

E. Challenges for Prudential Regulation and Supervision

65. **As the financial system becomes more complex and inter-connected, there will be an increasing need for information-sharing and coordination** between the BoL, LSC, SISA, DIF, and the MoF. Building on existing initiatives in the area of cooperation among the regulatory agencies, a regular dialogue could be held on bilateral and multilateral bases, particularly to exchange views on financial system stability and potential sources of vulnerability, on policy issues, on possible gaps or overlaps in financial system regulation, on issues relating to harmonisation of regulation with the EU and other jurisdictions, and on the nature of potential contagion between different components of the financial system (including for example through the growing activities of banks in the insurance field).

66. **Eventually, more far-reaching steps may be needed to adapt the regulatory framework and supervisory institutions** to address the increasing international integration of financial markets and the growth of domestic and foreign financial conglomerates that provide a wide range of different financial services. Modifying domestic legislation to conform to the requirements of the *acquis communautaire* is a necessary condition to meet these challenges, but it may not be sufficient. Significantly enhanced institutional capacity will also be required to ensure effective domestic and cross-border regulation and supervision of financial activity, and to limit the scope for regulatory arbitrage. In the longer term, it would be desirable to give consideration to the potential benefits and possible risks associated with moving towards a more formally integrated system of financial sector regulation, under which one supervisory agency would assume responsibility for the supervision of banks, credit unions, insurance companies and other financial institutions, and possibly securities markets.

F. Payment System

67. **The planned reduction in minimum reserve requirements will make it necessary to provide an alternative source of liquidity to ensure the smooth operation of the planned RTGS payment system,** especially in periods of financial system or market stress. Options being considered by the authorities include the creation of a secured intraday credit facility, or the more frequent settlement of netted positions, which would minimize the exposure of all participants. Another possibility would be a multilateral agreement with participants in the payment system covering the provision of liquidity in the event of payment

system gridlock. These considerations are all the more relevant given the expected increase in both the size and number of transactions through the payment system following the introduction of RTGS.

G. Managing Financial System Distress

68. **The BoL is the key institution in any response to episodes of financial system distress**, which in Lithuania is likely to mean banking system distress. The BoL has the power to provide liquidity to a bank in distress. Other steps that may be taken by the BoL include remedial action when a bank is in breach of prudential requirements.[30] Where there is doubt about a bank's solvency or a bank is otherwise in severe difficulty, the BoL also has the power to place a bank into temporary administration for up to five months, conduct an audit, and identify options for resolving the problem. The BoL may also initiate bankruptcy proceedings for an insolvent bank and withdraw its banking license.

69. **The authorities are of the view that the domestic banking crisis of 1995 demonstrated their capacity to respond quickly to financial system distress**, including through the rapid adoption of special legislation. They were willing to consider, however, some additional preparations for potential shocks. In this connection, the staff advanced the following observations:

- **Under existing law, the BoL may lend funds to a bank, but only on the basis of a relatively narrow range of types of security or with a government guarantee.** This may unduly constrain lender-of-last-resort operations in particular circumstances. It is not clear whether a government guarantee could be obtained quickly enough if a bank in need of funds did not have sufficient security of the types referred to in the law. To remove this constraint and the associated uncertainty, the BoL could consider widening the range of assets acceptable as collateral, provided that it obtains a standing government guarantee to protect itself against possible credit losses.

- **The legal powers of the BoL to manage financial distress are also limited in other respects.** Its powers may not extend to resolving the failure of foreign bank branches, or banks and their subsidiaries on a consolidated basis, and do not allow for rapid balance sheet restructuring of intervened banks, for example through deposit transfers and purchase and assumption transactions. When a bank is insolvent, the BoL does not have the ability to recapitalize a bank using creditors' funds, to set aside a proportion of creditors' funds to absorb estimated losses in order to facilitate a recapitalization of the bank by a third party, or to sell all or part of the bank. In addition, the BoL does not

[30] Notably, the bank may be required to take specified corrective action and to remove members of its management team.

appear to have sufficient control over the insolvency and liquidation process for a bank once formal bankruptcy proceedings have been initiated.

H. Deposit Insurance

70. **Deposit insurance was introduced in Lithuania in June 1996, with the establishment of the Deposit Insurance Fund (DIF).** The DIF began to insure deposits in March 1997. The enactment of the Law on Deposit Insurance in March 2001 laid the groundwork for the harmonization of the legal framework for deposit insurance with that prevailing in the EU.[31] Initially, deposit insurance applied only to deposits in licensed banks and branch banks where the deposits were held in the name of individuals. Insurance cover has since been extended to include deposits held by legal entities and deposits in credit unions and the Central Credit Union. The insurance applies to deposits in litas, US dollars, euro and the national currencies of the EU member states.

71. **The cap for insurance has been progressively increased since the DIF was established** and is currently set at LTL 45,000 (US$ 11,250 or 3 ½ times per capita GDP), with the first LTL 10,000 fully insured and the balance at 90 percent. Under the new law, the insurance cap will be further increased in coming years, to LTL 50,000 in 2004, LTL 60,000 in 2007, and Euro 20,000 in 2008, when it will reach the minimum level in the EU (still about 3 ½ times projected per capita GDP).[32]

72. **Initially, the insurance premium was set at a relatively high level**, exceeding 1 percent per annum of the average deposits held in the insured institution. In 2000, the premium was reduced to 1 percent; and under the law enacted in March 2001, the premium was reduced to 0.45 percent for average deposits in licensed banks and bank branches and to 0.2 percent for deposits in credit unions. The law allows the DIF's managing body to vary the insurance premium within prescribed limits.

73. **Currently, and for the foreseeable future, the funds held by the DIF would enable the DIF to provide full insurance cover only for deposits in the smaller banks and the credit unions operating in Lithuania.** The funds held by the DIF will be insufficient to meet likely insurance claims should any of the large banks fail. In the event of the failure of a large bank, the DIF would need to borrow from the government (which it is empowered to do) in order to meet its obligations.

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[31] The EU and Lithuania agreed on a four-year transitional period following Lithuania's accession during which its deposit insurance would be brought into line with EU requirements.

[32] Beginning in 2008, the first euro 2,500 will be fully insured and the balance at 90 percent.

74. **Other features of the deposit insurance scheme may, however, contribute to moral hazard.** First, depositors are able to spread deposits over several institutions and receive the full insurance amount for each deposit. It would have been preferable if the cap applied to the aggregate of all deposits of a particular depositor. Second, the deposit insurance premia paid by financial institutions are not differentiated by risk.

I. Asset Management

75. **The experience with the state-owned asset management company (Turto Bankas) has shown that current arrangements for large scale resolution of the assets of failed banks have resulted in slow recovery**, owing inter alia to initial capacity constraints, a lack of incentives, poor asset quality, and market illiquidity. As assets age, they lose their value and become more difficult to sell. Consequently, it may be preferable not to maintain indefinitely a full-fledged asset management company. Moreover, Turto Bankas has already been and is about to be charged with many additional tasks, including a general collection function for government overdues and arrears, and the liquidation of failed financial institutions. Although similar arrangements have been put into place in other countries, the staffing, incentives, and oversight over TurtoBankas would need to be significantly improved in order for it to successfully achieve its objectives.

J. Financial Statement Quality and Disclosure

76. **Significant changes are underway in the regulation of accounting, auditing, and disclosure rules, as the authorities seek to bring these rules into line with EU requirements and international standards.** To this end, new laws on accounting, financial statements, and consolidated financial statements were adopted in late 2001, which will alter the accounting requirements laid down by the 1992 Law on the Principles of Accounting.[33] A review of the legal framework for auditing, which is mainly embodied in the 1999 Audit Law, is also being undertaken. These reforms are being supported by the 2001 Law on the Legal Persons' Register.

77. **BoL regulations have placed some restrictions on the use of IAS 39 on financial instruments for banks' regulatory financial reporting.**[34] The BoL is concerned that the

[33] The three laws were adopted by parliament in November 2001. The Law on Accounting and will enter into force on January 1, 2002. The Law on Financial Reporting and the Law on Consolidated Financial Reporting will enter into force on January 1, 2003.

[34] Regulatory reporting standards in Lithuania also form the basis for general purpose financial reporting. Responsibility for promulgating the financial reporting applicable to banks and other financial institutions is conferred on the Bank of Lithuania (BoL) by the Law on Commercial Banks. The new 2001 laws on accounting, financial statements, and consolidated financial statements specifically exclude banks from their scope of application.

complexity of IAS 39 would impede effective banking supervision; and it cites the opposition to IAS 39 of banking regulators internationally (especially in certain EU member states). Banks wishing to report financial statements in accordance with IAS (which many do, in order to meet the needs of foreign investors and other counterparts) will therefore have to do so in addition to their legally required financial statements. However, banks are not legally required to produce statements in accordance with IAS; and indeed the decision of the BoL has removed any IAS statements prepared voluntarily from the regulatory jurisdiction of the BoL.

78. **Accounting, auditing, and financial disclosure rules for the enterprise sector still have significant shortcomings**. It is expected that many of these will be remedied by the new laws adopted in 2001 and by other reforms now underway. Notably, procedures for the enforcement of accounting, auditing, and disclosure rules are weak, with adverse effects on compliance. Audits of many enterprises' financial statements are considered to be unreliable; and enforcement actions against auditors for inadequate work are rare.

K. Anti-Money Laundering Policies[35]

79. **Lithuania appears committed to fighting money laundering and terrorist finance**. In recent years, Lithuania has on several occasions modified its legal framework to bring it more closely into line with current international standards, notably with respect to the regulation of customer identification. The Lithuanian authorities appear to be committed to firmly implementing their anti-money laundering (AML) legislation. Even so, some issues merit attention.

80. **The Tax Police may need additional human resources and improved information technology to ensure the effective enforcement and use of the AML reporting system.** Moreover, the sanctions for violations of AML provisions may be on the low side and could be increased. The Tax Police should also be given the power to suspend a transaction before a criminal investigation has been initiated.

81. **There is a need to strengthen the assessments made by the Bank of Lithuania of banks' internal control systems aimed at preventing money laundering.** This is all the more urgent as Lithuanian banks are increasingly engaged in cross-border operations and some of them are part of international financial groups. Contacts with foreign customers require increased due diligence. Moreover, international financial groups organized on a multi-level basis, with different levels domiciled in different countries, require intensified efforts to ensure that the effectiveness of internal controls is not undermined by the

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[35] The assessment was based on the preliminary methodology developed by the Fund and World Bank; and the authorities agreed to a pilot application of this methodology in Lithuania.

fragmentation of supervision. Furthermore, examiners could also focus more closely on the substance of transactions reported.

82. **Controls on money laundering in the insurance and securities sectors fall well short of those in the banking sector**. It will be essential to extend guidance on "know your customer" rules to all financial institutions, and provide specific guidance for detecting suspicious transactions. Moreover, the authorities may wish to consider periodic on-site examinations of compliance with anti-money laundering requirements, as well as controls over financial institutions' internal control procedures.

83. **Exchange of information among agencies involved in AML work could be strengthened**, also in the interest of reducing the impact that money laundering or other criminal financial activities may have on the safety and soundness of financial institutions. Information on suspicious transactions should be shared among the concerned agencies on a regular basis, and could be discussed in a joint forum of those agencies.

84. **It may also be desirable to spell out in binding legal acts the need for proper identification of customers seeking to open an account, especially with regard to the identification of beneficial owners.**

SECTION II—REPORT ON OBSERVANCE OF STANDARDS AND CODES

This section reviews the extent to which Lithuania observes certain internationally recognized standards relevant for the financial system. It contains summaries of detailed assessments prepared in connection with the Financial Sector Assessment Program (FSAP) missions by assessor teams from the International Monetary Fund, the World Bank, and cooperating institutions. The assessor teams were led by Marie-Renee Bakker (WB) and Karl Habermeier (IMF).

The detailed assessments were prepared on the basis of information provided by the Lithuanian authorities and discussions in the field. The assessor teams comprised Anne Kester (IMF) for the *Code of Good Practices on Transparency in Monetary and Financial Policies*; Geoffrey Mortlock (Reserve Bank of New Zealand) and Walter Zunic (WB) for the *Basel Core Principles for Effective Banking Supervision*; Tomas Hladek (Czech National Bank) for the *Core Principles for Systemically Important Payment Systems of the Committee on Payment and Settlement Systems (CPSS)*; and Gregorio Impavido (WB) for the *IAIS Insurance Supervisory Principles*. The appendix on anti-money laundering policies was prepared by Alessandro Portolano (Bank of Italy).

With the exception of insurance supervision, Lithuania has achieved a high degree of compliance with or observance of the international standards and codes that were assessed. Even so, the assessors found a number of areas in which policies could be strengthened. Key points are highlighted in Section I of this report; and details are provided in what follows.

The Lithuanian authorities indicated their broad agreement with these assessments. Technical discussions held during and after the FSAP missions have stimulated a productive exchange of views on strengthening the financial infrastructure in Lithuania.

I. Code of Good Practices on Transparency in Monetary and Financial Policies

A. General

85. This summary of the assessment of the Code of Good Practices in Monetary and Financial Policies was prepared by Anne Kester (IMF) in connection with the Financial Sector Assessment Program (FSAP). The Code identifies desirable transparency practices for central banks in the conduct of monetary policies, and for central banks, supervisory authorities, and other financial agencies, their conduct of financial policies. The assessment was guided by the *Supporting Document* to the Code and the Board paper on the Review of the Experience with the Assessment of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies.

86. The assessment was based on (1) discussions with the Ministry of the Finance (MoF), the Bank of Lithuania (BoL), the Settlement Center (SC) of the Bank of Lithuania, the Lithuanian Securities Commission (LSC), the State Insurance Supervision Agency (SISA), and the Deposit Insurance Fund (DIF), (2) reviews of questionnaires on the Code of Good Practices in Monetary and Financial Policies provided by the BoL and financial agencies:[36] (3) reviews of laws and regulations governing Lithuania's financial system; and (4) reviews of the BoL and the financial agencies' websites and their major publications.

B. Main Findings—Summary

87. Lithuania exhibits a high degree of transparency in its conduct of monetary and financial policies. The institutional framework of the Lithuanian financial system has evolved over the past decade to meet emerging needs as the country's financial system takes shape. Its aim is to promote monetary and financial stability, market efficiency, and client asset protection. Transparency has been considerably enhanced as financial agencies have gained experience in implementing international standards and codes. Consistent with Lithuania's preparation for accession to the European Union, the BoL and the other financial agencies have taken steps to move toward the EU's regulatory, supervisory, and oversight frameworks for monetary and financial policies.

88. Greater coordination among the agencies would further clarify the linkages of monetary and financial policies, promote efficiency in the supervisory framework, and strengthen crisis management among agencies. The new Securities Market Law, currently under consideration by Seimas, would authorize information sharing among the agencies for supervision purposes and foster a more collaborative approach to supervision.

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[36] The BoL, SC, LSC, SISA, and DIF provided questionnaire responses to the mission.

C. Transparency Practices for Monetary Policy

89. The BoL observes good practices of transparency in its conduct of monetary policy. Roles, responsibilities, and objectives of the BoL for monetary policy are clearly defined in laws, regulations, and operational guidelines. The BoL makes effective use of its website in disseminating information on monetary policy and other data.

Clarity of roles, responsibilities, and objectives of the central bank

90. The roles, responsibilities and objectives of the BoL are clearly defined in legislation. The Law of the Bank of Lithuania (as amended) defines the functions of the BoL, and the Law on the Credibility of the Litas (as amended) requires that the BoL guarantee that "the total amount of the litas put into circulation does not exceed the gold reserves (at market prices) and foreign exchange reserves (according to the official exchange rate of the litas) of the Bank of Lithuania at any time." The principal objective of the BoL is to seek price stability; and its monetary policy aims to maintain the currency board arrangement (CBA), established in 1994, which has been successful in achieving exchange rate stability and low inflation. The accountability of the BoL in its conduct of monetary policy is stipulated in the Resolution of the Board of the Bank of Lithuania on the Guidelines of the Application of the Bank of Lithuania Monetary Policy Instruments. These laws and regulations are posted on the BoL's website.

91. The BoL is governed by the Board of the BoL. Articles 10–17 of the Law of the Bank of Lithuania stipulate the structure, functions, and activities of the Board. The Board makes most of the decisions with regard to BoL's regulatory and operational procedures; it also approves liquidity loans to banks. The Board comprises a Chairperson, three Deputy Chairpersons, and seven members. The Chairperson is appointed by the President of Lithuania subject to Seimas approval; other members of the Board are appointed by the President at the recommendation of the Chairperson. The Chairperson and members of the Board can be dismissed on grounds of misconduct and inability to perform duties by the Seimas at the recommendation of the President.

92. To maintain the CBA, the key responsibility of the BoL is to manage its foreign exchange reserve assets to ensure their security and liquidity. The BoL uses a number of monetary policy instruments to regulate liquidity in the system, including (1) unrestricted anchor currency purchases and sales; (2) reserves requirements; (3) repo auctions to increase liquidity; and (4) deposit auctions to decrease liquidity. The BoL also provides a Lombard (collateralized overnight loan) facility for settlement purposes and lender of last resort loans in special cases.

93. The division between monetary policy and fiscal policy is clearly established under existing laws, which are publicly disclosed. As noted earlier, the BoL's conduct of monetary policy is set forth under the Law of the Bank of Lithuania and the Law on the Credibility of the litas. The BoL coordinates its monetary policy function with the MoF's fiscal policy

function through the Monetary and Fiscal Policy Coordination Committee. The Committee comprises three representatives of the BoL and three representatives from the MoF. The Committee is an advisory body to the Chairperson of the Board of the BoL and the Minister of Finance on strategic decisions regarding the monetary policy of the BoL and fiscal policy of the government.[37]

Open process for formulating and reporting monetary policy decisions

94. The BoL maintains good transparency practices for formulating and reporting monetary policy. It publishes monthly and quarterly monetary bulletins and annual reports providing information on its monetary policy operations and its financial positions. Furthermore, decisions of the Board of the BoL are disclosed and explained to the public shortly after its meetings. The BoL holds press conferences several times a year on the conduct of monetary policy, explains the policy objectives of the institution, and describes the BoL's performance in achieving its objectives. While there are no legal requirements for the BoL to consult the public before it changes monetary regulations, in practice, the BoL explains to the public its significant decisions before they are implemented, as in the forthcoming repegging of the litas from the dollar to the euro.

Public availability of information on monetary policy

95. The BoL maintains a high level of transparency by providing public access to information on monetary policy. Lithuania has subscribed to the IMF Special Data Dissemination Standard (SDDS) since 1996. The disclosure of BoL's macroeconomic data meets the SDDS specifications for coverage, periodicity, and timeliness and for the dissemination of advance release calendars. The financial accounts of the central bank, including its aggregate market transactions, are disclosed on a timely and preannounced schedule. The BoL posts on its website daily information on the liquidity situation in the banking system.[38] The Public Relations Division of the BoL prepares official statements, provides information on the BoL's activities to the mass media, and organizes press conferences, among its other functions. Three times a year, the BoL publishes the "Acts of Law Regulating the Activities of the Banks of Lithuania."

[37] The Committee was established at the initiative of the BoL. It can be dissolved by the BoL.

[38] The data cover reserves requirements in litas and foreign currencies for the specified maintenance period, current account holdings of commercial banks at the BoL, average if current account holdings of commercial banks in the specified maintenance period, currency outside the BoL, overnight loans granted by the BoL. The BoL also publishes the results of open market operations on the same day it undertakes the operations.

Accountability and assurances of integrity by the central bank

96. Transparency practices with respect to accountability and assurances of integrity by the central bank are generally good. The Governor of the BoL, who also serves as the Chairperson of the Board, reports twice a year to Seimas on the BoL's activities. The BoL's annual financial statements are audited by international auditing companies.[39] The BoL submits its annual financial statements along with the opinion of the auditor four months after the end of the financial year to Seimas and the public.

97. Article 15 of the Law of the Bank of Lithuania states that a Board member has no right to participate in decisions in which the member has a conflict of interest. Article 18 of the Law says that the staff of the BoL may not assume outside employment while in the employ of the BoL, except with the consent of the Board. However, there are no specific laws that provide legal protection of BoL employees other than that provided in the general law of Lithuania governing work contracts.

Recommended Plan of Action to Improve Observance of IMF's MFP Transparency Code—Monetary Policy

Subject	Recommended Action
V. Clarity of roles, responsibilities and objectives of financial supervisory agencies	To enhance the transparency of the CBA, the BoL might clarify in the "Guidelines for the Application of the Bank of Lithuania Monetary Policy Instruments" the procedures that it follows to ensure the liquidity and security of its international reserves.
VI. Open process for formulating and reporting of financial policies	In preparing for the repegging of the litas from the dollar to the euro in February 2002, the authorities could intensify the publicity campaign.
VII. Public availability of information on financial policies	The BoL could publish on its website the data reporting forms to be used by financial institutions.
VIII. Accountability and assurance of integrity by financial supervisory agencies	Transparency would be enhanced if all major legal acts governing the integrity of operations of the BoL were published on the BoL's website.

D. Transparency of Financial Policies

98. The BoL and other financial agencies observe most of the transparency practices in their supervisory responsibilities. Transparency could be enhanced if the relationships among financial agencies, their oversight responsibilities, and legislative amendments were

[39] Arthur Andersen audited the 1998 and 1999 statements and Pricewaterhouse Coopers audited the 2000 statements.

explained to the public in a common forum. Enhanced transparency, in turn, would deepen the public's understanding of these relationships and the respective roles of the different agencies in safeguarding financial system stability. Some weaknesses are found in the insurance sector, particularly with respect to transparency in the procedures for the criteria for appointment to and removal from office.

Clarity of roles, responsibilities, and objectives of financial agencies

99. The broad objectives and institutional framework governing the roles, responsibilities, and objectives of financial agencies are, in general, clearly defined in laws and regulations. They are also disclosed to the public in official gazettes, periodic reports, and websites by the respective agencies. With respect to banking supervision, Articles 8 and 42–47 of the Law of the Bank of Lithuania provide the BoL with the authority to supervise credit institutions in Lithuania. The BoL's supervisory responsibilities include issuing and revoking of licenses, off-site monitoring, and on-site inspections, of credit institutions. The Credit Institutions Supervision Department (CISD) of the BoL undertakes these tasks, and is functionally and financially responsible to the president and Board of the BoL.

100. The role, objectives, and responsibility of the BoL vis-à-vis the payment system are established by law; they are publicly disclosed in the official gazette "Valstybes zinios." In practice, however, the BoL oversees these systems as the owner of the payment system and as the supervisor of banks.

101. The Law on Public Trading in Securities sets forth clearly the objectives, role, and responsibilities of the LSC. SISA's functions are defined by the Law on Insurance adopted in 1996. The DIF's activities are based on the Law on Deposit Insurance. The budgets of LSC, SISA, and DIF are integrated within the state budget and must be approved by the executive branch, even though they have the legal capacity to finance their activities with their own resources. The head of these agencies is appointed by the Minister of Finance, who also approves the governing boards of LSC and SISA and the governing council of DIF.

102. However, there are concerns that SISA does not have sufficient organizational, financial and political independence. While the procedures for appointment to and removal from office at SISA are outlined in law, the actual processes are nontransparent. SISA has no written qualifications for the position of Director and the appointment of the Board is not subject to any official consultative process.

103. The broad modalities of accountability of the CISD and SC are those of the BoL. The BoL reports on the activities of CISD and SC in separate chapters in its annual reports. Accountability of the other financial agencies is mainly through the disclosure of their activities in their annual reports and on their websites.

104. There are agreements on the exchange of information signed by the BoL, the LSC, and SISA. However, the extent of information exchanged is limited by the confidentiality

law. The new Securities Market Law will allow these agencies to exchange relevant information for supervision purposes. Since the DIF is only a paying agent and does not have regulatory oversight, it is not a party to the agreements. There is no other formal mechanism to coordinate the activities of the different agencies.

Open process for formulating and reporting of financial policies

105. The conduct of policies by financial agencies is generally transparent. The regulatory framework and operating procedures of the financial agencies, as well as regulations for financial reporting of financial institutions to the agencies, are detailed in laws. The public disclosure of procedures for information sharing and consultation among financial agencies, and between domestic supervisory agencies and their foreign counterparts, would enhance the transparency of operations of the oversight agencies.

106. Although the fact that the BoL has signed information exchange agreements with SISA and LSC is known to the public, the formal procedures for information sharing under the agreements are not publicly disclosed. The BoL, SC, SISA, LSC, and DIF routinely discuss proposed substantial changes in regulations with interested parties and release the proposals for public comments.

Public availability of information on financial policies

107. All financial agencies post statistical and regulatory information on their websites. The BoL, in particular, has a comprehensive publications program, including monthly and quarterly monetary bulletins and annual reports. Transparency could be enhanced if appearances and presentations by officials were posted on the respective agencies' websites.

Accountability and assurances of integrity by financial agencies

108. According to the Statute of Seimas, senior officials of the agencies are required to appear before the designated authority to report on their conduct of financial policies and to describe their performance in achieving the agencies' objectives. However while SISA staff members are obliged to appear before Seimas upon request, there is no requirement for reporting on a regular basis.

109. As mentioned earlier, the BoL's annual financial statements are audited by international auditing companies. The BoL submits its annual financial statements along with the opinion of the auditor four months after the end of the financial year to the Seimas and the public. SISA and LSC annually submit their financial statements to the Ministry of Finance; their financial statements are not, however, audited or disclosed to the public. In late 2001, the BoL reviewed principle 39, on marking-to-market, of the International Accounting Standards on "Financial Instruments: Recognition and Measurement" and, for the financial year 2001 onward, there will be a restriction on the use of IAS 39 with respect to the financial reporting of banks. This implies that official accounting standards of banks will not be in

compliance with IAS, although banks can prepare their accounts according to IAS voluntarily. Regarding the SC, it is a budgetary center within the BoL and, as such, it accounts for its operational expenses and revenues; nonetheless, its operations are not separately reflected in the BoL financial statements.

Recommended Plan of Action to Improve Observance of IMF's MFP Transparency Code—Financial Policies

Bank of Lithuania (BoL)	
Subject	Recommended Action
V. Clarity of roles, responsibilities, and objectives of financial supervisory agencies	Transparency of financial polices would be enhanced if the relationships among supervisory agencies were explained to the public in a common forum.
VI. Open process for formulating and reporting of financial policies	Transparency in confidentiality requirements could be enhanced by explaining to the public types of information that are considered confidential.
VII. Public availability of information on financial policies	The BoL might consider posting all laws and regulations concerning banking supervision on its website to better inform prospective foreign investors.
VIII. Accountability and assurance of integrity by financial supervisory agencies	Transparency would be enhanced if all major legal acts governing the integrity of operations of the BoL were published on the BoL's website.

The Lithuanian Securities Commission (LSC)	
Subject	Recommended Action
V. Clarity of roles, responsibilities and objectives of supervisory agencies	The LSC could intensify its effort to educate the public on its broad objectives and functions and to deepen the public's understanding of the securities market, thereby promoting its development.
VI. Open process for formulating and reporting of supervisory policies	None.
VII. Public availability of information on securities supervisory policies	Public presentations of senior officials could be posted on the LSC's website. Financial information of brokerage firms and brokerage departments of banks could be disclosed more fully to the public on the LSC's website.
VIII. Accountability and assurance of integrity by supervisory agencies	The LSC's publication of independently audited financial statements and of operating incomes and expenses would enhance transparency and accountability. Internal control and internal audit policies should also be disclosed publicly.

The State Insurance Supervision Agency (SISA)	
Subject	Recommended Action
V. Clarity of roles, responsibilities and objectives of supervisory agencies	To educate the public, the broad objectives and functions of SISA could be more publicly explained. The procedures for appointment to and removal from office at SISA could be made more transparent.
VI. Open process for formulating and reporting of supervisory policies	Transparency in confidentiality requirements could be enhanced by explaining to the public the types of information that are considered confidential.
VII. Public availability of information on supervisory policies	A public information service program could be developed to better inform the public of SISA's functions and objectives and to deepen the public's understanding of the insurance sector, thereby promoting the development of the sector.
VIII. Accountability and assurance of integrity by supervisory agencies	SISA's publication of independently audited financial statements, as well as of operating incomes and expenses, would enhance SISA's transparency and accountability. Internal control and internal audit policies should also be disclosed publicly.

TARPBANK Payment System (BoL)	
Subject	Recommended Action
V. Clarity of roles, responsibilities, and objectives of financial supervisory agencies	Clarification of the oversight of the payments system as a whole would enhance the public's understanding of the responsibilities and objectives of the SC.
VI. Open process for formulating and reporting of financial policies	To enhance transparency, the BoL could consider providing additional information on the operations of the TARPBANK system, including fee schedules charged to participants in the payments system for settlement services.
VII. Public availability of information on financial policies	None.
VIII. Accountability and assurance of integrity by financial supervisory agencies	The disclosure of internal governance procedures would enhance transparency. The BoL has an Internal Audit Division. However, internal governance procedures and internal audit arrangements for the SC are not publicly disclosed.

Deposit Insurance Fund (DIF)	
Subject	Recommended Action
V. Clarity of roles, responsibilities and objectives of supervisory agencies	The DIF could develop a public relations program to publicize more widely its objectives and functions and to deepen the public's understanding of deposit insurance, thereby promoting the development of the banking sector.
VI. Open process for formulating and reporting of supervisory policies	Transparency would be enhanced if the DIF could disclose whether it has a back-up line of credit with the MoF in case it were to run short of funds in the event of failures of major banks.
VII. Public availability of information on securities supervisory policies	The DIF is seeking to provide more detailed information on the operations of the DIF; and a decision is being considered by the Council of the DIF.
VIII. Accountability and assurance of integrity by supervisory agencies	The DIF could enhance its transparency and accountability by disclosing publicly its internal control and internal audit policies.

E. Authorities' Response

110. The Bank of Lithuania and the respective financial agencies had an opportunity to review drafts of the assessment reports. The various institutions provided additional clarifying information, which was incorporated into the assessments. In the end, there were no significant disagreements on the substance of the assessments.

111. In addition, the institutions in question agreed to implement the majority of the recommendations for greater transparency and public disclosure, some of which are already underway or planned for the future.

II. Basel Core Principles for Effective Banking Supervision

A. General

112. This is a summary of the assessment of Lithuania's compliance with the Basel Core Principles for Effective Banking Supervision. The assessment was carried out by Geoffrey Mortlock (Reserve Bank of New Zealand) and Walter Zunic (World Bank) as part of the FSAP. The assessment was undertaken using the Core Principles Methodology published by the Basel Committee on Banking Supervision (October 1999). The preliminary part of the assessment was performed over the period September 10–21, 2001, with follow-up assessments being made in October and November 2001.

113. The authorities were very cooperative, professional, and helpful in facilitating this assessment. The self-assessment report prepared by the authorities was comprehensive, the authorities made available an extensive range of information in the assessment process,

including all relevant laws and regulations, and the assessors had unrestricted access to senior staff of the Credit Institutions Supervision Department.

Institutional and macroprudential setting, market structure—overview

114. The licensing and supervision of banks and credit unions in Lithuania is the sole responsibility of the Bank of Lithuania (BoL), Lithuania's central bank. The powers to conduct licensing and supervision are vested in the Board of the BoL, although the operational aspects of licensing and supervision, and the formulation of prudential requirements, are the responsibility of the Credit Institutions Supervision Department (CISD) within the BoL.

115. Bank licensing and supervision are governed by two principal statutes enacted by the Lithuanian Seimas: the Law on the Bank of Lithuania and the Law on Commercial Banks. These statutes set out the objectives of banking supervision and confer authority on the Board of the BoL to license and supervise banks and to take enforcement measures against banks. These laws also empower the Board of the BoL to issue specific prudential requirements and supervisory methodologies; these are affected by way of resolutions issued by the Board.

116. The supervisory framework includes a relatively comprehensive range of regulatory mechanisms for promoting a stable and efficient financial system, including:

- A system for determining applications from entities to be licensed as banks or credit unions. The Board of the BoL makes these determinations on the basis of recommendations from and analysis by the CISD.

- A minimum capital requirement for banks incorporated in Lithuania, of Euro 5 million.

- A minimum capital ratio requirement for banks incorporated in Lithuania (currently set at 10 percent of risk weighted exposures), calculated using the standard Basel Capital Accord methodology.[40]

- A range of prudential limits on exposure positions set in relation to bank and banking group capital (including limits on large exposures, connected exposures, and open foreign exchange positions).

- A minimum required ratio of liquid assets to current liabilities, applied to the bank and banking group.

[40] At the time of the mission, the calculation did not include market risk. As of January 1, 2002, banks will have to apply a market risk charge for exchange rate, interest rate, and securities price risks.

- Off-site monitoring and analysis of banks and credit unions on the basis of a wide range of financial and prudential information, including in respect of early warning indicators. This information is generally provided to the BoL at monthly or quarterly intervals, with some being provided at more frequent intervals.

- On-site examination of banks and credit unions, where each bank is examined annually and credit unions every two years.

- A range of enforcement measures designed to ensure compliance with prudential requirements.

- Powers to place banks experiencing acute financial difficulty into temporary administration and to initiate bankruptcy proceedings for insolvent banks.

117. Currently, the banking system comprises 10 licensed banks (incorporated in Lithuania), four branches of foreign banks and 41 credit unions. As of the end of December 2000, total assets of the banking system stood at more than LTL13 billion (US$3.3 billion), representing around 30 percent of Lithuania's GDP. Of these assets, more than 99 percent are held by the banks, with less than 0.5 percent being held by credit unions.

118. Following the banking crisis in the mid 1990s, there has been a substantial consolidation of the banking system, with a marked reduction in the number of banks (down from 27 in the mid-1990s to 14 now). The banking system is relatively highly concentrated, with the three largest banks having about 85 percent of total banking system assets and a similar share of deposits. Two of the three government-owned banks have been successfully privatized and there have been a number of bank mergers. The only remaining government-owned bank, the Agricultural Bank of Lithuania, is scheduled for privatization, although progress has been slower than had originally been anticipated.

119. Since the banking crisis, there has been a substantial improvement in the soundness of the banking system. Asset quality has improved considerably, with nonperforming loans falling steadily to a less concerning level, measured on the basis of what appears to be a relatively conservative system for classifying bank assets. The banking system is relatively well capitalized, with the aggregate capital ratio for the banking system exceeding 16 percent of risk-weighted exposures as of August 2001. Capital investments of foreign investors, primarily from Scandinavian countries, in domestic banks represents around 80 percent of the ownership of share capital of commercial banks. Two of the three largest banks in Lithuania are foreign owned and Vilnius Bank, the largest bank in the country, is under the control of a Swedish bank. The banking system appears to have a strong degree of liquidity, with liquid assets well in excess of the required minimum 30 percent ratio (of liquid assets to current liabilities). In part, this reflects a continuing caution by banks in granting loans to the commercial and household sectors. As a result, lending growth has been modest, with a large proportion of banks' assets being held in low risk securities.

120. In the period since the CISD was established, in 1992, much progress has been made in implementing prudential requirements, developing the on-site examination and off-site monitoring frameworks and building capacity in the CISD. Since the onset, the extent of overall progress, the nature of the regulatory framework, and the quality of the staff interviewed has been impressive.

121. In the last year or so, further progress has been made in developing the supervisory arrangements, including developing memoranda of understanding between the BoL, the Securities Commission and the State Insurance Supervisory Authority, and between the BoL and the banking supervision authorities in a number of countries with a banking presence in Lithuania. In addition, the BoL has made considerable progress in implementing supervisory measures to bring the supervision regime into line with the recommendations of the Basel Committee and directives from the European Union. In this regard, Lithuania has implemented the EU directives on capital adequacy—CAD I and CAD II. Progress has also been made in strengthening the regulatory arrangements applicable to credit unions. In particular, legislation has been enacted to establish a Central Credit Union, to be formed by the credit unions and the Government.

General preconditions for effective banking supervision

122. The Basel Committee recognizes that effective banking supervision requires a number of preconditions. These include sound, credible and sustainable macroeconomic policies, well developed commercial and securities law and judicial systems, mechanisms to encourage sound corporate governance, well developed and enforced accounting and auditing standards and practices, structures to facilitate market disciplines in the banking and corporate sectors and procedures for resolving bank distress and failure events. Most of these preconditions exist to a satisfactory extent in Lithuania. Although considerable progress is being made in Lithuania to promote high quality accounting and auditing practices, corporate governance, and sound insolvency law arrangements, there is scope for further progress in these areas.

B. Main Findings

123. The main findings of the BCP assessment are summarized below:

- **Objectives, autonomy, powers, and resources**. Under the law, the objectives of banking supervision are clear, transparent, internally consistent and achievable. However, for the sake of clarity and consistency it may be desirable for the objectives or purposes of banking supervision to also be set out in the Law on the Bank of Lithuania.

  The BoL has a satisfactory degree of independence to exercise its bank licensing and supervision powers. It has the legal authority to exercise all bank licensing and supervision powers without interference from other government agencies or from

Cabinet. However, given that bank licensing and supervision powers are vested in the Board of the BoL, and not in the head of the CISD, there is the potential for supervisory decisions to be taken on the basis of a broader consideration of issues than those strictly related to banking supervision. This has the potential to lead to decisions being made that are not necessarily consistent with the actions justified by reference solely to banking supervision considerations. Moreover, it is arguable that the composition of the Board (with some members of the Board being appointed from outside the BoL, including from the banking sector) could potentially compromise the BoL's effective independence in conducting banking supervision. This might suggest the merit of amending the Law on the Bank of Lithuania to make provision for a majority of the Board to be staff members of the BoL and to tighten the provisions relating to conflicts of interest of Board members.

The BoL has adequate legal powers to conduct its bank licensing and supervision responsibilities. However, there is scope to strengthen the BoL's powers to respond effectively to bank failure events. These issues are addressed in the main FSAP report.

The law does not protect banking supervision staff or members of the Board of the BoL from legal actions in the conduct of bank licensing and supervision. The absence of legal protection does not appear to have created difficulties to date, but it has the potential to dissuade the BoL supervisors from the full exercise of their responsibilities in some circumstances. Consideration should be given to the enactment of a suitable provision in the law to provide the BoL Board and the staff involved in banking supervision with an appropriate degree of legal protection, while preserving effective accountability and transparency for members of the Board and banking supervision staff.

- **Licensing and structure**. The current minimum level of capital for a licensed bank—set at Euro 5 million—seems broadly appropriate for the Lithuanian banking system at present. However, the authorities need to keep under review the minimum amount of capital required to establish a bank incorporated in Lithuania, with a view to ensuring that it remains an effective and appropriate hurdle for new bank entry. It is equally important, however, to balance this objective with the need to maintain a relatively contestable banking system.

  The criteria to which the BoL is legally required to follow when considering a bank license application are appropriate. However, it may be desirable to widen the list of criteria in statute law to make them more consistent with the considerations applied in ongoing supervision (e.g., by requiring the BoL to have regard to an applicant's systems for identifying, monitoring and managing risks and assessing an applicant's exposure concentration and asset quality).

The BoL does not have the legal authority to review a proposed acquisition by a bank, even where this might have material implications for the prudential soundness of the bank in question. Moreover, unlike in the case of a bank's equity holdings in entities that are not credit institutions (where limits apply to the amount of a bank's capital that can be held in such investments), there are no limits in the case of a bank's equity holdings in credit institutions. However, the BoL does require equity investments by a bank in other entities (including credit institutions) to be deducted from the bank's capital. Consideration should be given to the merit of providing the BoL with greater scope to review and approve/withhold approval of an acquisition by a bank of a credit institution.

- **Prudential regulations and requirements.** The legal framework and prudential rules enable the BoL to ensure that banks are required to hold a minimum level of capital relative to their risk weighted exposures, on both a solo and consolidated group basis, in line with the Basel Capital Accord.

  Given the risk profile of the Lithuanian economy, and the evolving nature of its regulatory frameworks and corporate governance arrangements, it is appropriate that banks in Lithuania are required to maintain a higher capital ratio than the standard 8 percent in the Basel Capital Accord. Whether 10 percent is necessarily sufficient is a matter of judgment and it is recommended that the BoL re-assess the adequacy of the 10 percent ratio from time to time to ensure that the minimum capital ratio adequately reflects the risk profile of the economy and financial system.

  The BoL does not currently require banks to hold capital against market risk in line with the Basel Capital Accord. However, this requirement will come into force with effect from December 31, 2001.

  The BoL has effective systems in place to evaluate banks' credit granting and loan portfolio management procedures. This is mainly achieved via the BoL's on-site examination processes and through the guidelines that the BoL has established for banks in relation to lending and loan review practices.

  The BoL has appropriate systems in place to enable it to assess banks' asset quality and provisioning and to require banks to maintain appropriate risk management practices in these areas. However, the difficulties inherent in determining accurate market valuations of collateral and for valuing certain types of assets impede the asset quality and provisioning assessment process to some extent. As with any standardized approach to loan classification and provision, the loan classification system and provisioning rules applied by the BoL create the potential for relatively arbitrary provisioning outcomes in some cases. It would be desirable for the authorities to keep the loan classification and provisioning rules under review, with a view to eventually moving towards a model that enables banks to use their own models for asset classification and provisioning (subject to supervisory approval).

There is also scope to strengthen the accountability of bank directors and senior management to take responsibility for ensuring that their bank maintains high quality risk management systems and internal controls. By way of example, the use of publicly disclosed director attestations (requiring directors/council members of banks to attest to the effectiveness of their bank's risk management systems and internal controls), with appropriate penalties for situations where the directors give false or misleading attestations on these matters, is one option for promoting greater director accountability. Enhanced public disclosure by banks is another option worthy of consideration.

The BoL maintains effective systems for monitoring and evaluating banks' exposure concentration. It imposes limits on banks' large exposure positions, on both a solo and consolidated group basis, and both with respect to exposures to particular counterparties or groups of closely related counterparties and in the aggregate. However, in some cases there is difficulty in accurately determining the nature of connections between borrowers, casting some doubt on whether groups of closely related borrowers are being accurately measured.

Although the large exposure limit (25 percent of bank or banking group capital) is consistent with international standards, it is arguable that the limit may be relatively high for the Lithuanian banking system and economy, given the small size of the economy and its risk dynamics. It would be desirable for the BoL to keep this limit under review, taking into account the risk profile of the financial system and economy, the credit quality of borrowers and the contagion risks within the economy.

The large exposure limit does not apply to credit exposures to banks where the exposure is of a maturity under 30 days. Consideration should be given to whether this leaves the banking system excessively exposed to inter-bank contagion and whether there might be a case for shortening the maturity for inter-bank exposures to be exempt from the large exposures limit.

Although a limit is applied to some forms of connected exposures, lending to parent banks and other corporate shareholders are not subject to the connected exposure limit (although they are subject to the large exposure limit). This gives rise to the potential for subsidiary banks licensed in Lithuania to have substantial exposures to parent banks, with attendant intra-group contagion risks, particularly in regards to exposures under 30 days in maturity. Given the potential for banks that are subsidiaries of other banks or corporate shareholders to be subject to intra-group contagion, it would be desirable if the connected exposure limit applied to bank exposures to parent banks and other corporate shareholders and affiliated entities could be tightened, particularly in the case of connected parties with relatively low credit ratings or otherwise considered to be of higher risk.

It would be desirable if the BoL could give careful consideration to the means by which bank directors could be assigned greater responsibility for overseeing their banks' connected exposures. For example, consideration could be given to requiring banks to have a minimum number of independent, non-executive directors (unconnected with any shareholders with a capacity to significantly influence or control the bank). And it would be desirable to consider the merit of requiring bank directors to issue regular public attestations that they are satisfied that all connected exposures have been subject to credit approval and loan review on terms at least equal to the standards applied to unconnected lending, and that all connected exposures are in the interests of the bank.

Through its on-site examination process, the BoL assesses banks' systems for monitoring and managing a wide range of banking risks. Although the BoL has issued guidelines to banks in relation to a number of risks and risk management systems, it has not issued guidelines with respect to the full range of risks to which a bank can be exposed. There is scope to provide more comprehensive guidance to banks on these matters (e.g., in regards to electronic banking, cyber risks, business continuity risks, payment system interface risks, etc.). However, as noted above, it is equally important that steps are taken to strengthen the accountability of bank directors and senior management for the identification, monitoring and control of the full range of business risks, and to strengthen market disciplines on banks via enhanced disclosure.

Lithuania has relatively comprehensive laws for dealing with money laundering and other financial crimes. For its part, the BoL's on-site examination of banks involves assessment of banks' systems for detecting potentially suspicious transactions and for combating money laundering and other financial crimes. However, there is scope for the BoL to strengthen its assessment of such matters, including by providing examination staff with further ongoing training to deepen their understanding of the systems needed for banks to effectively detect and prevent money laundering and other forms of financial crimes.

There is also scope to strengthen the duties of bank directors to ensure that their banks comply with all relevant statutory and regulatory requirements in relation to money laundering and financial crimes, and to ensure that their banks maintain effective systems for detecting and preventing money laundering and financial crimes. One option would be to require directors/council members to sign and disclose attestations in relation to the adequacy of their banks' systems for controlling money-laundering risks and to hold them liable for false or misleading attestations.

There would also be merit in strengthening the coordination between the various authorities responsible for different aspects of the laws relating to money laundering and other financial crimes.

- **Methods of ongoing supervision.** The BoL conducts regular on-site examinations of banks, generally on an annual basis. The examination process is comprehensive and covers a wide range of banking areas, including risk management systems, internal controls, management systems, compliance with prudential requirements, and asset quality and provisioning. There is also a comprehensive system of off-site monitoring of banks, involving the analysis of a wide range of information provided to the BoL by banks on a monthly and quarterly basis (with some information provided at more frequent intervals). This analysis includes assessment of a wide range of early warning indicators.

  In a banking system where an increasing number of banks are foreign owned, it is important for the BoL to ensure that it assesses the adequacy of the parent banks' supervision of their bank operations in Lithuania, and the adequacy of reporting from bank subsidiaries and branches to parent banks. It is also important for the BoL to ensure that it maintains a sound understanding of the financial condition of the parent banks and the financial systems within which the parent banks operate, given the contagion risks between parent banks and their subsidiaries or branches in Lithuania. This suggests the need for the BoL to maintain systems to enable it to be alert to salient developments in parent banking systems and in the parent banks themselves, and to maintain a regular dialogue with the parent supervisory authorities.

  There is scope for the BoL to further strengthen its macro-prudential analysis and to ensure that banking supervision staff maintain a sound understanding of the full range of factors that can give rise to financial system distress, including with respect to developments in the real economy, financial markets and capital account, and potential contagion channels within the Lithuanian financial system and vis a vis other countries' financial systems.

  At present, the financial statements of group members, which are consolidated into the parent bank's statements, are of considerably lower quality than those of the parent bank. There is a need for the BoL to ensure that, in its conduct of consolidated supervision, it has careful regard to the nature of the risks, and the adequacy of risk management systems, in the important subsidiaries within banking groups. This recognizes that bank distress events often arise as a result of problems within subsidiaries and inadequacies in a bank's systems for managing risks within its subsidiaries.

- **Information requirements.** Information requirements and disclosure are generally well-developed. Banks and their subsidiaries are required to comply with International Accounting Standards and are subject to annual external audit. However, the BoL does not sufficiently enforce the application of IAS principles in the preparation of commercial banks' financial statements. The BoL has the power to require banks to depart from IAS and has prohibited banks from complying with IAS39 (although this will no longer be the case now that the EU has issued a directive requiring compliance with IAS39). In order to avoid the need for banks to issue multiple sets of financial statements, and to promote compliance with IAS, it is important for the BoL to minimize departures from IAS and to ensure that any such departures are subject to careful assessment and consultations with banks and auditors.

A substantial range of information is publicly disclosed with regards to the financial condition of individual banks in Lithuania, both by the banks themselves and by the BoL. Information is generally available at quarterly intervals. However, there is scope to further strengthen financial disclosure by banks, including by requiring banks to incorporate more comprehensive prudential information in their disclosures, to require bank directors to sign the disclosure statements and to be held legally liable for the veracity of the disclosures, and to educate the news media and depositors on key information relating to banks' financial and prudential disclosures. Further steps could also be taken to improve depositors' access to banks' financial disclosures, possibly by requiring banks to make short-form, simplified disclosure statements available in bank branches and on the internet.

- **Formal powers of supervisors.** The banking supervisors have at their disposal adequate supervisory measures to bring about timely corrective actions at financial institutions. However, it would be desirable to widen the penalty provisions for non-compliance with supervisory requirements, including by making provision for the application of fines to banks and credit unions as well as to their directors and chief executive officer. There is also a need to ensure that the powers to respond to non-compliance with supervisory requirements are proportionate to the offence and for the grounds for invoking penalty provisions or other remedial measures to be specified in relation to each category of enforcement situation.

- **Cross-border banking.** The BoL has made substantial progress in implementing cooperation agreements with other supervisory and regulatory authorities. A memorandum of understanding has been entered into with the securities commission and insurance supervisor to facilitate information sharing. Agreements have also been entered into with the parent supervisory authorities in a number of other countries with a banking presence in Lithuania.

  Given the increasing extent to which the Lithuanian banking system is foreign owned, there is a need for the BoL to ensure that it maintains a regular dialogue with all parent supervisory authorities, particularly those with responsibilities for banks which have a substantial presence in Lithuania. This not only involves the need for regular information sharing between the authorities, but would also desirably involve sharing views and experience on policy issues, and developing a better understanding of how any cross-border bank insolvency or liquidity events would be handled.

Recommended Action Plan to Improve Compliance of the Basel Core Principles

Group of Principles	Recommended Actions
Objectives, Autonomy, Powers, and Resources	Incorporate specific banking supervision objectives in the Law on the Bank of Lithuania on a basis consistent with the banking supervision objectives in the Law on Commercial Banks. Make provisions for the legal protection of members of the Board of the BoL and banking supervision staff, while retaining robust accountability arrangements. Strengthen the legal powers relating to the capacity to respond to bank failure events.
Licensing and Structure	Widen the statutory criteria for determining applications for a bank license to include all relevant matters that are subject to ongoing supervision. Keep the minimum capital requirement for a bank incorporated in Lithuania under periodic review, to ensure that it strikes a reasonable balance between serving as a meaningful hurdle for new bank entry and maintaining a contestable banking system. Strengthen the BoL's power to assess and approve a bank's acquisition of another financial institution.
Prudential Regulations and Requirements	Give consideration to specifying triggers for enforcement actions where a bank's capital ratio falls below the required minimum level. Keep the minimum capital ratio requirement under periodic review to ensure that the minimum capital ratio for banks in Lithuania takes adequate account of banking system risks and the risk dynamics of the economy in general. Keep the loan classification and provisioning rules under review, with a view to eventually allowing banks to develop their own alternative loan classification and provisioning rules, subject to BoL approval. Strengthen the duties of bank directors to take responsibility for ensuring that their banks maintain effective risk management systems and internal controls, including by requiring directors to issue regular attestations of the extent of their satisfaction with the risk management systems and internal controls and that the systems are being properly applied at all times. Give consideration to the feasibility and efficacy of reducing the maturity (currently of 30 days) for inter-bank loans for the purpose of the large exposure limit, such that the limit applies to inter-bank loans of a shorter maturity than 30 days. Tighten the connected lending limit in regards to lending to parent banks or other corporate shareholders and their affiliates and subsidiaries, so as to reduce the risk of intra-group contagion. Give consideration to requiring banks to have a minimum number of fully independent, non-executive directors. Give consideration to requiring bank directors to attest on a regular basis that the bank's connected exposures have been subject to credit approval and review on terms at least equal to those applicable to lending to nonconnected parties, and make provision for appropriate penalties where such statements are false or misleading. Give consideration to the merit of requiring directors to attest that all connected exposures are in the commercial interests of the bank.

Group of Principles	Recommended Actions
	Give consideration to developing guidance for banks on a wider range of banking risks than is currently the case (including payment system risks, business continuity risk, cyber risks, reputation risks, etc). Give consideration to requiring bank directors to make regular attestations stating whether they are satisfied that their bank has adequate systems in place to identify, monitor and control all material business risks and that those systems are being effectively applied at all times, and make provision for appropriate penalties where such attestations are false or misleading. Provide examination staff with regular training to deepen their knowledge of the systems needed to detect and prevent money laundering and other financial crimes. Consider the efficacy of strengthening the duties of bank directors to satisfy themselves that their banks have effective systems for detecting and, to the extent practicable, preventing money laundering and financial crimes (including "know your customer" procedures) and that those systems are being properly applied at all times. One option for achieving this could be to require bank directors to sign regular attestations with respect to these matters and to hold them legally liable for any attestations that are false or misleading. Strengthen the coordination and cooperation between the agencies involved in detecting and preventing money laundering and financial crimes, including by way of forums for regular dialogue, exchange of views on policy issues, training and (where appropriate) coordination of on-site examinations.
Methods of Ongoing Supervision	Ensure that on-site examiners effectively assess the nature of risks, and the systems for managing these risks, in the important subsidiaries of banks, and that there is a careful assessment of the bank's systems for overseeing its subsidiaries.
Information Requirements	Minimize the extent to which banks are required to depart from IAS, and ensure that where any such departures are being considered by the BoL, they are subject to thorough consultation with banks, auditors and other affected parties. Consider the efficacy of strengthening the public disclosure requirements for banks, including by requiring banks to issue more frequent, comprehensive disclosures, with disclosure of key prudential information (in addition to the standard financial information), and short-form disclosures for depositors.
Formal Powers of Supervisors	Review the existing penalty provisions applicable to banks for non-compliance with supervisory requirements, with a view to empowering the BoL (or the Courts on the application of the BoL) to levy fines on banks, bank directors and bank CEOs, where the fines are proportionate to the seriousness of the offence. Consider the merit of modifying the existing statutory offence provisions and remedial/penalty provisions in the law, so that they are set out as a hierarchy of measures covering different levels of offence, and where the remedial and penalty provisions are specified in relation to each offence.
Cross-Border Banking	Develop systems for maintaining a sound understanding of the financial condition of parent banks (and other significant shareholders) of banks operating in Lithuania, for ensuring that the parent banks are adequately supervising their operations in Lithuania, and for ensuring that the banking operations in Lithuania have effective systems for keeping the parent banks well apprised of developments of the local operations. Complete memoranda of understanding with all parent supervisory authorities, and maintain a

Group of Principles	Recommended Actions
	close dialogue with them, including the regular exchange of information on banking groups operating in the respective jurisdictions, on broader banking system developments in the respective countries, on relevant policy issues and on methods for effectively coordinating the response to cross-border financial distress or bank failure events.

C. Authorities' Response

124. The BoL had an opportunity to review a draft of the BCP assessment report and provided detailed comments to the assessors. Based on further discussions with the assessors, most issues of fact and interpretation were resolved to the mutual satisfaction of the BoL and the assessors. Overall, the BoL felt that the assessment, while generally fair and thorough, was perhaps too critical of their practices in some areas. Key issues that arose during the discussions are listed below.

125. Thus, the BoL did not share the assessors' view that their loan classification and provisioning procedures might give rise to distortions in the banking market. They noted that the regulations establish only the main guidelines for the review of a bank's asset portfolio, but that bank specific information is also considered and assessed. These procedures ensured that the assets of a bank were appropriately valued in economic terms.

126. Regarding the supervision of banks' large exposures, the BoL noted that supervisors take a comprehensive approach to observing relations between bank borrowers, based inter alia on the use of the loan risk database established by the BoL. In its on-site supervision, the BoL places a particular emphasis on determining connections between a bank's borrowers, including with respect to relations with holding companies, bank subsidiaries, and principal shareholders. If necessary, foreign supervisory authorities or specialized enterprises in Lithuania are contacted for assistance in tracing the connections. The BoL expressed analogous reservations about the assessors' views of the supervision of connected lending.

127. The BoL also considered that its procedures for examining banks' compliance with money laundering regulations, particularly as regards the substance of the controls, would have merited a higher rating.

III. IAIS Insurance Supervisory Principles

A. General

128. This summary of the assessment of compliance by the State Insurance Supervisory Authority (SISA) of the Republic of Lithuania with the core supervisory principles established by the International Association of Insurance Supervisors (IAIS) was conducted

in early November 2001 as part of the Financial Sector Assessment Program (FSAP). The assessment was carried out by Gregorio Impavido (World Bank).

129. The assessment uses the October 2000 IAIS template and methodology papers. It benefited from a detailed self evaluation of the IAIS core principles conducted by SISA in February 2001, from replies to a questionnaire submitted by the FSAP team, and from extensive collaboration of SISA with the assessor.

B. Institutional Overview

Legal framework

130. Activities of insurance companies and insurance brokers and their supervision are regulated by the Law on Insurance (No. I-1456 of 1996). Supplementary regulations are provided in relevant orders of the MoF and in resolutions of the Board of SISA, the governing body of the agency. Relevant regulations are available on SISA's website at http://www.vdpt.lt. Other related Laws are: the Law on Compulsory Motor Third Party Liability Insurance (No. IX-379 of 2001), the Civil Code (No. VIII-1864), the Law on Civil Service (No. VIII-1316 of 1999), the Law on Public Administration (No. VIII-1234 of 1999), and the Company Law (No. I-528 of 1994).

Market

131. The insurance market in Lithuania comprised 6 life insurance companies and 27 nonlife insurance companies as of December 2000. In 2000, total gross premium income (GPI) as reported by SISA was LTL 437 million (1 percent of GDP). Total insurance assets amount to LTL 827.6 million (1.8 percent of GDP). The insurance market is small both in terms of GPI and assets relative to GDP and does not raise immediate concerns of systemic vulnerability for the financial sector.

132. The life insurance market is growing slowly with GPI of LTL 76.2 million in 2000, up from LTL 66 million in 1998. The nonlife insurance market is stagnant with GPI of LTL 360.8 million in 2000, down from LTL 381 million in 1998. A 30 to 40 percent growth in nonlife GPI is expected during a period of 2 to 3 years following the introduction of compulsory motor insurance in 2002.

133. Insurance companies are solvent, although for small companies this appears to be the result of low loss ratios. For the market as a whole, the average solvency ratio (solvency margin over minimum solvency margin) was 577 percent in 2000. Gross rates of return on GPI, average total assets, and average total equity were 5.7, 2.3, and 6.6 percent, respectively, in 2000.

General preconditions for effective insurance supervision

134. The principal responsibility of the supervisory authority is to ensure the financial solvency of the companies operating within its jurisdiction. Effective supervision entails the disclosure of adequate information by insurance companies, and the oversight of companies' management and internal controls. Insurance company failures often arise when owners lack the proper incentives to act prudently and supervise managers.

135. The supervisor is also expected to remove or at least minimize the information gap between the insured and the insurer. In all countries, the consumer of insurance is at a distinct disadvantage vis-à-vis the insurance company, since the company can and does request a considerable amount of information from the applicant for insurance, while the consumer often finds it difficult to obtain information about the financial condition and claims-handling practices of insurance companies.

136. Additional responsibilities of the supervisory authority are to promote public and international confidence in the quality and soundness of financial institutions and enable insurers to fulfill their role in spreading risk, thereby protecting invested capital and facilitating the growth of businesses, as well as providing the public with high quality investment vehicles and life insurance for estate planning and other purposes.

137. Within this framework, several preconditions are needed for effective supervision and growth of the private sector insurance market. In order to play its economic and financial role, the insurance sector requires stable and market-oriented regulation that provides adequate incentives for efficiency and allows companies to innovate. Insurance regulation must aim at creating a contestable market that is open to new entry by qualified companies and facilitates the exit of insolvent firms. It must also aim at safeguarding the stability of the sector and the solvency of individual companies and at protecting the interests of policyholders. A strong and consistent legal framework is needed for effective supervision, and a stable macroeconomic environment and the existence of strong governance mechanisms promote the development of the industry and the confidence of business.

138. Several of the above-mentioned preconditions are not present in Lithuania. As a result, both the development of the market and the effectiveness of supervision are limited. In the next section, the strengths and weaknesses of the Lithuanian insurance regulation and supervision are highlighted.

Main findings

139. The style of insurance supervision in Lithuania is traditional and aimed mainly at controlling compliance with existing regulations. At the same time, the legislative framework is weak in areas such as corporate governance and internal controls. In some cases, it does not give sufficient powers to the supervisory authority to fully discharge its responsibilities; and

it often allows for discretion, especially in the application of sanctions. As a result, the supervisory process lacks transparency, objectivity, and may be less than fully effective.

140. In more developed environments, supervision often encompasses partnership and consulting as well as auditing and policing, with a focus on ensuring fair market conduct and adequate solvency levels. In this second style of supervision, the supervisor needs to be able to rely to some extent on the internal controls and governance of the insurers. The supervisory authority, the representatives of the insurance association, and many insurers have already identified key weaknesses in the market and its regulation and are seeking to create a sound and effective regulatory and supervisory system, and to develop the technical expertise that a more sophisticated industry will require. However, this transformation may take a long time.

141. SISA puts a strong emphasis on disclosure of information within the limits of the current regulatory framework. Its web site and annual report contain important information regarding the market, inspection activity, and legislative changes. No information is available on expenses or commissions paid by insurance companies.

142. The legislative framework has important gaps in areas such as corporate governance, internal controls, and market conduct. Moreover, the Lithuanian authorities need to ensure the independence of the supervisory authority, including its financial and organizational independence. Regulation on entry needs tightening and the grounds for refusing licenses extended. The sanctioning framework is characterized by excessive discretion despite SISA's adoption of a de facto regulatory ladder approach. The liquidation process is slow; and the courts can choose a liquidator outside the list proposed by SISA.

Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principles	Recommended Actions
Organization of an Insurance Supervisor	The Lithuanian authorities need to be satisfied that the institutional arrangements for SISA meet the objective of independence, notably financial and organizational independence. The Lithuanian authorities need to be satisfied that SISA can outsource specific skills. Legislation may need to be amended to allow SISA to hire ad hoc consultants and eventually charge companies for their services. Amend legislation to allow SISA to independently establish an appropriate employment and remuneration system. Amend legislation to allow SISA to issue regulations on all aspects of prudential supervision. This would also cover investment regulation of reserves and authorized capital. Introduce transparency in the nomination and removal processes of the Director of SISA by requiring a formal consultative process to be in place. Introduce a formal legal protection scheme for SISA staff.
Licensing and Changes in Control	Introduce formal fit and proper tests for owners, directors and senior management. Expand the grounds for refusing a license to include at least the following cases: (1) unsatisfactory results of control of sources of funds; (2) the organizational, or group, structure of the applicant hinders effective supervision; (3) principles of anti-money laundering regulation are not met; (4) owners, and/or directors, and/or senior management are not fit and proper for their role; and (5) outsourcing contracts are thought to reduce the efficiency of the new entrant. Amend legislation to relax or eliminate the time limit given to SISA to process an application. Amend legislation to require SISA to control outsourcing contracts. Allow companies to use a "file and use" approach for new products. Require SISA to conduct ex-post checks on new products.

Reference Principles	Recommended Actions
Corporate Governance and Internal Controls	Amend legislation to require the board of directors to be responsible also for policyholders' interests. Require companies to hire a "compliance comptroller" with reporting duties to the board and SISA. Require company board of directors to establish investment, underwriting risk management, and market conduct committees with associated policies. Monitor standards and implementation. Require companies to establish an ongoing audit function. Require companies to appoint an external actuary.
Prudential Rules	Establish asset valuation standards. Require the use of independent custodians. Reduce the investment limit on real estate from 40 percent to 15 percent of technical provisions. Require companies to establish investment policies and SISA to monitor their implementation. Amend regulations to introduce maturity, liquidity, and foreign exchange matching criteria. Allow SISA to require companies to hold capital at higher levels than the minimum capital requirement in specified circumstances. Require SISA to conduct consolidated supervision. Allow SISA to require modification in the reinsurance treaties in specified circumstances.
Market Conduct	Require companies to establish a committee for the fair treatment of policyholders and related policies, including the requirement to process customers' complaints. Require SISA to monitor the implementation of the fair treatment of policyholders. Consider requiring the insurance association to develop standards of market conduct.

Reference Principles	Recommended Actions
Monitoring, Inspection, and Sanctions	Introduce an electronic system for filing financial reports. Develop a formal regulatory ladder for supervisory intervention. Develop a sanctioning manual to ensure objectivity in the sanctioning process. Allow SISA to transfer policy portfolios of financially unsound companies. Amend legislation to require the courts to appoint a liquidator only from the list prepared by SISA.
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality	Allow SISA to refuse the establishment of branches where parent companies are not subject to effective supervision.

C. Authorities' Response

143. **Organization of an insurance supervisor**. SISA is within the scope of the Law on Civil Service. Thus, it is difficult to influence such issues as the employment system and wages of personnel. However, efforts are being made by SISA to make corrections to the legislation as far as wages are concerned. The issue of giving complete authority to SISA to define prudential regulation should be considered, for example in the course of drafting of the Law on Insurance Activities, which is expected to be adopted in 2003. The internal structure of SISA is considered adequate for the day-to-day work; and it reflects the structure of the insurance business in Lithuania.

144. **Licensing and changes in control**. Fit and proper tests should be implemented in an appropriate and continuous manner. At the time of writing, legal amendments to this effect are being prepared by SISA. Amendments to the Insurance Law to allow SISA to control outsourcing contracts are being prepared by SISA.

145. **Corporate governance and internal controls**. Implementation of this principle is to be addressed in the new Law on Insurance Activities, though conceptual issues remain to be resolved.

146. **Prudential rules**. SISA believes that the setting of prudential requirements should be concentrated within SISA. The existing gaps (for example with respect to currency matching) should be closed. Prudential requirements in investment regulation are expected to be adopted in 2002. Issues such as consolidated accounting, valuation rules, etc. are outside the responsibility of SISA. The use of derivatives should be regulated by general provisions in the Law. Detailed regulation should be linked to the regulation of corporate governance and internal controls. It is intended to address the compliance with CP 9 in the forthcoming Law on Insurance Activities.

147. **Market conduct**. SISA is of the view that issues related to market conduct should be addressed by self-regulation of the industry. The observance of this principle should be encouraged by implementing the principle covering corporate governance and internal controls.

148. **Monitoring, inspection, and sanctions**. The monitoring of insurance companies and forms for financial reporting are expected to change considerably as SISA develops software for the electronic submission of financial reports. This project should be completed in one or two years. Changes to the Law on Accounting are expected take place in the near future. The development of a formal "regulatory ladder" is considered to be of interest and could be implemented in the future.

149. **Cross-border operations, supervisory coordination and cooperation, and confidentiality**. The authority to refuse a license for the establishment of a foreign insurance company when the parent company is not subject to effective supervision is considered essential and should be reflected in the Law on Insurance Activities.

IV. CPSS Core Principles for Systemically Important Payment Systems

A. General

150. This is a summary of the assessment of the Core Principles for Systemically Important Payment Systems, which was undertaken as a part of the Financial Sector Assessment Program (FSAP). It was carried out by Tomas Hladek (Czech National Bank), and seeks to identify potential vulnerabilities in the domestic payment systems and the systemic risks these may pose to the broader financial system.

151. The main sources of information for the detailed assessment of the payment system were the response of the authorities to an IMF questionnaire, the self-assessment by the BoL of its observance of the Core Principles for Systemically Important Payment Systems, official laws and regulations, and meetings with various government and financial sector representatives.

B. Institutional and Market Structure—Overview

152. There is only one payment system in Lithuania, TARPBANK, which was developed and is owned and operated by the central bank. TARPBANK is a designated time net settlement system that processes both high and low value payments, and is also used to perform the settlement of the cash leg of securities transactions. At present, low value transactions dominate TARPBANK activity.

153. The TARPBANK system is used both by domestic banks licensed by the BoL, and by branches of foreign banks that operate in Lithuania. Credit unions must make use of banks' services for making fund transfers.[41] In addition, all participants of the securities market are direct members of the system—the Central Securities Depository of Lithuania (CSDL), brokerage departments of commercial banks, and brokerage companies that have a Lithuanian Securities Commission (LSC) license. Branches of some commercial banks also participate in the system for the purpose of exchanging information on payments.

154. Today, ten commercial banks, with a network of about 160 branches, four foreign bank branches, as well as 41 credit unions are active in Lithuania. In addition, the commercial banks have 642 access points for banking services that are located separately from headquarters and branches and provide some banking services (the Lithuanian Post is not involved in payments). Banking services penetration is below the central European average.[42] An increase in banking activities and payments can be expected in the future, as the average number of intra-bank and inter-bank transactions per capita per annum (about 6 payment orders) is now much lower than in other European countries. All payments equipment used by the central bank, as well as by the commercial banks, is up to date. Communications procedures, including security, are in line with industry standards, as is the relevant legislation.

155. Although cash is still widely used for retail payments in Lithuania, its role is declining with the growth of noncash means of payment. Wages are directly transferred to bank accounts, usage of payment cards and the ATM network is expanding rapidly, and e-money schemes are in place. As in other Central and Eastern European countries, checks are not popular (the legal basis for checks is in place, but banks in Lithuania, including the central bank, are not interested in the development of this payment instrument). For noncash payments, credit transfers dominate. Direct debits are used especially in the area of payments for telecommunication services. The three largest banks conduct the majority of activity in inter-bank payments.

156. Market discipline appears to be good, reflecting the establishment of clear rules and regulations by the BoL. The market is quite small; therefore, cooperation and discussions among participants are relatively uncomplicated. There have been no apparent attempts to violate the rules of the payment system, and no reports of fraud or errors. Theoretically, delays in the start of the end-of-day procedure (of up to one hour) are permitted upon a

[41] At present, less than 0.5 percent of the assets of deposit-taking institutions are held by credit unions. In the near future, a Central Credit Union will be established, which will provide some services, including funds transfer, to credit cooperatives. The BoL has decided that the Central Credit Union will be a direct participant in TARPBANK.

[42] Lithuania has 55 bank branches per 1,000,000 inhabitants, the Czech Republic has 242, Poland has 298, Latvia has 310, and Estonia has 276.

written request by a bank, according to the Resolution of the Board of the BoL on the TARPBANK system. However, such a situation is very rare.

C. Main Findings—Summary

Legal foundation

157. The legal basis for the interbank payment services system, TARPBANK, is set out in the existing legislation (Law of the BoL, Law on Payments, Resolution of the Board of the BoL on the Interbank Funds Transfer System of the BoL, Rules of Settlements according to transactions concluded at the National Stock Exchange, and the Civil Code).

158. The moment of finality of any settlement is defined in the Law on Payments. Article 7 states that "when the funds are included into the settlement account of the payee or payee's bank, the settlement is final and irrevocable." Article 6 of the same Law states that "Funds transferred to payees' banks' accounts by the participant of the Interbank Funds Transfer System, for which the bankruptcy case is initiated the same day or the disposal of funds is prohibited to it in other cases provided for by the laws, are irrevocable and belong to payees, if the Bank of Lithuania did not know and could not know about it." Additionally, the BoL is well informed about credit institution bankruptcies, as Article 11, point 14, of the Law on the BoL states that the Bank Board must "decide on issues regarding initiation of bankruptcy proceedings against credit institutions." Consequently, the BoL has the right to suspend the submission of payment instructions to the system even before any participant's bankruptcy has commenced. A participant's payment instructions received up to that time will be executed, assuming the participant has sufficient funds. The Law on Bankruptcy of Enterprises and the Law on Commercial Banks do not provide for the right of an administrator of an enterprise or a bank to revoke obligations that were in place prior to the initiation of the bankruptcy case.

159. However, as there is no specific wording in the Bankruptcy Law ensuring the full enforceability of netting (both multilateral and bilateral), and as a multilateral netting scheme is used for pre-settlement (as well as for the settlement of securities), the Lithuanian authorities, especially the BoL and the LSC, should remain alert to the impact of bankruptcy on the netting system.

160. Early legislation required written documentation as the only legally acceptable payment order. Therefore, circulation of paper documents is still used among banks in Lithuania, with every transfer involving several stages. In the first stage, the payer's account is debited and the electronic instruction is passed to the BoL for confirming the interbank settlement. When the settlement is confirmed by the BoL to the payers' banks, these banks must send copies of payment orders to the payees' bank by mail. Only after these payment orders (with all the necessary details and entries) are physically delivered to the payees' banks is it possible to complete the transfer.

161. Recently adopted legal amendments allow the BoL and other credit institutions to implement changes in their procedures. As a result, there will be no need to deliver the copies of written payment orders; and all the data needed for the final settlement to the payees' accounts will be transmitted via the TARPBANK system. The first stage of testing the new procedures has been launched. Credit institutions, securities market regulators and participants are well informed and participate in the new projects.

162. During 2001, legal difficulties arose in the wording of the Civil Code, which came into effect in July 2001, and prevented the BoL from granting overnight credits. However, the Amendment of the Law on Public Trading in Securities adopted in September 2001 resolved this legal difficulty; and the BoL is able to grant credits as of November 1, 2001.

Understanding and management of risk

163. In principle, difficulties could arise in the payment system when a bank does not have sufficient funds to cover all of its debit transactions at the final settlement of the day. As a result, certain transaction(s) submitted by such a bank would be rejected from the queue. The rejection of a debit transaction means a subsequent rejection of a credit transaction, which provides liquidity to another bank. New limits must then be established for those institutions to which this liquidity was addressed. In theory, this could cause a shortage of liquidity at one of these recipients. In such a situation, a new limit for this bank would have to be set up and the whole process could cause a domino effect, resulting in a gridlock of the system.

164. At present, gridlock is unlikely, since reserve requirements are high (8 percent) and all banks have sufficient liquidity. The BoL, as part of its efforts to maintain the smooth operation and overall stability of the payment system, attempts to avoid gridlock from arising by providing access to its overnight credit facility (reinstated in December 2001) and through algorithms that minimize the number and value of transactions likely to be rejected.[43] If minimum reserve requirements are lowered to 6 percent (as expected sometime in 2002), the effect on the functioning of the payment system would not be significant. The impact of further reductions in reserve requirements on the payment system should, however, be carefully considered and planned for.

Settlement

165. The TARPBANK system, developed by the BoL in 1994, is a designated time net settlement system. Participants may submit payment instructions to the system from 8:00 a.m. to 3:00 p.m. Settlement of these transactions, conditional on the fulfillment of certain requirements, becomes final and irrevocable after the clearing and settlement process,

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[43] During 2001, up to 20 low value transactions were rejected by the TARPBANK system; and there has never been a need for recalculation as a result of such rejections.

which is initiated daily at 11:00 a.m. and 3:00 p.m. Payment instructions submitted by participants are queued according to priority (two priorities exist—urgent and usual) and time of submission. Participants may revoke a payment instruction submitted and entered into the queue or change its priority. At 2:45 p.m., the simulated estimation process is performed and its results are immediately presented to banks. Thus the banks are given a final opportunity to change their input queues according to their estimated positions. At 11:00 a.m. and 3:00 p.m., exact calculations are processed to establish a limit for each bank (the balance of the settlement account of a bank is increased by the amount of funds from the incoming payments and by any overnight loan granted to the bank and decreased by the amount of the limitations applied). Afterwards, the TARPBANK system initiates "estimations"—it checks if all payment instructions submitted by that time can be executed, i.e., accepted for settlement. If this is not possible, lower priority payment instructions—the most recent ones submitted—are not accepted for settlement at 11:00 a.m.; instead, they are queued for afternoon processing. In the event that it is not possible to execute all payment instructions at the end of the accounting day at 3:00 p.m., the system recalculates all positions in order to optimize the queues so that as many payment instructions as possible are accepted for settlement.

166. Immediately thereafter, the processing of payment instructions is performed. Balances (net values) of clearing accounts of bank branches calculated during processing are transferred into banks' clearing accounts and entered into their settlement accounts in the books of the BoL. At this point, settlement becomes final and irrevocable.

167. The BoL has opened special settlement accounts for securities market participants to settle the cash leg of securities transactions. These special TARPBANK system participants must accumulate adequate amounts for their cash leg securities settlements by 11:00 a.m., at which time the BoL informs the CSDL about the balance of these special accounts. The CSDL calculates needed funds as net cash positions of every participant, taking into account the participant's net position arising from "central market" trades (fixed price trades and continuous trading using different prices through the central counterparty). Block trades are not netted and are added trade by trade without any evaluation of the cash that is to be received by that participant. If the BoL informs the CSDL that funds are insufficient, the CSDL must re-run its netting and calculation procedures, excluding all central market trade movements of participant(s) who failed to accumulate sufficient funds. Before the Guarantee Fund[44] of the NSEL is accessed, another attempt to settle both cash and securities is

[44] The Guarantee Fund may be accessed in the event that one or several brokerage firms are not able to fulfill their obligations. The Fund is financed by the deposits of the members of the NSEL. The rules of the Fund, which is administered by the NSEL, are approved by the Securities Commission. The Guarantee Fund may not be used to finance current expenditures of the Exchange. The Fund has not been used since 2000, as the percentage of suspended trades is very low (0.1 percent).

attempted the following day.[45] The central market trade movements linked to the default are suspended.[46] Block trades with insufficient funds or securities are not covered by the Guarantee Fund and are simply cancelled. If the accumulated funds are sufficient, the CSDL ascertains that the number of securities in the securities accounts is sufficient as well. If so, delivery-versus-payment (DVP) conditions are fulfilled and the CSDL performs the transfer of securities and instructs the BoL to perform the transfer of funds at 3:00 p.m. (According to payments instructions submitted by the CSDL, funds are transferred from the clearing accounts of the securities market participants-payers at the BoL to the clearing accounts of the securities market participants-beneficiaries through the clearing account of the CSDL).

168. Despite the banking crisis at end-1995, the payment system has functioned without any significant failure or gridlock. Although two big banks were short of liquidity and it was necessary to reject a number of transactions from the input queues, these rejections did not result in any gridlock of the system.

Security and operational reliability, and contingency arrangements

169. The TARPBANK system is backed-up by a secondary site, situated in a different location. Both systems are interconnected by FDDI fiber optic network (Fiber Distributed Data Interface—high-speed communication technology). Network security is state-of-the-art. After every settlement cycle, the results are transmitted to the backup system. Should the primary system fail, the process can continue to run in the back-up site using the existing input data—if they were not destroyed and the communication lines are available. If this is not the case, the banks would be instructed to deliver their data to the back-up site once more. The detailed contingency procedures were adopted by the Resolution of the Board of the BoL on the Interbank Funds Transfer System of the BoL (No.149, September 2001). They have never been used.

170. The CSDL renders its services to most financial intermediaries by means of electronic communication. As a result, the nature of payment activities has substantially changed in recent years and the flow of paper documents has been reduced. Thus, an electronically operated securities accounting and settlement system prevails in the legal system of book-entry securities, which has been in force since the creation of the Lithuanian capital market.

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[45] Rules and exact procedures of when and how the Guarantee Fund can be used are detailed in the document called "Rules on Settlement of Transactions concluded on the NSEL" approved by the Council of the NSEL and approved by the Securities Commission in April 2000.

[46] To minimize the number of suspended trades, the CSDL plans to offer a securities lending facility and create a "reserve cash lending system" covering small "technical" cash defaults (approximately up to LTL 10,000) in the first half of 2002.

The same book-entry principle has been consistently applied in the CSDL data safekeeping and backup systems. The CSDL's data backup was upgraded by transferring an increasing portion of securities accounting data onto magnetic carriers. In order to reduce operational risk, the securities accounting software of the account managers is repeatedly tested with a view to its compliance with the laws and regulations. Thus far, there have been no errors, failures, or attempts of fraud. Procedures are in place for the efficient resolution of processing interruptions. However, the disaster recovery arrangements of the CSDL need to be made more robust and fully integrated with those for the settlement system.

171. Although the system meets present requirements, the BoL is aware of the need to provide for future developments, notably membership in the European Union. New legislation is being drafted; and the BoL is seeking to upgrade and modernize the existing payment system. This project is expected to be complete at the end of 2003. One of the most important aims of the new system is to implement different settlement methods for different types of transfers. Another issue to be addressed is the capacity of the system and the determination of a boundary between high and low value payments.

172. The first steps for the new payment system were taken in 2000 under the umbrella of PHARE.[47] Today, it is guided by the domestic authorities. The existing Function Specification describes functions of the system, liquidity sources, and interfaces with other domestic and international systems (integration with the EU's TARGET system is expected). It also elaborates on operating rules, technical architecture, security, and considers various risks and their management. An important aim of the project is to minimize any potential or theoretical gridlock of the payment system by introducing new features and methods to ensure sufficient liquidity. This is of particular importance since real time gross settlement systems (RTGS) need more liquidity in comparison with current netting schemes.

Practicality and efficiency

173. The TARPBANK system is fully centralized, owned and operated by the BoL. It settles both high and low value payments, as well as all payments originated by the securities market. The small size of the financial system has allowed the centralized system to function efficiently.

174. Presently, volumes are low in comparison with other Central European countries.[48] Furthermore, the values of transactions are low. Since it is expected that the number of both

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[47] PHARE is a pre-accession instrument, financed by the European community to assist applicant countries of Central Europe in their preparations to join the EU.

[48] The Czech Republic has more than 900,000 transactions per day, for 10 million inhabitants or 22.5 transactions per capita yearly; and Slovakia has 500,000 transactions, for 5 million

(continued...)

high and low value transactions will rise significantly, any new system must be designed accordingly. Although the peak volume today does not exceed 70,000 transactions, the new system should be designed not for 100,000 transactions per day, but perhaps half a million.

Criteria for participation and the governance

175. All banks have access to the TARBANK system. Rules are publicly described in Part II of the Resolution of the Board of the BoL on the Interbank Funds Transfer System of the BoL.

176. The TARPBANK system is governed by the BoL. All arrangements and rules are publicly disclosed in the Resolution of the Board of the BoL on the Interbank Funds Transfer System of the BoL, and in technical descriptions and requirements included in the bilateral agreements between the BoL and the participants of the TARPBANK system.

Central bank responsibilities

177. There is no specific clause in the Law on the BoL that explicitly establishes payment system oversight as a role of the central bank. Nevertheless, such a role is clearly given by the unique position of the BoL in the payment system in Lithuania. In light of the BoL's dual role as both payment system provider and regulator, good governance requires the separation of these two functions within the BoL. At present, the system operators, the policy makers, and the technology developers are in separate divisions of the BoL.

178. The BoL cooperates with other institutions in the area of payments. Its project for the new payment system is managed by a steering committee comprised of experts and managers from the BoL, commercial banks, the national stock exchange, the securities commission, the securities depository, and others.

179. The BoL regularly participates in international fora of central banks and clearing institutions, where experiences on all aspects of payment systems are exchanged. Upon entering the EU, Lithuania will contribute to the work of the official committees of the Eurosystem in the area of payments. Even today, Lithuanian payment system experts take part in the meetings of the European Central Bank, where future payment schemes and procedures are being discussed. Lithuania also plans to join other forms of co-operation in the area of payment systems in the EU.

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inhabitants or 25 transactions on an annual average. Lithuania averages about 6 transactions per capita.

Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPs

Reference principle	Recommended action
Legal foundation	As there is no specific wording in the Bankruptcy Law ensuring the full enforceability of netting (both multilateral and bilateral) and as a multilateral netting scheme is used as a pre-settlement method, the Lithuanian authorities, especially the BoL and the SC, should keep in mind the impact of bankruptcy on the netting system.
Understanding and management of risks	The authorities will want to monitor the behaviour and needs of the system, especially if the minimum reserve requirements are lowered. The expected reduction in the minimum reserve rate by 2 percentage points in 2002 would not have a significant influence on the liquidity used by the system, but will provide a first opportunity to study the behaviour of the system in the changing environment. The impact of a further decrease in the minimum reserve requirement is a task for following years. If the new payment system has not yet been implemented at the time of the subsequent reductions in the reserve requirement, it will be necessary to offer another source of liquidity. It is recommended that new liquidity features and facilities be incorporated in the planned new system. Responsibilities and liabilities of all participants should be redefined. In order to avoid long queues, one alternative is to consider the more frequent settlement of netted positions. The BoL should offer new, probably more attractive and technically less complicated sources of additional liquidity (such as intraday credits covered by securities or reserves in foreign currencies, which the banks hold as mandatory reserves with the BoL). Additionally, multilateral agreements with participants for potential liquidity shortfalls (in the case of predefined multi-level gridlock) is recommended.
Settlement	No tests were conducted to ensure the timely completion of daily settlements in the event of the inability to settle by the participant with the largest single settlement obligation. However, the experience during the Lithuanian banking crisis at the end of 1995 suggests that the system should be able to meet the Principle. It is recommended that several stress tests be conducted that demonstrate the capacity of the system under different conditions.
Efficiency and practicality of the system	As it is likely that the number of both high and low value transactions will rise significantly, the new system should be prepared to deal with these higher volumes in the future. The recommendation is to plan for a capacity of the new payment system of half a million transactions per day.
Central Bank Responsibilities in applying the CPs	The BoL is convinced that all core principles are observed. Nevertheless, potential risk does exist in the system. The recommendation would be for reengineering the system. The BoL is aware of this fact and has already launched a project to build a new payment system by the end of 2003. Requirements incorporated into the Functional Description of this new payment system do not deviate from the core principles for systemically important payment systems.

D. Authorities' Response

180. The BoL broadly agreed with the assessment. The BoL noted that the description of the TARPBANK system in the report is comprehensive and correct. More generally, the BoL thought that the assessment thoroughly covered the specific features of the system.

181. However, the BoL disagreed with the assessment of Core Principle II, noting that the existing rules describe the operations of the TARPBANK system clearly and comprehensively, which enables participants to understand the risks in the system, including the risk of gridlock. The rules also provide means for managing risk, through overnight credit and an optimization procedure during the second clearing. Furthermore, the authorities view the Comment section for Core Principle II to be more relevant to Core Principle III.

182. The BoL observed that the assessment of "partly observed" should be with respect to Core Principle III only. The BoL holds that the TARPBANK system fully complies with Core Principle V, because it believes that it is impossible for a situation to arise in which a participant is unable to perform a settlement obligation. The BoL noted that the TARPBANK system accepts for settlement only those payment instructions that the participant will be able to execute. This outcome is achieved by "cleaning" the input queues, i.e. by the rejection of certain transactions. Thus, the debit balances in the clearing accounts of participants during the processing of payment instructions (i.e., the amount of participants' settlement obligations) will not exceed their limits. Furthermore, final settlement is performed immediately after net balances are calculated (and thus, there is no time gap).

183. The BoL plans to implement recommendations pertaining to the design of the new interbank funds transfer system.

Assessment of Anti-Money Laundering Policies

A. Introduction

184. This appendix focuses on the financial aspects of the prevention of money laundering.[49] Within this framework, attention is paid to institutional arrangements, and the roles and responsibilities of the relevant authorities. The report focuses on the issues that are relevant from a supervisory point of view, such as "know your customer" rules and policies and the role played by supervisory authorities in preventing the voluntary or involuntary involvement of credit and financial intermediaries in money laundering or other financial crimes. The report does not address "law enforcement" issues in the wider sense and therefore it should not be regarded as an overall assessment of the adequacy of the Lithuanian anti-money laundering regime.[50]

185. Lithuania appears committed to fighting money laundering. In recent years it has adopted several legal acts that have largely brought the legal framework into line with current international standards.[51] The Lithuanian authorities appear to be committed to performing the tasks assigned by anti-money laundering legislation, in order to prevent the financial system from being abused by criminal organizations and individuals. Even so, some issues require further consideration by Lithuanian authorities.

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[49] With the issuance of the Communiqué of the International Monetary and Financial Committee of November 17, 2001, the IMF's action plan in this area envisages extending the IMF's involvement beyond anti-money laundering to efforts aimed at countering terrorism financing and expanding its anti-money laundering work, including through FSAPs, to cover legal and institutional frameworks, and helping countries identify gaps in their anti-money laundering and anti-terrorist financing regimes in the context of Article IV voluntary questionnaires. The present assessment was undertaken before the most recent Communiqué was issued. Even so, it already addresses a number of the issues raised by the IMFC.

[50] The *First Mutual Evaluation Report on Lithuania*, approved in 1999 by the Council of Europe's *Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures* provides a full assessment of the Lithuanian regime.

[51] In 1997, a provision of the Criminal Code was introduced in order to criminalize money laundering. It carries basic penalties of 3 to 7 years, and 5 to 8 years where there are aggravating features. Lithuania has signed and ratified the Council of Europe 1990 Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime, No. 141 (the Strasbourg Convention), which came into force in 1995, and the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the Vienna Convention), which came into force in 1998. Lithuania is not a member of the *Financial Action Task Force* on the prevention of money laundering.

B. The Legal Framework

The law on the prevention of money laundering

186. The Lithuanian law on the prevention of money laundering entered into force on January 1, 1998 (Act VIII-275), and was amended later the same year.[52] The law, together with the resolutions issued by relevant authorities, provides a framework that appears broadly sufficient to effectively prevent money laundering.

187. Act VIII-275 defines money laundering and identifies the authorities involved in its prevention.[53] The preventive regime is founded on identification and reporting obligations and record keeping requirements.

188. Credit and financial institutions[54] are required to:[55]

- identify the customer and communicate without delay information to the Tax Police on monetary transactions irrespective of the amount if there is a suspicion of money laundering;[56]

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[52] Minor amendments were later adopted in 1999 and 2001.

[53] Money laundering is defined as the "activities aimed at the legitimization or concealment of the origin of money derived from criminal activity." Any criminal activity can be a predicate offense.

[54] The former are defined in Act VIII-275 as banks and credit unions and other institutions licensed by the Bank of Lithuania, while the latter are defined as insurance companies and insurance brokers, investment companies of variable capital, managing enterprises and depositories of investment companies, brokerage firms, investment management, and consulting firms.

[55] The scope of the obligations falling on credit and financial intermediaries is governed by the concept of "monetary transactions," which are defined by Act VIII-275 as "depositing or receipt of money, withdrawal or payment of cash, exchange of currency at financial and credit institutions, also lending, gift and other types of payment, and receipt of money in civil monetary transactions or in some other manner other than the payments or settlements with state and municipal institutions, other institutions maintained from the budget, the Bank of Lithuania and state municipal funds, diplomatic missions or consular institutions of foreign countries."

[56] This obligation falls also on notaries and persons authorized to perform notarial acts.

- identify the customer if the monetary transactions in which the customer is engaged involve a sum in excess of 50,000 litas;

- refuse to conduct a monetary transaction if the customer fails to provide confirmation of identity, or if the identification is insufficient or false;

- identify the customer and the customer's agent when a transaction that has to be reported to the Tax Police is made through an agent;

- maintain a register of monetary operations in excess of 50,000 litas, and of transactions considered suspicious;[57]

- retain documents confirming monetary transactions and other legal documents related to them for 10 years after relations with the customer have ended;

- notify the Tax Police of details of customer identification of a single monetary transaction or several operations exceeding 50,000 litas or where the annual sum of insurance premiums is in excess of 10,000 litas;[58]

- report to the Tax Police data on customer identification and information about a single exchange of currency in cash where the exchange exceeds 20,000 litas;[59]

- appoint persons to organize the implementation of measures for the prevention of money laundering.

189. Act VIII-275 prohibits persons who report information to the Tax Police from disclosing this fact to the customer involved or other persons; and the Tax Police are subject to limits on the dissemination of the information they receive. Act VIII-275 also protects the anonymity of persons who have assisted in detecting violations in the implementation of preventive measures against money laundering and instances of money laundering; and it specifies that the reporting of information required by the act shall not be regarded as an illegal disclosure of an industrial, commercial, or bank secret.

[57] This obligation falls also on notaries and persons authorized to perform notarial acts.

[58] The law exempts credit and financial institutions from communicating to the Tax Police information described in the text when the customer's activities involve continuous and regular monetary transactions. The exemption, however, does not apply if the customer is involved in a set of activities described in Art. 12, s. 7 (e.g., dealing in precious stones, organizing auctions, etc.).

[59] This obligation applies only to credit institutions.

190. ActVIII-275 establishes that any person who commits a breach of the requirements set out in the law shall be held liable. In February 2000, the sanctions for violations of Act VIII-275 were reduced from a range of 1,000 to 10,000 litas to a range of 1,000 to 2,000 litas. It appears that in practice sanctions rarely exceed 1,000 litas.

Customer identification requirements

191. The regulation of customer identification in Lithuania broadly meets international standards in this area.

192. Resolution of the Bank of Lithuania No. 34 of March 18, 1999, implements Act VIII-275, providing guidance to credit institutions.[60] The purpose of the "methodological recommendations" provided by the resolution is to assist credit institutions in properly implementing the requirements of the relevant legal acts. It should be underscored that Resolution No. 34 applies only to credit institutions.

193. The resolution specifies the "know your customer principle:"[61]

- natural persons need to provide the bank's staff with documents showing name and personal code number (or as appropriate, the duration of residency permit and country of origin). Credit institution are advised to define what documents must be submitted. Evidence of identification needs to be confirmed by official documents, bearing a photograph and/or a registration number that cannot be easily copied or forged;

- legal persons need to provide the bank's staff with documents showing the name, residence address, code number, and issue date of registration certificate;

- agents should provide data specified above and the required authorization.[62]

194. With regard to the information required when a customer seeks to open an account in a bank, it should also be noted that Article 6.914, Section 2, of the new Civil Code

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[60] Resolution No. 34 incorporates, with minor amendments, previous Resolution No. 296 of December 18, 1997.

[61] Resolution No. 34 also addresses other issues, including guidance on how the register of information should be kept by intermediaries using appropriate software programs. The resolution details the information that has to be kept in the register. The main regulation of the Register, however, is to be found in Resolution No. 1382/10, which provides for retention of the data and information for 10 years.

[62] When a transaction is entered into through an agent, staff must establish the required data on the person represented, and also on the agent.

establishes that a bank has to open an account when the conditions specified by the bank itself have been met. It further explains that such conditions have to comply with rules and regulations governing banking activity. The Bank of Lithuania has reported that this requirement implies that banks have to fully identify their customers and that this includes identifying corporate directors and ultimate beneficial owners. The Bank of Lithuania has also reported that it could take enforcement action if a bank does not properly identify ultimate beneficial owners of accounts, under Articles 37 and 38 of the Law on Commercial Banks.

Suspicious transactions reporting

195. Act VIII-275 requires the government in conjunction with the Bank of Lithuania to establish the criteria for determining whether transactions have to be regarded as suspicious. In furtherance of this provision, Resolution No. 1381/9 of December 11, 1997 was adopted, providing nine criteria which define when a monetary transaction can be deemed suspicious. The list which is not to be considered exhaustive includes the following:

- transactions that do not appear to be consistent with the registered activity of the enterprise;
- the customer has more than two accounts in different currencies, and the customer's activity does not substantiate a need for different currencies;
- an extraordinary increase in cash payments made by the customer.

196. It is important to stress that while Resolution No. 1381/9 is directed not only to credit institutions but to financial institutions more generally, the list of criteria appears to be tailored mainly to the characteristics of banking institutions.

197. Resolution No. 1381/9 provides that each credit and financial institution further specify the criteria contained in the resolution itself, identifying "conditional features." Resolution No. 34 (mentioned above) provides further general guidance on the matter.

198. There appears to be no specific obligations in Act VIII-275 or elsewhere for credit and financial institutions to report to the supervisory authorities suspicious activities and incidents of fraud that may be material to the safety, soundness, and reputation of an intermediary.

Guidelines on the internal procedures of banks

199. Resolution No. 34 also provides guidance on the internal procedures of credit institutions in implementing measures for the prevention of money laundering. The governing body of the bank is responsible for the implementation of the provisions of Act VIII-275. Credit institutions are required to adopt internal procedures defining who shall carry out specific functions in implementing preventive measures.

200. Credit institutions are urged by Resolution No. 34 to establish a separate structural unit or a person in charge to which or to whom employees should report their suspicions. The separate structural unit or the person in charge shall verify whether the transaction is suspicious, and if this is the case make a report to the Tax Police. The Resolution requires that the heads of credit institutions familiarize themselves and their staff with legal requirements and liabilities for non compliance, and further calls for training courses to be organized for staff at all levels.

C. The Authorities Involved in Preventing Money Laundering in the Financial Sector

201. Act VIII-275 designates the institutions responsible for the prevention of money laundering: the Government of the Republic of Lithuania, the Tax Police, the Bank of Lithuania, and the Customs Department under the Ministry of Finance of the Republic of Lithuania.[63]

The Ministry of Finance

202. The Ministry of Finance represents the Government vis-à-vis the financial sector, and is charged with securing that the responsibilities of the Government under Act VIII-275 are met. The Ministry of Finance does not perform any operational role, and is responsible mainly for political oversight.

The Tax Police

203. The Money Laundering Prevention Division, an independent unit within the Tax Police Department, performs the role of Financial Intelligence Unit (FIU). It is the centralized recipient of the information that credit institutions, financial institutions, and other entities have to report according to Act VIII-275. Within this framework, it is also called upon to perform a regulatory role by providing recommendations to financial institutions, notaries, and persons authorized to perform notarial acts that have an obligation to provide information to the Tax Police.

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[63] This report does not describe and assess the role of other authorities which perform law enforcement tasks or which are otherwise not directly relevant to this assessment, such as the Ministry of Internal Affairs, the Ministry of Justice, the Ministry of Foreign Affairs, the Organized Crime Investigation Service, the Customs Department under the Ministry of Finance, the Prosecutor General's Office, the Chamber of Notaries Public of Lithuania, and the Association of Banks of Lithuania.

204. The functions of the Tax Police are to:

- collect and record the information specified in Act VIII-275 about the monetary transactions of the customer and the customer engaged in such transactions;
- gather and examine the information relating to the implementation of the preventive measures against money laundering;
- submit reports to law enforcement and other state institutions, upon reasonable request, about the monetary transactions conducted by the customer;
- conduct inquiries in money laundering cases;
- co-operate with foreign institutions and international organizations implementing preventive measures against money laundering;
- make recommendations to financial institutions, notaries and persons authorized to carry out notarial operations, who, under Act VIII-275, are obligated to submit reports to the Tax Police on the gathering and filing of the required data;
- report on its activities to the government at least once a year.

205. Act VIII-275 also gives the Tax Police the power to:

- obtain from state institutions, credit and financial institutions, other legal persons and enterprises without the status of a legal person, and notaries and persons authorized to carry out notarial operations, the data and documents about monetary transactions necessary for carrying out its functions;
- inspect the activities of state institutions, credit and financial institutions, other legal persons and enterprises without the status of a legal person related to the implementation of preventive measures against money laundering;
- obtain from state institutions, credit and financial institutions, other legal persons and enterprises without the status of the legal person, information related to the implementation of the preventive measures against money laundering;
- co-ordinate the activities of state institutions related to the implementation of preventive measures against money laundering;
- instruct the administration of state institutions, credit and financial institutions about the circumstances and conditions associated with violations of the law and other legal acts related to the implementation of preventive measures against money laundering.

206. The Tax Police has reported that it provides both direct and indirect feedback to the intermediaries filing reports under Act VIII-275. Information appears to be given with regard to the reports filed. Furthermore, during training courses and seminars with the banking sector, real cases are used to teach staff about patterns of suspicious conduct that may point to money laundering schemes.

207. The Tax Police has reported that it can suspend a transaction only if a criminal investigation has been initiated. It therefore appears to lack the general power to suspend an operation as a preventive measure, at an earlier stage of the investigation.

208. The Tax Police can cooperate with other FIUs and through Interpol. There are no legal impediments to the communication of intelligence. In 1999, the Tax Police became a member of the Egmont Group. Memoranda of understanding on cooperation in exchanging financial intelligence related to money laundering have been signed with the FIUs of Belgium, Croatia, the Czech Republic, Estonia, Finland, and Latvia. An MOU with Poland is currently being discussed.

The Bank of Lithuania

209. Act VIII-275 establishes that the Bank of Lithuania is required to issue recommendations to credit institutions to deal with matters related to money laundering.[64] During on-site examinations, the Bank of Lithuania addresses compliance by banks with regard to the obligations set forth by in law. The assessor was advised that when a violation of the rules set forth by Act VIII-275 is identified, the Bank of Lithuania would report it to the Tax Police. However, no such violations have been detected thus far.

210. The Bank of Lithuania has advised that in performing banking supervision, it follows the principles set forth in the Basel Committee document on the "Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering."

211. Furthermore, the Bank of Lithuania requires banks to prepare an "activity risk management strategy" that, among other things, addresses the risks related to money laundering. The Bank of Lithuania has reported that the effectiveness of this system is evaluated during on-site inspections. In fact, the Bank of Lithuania's Inspection Manual, which contains a paragraph on the "Implementation of Money Laundering Prevention Measures," provides comprehensive and detailed guidelines for the on-site visits. The purpose of the examinations is to determine compliance with legislation regulating the prevention of money laundering and to assess the effectiveness of money laundering prevention measures and procedures implemented by a credit institution.

[64] Such as the above mentioned Regulation No. 34. The Bank of Lithuania, as also noted, has issued other regulations together with the Government of the Republic of Lithuania.

212. Within this framework, the Manual describes in detail the task assigned to the examiners in verifying compliance with obligations falling on credit institutions under Act VIII-275. The Manual asks the examiners to determine whether a credit institution has internal procedures in place that define responsibility and functions to prevent money laundering. Examiners are expected to determine whether a person has been appointed for organizing the implementation of money laundering prevention measures and for maintaining relations with the Tax Police; and whether another person has been charged with registering clients' monetary transactions. The examiner must determine whether the institution's internal audit has verified compliance with legal requirements concerning anti-money laundering and whether it has taken note of violations, their elimination, and measures to prevent their recurrence. Examiners are required to check whether compliance with the "know your customer" principle is ensured. This includes, among other things: (a) establishing what documents are to be submitted in accordance with the institution's internal procedures, in order to obtain data confirming the client's identity; (b) ascertaining whether particular attention is devoted to identification documents submitted by noncitizens and legal persons registered in tax havens. The examiners are also called upon to determine whether a credit institution, in performing customer due diligence, makes an assessment of risk management in client relations (considering, for example, the substance, importance, and implications of risk related to parties to transactions, concentration risk, operational risk, etc.).

The State Insurance Supervision Authority

213. The State Insurance Supervision Authority (SISA), under the Ministry of Finance, is responsible for the regulation and supervision of the insurance sector. SISA carries out off-site and on-site examinations of insurance companies, but it does not examine compliance with obligations set forth by Act VIII-275, because it considers that this is the responsibility of the Tax Police.

The Lithuanian Securities Commission

214. The Lithuanian Securities Commission (LSC) is responsible for the regulation and supervision of the securities market. The LSC carries out off-site and on-site examinations of authorized entities, but it does not address compliance with anti-money laundering obligations, as it considers that this is the responsibility of the Tax Police.

215. With regard to the two preceding points, it should be noted that the Tax Police undertakes on-site examinations related to anti-money laundering only when it has received information concerning a given intermediary or operation. As a result, there is no systematic examination of compliance in the insurance and securities sectors.

Cooperation among the authorities

216. The assessor was advised that the Tax Police and the Bank of Lithuania cooperate in a variety of ways. The Tax Police informs the Bank of Lithuania of ongoing bank investigations, requesting the participation of examiners from the Bank of Lithuania in on-site examinations conducted by the Tax Police. Similarly, the Tax Police requests background information from the LSC when investigating securities firms. SISA, if requested, could provide the Tax Police with technical assistance and information.

217. Thus, information on the involvement of intermediaries in money laundering schemes appears to reach the supervisory authorities only when the Tax Police requests information or technical cooperation. Otherwise, there appears to be little or no exchange of information among the Tax Police and supervisory authorities.

D. Assessment and Recommendations

218. Lithuania appears committed to fighting money laundering. In recent years it has adopted several legal acts that have largely brought the legal framework into line with current international standards. The Lithuanian authorities appear to be committed to performing the tasks assigned by anti-money laundering legislation, in order to prevent the financial system from being abused by criminal organizations and individuals. They have explored different forms of cooperation.

219. Even so, some issues require further consideration by Lithuanian authorities.

The Tax Police and the adequacy of sanctions

220. The prevention of money laundering in Lithuania is to a large extent grounded on reports made to the Tax Police. Between January 1998—when the reporting system provided for by Act VIII-275 became effective—and October 2001, 207 suspicious transactions reports were filed with the Tax Police. Over the same period, there were about 1 ½ million reports on different grounds, e.g. transactions exceeding 50,000 litas. In total, 478 cases were further investigated by the territorial units of the Tax Police. There have been 38 criminal proceedings, 12 of which relate to money laundering.[65]

221. The effectiveness of this system depends on the adequacy of the human and information technology resources of the Tax Police. The assessor has been advised that staffing in the Money Laundering Prevention Department has actually decreased since 1998,

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[65] Reports by credit and financial institutions are sent on floppy disks, while reports from notaries and customs are provided on paper.

and that 6 persons are now working in this department. The Lithuanian authorities are urged to provide adequate resources for combating money laundering.

222. The Lithuanian authorities are also advised to increase the sanctions for violations of anti-money laundering provisions, which are currently set at a maximum of 2,000 litas. Furthermore, consideration should be given to the possibility of criminalizing the willful omission of suspicious transactions reports.

223. It is also recommended that the Tax Police be given the power to suspend a transaction before a criminal investigation has been initiated.

Financial supervisors

224. Financial supervisors play a central role in ensuring that financial institutions have adequate controls and procedures in place to prevent money laundering and other forms of financial crime. It is the province of supervisors and not of law enforcement agencies to assess the adequacy of such internal control mechanisms and procedures.

The Bank of Lithuania

225. The Inspection Manual of the Bank of Lithuania provides extensive and comprehensive guidelines for assessing compliance with anti-money laundering provisions. If properly followed, these guidelines can ensure that banks adopt adequate internal procedures and internal control mechanisms, and that they fully know their customers.

226. However, it appears that the assessments made by the Bank of Lithuania (of the adequacy of internal control mechanisms for preventing the voluntary or involuntary involvement in fraud, financial crimes, or money laundering) may need to be strengthened. The Bank of Lithuania may evaluate the possibility of giving specific relevance, in the reports drafted after on-site visits, to the results of such supervisory activity, which, it needs to be stressed, extend beyond controls over compliance with anti-money laundering requirements. The Bank of Lithuania feels that its role in preventing money laundering and other financial crimes in the banking sector is limited to checking compliance with the requirements of Act VIII-275, as the burden of prevention falls on the Tax Police. As a result, the Bank of Lithuania appears to focus its supervisory activities on the adequacy of the internal control framework in addressing traditional forms of risk (e.g., credit risk); and it pays less attention to the risks that are raised by illicit activities.

227. Lithuanian banks are increasingly carrying out cross-border operations; and some of them are part of international financial groups. Contacts with foreign customers require increased due diligence. Notably, the regulations concerning "country risk" exposure do not address the issue, as they only take into account noncustomer-specific risk and do not cover transactions such as the opening of accounts. Moreover, international financial groups organized on a multi-level basis, with different levels domiciled in different countries, require

intensified efforts to ensure that the effectiveness of internal controls is not undermined by the fragmentation of supervisory controls.

Securities and insurance supervisors

228. Controls on money laundering in the insurance and securities sectors fall well short of those in the banking sector. Thus, no specific recommendation has been issued for the securities and insurance sectors; and no periodic controls of compliance are undertaken. Even if the risk of money laundering is usually thought to be greater in the banking sector, the lack of specific guidance and controls may pave the way for illicit activities. The Lithuanian authorities should consider the following recommendations:

- Resolution No. 34, which provides more complete guidance on "know your customer" policies, should be extended to all financial institutions and entities which have obligations under the anti-money laundering law.[66] It is a matter for the Lithuanian authorities to decide who is to issue these guidelines. However, it appears necessary that both the Tax Police and the relevant supervisory authority be involved in the drafting process.

- Resolution No. 34, which provides guidance on the reporting of suspicious transactions, and Resolution No. 1381/9 appear to be tailored mainly to banking institutions and should be extended and customized for the securities and insurance sector. Specific attention should be paid to the identification of suspicious transactions in these sectors, possibly with the introduction of specific anomaly indicators. As with the recommendation contained in the previous point, it appears necessary that such guidelines be jointly drafted by the Tax Police and the relevant supervisory authority.

- A program of periodic on-site examinations of compliance with anti-money laundering requirements in these sectors appears to be warranted. Such examinations could be coordinated with the regular on-site examinations by SISA and the LSC.

- SISA and the LSC are urged to extend their controls over internal control procedures, policies, and mechanisms of intermediaries, in order to encompass an evaluation of the adequacy of such measures to prevent the infiltration of illicit funds in these sectors.

[66] Resolution No. 1331 if December 3, 1997, issued by the Government of Lithuania and the Bank of Lithuania, provides guidance to credit and financial institutions on the information required to identify customers. While it provides some guidance for financial institutions, it does not cover all issues touched upon by Resolution No. 34.

Exchange of information and inter-agency cooperation

229. Information on the involvement of financial intermediaries in money laundering or other criminal financial activities is also relevant for supervisory authorities in that such involvement may impinge upon the safety and soundness of the intermediaries. In light of the above, the Lithuanian authorities could consider the following recommendations:

- evaluate the possibility of introducing a system that provides for the sharing, on a regular basis, of information on suspicious transactions;

- introduce a general obligation for intermediaries to report to the supervisory authorities suspicious activities and incidents of fraud that may be material to the supervisory activity.[67]

230. The fight against money laundering requires effective cooperation among the authorities involved. Work needs to be done across the different sectors that comprise the anti-money laundering regime. The Lithuanian authorities are urged to establish a joint forum for the discussion and comprehensive evaluation of money laundering.[68]

Customer identification

231. As noted above, the Bank of Lithuania has observed that according to a systematic reading of the rules concerning the opening of accounts, banks have an obligation to fully identify beneficial owners of accounts. In the light of the paramount importance of identification requirements, however, the Lithuanian authorities are advised to explicitly spell out in binding legal acts the need for proper identification of customers, asking, for example, that corporate directors be identified as well as beneficial owners.

E. Planned Changes in the Legal Framework

232. The Lithuanian authorities have indicated that a number of laws and regulations currently under discussion may enhance the effectiveness of the anti-money laundering regime. The most relevant among these is the amendment of Act VIII-275, which will:

- establish the role of SISA and the LSC in preventing money laundering;

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[67] It should be noted that the two recommendations are not meant to be mutually exclusive, as the second may embrace a broader set of cases than the first, which is restricted to the suspicious transactions reports transmitted to the Tax Police under Act VIII-275.

[68] Thus, beyond the authorities mentioned in this report, the forum should include all the authorities involved, such as the Ministry of Justice, the Notaries, and possibly industry representatives.

- require credit and financial institutions to establish the identity of a customer when opening an account, accepting a deposit, providing safe custody facilities, entering into other business, or conducting transactions involving a sum in excess of 50,000 litas.

233. The first amendment listed above would provide a legal basis for controls by SISA and the LSC on compliance with Act VIII-275. As noted previously, however, the prevention of money laundering requires more than an examination of formal compliance with anti-money laundering rules.

234. The second amendment listed above will need to be supported by detailed secondary regulations, in order to articulate fully the requirements for customer identification, especially with regard to the identification of beneficial owners of funds.