Periodical Part

Annual report of the Bank of Lithuania ; 2016

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2016

ANNUAL REPORT OF THE BANK OF LITHUANIA

2016

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Abbreviations

AB	public limited liability company
APP	asset purchase programme
CIU	collective investment undertaking
CSPP	corporate sector purchase programme
ECB	European Central Bank
ESCB	European System of Central Banks
ESRB	European Systemic Risk Board
EU	European Union
Eurostat	Statistical Office of the European Union
FDI	foreign direct investment
GDP	gross domestic product
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
LCCU	Lithuanian Central Credit Union
MFI	monetary financial institution
MRO	main refinancing operation
NCB	national central bank
OECD	Organisation for Economic Cooperation and Development
PSPP	public sector purchase programme
RE	real estate
SSM	Single Supervisory Mechanism
TLTRO	targeted longer-term refinancing operation
UAB	private limited liability company
UK	United Kingdom
US	United States of America
VĮ	state enterprise

Totals/percentages in some tables and charts may not add up due to rounding (‘Total’ and 100%).

INTRODUCTORY STATEMENT

Presenting the work done by the Bank of Lithuania in 2016 whilst implementing the objectives of the central bank of the Republic of Lithuania, we would also like to share with you our achievements in reaching the strategic goals that we set three years ago.

This was a period of intense activity, bringing with it a copious amount of changes that not only had a substantial effect on the domestic financial system and the users of financial services, but also profoundly transformed the Bank of Lithuania itself, broadening the scope of our responsibilities and functions.

1 January 2015 marked one of the major events during the period under review: the Bank of Lithuania joined the Eurosystem, paving the way for the introduction of the single European currency – the euro. Careful preparations were made, hence the replacement of the currency went smoothly, drawing strong public support. Now, together with the ECB and the central banks of 18 other euro area countries, we draft and make decisions on formulating and implementing euro area monetary policy, management of the ECB's foreign reserves, and other major financial issues. The Eurosystem's accommodative monetary policy measures exerted a positive impact on the euro area and Lithuania's economy. First of all, they continued to improve bank funding conditions and substantially facilitated lending to the real economy. One year after the adoption of the single European currency, we took yet another essential step towards joining the single payments market in Europe – Lithuania migrated to the Single Euro Payments Area, known as SEPA. This project, encompassing 34 countries, aims to standardise electronic payments across Europe, consequently offering new possibilities for both households and businesses.

Taking an active role in the activities of the banking union and the Single Supervisory Mechanism, the Bank of Lithuania became responsible for financial institution resolution. It is a Pan-European banking crisis management framework ensuring that key functions of systemically important commercial banks (e.g. payments) are in full force even if they encounter difficulties, while depositor and taxpayer funds are effectively protected. Together with the Single Resolution Board (an EU-level institution) and the national resolution authorities of foreign banks operating in Lithuania, we are responsible for resolution plans of banks and other important financial institutions, and, if necessary, their implementation.

In recent years, the EU institutional and regulatory framework for financial sector supervision has been restructured to diminish the possibility of financial crisis formation and its negative effect on economic growth and employment levels in the country. One of the key components of this reform is granting of the macroprudential policy mandate to responsible authorities in each EU country. Under our mandate, we carry out macroprudential policy targeted at ensuring the stability of our country's financial system.

To achieve this goal, we limit excessive credit growth, surplus of liquidity and other risks in the financial system, strengthen the resilience of the financial market infrastructure to potential shocks, as well as apply other measures.

Maintaining an open dialogue with the supervised market participants, we seek to create an innovation-friendly, attractive and competitive environment for financial sector regulation. Having carried out a survey and taken into account the proposals from market participants, we are implementing a package of measures to increase the effectiveness of our activities and cooperation with market participants; however, we will continue to maintain a high standard of ambitious supervision. Aiming to enhance protection of consumer interests, we dedicated much attention to regulation and monitoring of financial services, proposing suggestions and preparing draft laws. Upon their adoption, regulation of the consumer credit market, which is in line with public interest, was tightened. This lead to more responsible lending practices among consumer credit providers, reduced late payments for credits bearing unfortunate social consequences.

One particularly important achievement is the initiation and implementation of the credit union sector reform. Financial performance of a significant share of credit unions has been disappointing for a long period of time, thus, aiming at sustainable development, it was decided to restructure the sector. Discussions were held with its participants, concluding in a consensus among all parties concerned on future development of the sector. Cooperation between public institutions and corporates produced fruitful results in terms of the onward path for credit unions which were cemented by laws. Currently we are in a transitional phase, during which credit unions have to make necessary preparations for the launch of the new system in 2018.

We took action to increase accessibility of payment services and promote competition in this market as there are still impediments to its more robust growth. Our initiatives in the payments market attract new market participants from the non-bank sectors in China, Great Britain and other countries, i.e. electronic money and payment institutions. We notice particularly strong interest in Lithuania among potential market participants, thus we hope that they and other FinTech companies will play an increasingly important role in our financial sector.

Shifts in the overall context, goals and objectives over the last three years brought about changes in the Bank of Lithuania, which seeks to actively participate in the activities of the Eurosystem and EU supervisory institutions, ensure stability of the national financial system, regulation and supervision of the financial market, as well as encourage innovation and more sustainable financial services and market development. For several years now, internationally-acclaimed economic and financial research conducted by Lithuanian and foreign economists working at the Center of Excellence in Finance and Economic Research is instrumental in our activities and the decision-making process. Such research and analysis of economic development, projections, high-level conferences where we join forces with leading experts from Lithuania and abroad to analyse economic and financial issues, and financial education activities enable our organisation to consolidate its position as a centre of excellence.

In a complex investment climate characterised by particularly low interest rates we managed to achieve positive results in terms of investing our assets. The decision to pursue a laxer financial assets strategy in order to yield higher returns paid off. We aim to become one of the most efficient central banks in the Nordic-Baltic region – at the end of the period under review we ranked first in terms of lowest operational costs.

Having assessed the work done in three years and taking into account new challenges, the Board of the Bank of Lithuania identified the strategic directions for 2017–2020. They are drawn from a common background reflecting our mission – *to bring benefits to society*. The essence of the chosen directions is defined by the following keywords: competence, competition, return, partnership and efficiency. Over the upcoming four years we aim to:

- strengthen the Bank of Lithuania role as a centre of excellence in economics and finance;
- work to create a competitive and advanced payments market in Lithuania as well as a favourable environment for innovative financial service provision models;
- develop investment strategies and strengthen risk management in order to meet challenges related to low interest rates and financial assets management;
- become a financial sector partner encouraging innovation and sustainable financial market growth;
- be one of the top three most effective central banks in the Nordic-Baltic region.

Our vision is an *innovative, proactive and open Eurosystem central bank*.

Vitas Vasiliauskas

Chairman of the Board
of the Bank of Lithuania

SUMMARY

This section presents a brief overview of the 2016 economic and financial reviews carried out by the Bank of Lithuania as well as concentrated information on the activities of the Bank of Lithuania in shaping and implementing the Eurosystem monetary policy in our country, implementing macroprudential policy, supervising the financial market, managing Bank of Lithuania assets, handling cash and carrying out other central bank functions. These and other issues are presented in more detail in respective sections.

In 2016, the Eurosystem further reinforced the accommodative stance of its monetary policy. At the beginning of the year, there was higher risk that in the medium term the ECB price stability objective will not be achieved, i.e. inflation rates in the euro area may not reach the level below, but close to, 2 per cent over the medium term. The ECB Governing Council decided to implement an extensive package of additional monetary policy measures aiming to ensure more favourable conditions for sustainable economic recovery in the euro area and stronger rise in inflation. However, towards the end of the year, the previously-set horizon of the expanded APP was nearing, while prices in the euro area were still not rising in a sustainable manner. Nonetheless in December 2016 the Governing Council decided to extend the expanded APP at least until December 2017 or beyond, if necessary. The Governing Council continued to expect the key ECB interest rates to remain at present or lower levels well past the horizon of the expanded APP.

The Eurosystem's accommodative monetary policy measures exerted a positive impact on the euro area and Lithuania's economy. First of all, they continued to improve bank funding conditions and lending to the real economy. The accommodative monetary policy continued to add to more successful economic developments in Lithuania, increasing its export volumes on account of higher demand in the euro area and the lower euro foreign exchange rate. According to the ECB, the accommodative monetary policy measures are expected to increase euro area real GDP growth in 2015–2017 by 1.6 p.p., inflation – 1.4 p.p. According to the Bank of Lithuania assessment, accommodative monetary policy measures in Lithuania should increase real GDP growth over the same period by 1.0 p.p., inflation – 1.3 p.p.

2016 was a year of stronger growth in all private sector loan portfolios. During this period, the total amount of loans granted to households and non-financial corporations followed an upward trajectory. Resident borrowing for house purchase and for consumption and other purposes was rigorous. Growth in non-financial corporation portfolios stemmed from real estate operations, wholesale and retail, manufacturing, and transport activities. In addition, lending to small and medium-sized enterprises intensified. The private sector loan portfolio expanded due to increasing credit demand, good financial position of borrowers, and favourable financing conditions.

Rapidly rising housing prices and significantly increasing household indebtedness in some Northern European states remains one of the main systemic risks to the stability of Lithuania's financial system. If rapid growth of credit and real estate market were to persist, this would increase systemic risk in the medium term. Owing to an increase in the number of cybercrimes, more attention should be devoted to cyberspace security.

In 2016, seeking to mitigate the potential effect of systemic risk to Lithuania's financial system, the Bank of Lithuania, under its macroprudential policy mandate, continued to implement the Macroprudential Policy Strategy and applied macroprudential measures. Macroprudential policy instrument rates remained unchanged in 2016. With no imbalances in the housing and credit markets, the applied countercyclical capital buffer rate continued to be set at 0 per cent. Since the market shares and importance of major credit institutions changed only slightly last year, the other systemically important institutions buffers, which were set in 2015, were left unchanged. The Bank of Lithuania analysis showed that there was no need to apply the additional systemic risk buffer.

The performance of non-financial corporations operating in Lithuania for 2016 was good – sales and profits rose, while profitability remained stable despite commodity price increases and rising wage costs. Corporations increased their financial liabilities, but the possibilities to meet them were no worse than before on account of profitable operations and considerable amount of liquid assets accumulated. While initiated bankruptcy proceedings increased significantly in number over the year, the major contribution stemmed mainly from amended legal regulation of bankruptcy proceedings and intensified initiation of bankruptcy proceedings against insolvent corporations by state authorities rather than developments in the financial standing of corporations. Corporation assessment of business prospects improved from last year, leading to majority of them planning an increase in investment for business development.

As the financial situation of households improved, income grew and unemployment declined, households borrowed more actively and their overall indebtedness moderately increased.

In supervising the financial market with more than 450 participants and aiming to ensure its sustainable development, the Bank of Lithuania improves the regulatory and supervisory environment. The credit union sector reform, aiming at strengthening the sector and encouraging financing of small and medium-sized business, continues to be pushed through. With competition in the banking sector enhancing, credit unions not willing to join central credit unions will be able to seek restructuring into a specialised bank, catching the attention of financial technology companies. Active efforts are devoted to attracting new market participants and increasing competition in the field of financial services. The Bank of Lithuania carried out active supervision of consumer credit providers to help the general public to secure against excessive and irresponsible borrowing, providing a new service *STOP: Consumer Credits*.

Since 2015, supervision of banks in Lithuania has been carried out jointly with the ECB Single Supervisory Mechanism, which is responsible for direct supervision of the three largest banks; however, Bank of Lithuania experts work as members of joint supervisory teams. Following an annual supervisory review and evaluation process, banks have been set new capital requirements, which will be effective until a new process is carried out in 2017. 2016 was profitable for the sector, capital was sustainable, and the liquidity level was high. Asset growth was driven mainly by an increase in the net value of the customer loan portfolio, growth in liabilities – by deposits. In 2016, consolidation within the banking sector was observed; however, with a possibility to establish a specialised bank, new financial market participants are taking an interest.

During the first three quarters of 2016, insurance market growth was supported by the non-life insurance sector, whereas, at the end of the year, life assurance volumes expanded as well. In the fourth quarter, faster annual growth in the life assurance market was driven by the record-large amount of insurance premiums. The volumes of both non-life insurance and life assurance branches were the largest over the last decade. In 2016, insurance undertakings earned EUR 6.5 million in profits; the results of insurance branches diverged though: life assurance undertakings operated at a profit, non-life assurance undertakings – at a loss. All insurance undertakings complied with the solvency margin requirements.

On 1 January 2017, 73 credit unions operated in Lithuania. According to data as at 1 January 2017, credit union assets amounted to EUR 663.9 million, or 2.6 per cent of the total assets of the banking system. Loans represented their largest share. In 2016, credit union investment in securities decreased significantly – by almost two-thirds. Deposits of natural persons is the major funding source for credit unions. According to unaudited data, in 2016 the credit union sector bore almost EUR 39 thousand in losses. 48 credit unions operated profitably, 25 – at a loss.

From the day of the adoption of the euro in the Republic of Lithuania until 31 December 2016, the total value of currency issued into circulation by the Bank of Lithuania was EUR 2,604.3 million. €20 and €50 banknotes as well as €1 and €2 coins were most prominent currency in circulation. Over 2016, the total value of litas banknotes and coins in circulation, which remained in circulation after the adoption of the euro, decreased by 8.4 per cent – to LTL 473.4 million. In 2016, 1,663 counterfeit euro banknotes, 66 counterfeit euro coins and 9 counterfeit litas banknotes were withdrawn from circulation.

Seeking to increase the efficiency of the cash supply system in Lithuania and optimise Bank of Lithuania operational costs related to cash cycle management, the implementation of the Project on the Reform of Cash Circulation continued in 2016.

The Bank of Lithuania managed its financial assets seeking to diversify investment risk and increase expected return over a 3-year investment horizon. In pursuit of these objectives, the Bank of Lithuania invests in investment-grade debt securities issued by European, North American and Chinese central governments, government agencies, and international organisations as well as corporate debt and equity securities of advanced economies. In 2016, the financial assets (excluding those related to monetary policy) at market value amounted to, on average, EUR 2,081.6 million, return on investment – 2.58 per cent.

As top authority in charge of domestic financial statistics, the Bank of Lithuania develops, collects, compiles and publishes monetary and financial statistics, external statistics and financial accounts statistics, adhering to high-quality standards laid down in the Public commitment on European Statistics by the ESCB. Statistical data collected by the Bank of Lithuania is also used to compile aggregate euro area statistics. Taking into consideration the growing needs of users, the Bank of Lithuania began publishing more comprehensive data on MFI interest rates, started to compile the balance sheet statistics of insurance corporations, improved statistics on foreign direct investment and expanded micro-databases. To enhance international cooperation, intensive work was carried out together with the OECD and IMF representatives.

Under the new Law on Payments, as of 1 February 2017 credit institutions are obliged to ensure the right to use the basic payment account service, and thus the basic payment services, for a set fee – EUR 1.5 per month for the general public, EUR 0.75 per month for low-income residents. Basic payment account regulation was accompanied by changes in the usual banks' pricing – the previous unfavourable pricing for electronic payments, when a fee was charged for each payment transaction, was changed into one that is based on a fixed monthly fee for a payment services basket.

As a member of the Eurosystem and participating in the meetings of the ECB Governing Council every two weeks, the Bank of Lithuania mainly cooperated with the ECB and other NCBs, tackling not only issues related to euro area monetary policy but also other issues related to the functioning of the Eurosystem. The Bank of Lithuania continued to take an active role in the activities of the Single Supervisory Mechanism, the single resolution mechanism, and other EU institutions, maintained its cooperation with the IMF and other international organisations, rating agencies and supervisory authorities. In 2016, the Bank of Lithuania was also involved in the process of Lithuania's accession to the OECD.

To ensure transparency of activities – one of the core values of the institution – the Bank of Lithuania publishes and disseminates through various channels information on its activities. In 2016, the Bank of Lithuania began implementing new information dissemination means and tools. The Bank of Lithuania created and actively used its Facebook page, sharing video content to introduce the latest news. The Bank of Lithuania began broadcasting its most important press conferences online. It also started publishing economic commentaries.

I. REVIEW OF THE ECONOMY AND FINANCE

Global economic developments

In 2016, global economic growth decelerated. This was underpinned by decreasing growth in advanced economies, especially the US and the euro area, as well as moderately slowing China's economic growth. The UK's decision to leave the EU did not have a significant impact on the growth of the region in 2016. Expectations about global economic growth prospects began improving at the end of 2016.

As the global trade and investment growth decelerated, in 2016 global economic growth decreased to 3.1 per cent; however, assessments regarding future growth prospects began improving at the end of 2016 – thus, an increase to 3.4 per cent is expected in 2017. Even though real GDP growth in emerging market economies was stable, lower growth rates among advanced economies determined slower total global economic growth. In the US, real GDP rose by 1.6 per cent in 2016 – 0.6 p.p. less than a year before. Decelerated investment growth (especially in the energy sector) and weak export growth weighted on economic expansion. Business and consumer confidence indicators, which increased at the end of the year, show that expectations regarding the US economic growth outlook began improving in the fourth quarter of 2016 (after the presidential election). This is mainly related to the expected economic policy developments, such as investment in infrastructure programme, tax reduction, and less-extensive financial sector regulation. Improvements in expectations underpinned the strengthening of the US dollar and the rise in stock prices at the end of 2016.

In 2016, euro area economic growth also decelerated (to 1.7%), yet at the end of the year growth in various countries became stronger, encompassing increasingly more sectors. Growth was limited by weaker investment and export developments and mainly driven by private consumption supported by the improving labour market situation, and the low interest rate environment. In 2016, inflation in the euro area remained very low – 0.2 per cent; however, as commodity prices started to recover, at the end of the year it began increasing. The medium-term euro area growth outlook was dampened by future withdrawal of the UK from the EU which was determined by the referendum in June. Even though the 2016 real economy data does not show any significant deterioration of the economic situation, stronger economic growth is not expected in the medium term – in 2017 and 2018 growth in the euro area is projected to stand at 1.6 per cent (according to the IMF).

Table 1. Global real GDP growth
(percentages)

	2015	2016*	2017*	2018*
World	3.2	3.1	3.4	3.6
Developed countries	2.1	1.6	1.9	2.0
US	2.6	1.6	2.3	2.5
Euro area	2.0	1.7	1.6	1.6
Lithuania	**1.7**	**2.3**	**2.6****	**2.8****
Emerging market economies	4.1	4.1	4.5	4.8
China	6.9	6.7	6.5	6.0
Russia	–3.7	–0.6	1.1	1.2

Source: IMF.
** Forecasts.*
*** Bank of Lithuania forecast.*

Real GDP growth in emerging market economies was stable in 2016, amounting to 4.1 per cent; however expectations about their future growth prospects have improved. China's economic growth decelerated relatively marginally – to 6.7 per cent due to the accommodative economic policy, while concerns regarding rapid slowdown somewhat decreased. On the other hand, China's economic growth outlook is dampened by increasingly growing debt. Further deceleration is projected over the medium term, influenced by the changing economic structure – growth based on consumption rather than investment. In Russia and Brazil recession was milder. However, as commodity prices were low, the situation in many commodity-exporting countries was poor – growth rates reduced or were negative, public finances deteriorated, financing conditions tightened. Commodity prices saw improvements only at the end of 2016. The rise in oil prices was led by the OPEC agreement reached in November to curtail output in the first half of 2017.

Economic developments in Lithuania

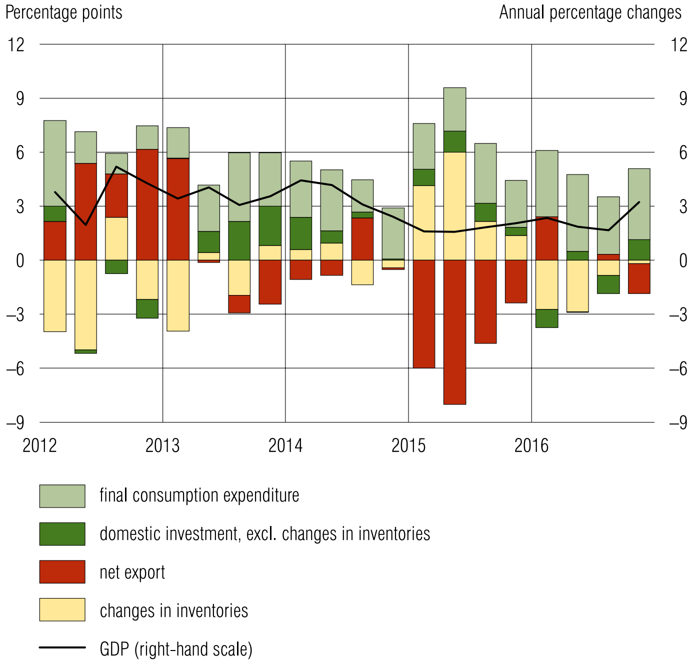
Real sector

Following significant deceleration in 2015, Lithuania's economic development strengthened in 2016. Recovery of the export sector had the most significant impact on economic development, especially in activities related to transportation of goods and re-export. Household consumption remained the main driver of economic growth. Weaker construction sector activity and not growing investment due to a temporary decline in EU support funds prevented more robust growth of the economy.

Aggregate demand

In 2016, economic development accelerated in Lithuania, growing by 2.2 per cent (adjusted for seasonal and workday effects). The major contributions to economic recovery were once again increasing real exports of goods and services and household consumption, whose growth has been the fastest since the beginning of economic recovery.

Chart 1. Contributions to the development of real GDP (by expenditure approach)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Household consumption was the main driver behind economic growth. One of the major reasons for the increase in household consumption was the rather favourable situation in the labour market, particularly robust wage growth. In addition, the trend of faster wage growth among those with lower income prevailed. Given that the marginal propensity of households with low income to consume is larger than that of households with high income, such wage developments determined the robust growth in household consumption even with the weak increase of disposable income. The only drivers behind the growth in income were the increasing wage fund and larger social benefits. Income from various other sources – economic activity, accumulated capital, transfers from abroad – have not increased or dropped.

Relatively robust development of aggregate demand was suspended by investment development: due to a sharp decline in the flows of EU support funds, investment expenditure did not increase. The direction of EU support funds was determined by the fact that funds from the previous EU financial perspective in 2007–2013 are no longer available (2015 was the last year), whereas the funds of the current 2014–2020 EU financial perspective are being used sparingly. This had the largest impact on the decline by almost one-fifth in general government investment, while private sector investment grew further. This sector was more active in using MFI services[1] to attract funds needed to finance investment.

Aggregate supply

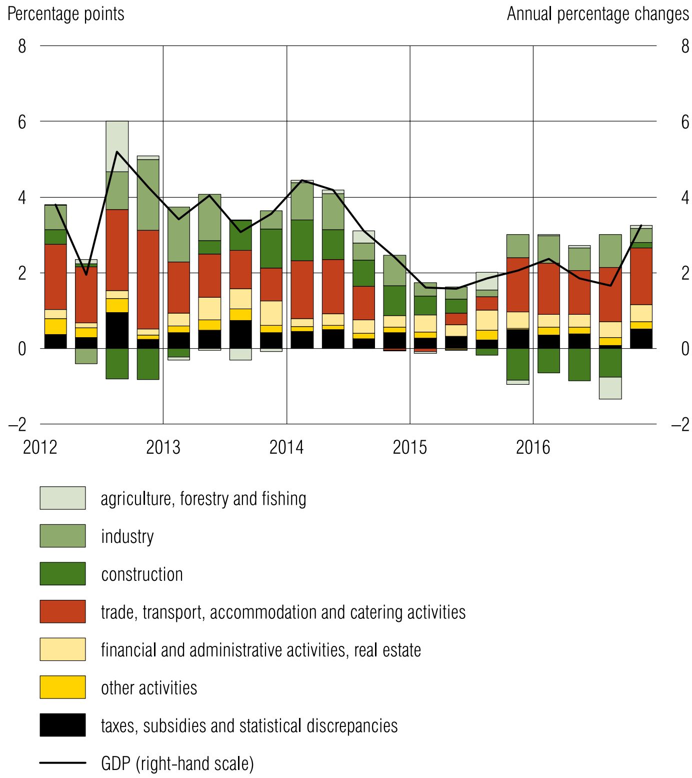
In terms of the production approach, it should be noted that more intensive economic activity in 2016 was driven by trade and transport activities. It has offset the impact of declining activity within the construction sector. In many other economic activities, the value added grew as well. Their impact on GDP growth was close to their development in 2015.

[1] *More information on the dynamics of the crediting of companies is presented in the section 'Private sector crediting dynamics'.*

More robust growth in household consumption led to intensified trade activity, whereas intensified transport and storage activity was driven by the ability of companies to find new trade partners in Western European countries; this particularly applies to the activities of road transport companies. However, this reorientation of road transport companies, due to trade restrictions imposed by Russia, has negative implications for the warehousing and support activities for transportation in Lithuania. After losing orders from the Russian market and reorientation towards work in Western European markets, road transport companies are focusing on transportation of cargo among Western European countries and, where necessary, use warehousing and support activities for transportation of those countries, which forces Lithuanian companies providing these services to look for other clients.

Among major economic activities, only the construction sector posted significantly weaker activity in 2016, especially in terms of engineering construction volumes. The largest contribution to such development stemmed from a substantial decline in the use of EU support funds. Within the construction activity, growth was only recorded in the volumes of construction of residential buildings, especially new-construction housing. It was driven by the favourable development of the underlying factors within the real estate market[2]. It should be noted that the weakening activity of the construction sector affects the Lithuanian economy not only directly, but indirectly as well. The latter impact includes, for example, the influence of the much more weakly growing construction sector's wage fund on household consumption, the influence of fewer orders within the construction sector on other economic activities. This also negatively contributes to economic development.

Chart 2. Contributions to the development of real GDP (by production approach)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

[2] *For more information on RE market development, see the Financial Stability Review 2016.*

External sector

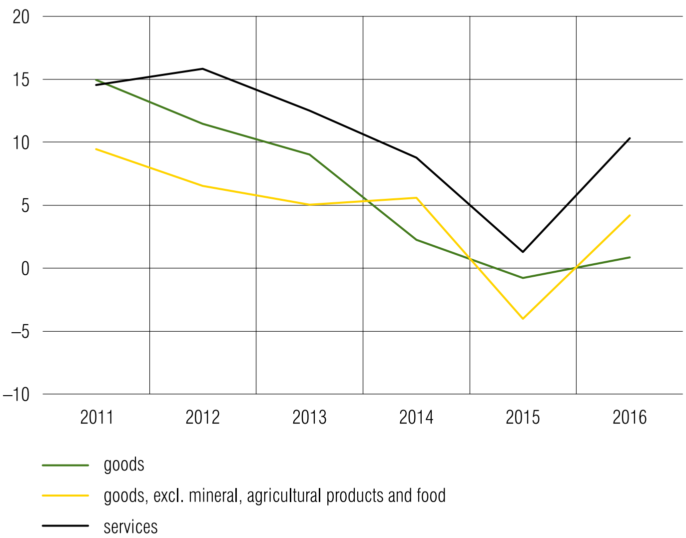
The recovery in export growth, following the 2015 shocks, is similar to the growth patterns observed prior to the trade restrictions imposed by Russia. In addition to some exporters' quite successful reorientation to other markets, accelerating foreign demand in Lithuania contributed to higher export performance as well. The current account is still close to balanced; however, a deficit in it is still likely in the future due to import, which is necessary for investment.

Reported annual real data for 2016 shows robust growth in the export of services – at an annual rate of as much as 10 per cent. While intensive development of road carriers' activity explains most of the growth, other sectors are posting growth as well. For example, exports of construction services boosted by about 10 per cent, although the construction sector as a whole has contracted in Lithuania.

In 2016, real exports of goods, excluding mineral products, grew strongly as well, especially given the changed strategy of companies engaged in re-export and global economic growth. Re-exports contracted due to trade restrictions imposed by Russia and its economic recession, while companies engaged in re-export (especially road transport companies) had to search for other markets. Lithuanian road transport companies intensified their activities in western European countries[3] and no longer carry goods across the territory of Lithuania. By organising activities in such a way, re-export grows less. A particular decline was noticeable in the re-exports of mineral, agricultural products and food. However, towards the end of 2016 and in January 2017, re-exports to the CIS countries posted an increase.

Chart 3. Real exports of goods and services

Annual percentage changes



Sources: Statistics Lithuania and Bank of Lithuania calculations.

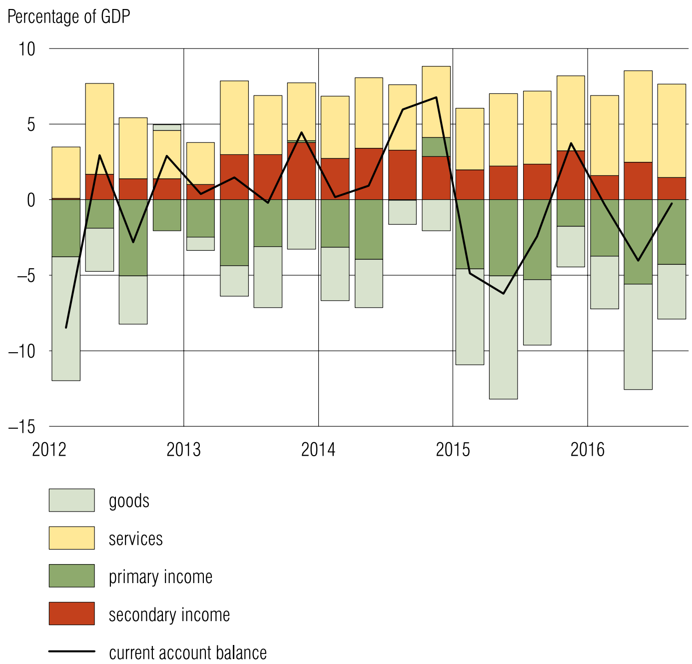
As imports of goods and services expanded less than their exports, the balance of goods and services was in surplus; however, this is likely to deteriorate in the future. The deficit in the balance of goods is likely to widen on account of higher imports of machinery and equipment, which are necessary for investment, and oil price increases. The surplus in the balance of services is likely to widen further, but is not likely to outweigh the deficit in the balance of goods.

[3] *For more information on the development of road transport companies, see the section 'Real sector'.*

The deficit in the balance of primary income narrowed, as the income of non-residents holding property in Lithuania dropped in the country. Corporate profitability increased less at least until the third quarter of 2016, which also entailed a decline in non-resident income. Moreover, general government deficit has recently been narrowing in Lithuania[4] and residents are financing an increasingly larger share of debt; as a result, non-resident income related to the state debt is decreasing in Lithuania. The deficit in the balance of primary income may continue to narrow until FDI starts increasing more intensively or corporate profitability starts rising in Lithuania.

The surplus in the balance of secondary income decreased on account of the slowly increasing usage of funds of the new EU financial perspective and smaller private individual remittances to Lithuania. The surplus in the balance under review is not likely to change markedly in the future: the usage of EU support funds is likely to intensify, thereby positively contributing to this balance. However, the latter is likely to be negatively affected further by decreasing private individual remittances to Lithuania, in which a recovery is not yet expected.

Chart 4. Current account balance



Sources: Statistics Lithuania, Bank of Lithuania and Bank of Lithuania calculations.

Labour market

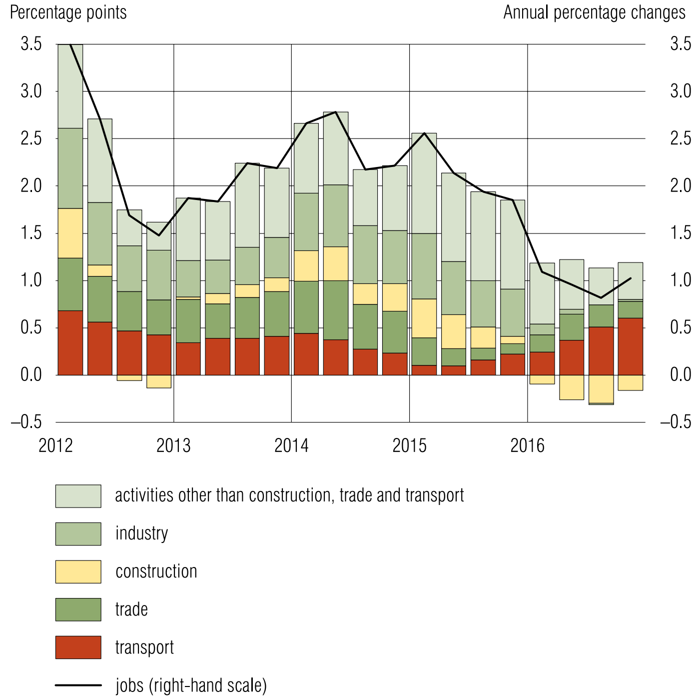
Job growth was two times slower than in recent years. This is mainly related to manufacturing activities and the decline in the volume of construction works. However, the number of companies facing a shortage of employees increased markedly. Such a shortage as well as the rising minimum wage underpinned rapid wage growth.

In 2016, the number of jobs increased, yet its growth rate halved compared to the average growth during the period of economic recovery. Slower growth was mainly influenced by construction and industry. Construction suffered a decline: there were more companies facing insufficient demand, the volume of construction works fell

[4] *For more information on the narrowing of general government deficit, see the section 'General government finance'.*

considerably. This exerted pressure on construction companies to reduce the number of jobs. In terms of industry, the number of jobs grew at a much slower pace than before. Such a trend was prevalent in many industries: food, wood, furniture, equipment production. Nonetheless, favourable shifts were also seen: transport companies, which were affected by the recession in Russia, managed to redirect part of their activities to Western countries, thus increasing the number of employees.

Chart 5. Jobs



Sources: Statistics Lithuania and Bank of Lithuania calculations.

Hiring and emigration continued to drag on the unemployment rate. In 2016, the unemployment rate stood at 7.9 per cent and was 1.2 p.p. lower than in 2015. In terms of unskilled persons related to structural unemployment, the unemployment rate began decreasing at a significantly slower pace than before. Their unemployment was still high, amounting to 20 per cent.

Rising minimum wage and growing shortage of employees stimulate rapid wage growth. Last year, minimum wage was increased by as much as 16.9 per cent. Nonetheless, a major factor behind wage growth was also a shortage of employees which last year continued to increase. It was influenced not only by a significantly lower unemployment rate but also rather high emigration and the fact that fewer younger persons entered the labour market.

Prices and costs

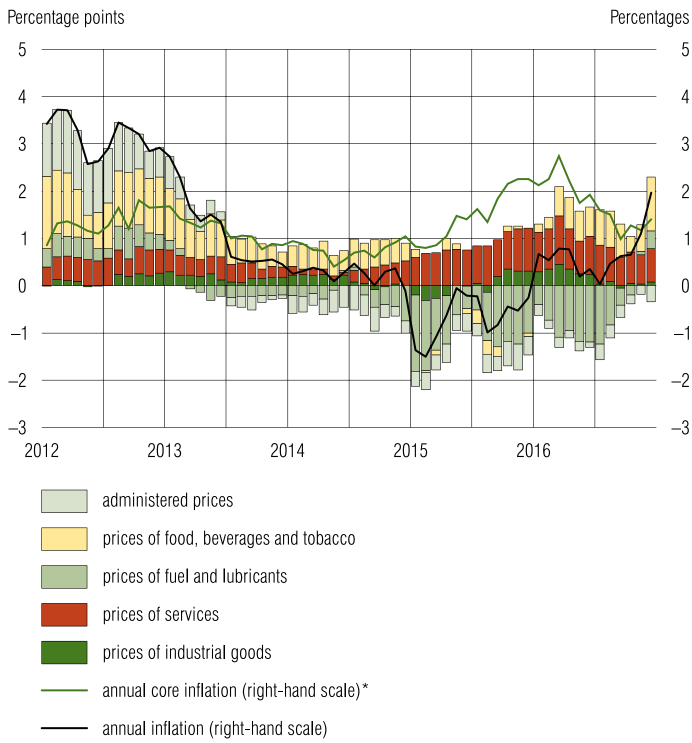
At the end of 2016, the rise in the prices of petroleum products and food commodities significantly boosted prices of goods not only in Lithuania but also across the EU. In Lithuania, rising inflation was also driven by service price growth underpinned by rapidly increasing wages.

In the first three quarters of 2016, price growth was sluggish, yet in the fourth quarter inflation rates escalated, standing at 2 per cent in December. For a couple of years, low inflation (in 2015 even negative) was favourable to consumers as fuel and administered prices fell markedly. Even though, in the first half of 2016, lower-than-a-year-ago energy prices exerted a downward pressure on inflation, in the second half of the year fuel prices ceased to fall, thus in November, for the first time since the end of 2014, the annual fuel price change in Lithuania was positive. In the fourth quarter of 2016, annual inflation grew not only as a result of rising fuel prices, but also of food prices, especially dairy, which in December were more than 6 per cent higher year on year. Similar trends were observed in other euro area countries. Underlying components reveal that euro area countries and Lithuania recently witnessed higher energy and food prices than previously.

Food price growth was driven by two major factors. First, EU seasonal food product supply, which had been small for some time, exerted strong pressure on vegetable and fruit prices due to poor harvest in Southern Europe in 2016. Second, raw milk prices rose considerably (in Lithuania – around 30% over the year). Increased raw milk prices also had significant implications for consumer prices. It should be noted, however, that dairy prices, which rose over a very short period of time, should once again stimulate global dairy production, hence dairy prices should grow slower.

In 2016, prices of services rose considerably – their annual change amounted to 3 per cent, yet their yearly growth did not accelerate. As in 2015, prices of services went up due to higher domestic demand and growing labour costs. Minimum wage was increased several times, also attributing to the rise of wages for employees earning higher than minimum wages. This had a substantial upward effect on prices of services. On the other hand, last year heat energy, electricity and gas prices contributed negatively to inflation, albeit less than in 2015. Another factor restricting the rise in headline inflation was lower maximum roaming tariffs, which have been applied since April 2016 under the Regulation of the European Parliament and of the Council.

Chart 6. Contributions to the annual HICP inflation



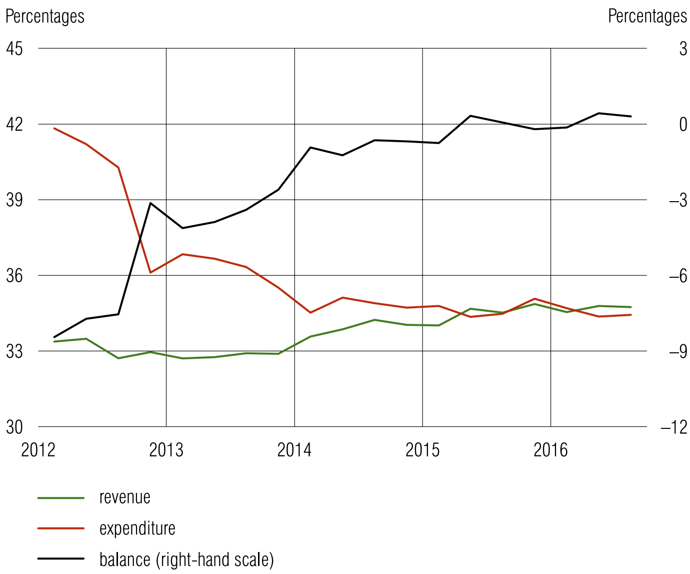
Sources: Statistics Lithuania and Bank of Lithuania calculations.
**Change in HICP, excl. food, fuel and lubricants, and administered prices.*

General government finance

In 2016, an increase in general government revenue was driven mainly by the contributions from the internal demand-related revenue groups – direct and indirect taxes, social contributions. With limited growth in government spending, the general government balance was in surplus. This reduced the borrowing requirement and the debt-to-GDP ratio. The latter decreased even more because of the redemption of a large bond issue.

In 2016, the ratio of general government balance to GDP was 0.3 per cent. The balance improved over the year mainly due to the slightly lower ratio of government spending to GDP than a year ago. The ratio of general government revenue to GDP also decreased, mainly due to a rather substantial decline in capital and current transfers from *VĮ Indėlių ir investicijų draudimas* (Deposit and Investment Insurance), as well as a decline in EU support funds for general government. Sub-sectoral analysis suggests that the general government balance improved mainly on account of the narrowing of the deficits in central government and social security funds, as well as an increase in the surplus on the local government balance.

Chart 7. General government revenue, expenditure and balance
(four-quarter moving sums, compared to GDP)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

The major positive contribution to sub-sectoral balances stemmed from a good labour market situation – rising wages and the growing number of the employed. This entailed a strong rise in revenues from direct taxes and social contributions. The increasing wage fund exerted a favourable influence on household consumption expenditure, which, together with one-off factors – increased excise duties on processed tobacco and alcoholic beverages as of 1 March 2016 – provided conditions for general government revenue from indirect taxes to also increase. Collection of local government revenue also improved on account of administrative changes – the share of personal income tax allocated to municipalities was increased as of early 2016.

The balances of all sub-sectors were negatively affected by a substantial decline in EU funds for general government in 2016. Less were received, as the use of the funds for the EU financial horizon 2014–2020 was not intensive enough.

This contributed to government spending dynamics: general government investment shrank by approximately one-fifth over 2016. Spending also decreased, as refinancing of the more expensive previous bond issues in a low interest environment entailed a decline in interest payments[5]. There were factors that increased government spending as well, the major one being higher social benefits (due to raised pensions and other social benefits related to increased insured income as of early 2016) and higher remuneration of employees (due to the increased minimum monthly wage and last year's decision to raise wages for public servants with the lowest remuneration).

A decline in the borrowing requirement to finance general government deficit and the redemption of a large bond issue led to a decrease in the debt-to-GDP ratio (general government). The debt-to-GDP ratio (general government) dropped by 2.5 p.p. in 2016, to 40.2 per cent. The net borrowing of the Government of the Republic of Lithuania was negative in 2016: a total of EUR 1.5 billion was borrowed and EUR 1.9 billion was repaid.

Financial standing of the private sector

Activities of non-financial corporations

The performance of non-financial corporations operating in Lithuania for 2016 was good – sales and profits rose, while profitability remained stable despite commodity price increases and rising wage costs. Corporations increased their financial liabilities, but the possibilities to meet them were no worse than before on account of profitable operations and considerable amount of liquid assets accumulated. While initiated bankruptcy proceedings increased significantly in number over the year, the major contribution stemmed mainly from amended legal regulation of bankruptcy proceedings and intensified initiation of bankruptcy proceedings against insolvent corporations by state authorities rather than developments in the financial standing of corporations. Corporation assessment of business prospects improved from last year, leading to majority of them planning an increase in investment for business development.

2016 was a year of success for non-financial corporations operating in Lithuania – both their sales and earnings were on the rise. The revenue of corporations grew by 2.6 per cent, while earnings before interest, taxes, depreciation and amortisation (EBITDA) – by 1.2 per cent over the year. However, while revenue and profits rose, the EBITDA margin[6] remained almost unchanged, standing at 8.3 per cent at the end of the year. Profitability growth was hindered mostly by commodity price increases and rising wage costs.

Borrowing by corporations increased, but the possibilities for them to meet financial liabilities remained basically unchanged, owing to profitable activities and the growing reserves of liquid assets. Despite a 10.0 per cent increase in corporations' liabilities over the year, their equity capital posted growth accordingly (10.8%); as a result, the corporations' equity capital-to-assets ratio remained almost unchanged over the year, at 57.1 per cent at the end of 2016. The possibilities for corporations to meet financial liabilities did not change significantly either. Towards the end of the year, the corporations' net debt-to-EBITDA ratio was 4.4, an increase

[5] In addition, in 2016, unlike in 2015, there was no need for funds to implement decisions of the Constitutional Court.
[6] The ratio of earnings before interest, taxes, depreciation and amortisation to sales revenue.

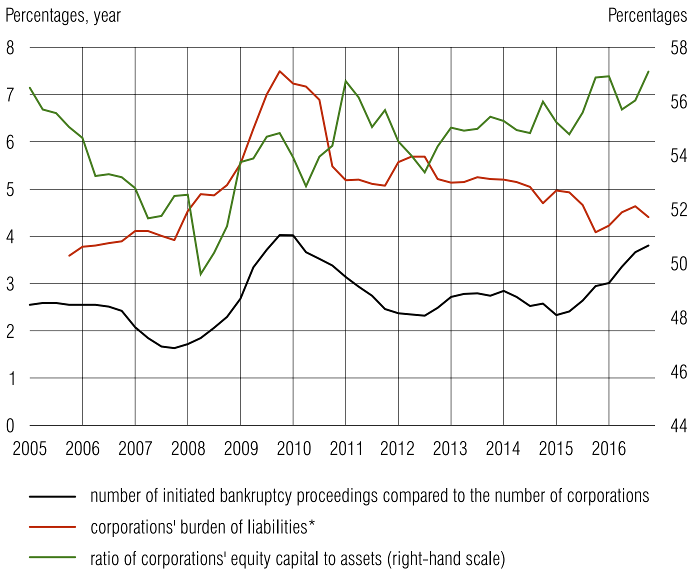
of 0.3 p.p. from the previous year. Despite debt growth outpacing EBITDA growth, an increase in corporations' holdings of cash reserves facilitated the possibilities for meeting financial liabilities.

Driven by administrative changes, corporation bankruptcy proceedings continued to increase in number. In 2016, bankruptcy proceedings were initiated against 2,684 corporations (an increase of 36.9% from 2015). As in the previous year, in terms of the number of bankruptcies, corporations engaged in administrative and support service activities as well as in catering services, entailed the highest risk: the share of initiated bankruptcy proceedings, compared to the number of corporations in operation, within these branches was the largest (9.0% and 7.2% per cent respectively). The aggregate ratio of corporations against which bankruptcy proceedings were initiated to the total number of corporations registered in Lithuania was 3.8 per cent at the end of 2016, thereby approaching the peak observed in 2009 (4.0%). Such changes must have been driven by changed bankruptcy proceedings, which allow automatic appointment of a bankruptcy administrator, and intensified activities of state authorities in initiating bankruptcy proceedings.

The results of the surveys conducted by Statistics Lithuania suggest that corporations became more optimistic about business prospects over the year. Although at the end of 2016 the economic sentiment indicator of corporations was still negative (–3%), it increased by 6 p.p. from the previous year. In addition, the share of corporations planning to increase investment in 2017 expanded moderately (from 17 to 21%). Compared to 2015, the differential between corporations that are going to increase and decrease investment rose by 6 p.p., to 12 per cent.

Chart 8. Corporations' burden of liabilities and the number of bankruptcy proceedings initiated within 12 months as compared to the number of corporations

(Q1 2005–Q4 2016)



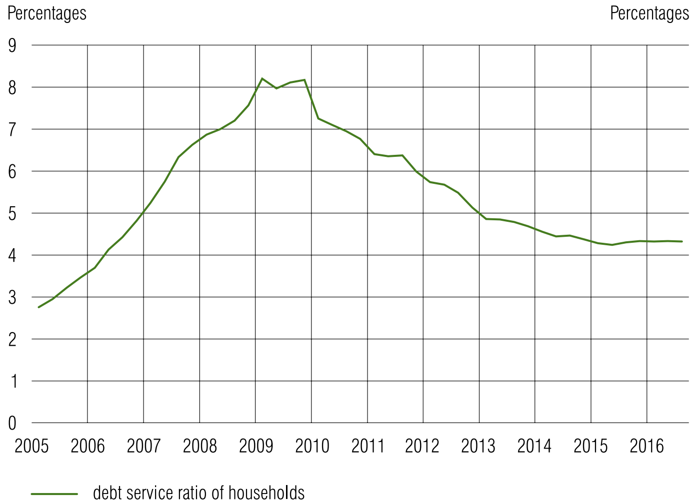
Sources: Statistics Lithuania and Bank of Lithuania calculations.
**The ratio of the differential between liabilities and cash to EBITDA. The indicator shows in how many years a corporation would be able to cover existing liabilities.*

Household finances

As the financial situation of households improved, income grew and unemployment declined, households borrowed more actively and their overall indebtedness moderately increased.

The prolonged period of low interest rates had a positive impact on the financial situation of households – their loan repayment burden, which had been easing since 2010, was rather stable in 2016. With low interest rates and growing household income, the household insolvency risk reduced. At the end of 2016, the share of non-performing loans granted by banks to households amounted to 4.8 per cent, or 2.6 p.p. less year on year.

Chart 9. Ratio of repayment of household loans to MFI to total income over the quarter



Sources: Statistics Lithuania and Bank of Lithuania calculations.

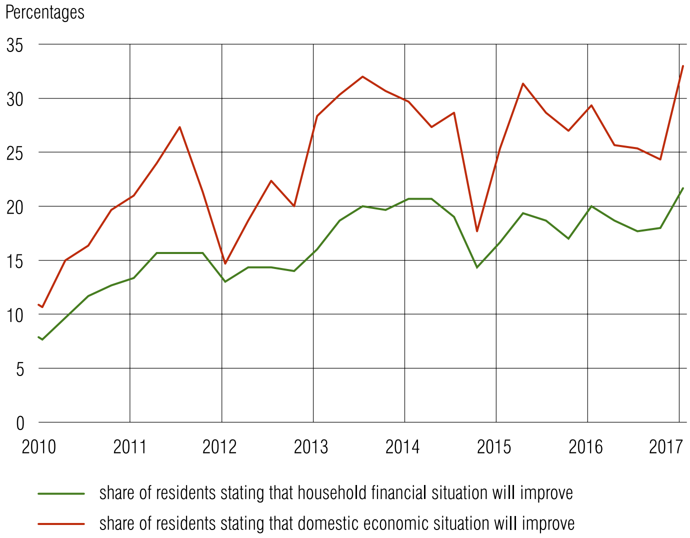
Households borrowed more, yet their financial assets grew faster (by 8.0% – to EUR 36.1 billion) than liabilities (by 3.0% – to EUR 13.1 billion). The ratio of household net assets to GDP[7] increased moderately – from 56.1 per cent (Q3 2015) to 60.3 per cent (Q3 2016). No major changes were seen in the structure of household financial assets – securities issued by non-financial corporations and other securities as well as currency and deposits continued to comprise the largest share of household financial assets (40.6 and 34.1% of total financial assets respectively).

Future expectations of households improved. The share of residents stating that in the next 12 months the financial situation of households will improve grew. There were more residents indicating that the domestic economic situation will ameliorate in the near future. The Survey of Households carried out by the Bank of Lithuania also revealed that the share of residents stating that their family's financial situation is good or average (according to data of the latest survey, at the beginning of 2017 it accounted for approximately 62%) continues to grow at a moderate pace.

[7] *The ratio of household net assets to GDP is calculated by comparing household net assets with a 4-quarter sum of GDP.*

Chart 10. Share of residents stating that the financial situation of households will improve

(January 2010–January 2017)



Sources: Statistics Lithuania and Bank of Lithuania calculations.

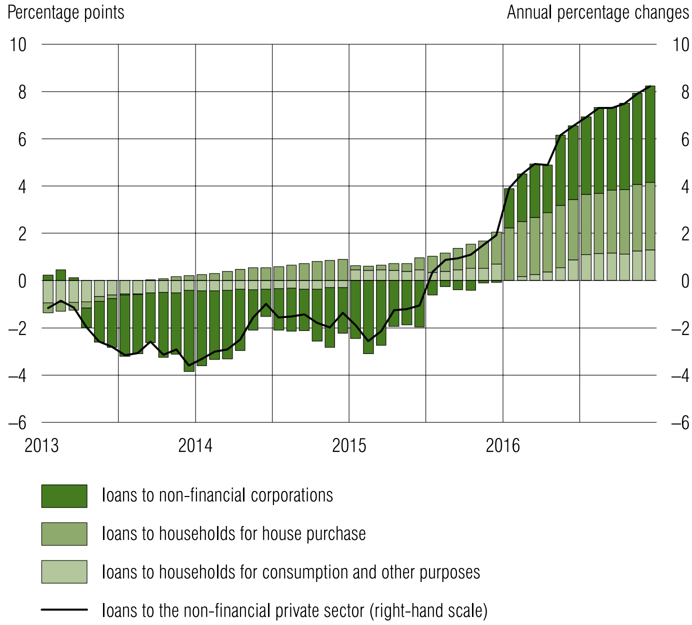
Private sector crediting dynamics

2016 was a year of stronger growth in all private sector loan portfolios. Credit growth was driven by increasing credit demand, good financial position of borrowers, and favourable financing conditions.

Household and non-financial corporation credit portfolios exhibited strong growth in 2016. After starting to expand in the second half of 2015, the credit portfolio increased even more last year. The financial standing of households and companies continued to be good: income grew, possibilities for consumption increased, while low interest rates were conducive to borrowers. This increased the need for circulating capital, loan demand, and contributed positively to the loan portfolio. The portfolio of MFI[8] loans to the non-financial private sector expanded by 8.2 per cent over 2016, whereas a year ago, this indicator was a mere 1.9 per cent.

[8] *For the assessment of loan dynamics in Lithuania, in this section, adjusted statistical reporting data prepared by the Bank of Lithuania is used (for more information on the data, see Annex 2 of the December 2014 Lithuanian Economic Review, prepared by the Bank of Lithuania); it may differ from data collected for supervisory purposes.*

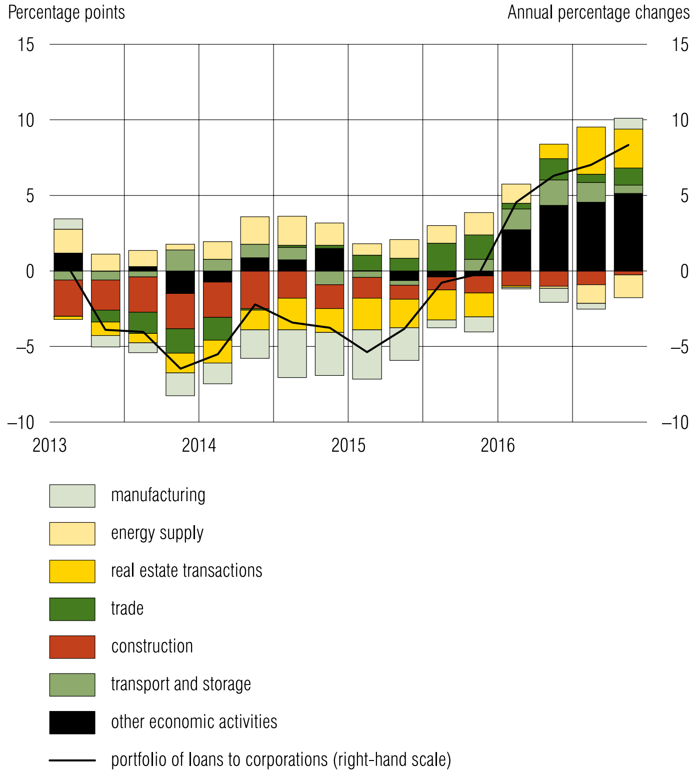
Chart 11. Dynamics of the portfolio of IMF loans to the non-financial private sector



Sources: Bank of Lithuania and Bank of Lithuania calculations.
Note: MFI balance sheet data adjusted for technical factors.

In 2016, growth in the portfolio of loans to households was much more robust. In December, the portfolio of loans to households expanded by 8.1 per cent year on year, an expansion two times stronger than last year. The portfolio's growth was driven by both loans for house purchase and loans for consumption and other purposes. In 2016, employment grew, wages rose, and unemployment expectations decreased, which was favourable for those wishing to purchase durable goods (e.g. housing or a car). In addition, rising housing rental prices and low return on financial instruments (e.g. deposits) encouraged house purchases. Such purchases contribute to the growth of the banks' loan portfolio as they are often financed with borrowed money.

Chart 12. Loans to non-financial corporations by economic activity

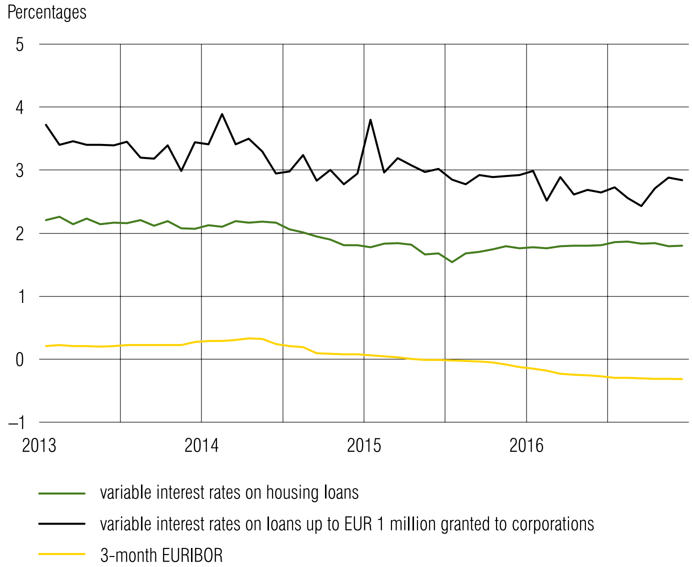


Note: Strong growth in other economic activities was driven by one-off factors within information and communications, and administrative activities.
Sources: Bank of Lithuania and Bank of Lithuania calculations.

In 2016, the trend of financing non-financial sector corporations with bank loans changed. The previously declining amount of loans to non-financial corporations started to increase, while by the end of the year the portfolio of these loans had already increased by 8.3 per cent from last year. Growth in these portfolios stemmed from real estate operations, wholesale and retail, manufacturing, and transport activities. Circulating capital needs, enterprise mergers and acquisitions, renewal of the truck fleet within the transport sector as well as one-off factors were the drivers of higher lending activity within the non-financial sector. In addition, the amount of smaller loans increased, which suggests intensified lending to small and medium-sized enterprises. Energy supply and construction activities contributed negatively to the loan portfolio. State-owned energy supply companies, once last years' large investment projects were completed, were subject to relatively fewer infrastructure renewal works in 2016. Meanwhile, construction sector volumes contracted as a result of a decline in water, energy and heat supply, wastewater treatment and railway track works[9]. Nevertheless, despite robust growth in the portfolio of credit to non-financial corporations, high financial performance of corporations determined that their liabilities-to-equity ratio was below their long-term average (in Q3 2016 – 69.7), remaining at almost the same level as a year ago (in Q3 2015 – 69.1).

[9] *As discussed in the section 'Real sector', the decline in government spending on investment projects is related to less intensive use of EU support funds.*

Chart 13. Dynamics of lending rates



Sources: ECB and Bank of Lithuania.

Interbank lending rates continued to decline, prompting a decline in bank lending rates. In 2016, as compared to last year, the average variable interest rate on new loans granted to financial undertakings dropped by 0.3 p.p. This lending rate declined not only due to a drop in interbank offered rates, but also lower bank margins. Moreover, lending conditions in non-price terms improved as well. In addition, the cost of consumer loans decreased. The variable interest rate on these loans dropped by 0.8 p.p., but the standards for the provision of these loans somewhat tightened. The residential mortgage conditions for households became less favourable. Variable interest rates on these loans were higher by 0.1 p.p. in 2016, as compared to 2015, and credit standards tightened.

II. KEY FUNCTIONS OF THE BANK OF LITHUANIA

Participation in the formulation and implementation of the Eurosystem's monetary policy[10]

Decisions regarding the monetary policy of the Eurosystem

In 2016, the Eurosystem further reinforced the accommodative stance of its monetary policy. In March and December 2016, the Governing Council adopted new accommodative monetary policies. They contributed to further improving bank financing conditions, lending standards to the real economy, as well as directly and indirectly weighed on debt security yields. All this had a positive impact on GDP growth and inflation both in the euro area and in Lithuania.

In March 2016, the Governing Council decided to reinforce the accommodative monetary policy stance, as there was higher risk that in the medium term the ECB price stability objective will not be achieved, i.e. inflation rates in the euro area may not reach the level below, but close to, 2 per cent over the medium term. Risk was elevated due to the fact that in February 2016, after several months, the euro area dipped again into deflation, inflation expectations once again lowered (long-term expectations reached all time lows), while in March the ECB staff significantly revised down their inflation projections. In March 2016, the Governing Council decided to:

- lower the official monetary policy interest rates even more. Interest rates on MROs and the marginal lending facility were lowered by 5 basis points – to 0.00 and 0.25 per cent respectively, while the rate on the deposit facility was lowered by 10 basis points (to –0.40%);
- expand the monthly purchases under the expanded APP from EUR 60 billion to EUR 80 billion. The horizon of the expanded APP remained unchanged – it was intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its price stability objective;
- include the new CSPP in the expanded APP and, as of June 2016, begin purchasing investment-grade euro-denominated debt securities issued by non-bank corporations established in the euro area;
- increase the issuer and issue share limits for the purchases of debt securities issued by European institutions from 33 to 50 per cent;
- launch a new series of four TLTROs (TLTRO II), starting in June 2016, each with a maturity of four years. The interest rate under TLTRO II is set for each bank individually. It cannot be higher than the MRO rate as well as lower than the interest rate

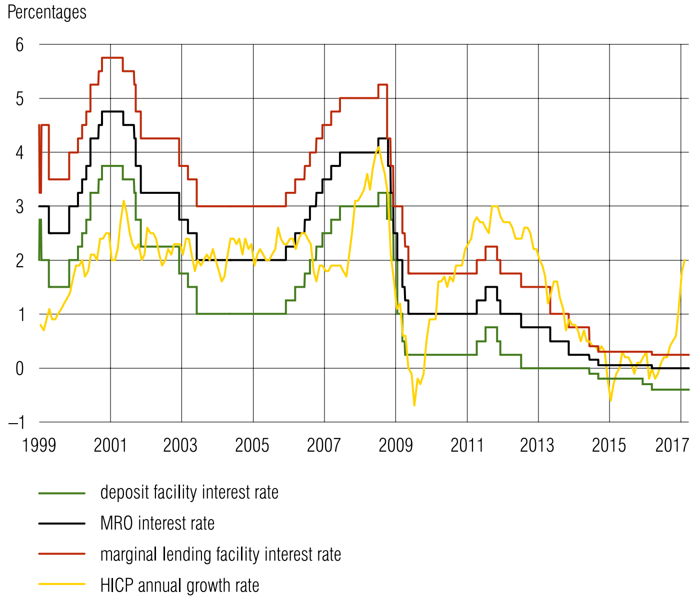
[10] *More on the contribution of the Bank of Lithuania to the formulation and implementation of the Eurosystem's decisions is available in the section 'Cooperation in the Eurosystem and international fora'.*

on the deposit facility. The more the bank expands the volume of its household and corporate lending, the lower the interest rate is applied under TLTRO II;

- adjust forward guidance on key monetary policy interest rates. The previous regularly-communicated message, i.e. that 'the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time', was changed to one stating that 'the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases'.

With its new accommodative monetary policy, the Governing Council aimed to further reduce the cost of bank financing, ease financing conditions, ensure smooth implementation of the expanded APP by increasing the volume of eligible debt securities, and promote lending to the real economy.

Chart 14. ECB official interest rates and inflation in the euro area



Source: Thomson Reuters Datastream.

Right after the UK referendum on EU membership in June 2016, the Governing Council did not need to adjust the Eurosystem's monetary policy stance. At first, global financial market indicators were sensitive to the UK referendum results. This is especially relevant to the value of euro area shares, which plummeted. However, in several weeks the majority of euro area financial indicators (like those of the rest of the world) returned to the levels observed pre-referendum. The fact that the ECB was prepared to provide additional liquidity to banks, if necessary, was beneficial to euro area financial markets; they also contributed from the fact that the euro area banking regulatory and supervision system had been overhauled and ECB accommodative monetary policy measures had been implemented.

In December 2016, the Governing Council decided to extend the smaller-sized expanded APP until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. At the end of 2016, the previously-set horizon of the expanded APP was nearing, while prices, according to the Governing Council, were still not rising in a sustainable manner, yet deflation risk generally reduced. Sustainable inflation was possible only with further maintaining especially loose financial conditions in the euro area. As a result, at the monetary policy meeting in December 2016, the Governing Council decided to:

- extend the expanded APP at least until December 2017, reducing the volume of monthly purchases to EUR 60 billion starting from April 2017. The Governing Council noted that if, in the meantime, the outlook becomes less favourable, or if financial conditions tighten and thus become inconsistent with further progress towards a sustained adjustment of the path of inflation, it intends to increase the programme in terms of size and/or duration;
- as of January 2017, decrease the minimum remaining maturity for PSPP-eligible debt securities from two years to one year;
- buy debt securities whose yield is lower than the interest rate on the deposit facility, to the extent necessary.

In addition, the Governing Council continued to expect the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the expanded APP.

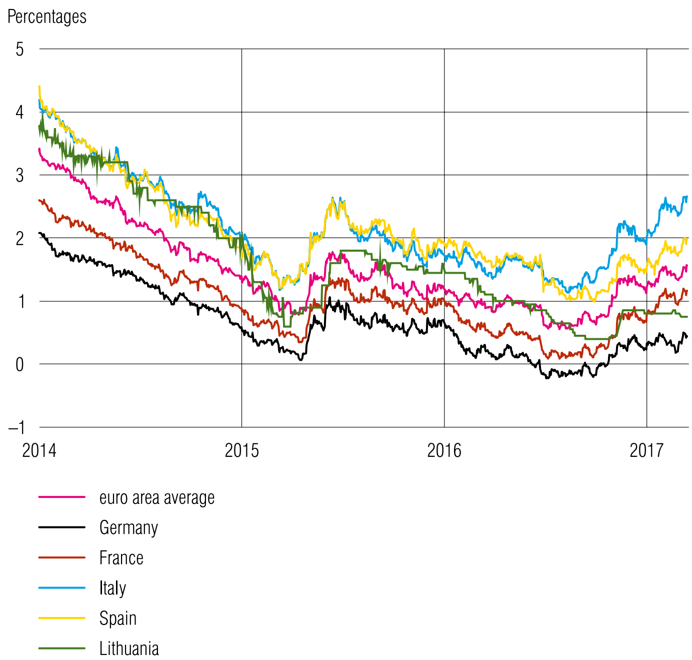
The Eurosystem's accommodative monetary policy measures contributed to the further improvement of conditions for bank funding and lending to the real economy in the euro area. Due to ECB official interest rates, reduced in March 2016, and increasing bank liquidity, the interbank lending interest rates decreased. TLTROs reduced the price of longer-term funding: two final rounds of TLTRO I allowed banks to borrow funds for more than two years at 0.00 per cent, while three rounds of TLTRO II enabled banks to borrow funds for four years at –0.40–0.00 per cent. From the beginning of 2016 to February 2017, the average interest rate on new mortgage loans to households in the euro area decreased from 2.3 to 1.8 per cent, whereas the interest rate on new loans to non-financial corporations – from 1.9 to 1.6 per cent.[11] Not only the average interest rate on new loans, but also the dispersion of interest rates across euro area countries continued to decline.

The expanded APP continued to weigh on the yields of euro-denominated debt securities (both directly and indirectly), yet, at the beginning of 2017, average euro area long-term (10 years) yields of government debt securities were higher than in early-2016: even though until July 2016 they had been declining due to the increased volume of monthly purchases under the expanded APP as well as the UK referendum results, at the end of the year yields once again grew on the back of improved euro area macroeconomic data and changes observed in the US. With the election of Donald Trump, interest rates of US government securities increased significantly, which also raised the yields of longer-term euro area government securities. In 2017, yields of debt securities of some euro area countries (especially France) were also increased due to increasing political risk that Euro-sceptic persons or parties may win the national election. Debt security yields of non-bank corporations – both investment- and speculative-grade – decreased significantly at the beginning of 2016 as a result of the Governing Council's decision, made in March 2016, to include the new CSPP in the expanded APP. No debt

[11] To minimise the effects of temporary fluctuations and filter out the trends, 3-month moving averages of interest rates for loans to non-financial corporations and mortgage loans are compared.

securities of Lithuanian corporations have been bought under the expanded APP yet as there are no corporate bonds issued that would be in line with CSPP requirements.

Chart 15. Annual yields of 10-year euro area sovereign debt securities issued in national currency



Sources: ECB and Thomson Reuters Datastream.

The Eurosystem's accommodative monetary policy stance continued to add to more successful macroeconomic developments in the euro area and Lithuania. According to the ECB, the Eurosystem's accommodative monetary policy measures are expected to increase euro area real GDP growth in 2015–2017 by 1.6 p.p., inflation – 1.4 p.p. According to the Bank of Lithuania assessment, accommodative monetary policy measures in Lithuania should increase real GDP growth over the same period by 1.0 p.p., inflation – 1.3 p.p. In 2016, the impact on both Lithuania's real GDP growth and on inflation was 0.4 p.p. The main channels of impact on the Lithuanian economy are the faster growth of euro area economy, which grew faster due to the Eurosystem's accommodative monetary policy, and the significantly lower nominal exchange rate of the euro – all this boosted Lithuania's export.

Implementation of the Eurosystem's monetary policy

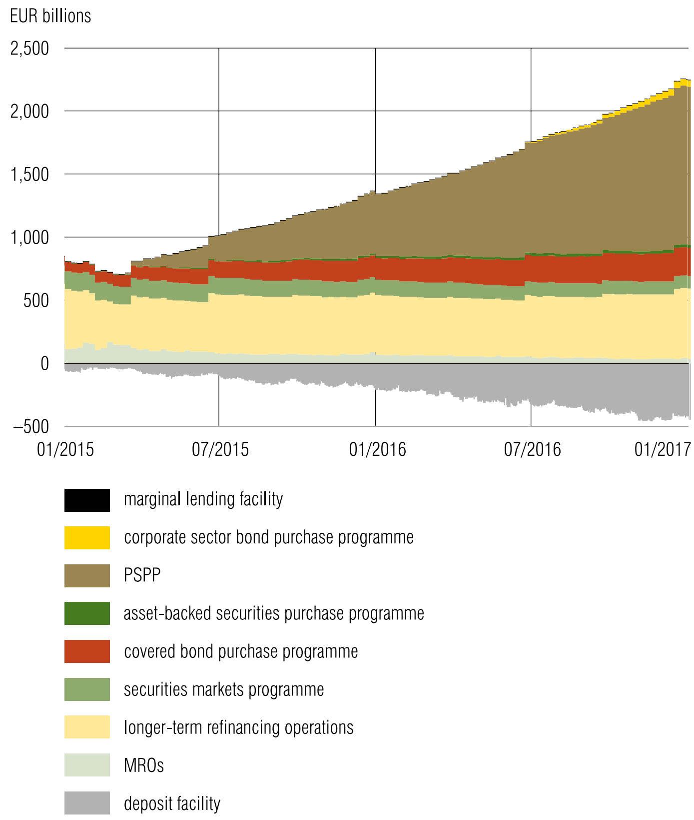
Seeking to implement its objectives, the Eurosystem has a set of monetary policy instruments, consisting of open market operations, standing facilities and minimum reserves. Applying these instruments, in 2016 the Eurosystem injected into the financial market EUR 888.1 billion, the Bank of Lithuania – EUR 3.8 billion. To this end, non-standard monetary policy measures – the expanded APP and TLTROs – were used.

Implementation of the Eurosystem's monetary policy in the euro area

Open market operations. In 2016, the Eurosystem performed via tenders 119 open market operations. At the end of 2016, using these instruments, the Eurosystem's counterparties had borrowed EUR 39.1 billion via MROs and EUR 556.6 billion via longer-term refinancing operations, including TLTROs. TLTROs are used by the Governing Council of the ECB to support bank lending to the non-financial private sector, i.e. households and non-financial corporations (excluding housing loans to households). Credit institutions wishing to participate in these operations must comply with certain reporting requirements, i.e. each institution has to present reports on balances of eligible loans and eligible net lending over reporting periods. Such data is used in setting the borrowing threshold and borrowing limits to these institutions. In addition, the data is subject to mandatory audit.

Implementing asset purchases, in 2016 the Eurosystem expanded the debt security portfolio by EUR 850.9 billion – to EUR 1,654.0 billion. The Eurosystem continued to implement the expanded APP in 2016. Under the expanded APP, which includes the third covered bond purchase programme, the asset-backed securities purchase programme, the corporate sector bond purchase programme and the PSPP, the Eurosystem purchased each month securities for the amount of EUR 80 billion (until March – EUR 60 billion).[12]

Chart 16. Eurosystem's liquidity-providing and liquidity-absorbing monetary policy operations



Sources: ECB and Bank of Lithuania calculations.

Standing facilities. Using the deposit facility, the value of overnight deposits held by Eurosystem's counterparties at NCBs amounted to EUR 424.21 billion at the end of 2016. From the beginning of 2016, the interest rate on the deposit facility was –0.3 per cent, from 16 March 2016 – –0.4 per cent. The marginal lending facility, for which the interest rate of 0.3 per cent (from the beginning of 2016) and 0.25 per cent (from 16 March 2016) was applied, was also used during the period

[12] *More information on the expansion of the APP and adjustments in its other parameters made in 2016 is available in the section 'Participation in the formulation and implementation of the Eurosystem's monetary policy'.*

under review: the largest amount borrowed was EUR 2.36 billion, whereas the smallest – EUR 0.001 billion.

Minimum reserves. Over the year, as the reserve base expanded, the minimum reserves of the Eurosystem's credit institutions increased by almost 5 per cent – from EUR 113.29 billion to EUR 118.75 billion. Minimum reserves are calculated on the basis of the reserve base, consisting of deposits and debt securities issued. In 2016, the euro area was subject to a 1 per cent reserve requirement ratio. The average amount of minimum reserves was EUR 115.81 billion in 2016.

Implementation of the Eurosystem's monetary policy in Lithuania

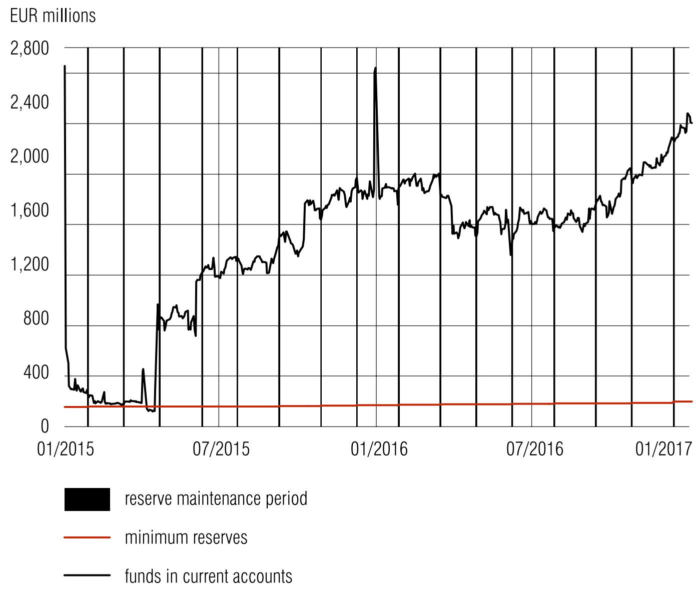
Open market operations. In 2016, the counterparties of the Bank of Lithuania participated quite actively both in the MROs, longer-term refinancing operations and targeted refinancing operations. In the first half of the year, they participated more actively in the main and longer term refinancing operations, in the second half – in targeted refinancing operations. Using these instruments, counterparties had borrowed EUR 0.30 billion at the end of the year.

In 2016, the Bank of Lithuania, together with the other Eurosystem NCBs, continued to implement the PSPP. The Bank of Lithuania, as a participant in the PSPP, purchases government securities of the Republic of Lithuania and bonds of the European supranational institutions. The share of purchases by an NCB is calculated according to its contribution to the ECB capital. Over a month, the Bank of Lithuania purchased, on average, EUR 325 million worth of securities. The value of euro area resident securities bought by the Bank of Lithuania for monetary policy purposes was EUR 6.3 billion at the end of 2016. The Eurosystem had bought government securities of the Republic of Lithuania for the amount of EUR 2.3 billion.

Standing facilities. In 2016, the counterparties did not use the deposit facility. The marginal lending facility, for which an interest rate of 0.30 per cent was applied at the beginning of the year (on 16 March 2016 – 0.25 per cent), was used several times during the period under review; the largest amount borrowed was EUR 0.7 million.

Minimum reserves. Over the year, as the reserve base expanded, the minimum reserves of Lithuania's credit institutions increased by almost 16 per cent – from EUR 169.8 million to EUR 196.6 million. The average amount of minimum reserves was EUR 180.1 million in 2016. At the beginning of 2016, the Eurosystem applied a negative interest rate of 0.3 per cent on excess reserves, as of 16 March 2016 – a negative interest rate of 0.4 per cent. The active quantitative easing limited the possibility for credit institutions to earn profit from short-term safe investment in the euro area, hence excess reserves continued to be especially prominent, increasing further over the fourth quarter.

Chart 17. Changes of bank reserves in euro at the Bank of Lithuania



Source: Bank of Lithuania.

Macroprudential policy

Analysis of systemic risks

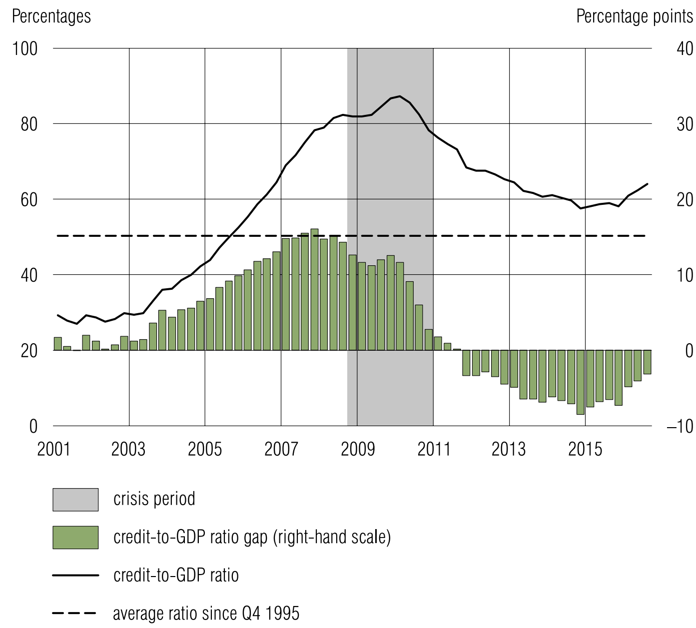
Rapidly rising housing prices and significantly increasing household indebtedness in several Northern European states remains one of the main systemic risks to the stability of Lithuania's financial system. If rapid growth of credit and real estate market were to persist, this would increase systemic risk in the medium term. Owing to an increase in the number of cybercrimes, more attention should be devoted to cyberspace security.

Formation of imbalances in the Northern European states is still rated as one of the most important risks to the stability of Lithuania's financial system. In contrast to the majority of other European countries, housing prices fell only slightly in Sweden and Norway in 2008 and 2009, whereas later they started to grow increasingly faster and exceeded the income growth rate of the population. In Q4 2016, the nominal housing price level in Sweden and Norway increased by 51.6 and 61.6 per cent respectively, compared to the highs recorded before the recession of 2008. In addition, as housing was purchased for borrowed funds, the household indebtedness level of these states grew as well and was one of the highest in Europe. The emergence of imbalances increases the probability of housing market overheating and thus the losses of the Scandinavian banking system. The assets of Scandinavian capital banks in Lithuania comprise around 90 per cent of the banking system's total assets; therefore, a shock in one of the Nordic countries could have an adverse effect on the stability of Lithuania's financial system through at least several channels: decline of lending volumes, higher cost of financing and higher uncertainty among depositors. On the other hand, risk is reduced by the increase in the share of internal financing in several recent years (the decline of direct dependence on parent banks) and more active application of macroprudential measures. After the minimum housing loan amortisation requirement was introduced in Sweden in June 2016, the annual growth of housing prices in Q1–Q4 2016 declined from 12.4 to 5.1 per cent.

In 2016, as crediting increased, indebtedness of the non-financial private sector in Lithuania increased as well. The portfolio of loans to the non-financial private sector granted by MFIs increased by 8.2 per cent in 2016[13] – this increase exceeded domestic economic growth[14] 2.5 times. The credit-to-GDP ratio, which reflects the indebtedness level of Lithuania's private sector – enterprises and households – comprised 64.1 per cent in Q3 2016 and was 5.1 p.p. higher than a year ago. On the other hand, the gap between the ratio and the long-term trend[15] remained negative (–3.1 p.p.), which shows that as of yet there is no imbalance in the credit market.

Chart 18. Long-term trend of the ratio of credit to the non-financial private sector to GDP and the gap between this trend and the ratio

(Q1 2001–Q3 2016)



Sources: Statistics Lithuania and Bank of Lithuania calculations.
Note: The long-term trend was calculated by applying the one-sided HP filter with a smoothing parameter of 400,000; before applying this filter, the credit-to-GDP ratio 5 years ahead is extended by the four-quarter weighted average.

The protracted acceleration of the growth of Lithuania's real estate prices and crediting may form imbalances in the medium term. The number of real estate transactions concluded in the country in 2016 approached the peak number observed in 2007 and even exceeded it in Vilnius. High activity of buyers boosted supply, which is why the number of real estate objects under construction increased both in the residential housing sector and in the commercial real estate sector, whereas the number of apartments built in 2016 was the highest during the period of independence in Lithuania. The growth of the housing loan portfolio was the fastest; therefore, the share of housing purchase transactions using a loan increased. In the environment of still-low interest rates, incentives to buy housing as an investment increased as the supply of rented housing grew. With the growth

[13] *MFI balance-sheet statistics data adjusted for the removal of bankrupt MFIs from statistics and other technical factors is used. For more information, see Annex 2 'Adjustment of the MFI loan portfolio taking into consideration changes due to technical factors' to the Lithuanian Economic Review of December 2014.*

[14] *Nominal GDP increased by 3.3 per cent in 2016.*

[15] *The positive gap between the credit-to-GDP ratio and the long-term trend shows a potentially excessive private sector indebtedness level determined by rapid credit growth. On the other hand, when the credit-to-GDP ratio is lower than its long-term trend, the country's private sector indebtedness level is considered to be sustainable. The long-term trend of this ratio is calculated by applying the one-sided HP filter with a smoothing parameter of 400,000; before applying this filter, the ratio 5 years in advance is extended by the four-quarter weighted average.*

of housing market activity, the annual growth rate of housing prices accelerated and comprised 9.5 per cent at the end of the year. On the other hand, the surveys of real estate market participants conducted by the Bank of Lithuania show that the growth rate should decline in the nearest future, since the majority of participants expect the annual growth of housing prices to be up to 5 per cent at the end of 2017. Nevertheless, high activity in the market, the environment of low interest rates and rapid crediting growth may increase systemic risk in the medium term. The fall of housing demand due to an unexpected economic shock or negative demographic trends, or the growth of supply due to high optimism of developers or an increase in rented housing sales (for example, due to a rise in interest rates) could determine price adjustments and the financial system's losses. On the other hand, the risk of imbalances is reduced by the Responsible Lending Regulations currently in force and the improvement in the financial situation of residents.

With the increase in the number of incidents in Lithuania's cyberspace and the growing digitalisation of financial services, cybercrimes are becoming an increasingly greater challenge to the financial system. The number of incidents related to electronic communications in Lithuania increased by 19.0 per cent in 2016. The number of information system hacking incidents increased by 53 per cent, whereas the number of attacks disrupting electronic services grew by one-fifth. The annual increase in the number of cyberattacks in Europe was high and comprised 66 per cent in Q2 2016. The number of initiatives related to the increase of cyber security is growing in Lithuania and Europe – this may help reduce the risk to the financial system posed by cybercrimes in the future. Nevertheless, it should be noted that currently many different institutions[16] take care of cyber security in Lithuania, their interrelations are complex and the limits of their responsibility are not fully clear. The Bank of Lithuania, in cooperation with the National Cyber Security Center, the Communications Regulatory Authority, Lithuanian commercial banks, the largest foreign bank branches and the Lithuanian Central Credit Union, conducted testing during which it identified not only important cyber threats to financial market participants, but also potential control gaps. Further possibilities for control strengthening and improvement of communications between financial market participants and public authorities in the event of cyber incidents were discussed. Taking into consideration the testing results, the Bank of Lithuania plans to initiate discussions, consultations and training for market participants and prepare joint recommendations for reducing the risk of cyber threats.

Macroprudential policy instruments

In 2016, seeking to mitigate the potential effect of systemic risk to Lithuania's financial system, the Bank of Lithuania, under its macroprudential policy mandate, continued to implement the Macroprudential Policy Strategy and applied macroprudential measures. Macroprudential policy instrument rates remained unchanged in 2016. With no imbalances in the housing and credit markets, the applied countercyclical capital buffer rate continued to be set at 0 per cent. Since the market shares and importance of major credit institutions changed only slightly last year, the other systemically important institutions buffers, which were set in 2015, were left

[16] In Lithuania, cyber security is regulated not only by the Republic of Lithuania Law on Cyber Security and various other Republic of Lithuania legal acts, but also the draft Directive of the European Parliament and of the Council concerning measures for a high common level of security of network and information systems across the Union as well as the EU cyber security strategy.

unchanged. The Bank of Lithuania analysis showed that there was no need to apply the additional systemic risk buffer. In 2017, the Bank of Lithuania will aim to analyse in greater detail the effectiveness of the applied macroprudential measures and continue to monitor new EU regulatory initiatives.

In 2016, the Bank of Lithuania, under its macroprudential policy mandate[17]**, continued to implement the Macroprudential Policy Strategy**[18]**; in implementing the first interim objective (to limit and prevent excessive credit growth and leverage), it set a 0 per cent countercyclical capital buffer rate in the fourth quarter of 2016.** Since mid-2015, the Bank of Lithuania has been adopting a decision for setting the countercyclical capital buffer rate quarterly. The required buffer rate is set on the basis of detailed analysis of the situation in the credit and real estate markets. On 22 December 2016, the Bank of Lithuania took the decision to keep the set 0 per cent countercyclical capital buffer rate (the same decision was also made in previous quarters).[19] The countercyclical capital buffer rate would be set above 0 per cent if it was assessed that credit institutions need additional protection due to excessive credit growth during the financial cycle upturn.

On 26 January 2017, the Responsible Lending Regulations[20]**, ensuring responsible lending under low interest rates and safeguarding the financial system against imbalances, were amended taking into account the Republic of Lithuania Law on Credit Relating to Immovable Property implementing the Mortgage Credit Directive**[21]**, adopted on 10 November 2016.** As of 1 July 2017, when the Law is to come into effect, the Responsible Lending Regulations will apply not only to credit intended for acquiring or building real estate objects, but also credit that is secured by collateralised real estate. Major lending principles laid down in the Regulations remained unchanged. The maximum loan-to-value ratio still cannot be higher than 85 per cent. In addition, credit institutions are obliged to ensure that the debt service-to-income ratio would not amount to more than 40 per cent; using a 5 per cent medium term annual interest rate, they must additionally ensure that the ratio does not account for more than 50 per cent. This additional requirement aims at safeguarding households against the risk of encountering difficulties in paying larger loan instalments should interest rates increase in the future. In order to safeguard households against over-indebtedness when taking long-term loans, maximum loan maturity is limited to 30 years.

During the 2016 assessment, it was decided to keep the list of domestic systemically important institutions, the size of the other systemically important institutions capital buffer set for them, and the date of accumulation of the reserve unchanged. The additional capital buffer requirement for systemically important institutions came into effect on 31 December 2016 after a one year transitional

[17] Law on the Amendment of Articles 8, 11, 27, 51, 55, Annex 2 of Republic of Lithuania Law on the Bank of Lithuania No I-678 and its Supplement with Paragraph 7 and Article 52 (18 September 2014, No XII-1097) Register of Legal Acts, 23/09/2014, No 2014-12712.

[18] Resolution No 03-31 of the Board of the Bank of Lithuania of 12 March 2015 on the approval of the Macroprudential Policy Strategy.

[19] Resolution No 03-210 of the Board of the Bank of Lithuania of 22 December 2016 on the application of the countercyclical capital buffer.

[20] Resolution No 03-90 of the Board of the Bank of Lithuania of 28 May 2015 on the amendment to Resolution No 03-144 of the Board of the Bank of Lithuania of 1 September 2011 on the Responsible Lending Regulations.

[21] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ 2014 L 60, p. 34).

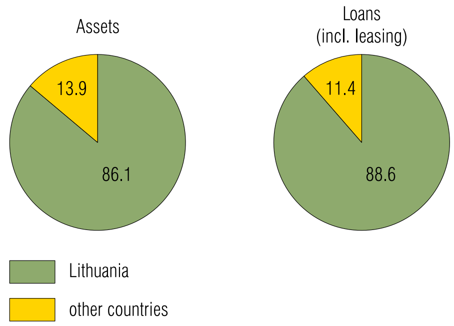
period.[22] The other systemically important institutions capital buffer rate is set at the end of each year in order to increase the resilience of systemically important institutions to potential losses and limit their incentives for excessive risk taking. Four systemically important institutions were identified in Lithuania. A 2 per cent other systemically important institutions capital buffer was set for *AB SEB bankas*, *Swedbank, AB*, and *AB DNB bankas*, a 0.5 per cent capital buffer for *AB Šiaulių bankas*.

In 2016, the Bank of Lithuania assessed the possibility of applying another macroprudential measure (the systemic risk buffer), determining that currently there is no need to apply the additional systemic risk buffer. Such a measure is applied in seeking to increase banks' resilience to structural systemic risk. Under the Rules for the Formation of Capital Buffers[23], the systemic risk buffer may be 1–5 per cent and may be applied to the entire sector or individual banks to which the identified structural risk is relevant. Structural systemic risk is a long-term risk arising due to the characteristics of the domestic financial system or the environment in which it operates. With regard to Lithuania's financial sector, there are factors that could enhance the impact of unfavourable shocks on the economy, for example, the assets of the Lithuanian banks are concentrated in Lithuania, thus banking activity results are highly dependant on the economic situation of a single specific country. Analysis[24] showed that the capital requirements that are currently in effect broadly take into account relevant risks, while the bank capital reserve makes banks resilient to economic shocks. Even though currently there is no evident need to apply the systemic risk buffer, structural risk will be assessed at least every two years so that threats are identified on time and measures are taken to mitigate them.

Chart 19. Geographical breakdown of Lithuanian banks' assets and loans

(Q1–Q4 2016 average)

Percentages



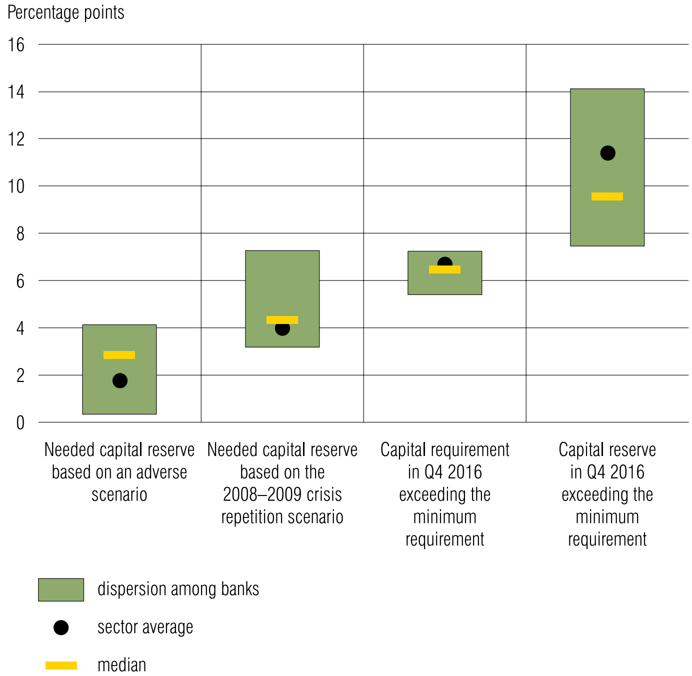
Source: Bank of Lithuania calculations.

[22] *Resolution No 03-192 of the Board of the Bank of Lithuania of 15 December 2015 on the setting of the capital buffer for other systemically important institutions.*

[23] *Rules for the Formation of Capital Buffers, approved by Resolution No 03-51 of the Board of the Bank of Lithuania of 9 April 2015.*

[24] *The Bank of Lithuania occasional paper 'Systemic risk buffer: application possibilities' (forthcoming).*

Chart 20. Stress testing results and bank capital reserve
(Q4 2016)



Source: Bank of Lithuania calculations.

Handling of statistics

In 2016, the Bank of Lithuania published more comprehensive data on MFI interest rates, started to compile the balance sheet statistics of insurance corporations, improved statistics on foreign direct investment and holdings of securities and expanded micro-databases. In order to enhance international cooperation, the Bank of Lithuania implemented action plans in the area of statistics for accession to the OECD as well as in relation to Lithuania's adhering to the IMF Special Data Dissemination Standard Plus.

The statistics compiled by the Bank of Lithuania are primarily used for the purposes of monetary policy formation and implementation, macroprudential policy, microprudential supervision, macroeconomic analysis and research. They are also increasingly used by external users, such as international organisations and public authorities, financial market participants, the media, researchers and the general public. These statistics were further expanded in 2016, taking into consideration Lithuania's preparation for accession to the OECD. Much attention was devoted to the expansion of statistics dissemination, including the intention to adhere to the IMF Special Data Dissemination Standard Plus (SDDS Plus) and data provision to the ECB and other international organisations.

Taking into consideration the growing needs of users, the Bank of Lithuania expanded the dissemination of MFI interest rate statistics and started publishing the interest rates and amounts of new business loans secured by collateral and/or guarantees as well as pure new loans in euro to euro area residents in 2016. Taking into account the needs of those forming and implementing financial stability policy, the Bank of Lithuania started to collect new quarterly macroprudential reporting data from banks and foreign bank branches.

The needs of users to have access to comprehensive statistics harmonised on the euro area level increased further; therefore, the Bank of Lithuania implemented the ECB regulation on statistical reporting requirements for insurance corporations and started to compile and provide to the ECB the new insurance corporation balance sheet statistics in 2016. In order to avoid increasing the statistical reporting burden to market participants, statistics on insurance corporations are compiled using the data of supervisory reporting under Solvency II supplemented by the ECB requirements (add-ons). Reports under Solvency II are also used to compile statistics on holdings of securities (security-by-security data on the holdings of securities by insurance corporations). In addition, in order to compile high quality statistics covering the activity of Lithuanian insurance corporations, with the exceptions of their foreign branches, and branches of foreign insurance corporations in Lithuania, the Bank of Lithuania started to exchange the estimated data on branches of insurance corporations with the Bank of Estonia in accordance with the bilateral memorandum of understanding. The Bank of Lithuania will start to publish these new insurance corporation balance sheet statistics in the second half of 2017.

In order to reduce the statistical reporting burden on economic entities, the Bank of Lithuania has linked securities and other databases which are used to compile statistics on investment fund assets and liabilities, insurance corporations, pension funds, securities issues and holdings and external statistics and to produce the country's quarterly financial accounts. Therefore, the Bank of Lithuania continued to devote considerable effort to the expansion of micro-databases in 2016.

In order to ensure the quality of external statistics, the Bank of Lithuania updated the procedure for registration with the Bank of Lithuania of foreign loans without a state guarantee received by legal entities and loans granted to foreign economic entities. As the update of the procedure was related to the application of international statistical standards to direct investment statistics, more comprehensive information on loan flows by institutional sector is compiled and the ultimate ownership concept has been introduced in the assessment of corporate loans linked by direct investment relations.

In order to ensure efficient functioning of the credit system and the right of the Bank of Lithuania to obtain information required for conducting microprudential supervision and implementing macroprudential policy, the Loan Risk Database (LRDB) was further expanded. Natural persons actively used the information system of electronic services to residents implemented by the Bank of Lithuania, which provides a possibility to comfortably access the information about their personal data handled in the LRDB. The Bank of Lithuania publishes on its website the data on loans to non-financial corporations by economic activity prepared by using the information included in the LRDB. In order to fully cover the consumer credit market, conditions were created for consumer credit providers included in the public lists and operators of peer-to-peer lending platforms to submit data to the LRDB.

Taking into consideration the needs of the Bank of Lithuania and participants of Lithuania's financial market as well as the requirements of the ECB regulation on the collection of granular credit and credit risk data, the project for the development of the new LRDB was continued and the legal requirements and user needs analysis stage was completed. During the meetings organised by the Bank of Lithuania, the said ECB regulation requirements and the requirements covering additional national needs were introduced to market participants, the model of the new LRDB was presented, methodical consultations were provided, the functional requirements of the new LRDB were specified and active participation in the activity of the Nordic and Baltic task force on the implementation of the ECB regulation was ensured.

In cooperation with Lithuanian institutions, statistical information and data provision agreements with Statistics Lithuania and the Ministry of Finance were updated in 2016. In order to reduce the burden to financial market participants, the agreement between the Bank of Lithuania and the State Tax Inspectorate on the LRDB data provision was signed. To expand international cooperation, intensive work was carried out together with the OECD representatives concerning Lithuania's preparation for accession to this organisation. The Bank started to provide regular quarterly data on institutional investors and households as well as external statistics. During the visit of OECD representatives in Lithuania in autumn, a significant progress in implementing the harmonised action plan measures was acknowledged and further actions related to the accession process were adopted.

As a coordinator of the application of the IMF Special Data Dissemination Standard in Lithuania, at the end of 2016, the Bank of Lithuania addressed the IMF to express Lithuania's intention to adhere to the higher level standard – SDDS Plus. The adherence would be an important acknowledgement of Lithuania's statistics compliance with high quality standards.

Management of financial assets

Investment policy

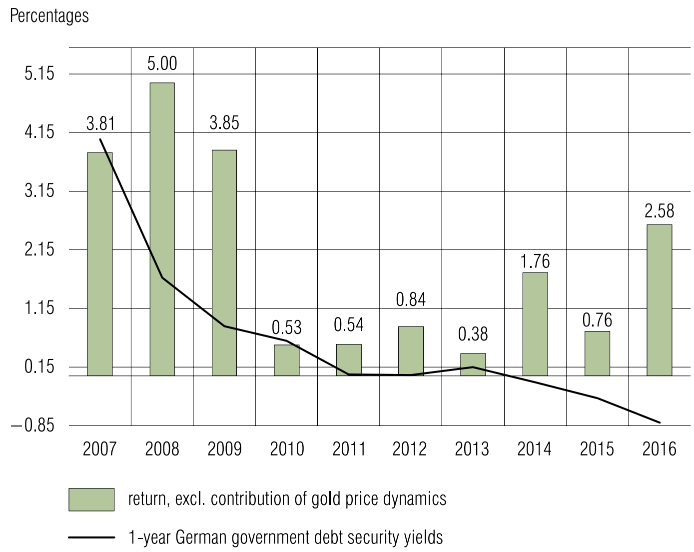
Managing financial assets that are not related to monetary policy operations, the Bank of Lithuania seeks to ensure the financial stability in Lithuania as well as in the euro area, safeguard the financial independence of the Bank of Lithuania, and establish financial buffer for the country to properly withstand economic and financial shocks as well as other extraordinary situations.

The Bank of Lithuania invests financial assets seeking to diversify investment risk and increase expected return over a 3-year investment horizon. Due to potentially higher returns in the medium-term, the Bank of Lithuania tolerates the risk of short-term loss, whose size with high probability should not exceed the risk budget predefined in the investment policy.

Investment results

In 2016, the Bank of Lithuania earned EUR 47.9 million from financial assets investment, while the return on investment was 2.58 per cent. The bulk of the return on investment was generated from the rise in prices of euro area debt securities and global equities and favourable exchange rate developments. Against a backdrop of ECB accommodative monetary policy, yields in the euro area continued to decline, while the prices of debt securities, which are inversely related to their yields, continued to rise. Equities and the exchange rate of the US dollar were on the rise mainly due to favourable expectations of future US economic expansion.

Chart 21. Return on investment



Source: Bank of Lithuania.

Over the past three years (2014–2016), the Bank of Lithuania earned EUR 198.3 million from investments of financial assets, whereas the 3-year investment return stood at 5.18 per cent (approximately 1.7% each year). However, risk that conditions in financial markets might be less favourable in the near term is high, hence losses in the future are not exclusive. The Bank of Lithuania's decision-making process related to the management of financial assets (except gold) consists of two layers: the strategic benchmark, which sets and dynamically manages the long-term strategic structure of investments, and active management, which takes decisions to deviate from the strategic benchmark in order to exploit favourable short- and medium-term market opportunities and trends. Over the past three years, market conditions were complex (economic slowdown in China, Brexit, US presidential election), yet favourable to Bank of Lithuania's strategic and active investment decisions. In 2014–2016, the Bank of Lithuania earned EUR 24.7 million from the active management of financial assets (except gold). In terms of the strategic benchmark, decisions to extend the investment horizon to three years, increase the risk budget, diversify investment and start investing in corporate debt securities, equities, China government debt securities, and enhance investments in US dollar paid off. Complex market conditions prompted the search for new investment strategies, yet risk of losses also increased. Debt security yields remain at historically low levels, share prices are relatively high, thus there is a rather high risk that market trends in the near future may change unfavourably for Bank of Lithuania's investment.

Gold investment

In 2016, the Bank of Lithuania earned EUR 2.0 million from gold investments, in 2014–2016 – EUR 2.7 million. The Bank of Lithuania manages 5.8 tons of gold, which is stored at the Bank of England. Under favourable market conditions, gold is invested in gold deposits, thus earning interests, or through gold swaps, i.e. temporarily exchanging gold into other currencies and then investing them.

Investment composition

In 2016, the financial assets (excluding those related to monetary policy) at market value amounted to, on average, EUR 2,081.6 million. Over the year, on average, investment in debt securities stood at 66.4 per cent, in money market instruments – 27.9 per cent, and in equity securities – 5.8 per cent. The Bank of Lithuania invests in investment-grade debt securities issued by European, North American and Chinese central governments, government agencies, and international organisations and institutions. In 2016, the Bank of Lithuania entrusted management of part of its investment to the World Bank under the Reserves Advisory and Management Program. Under the Program, investments are made in US, Canadian and United Kingdom central government, government agency, municipality, etc. debt securities.

Chart 22. Average distribution of investment in 2016

Source: Bank of Lithuania.

The bulk of Bank of Lithuania's investments is in euro or other currencies whose currency risk is hedged. Aiming at higher investment diversification, part of currency risk of investments in US dollar, Japanese yen, pound sterling and other currencies (in 2016 – 20.5% on average) was not hedged.

Security of financial assets is ensured through diversifying investment, concluding transactions only with investment grade rating and good repute financial institutions, and investing only in investment grade rating debt securities. The investment grade rating assigned to financial institutions and issuers of debt securities by international rating agencies indicates low probability of default on their liabilities. At the end of 2016, the average investment rating was AA-, while 42 per cent of investments were rated AAA (the highest rating).

Administration of the accounts of the State Treasury and other institutions

Acting as a state treasury agent under the Law on the Bank of Lithuania, in 2016 the Bank of Lithuania administered euro and foreign currency accounts of the State Treasury. The state monetary resources held in these accounts are managed by the Ministry of Finance. The resources are accumulated and used in accordance with the procedure set forth by the State Treasury Law of the Republic of Lithuania and other legal acts. In addition, the Bank of Lithuania managed euro accounts of EU institutions and international financial institutions (hereinafter – other institutions). Monetary resources in the State Treasury accounts managed by the Ministry of Finance made up the largest share of funds held in all accounts.

As at 31 December 2016, 68 accounts of the State Treasury and other institutions were administered by the Bank of Lithuania (over the year, the number of administered accounts did not change). In 2016, the Bank of Lithuania executed 486.0 thousand credit transfer instructions of the Ministry of Finance and other institutions; their total value amounted to EUR 16.04 billion.

Payment and securities settlement systems

Encouraging sound and efficient operation of payment and securities settlement systems, the Bank of Lithuania provided settlement services to payment service providers, assessed SEPA-MMS against international principles, and started preparations for the transformation of the central securities depository (CSD) in Lithuania. Aiming at an effective and competitive payments market, the Bank of Lithuania publicly put forward a proposal for the National Payments Strategy as well as determined the composition of the basic payment services basket and set its price cap.

Payment systems

The Bank of Lithuania provides settlement services to payment service providers. Together with other Eurosystem central banks, the Bank of Lithuania manages TARGET2, a real time system for settlements in euro. The Bank of Lithuania is responsible for a component of this system – the payment system TARGET2-LIETUVOS BANKAS. The Bank of Lithuania also manages the retail payment system SEPA-MMS.

SEPA-MMS, the Bank of Lithuania's retail payment system, is intended for executing SEPA payments in real time and at a designated time. It began operating on 8 December 2015 and is linked with another payment system in line with SEPA requirements – STEP2, to which it transfers and from which it receives payments several times per day at a designated time. STEP2 is used by Lithuanian banks and foreign bank branches that are part of international banking groups. Through this system, SEPA payments reach payee accounts across the entire SEPA area.[25]

Payment and electronic money institutions may also execute payments via SEPA-MMS if they use the system through direct system participants. On 31 December 2016, SEPA-MMS had 12 participants. In 2016, almost 0.3 million payments, the value of which totalled EUR 4.3 billion, were executed between SEPA-MMS participants. SEPA-MMS participants sent to STEP2 5.4 million payments with the value of EUR 14.7 billion; 3.4 million payments, amounting to EUR 11.5 billion, were received from STEP2.

TARGET2-LIETUVOS BANKAS is used to carry out key central bank functions. Eurosystem monetary policy transactions as well as cash transactions between the Bank and Lithuania and credit institutions are settled in the system. The system is also used for executing urgent payment orders of bank clients and for transfers of funds when performing settlements of securities transactions in the securities settlement system.

[25] *The Single Euro Payments Area, known as SEPA, encompasses 34 European countries – the EEA countries, the Principality of Monaco, Switzerland and San Marino.*

Table 2. TARGET2-LIETUVOS BANKAS participants and transactions

Year	End-of-period number of participants	Number of transactions			Value of transactions, EUR millions		
		Domestic payments	Cross-border payments sent	Cross-border payments received	Domestic payments	Cross-border payments sent	Cross-border payments received
2015	**14**	21,304	54,516	149,275	145,906	134,647	135,115
2016	**14**	29,241	34,140	165,463	44,826	90,259	86,427

Source: Bank of Lithuania calculations.

Oversight of payment and securities settlement systems

Seeking sound and efficient operation of payment and securities settlement systems, the Bank of Lithuania conducts oversight of these systems. In 2016, the assessment of the compliance of SEPA-MMS to the CPSS-IOSCO principles for financial market infrastructures was carried out. No inconsistencies that could significantly affect system operation were identified.

The Bank of Lithuania, together with the central banks of Estonia and Latvia as well as supervisory authorities, entered the preparation stage for the authorisation of the new central securities depository (CSD). Taking into account the provisions of the Regulation on CSDs[26], the Nasdaq group decided to establish one CSD for the three Baltic States, setting up its head office in Latvia and branches in Estonia and Lithuania. Based on the CSD transformation plan, Nasdaq CSD is to be authorised in 2017. In 2016, the Bank of Lithuania, together with the central banks of Estonia and Latvia, began the assessment of the future CSD against the principles for financial market infrastructures. The results of the assessment will help the Bank of Lithuania – the supervisory institution – form its opinion on the authorisation of Nasdaq CSD and make a decision on the registration of the securities settlement system managed by it.

Setting of the price and composition of the basic payment account service

Lithuanian residents are ensured the right to use the basic payment account service and thus the possibility to use the basic payment services for a reasonable price. On 1 February 2017, as the amended Law on Payments came into force, the provisions of the Payment Accounts Directive[27] were implemented. Banks and credit unions have the obligation to offer basic payment services for no more than a set price cap.

Fulfilling the obligations established in the Law on Payments, the Bank of Lithuania determined the composition of the basic payment account service (the payment services basket) and set a price cap. Having assessed the requirements set forth in the Law, analysed user payment habits and taking into account the views expressed during the public consultation with market participants, which was carried out in August 2016, the Bank of Lithuania determined the composition of the basic payment account service. In line with an approved methodology, it also set the maximum fee for

[26] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012.

[27] Directive 2014/92/EU of the European Parliament and of the Council of 23 July 2014 on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features.

this service – EUR 1.5 per month. For low-income residents who receive financial social aid, the fee for the basic payment account service cannot exceed EUR 0.75 per month. Such fees will stand until the end of 2017. The Bank of Lithuania will review the price cap each year considering the changes in average consumption expenses per capita.

The legalisation of the basic payment account service was accompanied by the changes in the usual banks' pricing. The previous pricing for payment services, when a fee was charged for each transfer, crediting of funds or other payment services, was changed into one that is based on a fixed monthly fee for a payment services basket. Such pricing is more convenient when encouraging the public to execute more cashless payments. Banks started offering various payment services baskets which are different than the basic payment account service, for example, they include more transfers, a larger amount for cash withdrawal, a credit card.

National Payments Strategy

The draft National Payments Strategy, prepared and publicly announced by the Bank of Lithuania in 2016, was met with a strong response by market participants and other interested parties. The draft Strategy aims at tackling issues related to lack of competition in the payments market, slow implementation of innovations, insufficient user engagement and cash usage habits. During the public consultation on the draft National Payments Strategy, the majority of participants generally agreed with the strategic directions and measures proposed by the Bank of Lithuania and provided useful insights. The results of the public consultation are presented in the Review, published at the end of 2016. The Bank of Lithuania also made available all the comments received after the public consultation whose authors had not objected the publication.

Many institutions will have to contribute to the implementation of the measures proposed in the National Payments Strategy. Measures within the competence of the Bank of Lithuania were included in its strategic plan for 2017–2020. Other measures, which are mainly within the competence of the Government and other institutions, will be presented to respective institutions, proposing to implement them. The Bank of Lithuania will also propose draft legal acts, contributing to the implementation of some measures, such as establishment of a payments council.

Currency management

On 31 December 2016, compared to 31 December 2015, the total value of euro banknotes and coins issued into circulation by the Bank of Lithuania increased by 20.5 per cent and amounted to EUR 2,604.3 million. In 2016, the total value of litas banknotes and coins in circulation decreased by 8.4 per cent – to LTL 473.4 million. Over the year, the Bank of Lithuania issued into circulation three collector euro coins and one commemorative euro coin. The Project on the Reform of Cash Circulation continued in 2016 and is projected to end in 2017.

Reform of cash circulation

Seeking to implement a more practical and efficient cash supply system, the Project on the Reform of Cash Circulation continued in 2016. On 1 July 2016, a new procedure for the operation of the Bank of Lithuania cash offices came into force (minimum packages of issued and accepted euro were increased, bank opening hours were shortened, a fee was set for the service of accepting unpackaged euro coins and packaging them into rolls at the Bank of Lithuania). The new system aims at delegating part of cash management functions to cash handlers so that the majority of cash would be transferred to the Bank of Lithuania only when there is a surplus or when it is unfit for recirculation. This allows optimising cash management processes, reducing cash management and transport costs as well as costs related to cash cycle management incurred by the Bank of Lithuania.

The Project increases the efficiency of Bank of Lithuania cash handling and storage processes – on 1 July 2016, the organisational structure of the Bank of Lithuania unit in charge of currency management and storage was changed (the number of staff positions decreased from 71 to 54).

Currency issue and withdrawal

From the day of the adoption of the euro in the Republic of Lithuania until 31 December 2016, the total value of currency issued into circulation by the Bank of Lithuania, including numismatic items, was EUR 2,604.3 million. On 31 December 2016, year on year, the total value of euro banknotes and coins issued into circulation by the Bank of Lithuania increased by EUR 443.5 million, or 20.5 per cent.

Table 3. Net currency issue
(EUR millions)

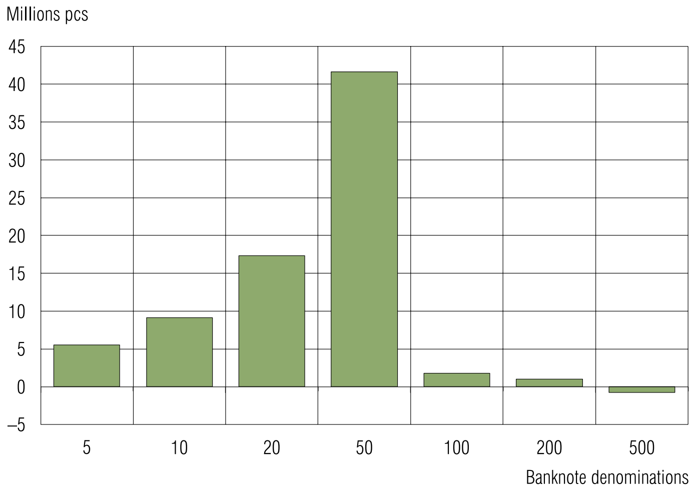
Year	Quarter				Total
	I	II	III	IV	
2015	1,618.9	204.1	133.2	204.5	2,160.7
2016	43.6	149.8	90.0	160.2	2,604.3

Source: Bank of Lithuania.

As at 31 December 2016, the volume of euro banknotes and circulation euro coins issued by the Bank of Lithuania totalled 75.6 and 246.1 million pcs respectively. The most popular were €20 and €50 banknotes (17.4 and 41.6 million pcs respectively) and circulation €1 and €2 coins (67.6 and 55.4 million pcs respectively). Over the year, the total amount of euro banknotes, issued by the Bank of Lithuania, in circulation increased by 15.7 million pcs, circulation euro coins – 68.1 million pcs.

Chart 23. Euro banknotes issued into circulation by the Bank of Lithuania

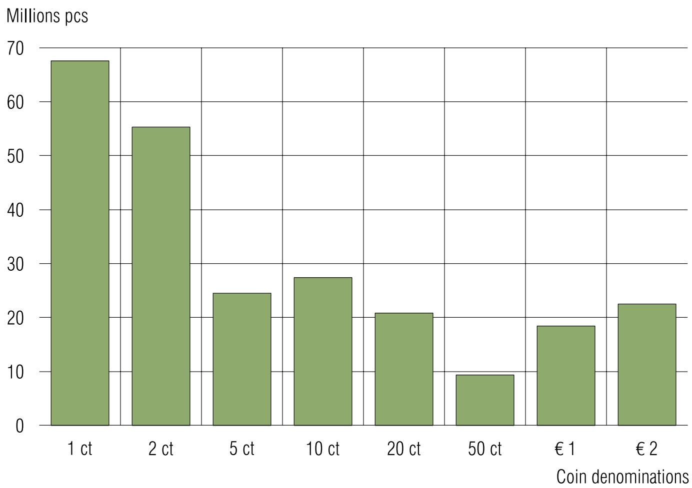
(according to data as at 31 December 2016)



Source: Bank of Lithuania.

Chart 24. Circulation euro coins issued into circulation by the Bank of Lithuania

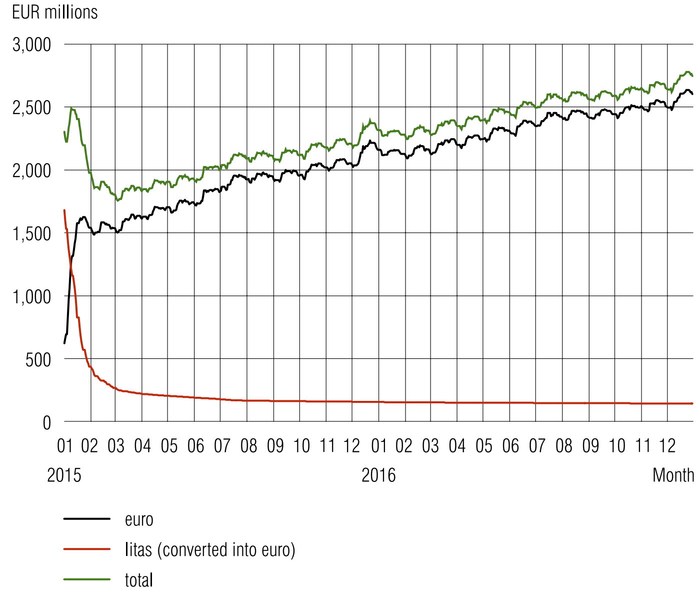
(according to data as at 31 December 2016)



Source: Bank of Lithuania.

As at 31 December 2016, the volume of litas banknotes in circulation amounted to 11.1 million pcs, circulation litas coins – 849.4 million pcs; their total value reached EUR 137.1 million (LTL 473.4 million). In 2016, the value of litas banknotes in circulation and circulation coins decreased by EUR 12.6 million (LTL 43.3 million), or 8.4 per cent.

Chart 25. Currency issued into circulation by the Bank of Lithuania



Source: Bank of Lithuania.

In 2016, the volume of euro banknotes, litas banknotes and circulation litas coins unfit for circulation destroyed at the Bank of Lithuania amounted to 25.7, 0.4 and 71.4 million pcs respectively.

Pursuant to EU and Bank of Lithuania legal acts and seeking to ensure the quality of euro cash in circulation, six cash handlers (four banks and two companies providing cash-in-transit services) were inspected in 2016. During the investigation, it was verified whether cash handlers are following the set requirements for cash authenticity and fitness checking and their recirculation.

Collector and commemorative coins

In 2016, the Bank of Lithuania issued into circulation three collector euro coins, two of which were minted in silver (Ag 925), one – in gold (Au 999). It also issued the €2 commemorative coin with Lithuanian national side. All coins were minted at the Lithuanian Mint. For more details, see the Annex.

Counterfeit banknotes and coins

In 2016, 1,663 counterfeit euro banknotes were found in Lithuania (150 banknotes less than in 2015). The majority of counterfeit notes were €50 banknotes. Counterfeits are easily recognised applying the 'feel-look-tilt' method as well as comparing them to genuine banknotes. The €50 banknotes from the Europa series, issued into circulation on 4 April 2017, have even more security features.

In 2016, 66 counterfeit euro coins were found in Lithuania. Nine counterfeit litas banknotes were found during the same period.

Financial market supervision

Supervisory trends

The Bank of Lithuania is responsible for the supervision of the entire financial market. It currently supervises more than 450 financial market participants and aims to ensure reliable and effective functioning of the financial market as well as its sustainable development, responsible behaviour of market participants and rational decision-making by consumers. Legal acts were prepared in 2016, on the basis of which credit union reform will be pushed through, significant attention was devoted to the implementation of measures aimed at easing the financial burden and creating favourable conditions for attracting new market participants. Consumer credit supervision continued to be a major focus of attention.

The Bank of Lithuania is currently actively trying to attract new market participants. New and sustainable market participants are desirable, as their market entry increases competition in the field of financial services and provides preconditions for greater diversity, higher quality, and lower prices of services. The arrival of financial technology as well as other companies to Lithuania confirms that conditions for launching business in our country are favourable, with a flexible institutional attitude, proper regulatory environment, and favourable technical infrastructure in place. Nonetheless the Bank of Lithuania's primary objective is to further ensure that the domestic financial system is stable and no representatives of unsustainable and criminal business enter it.

A number of measures to ease the administrative burden on financial market participants were implemented in 2016: part of information, collected on a periodical basis, was renounced; some reports were combined or abandoned in order to help businesses avoid the burden of double reporting; information which is already being accumulated in the state registers began to be used; excess requirements for small market participants to have certain management bodies in place were abandoned. Seeking to create an advanced, attractive and competitive regulatory and supervisory environment in the financial sector, in 2017 it is planned to assess the attractiveness of the Lithuanian financial sector's legal environment and improve national regulation so that excess barriers for market entry and operation therein are lifted; measures to ease the administrative burden will be further implemented.

The Bank of Lithuania, as the supervisory authority of the financial sector, actively implemented the National Plan for the Mitigation of the Risk of Money Laundering and Terrorist Financing for 2016–2018: it conducts ongoing supervision of financial market participants with regard to proper implementation of measures for the prevention of money laundering and terrorist financing, carried out some important investigations in the field of the prevention of money laundering and terrorist financing. To enhance supervision in this field, the importance of information technology security is emphasised. In 2016, issues of commercial banks' cyber security were analysed: a survey of the control measures applicable by banks to manage cyber risk was conducted; testing of cyber risk is also taking place, to be completed at the end of the first half of 2017.

In the field of financial services supervision, significant attention was devoted to consumer credit in order to protect consumer credit borrowers. Active supervision of creditors (32 investigations into the assessment of the creditworthiness of borrowers were conducted, 25 enforcement measures were applied), tighter requirements of the Republic of Lithuania Law on Consumer Credit, which came into force at the beginning of 2016, and competition led to significant market changes – consumer credits granted dropped by more than two times over 2016, year on year. Changes in the credit market related to real estate are also pending. The Seimas of the Republic of Lithuania passed the Republic of Lithuania Law on Credit Relating to Immovable Property, to come into force on 1 July 2017, whereby Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property has been transposed into national law. The Law enacts the list of mandatory conditions for credit agreements, standardises the disclosure of the structure of interest rates and their change to the consumer, prohibits pairing practices (practices preventing from signing a credit agreement without purchasing other products that are virtually unnecessary for the consumer (e.g. life assurance, investment products, payment services, etc.)).

Financial market participants and their supervision

Banks

Since 2015, supervision of banks in Lithuania has been carried out jointly with the ECB Single Supervisory Mechanism, which is responsible for direct supervision of three largest banks; however, Bank of Lithuania experts work as members of joint supervisory teams. Following an annual supervisory review and evaluation process, banks have been set new capital requirements, which will be effective until a new process is carried out in 2017. 2016 was profitable for the sector, capital was sustainable, and the liquidity level was high. Asset growth was driven mainly by an increase in the net value of the customer loan portfolio, growth in liabilities – by deposits. In 2016, consolidation within the banking sector was observed; however, with a possibility to establish a specialised bank, new financial market participants are taking an interest.

Banking supervision

Banking supervision in Lithuania is carried out jointly with the ECB adhering to common principles. The supervision of banks operating in Lithuania is part of the euro area Single Supervisory Mechanism. The ECB is responsible for direct supervision of the three largest banks in Lithuania; other market participants are supervised according to the supervisory standards of the ECB, applicable in proportion to the size of and the risk assumed by the market participant.

New capital requirements for banks were set during the annual supervisory review and evaluation process (SREP). Capital requirements for banks were revised in 2016; the Bank of Lithuania revises them during the SREP on an annual basis. These requirements include the minimum capital adequacy ratio (Pillar I) requirement, amounting to 8 per cent, and the Pillar II additional capital requirement, which is set on an individual basis taking into account the risks inherent in banks and the combined capital buffer requirement.[28] The total capital requirement of 12.9 per cent was set for *AB Šiaulių bankas*, 13.9 per cent for *UAB Medicinos bankas*, and 14.5 per cent for *AB Citadele bankas*. Similar capital requirements are also set for banks falling under the direct supervision of the ECB; however, by its decision, they are not published. According to the supervisory

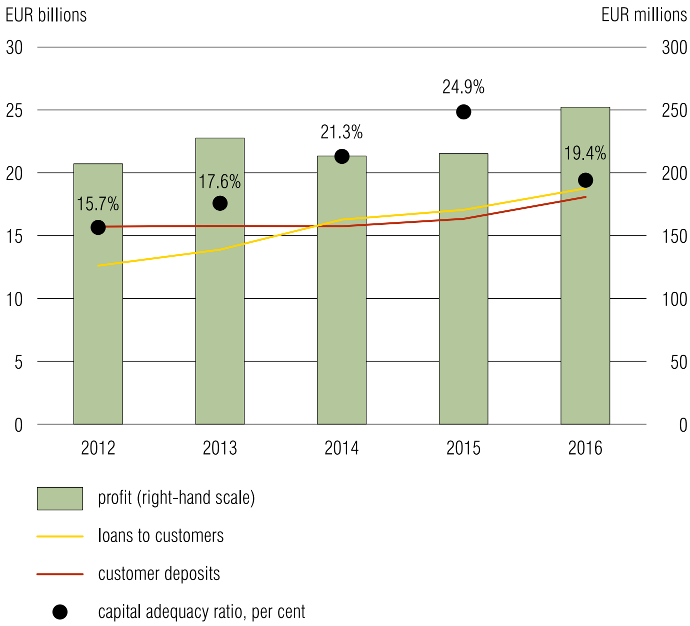
[28] *As of 31 December 2016, banks were subject to the following capital buffer requirements: the capital conservation requirement (2.5%), the countercyclical capital buffer (0%), and the capital buffer of other systemically important institutions (for* AB Šiaulių bankas *– 0.5%, for the three largest banks – 2.0%).*

reports, all banks operating in Lithuania complied with the established requirements. It should be noted, however, that the issue of capital strengthening remains relevant for some banks operating in Lithuania.

Activities of the banking sector

Banking sector consolidation is being observed; however, new opportunities for the establishment of specialised banks open up in 2017. In 2016, 6 banks and 8 foreign bank branches[29] operated in Lithuania; they did not change in number over the year, but consolidation processes were observed within the sector. In June 2016, *Swedbank, AB* took over the retail customer portfolio of *Danske Bank A/S* Lithuania branch; in August, *DNB ASA* and *Nordea Bank AB* announced their intention to combine forces and establish a common bank in the Baltic countries. Amendments to the Law on Banks came into force in 2017; they provide for the establishment of a specialised bank under simplified conditions. Such a bank would be subject to the minimum authorised capital requirement (EUR 1 million); it would not be able to provide investment services, but would be subject to all other supervisory requirements applicable to banks.

Chart 26. Key performance indicators of the banking system



Source: Bank of Lithuania.

The largest contribution to the developments in the balance sheets of banks stemmed from growth in lending and the amount of deposits. Bank assets amounted to EUR 25.8 billion in 2016, a year-on-year increase of 9.9 per cent. Asset growth was mainly driven by an increase in the net value of the loan portfolio, which grew by 10.6 per cent over the year, to EUR 18.1 billion. Both household and corporate loan portfolios posted growth in net value. The value of the household loan portfolio was driven mainly by loans for house purchase, of the corporate loan portfolio – by individual large corporate loans. It seems that the credit market, including housing loans, has been so far rapidly expanding; hence, it needs to be further monitored. The banks' loan portfolio quality continues to improve: the share of non-performing debt instruments contracted

[29] *Supervisory financial reporting was carried out by 7 foreign bank branches in 2016, as Telia Finance Lietuva,* Telia Finance AB *Lithuania branch, is not yet in operation.*

by 1.7 p.p. over the year, to 3.8 per cent of the banks' loan portfolio. According to data for Q3 2016, the ratio of non-performing debt instruments, calculated by the European Banking Authority, was 4.7 per cent in the EU. Bank liabilities amounted to EUR 23.5 billion at the end of 2016, an increase of 12.9 per cent. The main driver behind this change was customer deposits, which accounted for 80 per cent of banks' total liabilities. Deposits within the banking sector continue to grow despite low interest rates; the amount of customer deposits rose by 10.0 per cent over the year, to EUR 18.8 billion.

In 2016, the operations of the banking sector were profitable – according to unaudited data, EUR 252 million were earned in profits, an increase of 17.1 per cent over the year. Most banks (10) operated at a profit, whereas 3 banks operated at a loss. Profit growth was driven mainly by net interest income; a decrease in deposit insurance costs due to a lower deposit insurance fee as well as new loans contributed to net interest income growth. The trend in the development of net income from services and commissions was favourable as well. In 2016 administrative expenses of banks rose for the first time after a lengthy period of time. In addition to these factors, one-off factors should also be mentioned, with their aggregate contribution to bank profits amounting to EUR –17 million. According to the information provided to the Bank of Lithuania, 3 banks will pay dividends for 2016. So far, this was publicly announced by *AB SEB bankas* and *AB Šiaulių bankas*, which allocated EUR 123.1 million and EUR 1.9 million to dividends respectively. The decisions of other banks should be made public by 1 May 2017 together with publishable annual financial reporting approved by their shareholders.

The banking sector is well-capitalised and its liquidity level is high. The general quality of the banking sector's capital was good, the total capital adequacy ratio stood at 19.4 per cent as at 31 December 2016. The ratio decreased by 5.5 p.p. over the year; however, this was not due to the deteriorating situation of banks' capitalisation in general, but the dividends paid out by *Swedbank, AB* at the beginning of 2016. The largest banks' capital was stable, but some smaller market participants were encouraged to strengthen their capital. The capital adequacy ratio of *UAB Medicinos bankas* is the lowest in the banking sector and, in view of the established requirements, strengthening of capital continues to be relevant for this market participant. The liquidity level of banks continued to be high, the liquid asset reserves – sufficient. The liquidity coverage ratio of the banking system was 266 per cent (the ratio is 100%).

For more information on banking sector activities in 2016, see the Banking Activity Review.

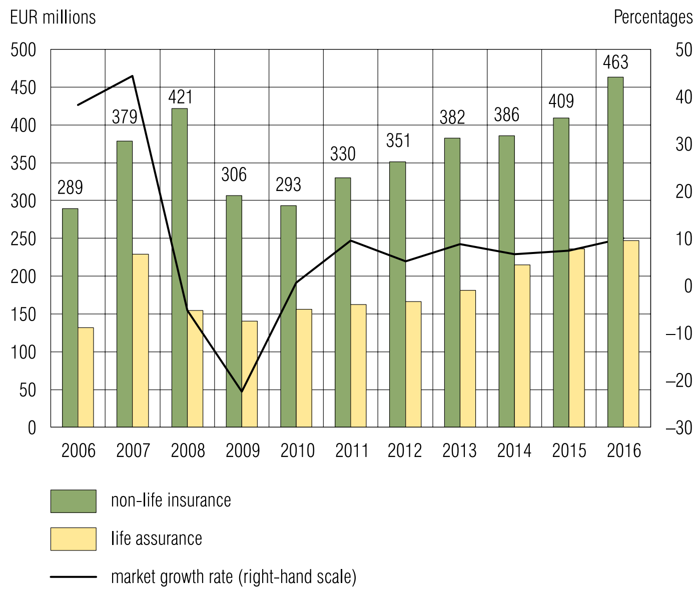
Insurance market

2016 was a year of change for insurance undertakings: it was the first year when undertakings were subject to the risk assessment-based requirements of Solvency II Directive for the activities and supervision of insurance undertakings, and the International Accounting Standards (IAS) were applied instead of the Business Accounting Standards (BAS). In 2016, insurance premiums, insurance undertaking assets and investment grew in volume. The volumes of both non-life insurance and life assurance branches were the largest over the last decade. The entire insurance market operated profitably, but the insurance results of the two branches diverged: life assurance undertakings ended the year at a profit, while non-life insurance undertakings bore losses. All insurance undertakings complied with the solvency margin requirements.

As at 31 December 2016, 20 insurers[30] provided insurance services in Lithuania, of which 9 are insurance undertakings registered in Lithuania (hereinafter 'insurance undertakings'), while 11 are branches of insurance undertakings established in other EU countries, and 97 – insurance brokerage firms. In 2016, insurance premiums rose to EUR 709.8 million – the market grew stronger by one-tenth over the year. In the reporting period, both branches of insurance posted growth: the non-life insurance branch grew by 13.2 per cent (to EUR 463.1 million), life assurance – by 4.6 per cent (to EUR 246.7 million).

The Bank of Lithuania projects a positive contribution of the expansion of the domestic economy to non-life insurance market growth in 2017 and, while the rate of expansion will decelerate somewhat, it is likely to be 10–12 per cent. The projections for the life assurance market are the opposite: changes in the regulatory and taxation environment and persisting low interest rate environment may lead to a negative rate of growth in 2017. Lithuania's market is projected to grow by 6–7 per cent.

Chart 27. Dynamics of insurance premiums written



During the first three quarters of 2016, insurance market growth was supported by the non-life insurance sector, while, at the end of the year, life assurance volumes expanded as well, in line with the trend that prevailed for a number of years. In December, insurance policy holders paid a record large amount – EUR 54.2 million – in life assurance premiums, while in 2016 the average monthly amount of premiums (except in December) stood at EUR 17.5 million. Such growth was driven by an increase in single premiums[31]. Another contribution to volume growth stemmed from an increase of over 50 per cent in the number of concluded insurance contracts in December, as compared to the monthly average amount of contracts (except in December).

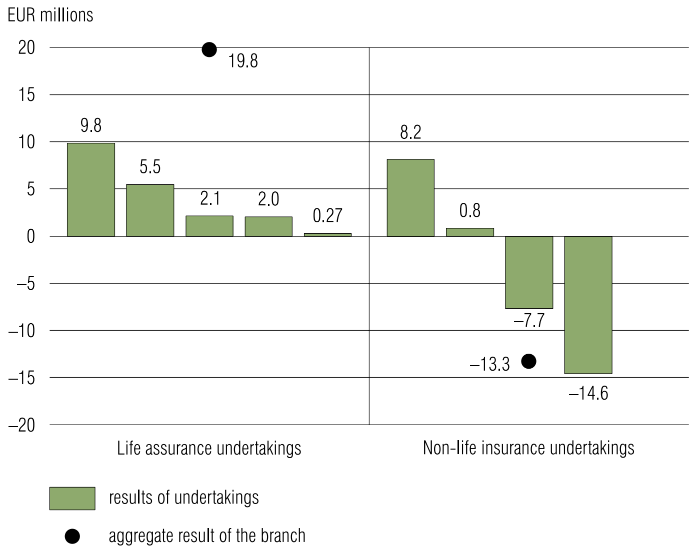
[30] The assessment of insurance market developments in this Report is based on the assessment of the activities of all market participants (9 insurance undertakings and 11 branches of insurance undertakings registered in other EU countries) carried out in Lithuania. The assessment of compliance with the financial and capital ratios only covers the activities of insurance undertakings and insurance brokerage firms (97) registered in the country.

[31] Single premiums are premiums that are paid with a periodicity not established in the insurance contract and additional premiums payable under insurance contracts.

Non-life insurance sector premium volumes were the largest in the last decade, expanding by 13.2 per cent in 2016. Market growth was mainly due to the expansion in the volumes of the prevalent vehicle, property, and medical expenses insurance types. The rising average prices of motor third party liability and Casco insurance contracts, and larger sales of new cars determined an expansion of the vehicle insurance market of 16 per cent.

According to data as at 31 December 2016, insurance undertakings earned EUR 6.5 million in profits; however, the results of insurance branches diverged: life assurance undertakings earned EUR 19.8 million in profits, while non-life insurance undertakings suffered EUR 13.3 million in losses. Last year was a success for all life assurance undertakings, while 2 out of 4 non-life insurance undertakings operated at a loss, leading to the overall loss for non-life insurance undertakings. The operating loss of the latter is related to reorganisation or restructuring processes that took place in the reporting period.

Chart 28. Operating performance of insurance undertakings as at 31 December 2016



Both assets and investment of insurance undertakings were growing. Assets managed by insurance undertakings amounted to EUR 1,399 billion as of 31 December 2016, an increase of 18.7 per cent over the year. The surge in the assets amount should be associated with the end of the reorganisation process in one insurance undertaking, whereby the insurance undertaking operating in Lithuania carried out a merger with an undertaking which operated in one of the Baltic countries. The share of undertaking investments (together with cash on settlement accounts, excluding the funds of unit-linked life assurance) remained unchanged during the reporting period, at 52.3 per cent of total assets of insurance undertakings.

Insurance undertakings' own capital increased by 20.7 per cent over 2016, to EUR 280 million. The own capital of life assurance undertakings grew by 11.2 per cent on account of their profitable operations (to EUR129 million), of non-life insurance undertakings due to the strengthening of their capital base – by 30.2 per cent (to EUR 151 million). The shareholders of two non-life insurance undertakings, in pursuit of financial stability for these undertakings, increased their authorised capital by more than EUR 36.3 million in 2016. As of 31 December 2016, the authorised capital of all undertakings amounted to EUR 91.5 million, an increase of 66 per cent from the end of last year.

All insurance undertakings complied with the solvency margin requirements. After calculating the capital requirement and evaluating the amount of available own funds according to Solvency II requirements, all insurance undertakings held sufficient own funds to satisfy higher capital requirements. According to the reported data as of 31 December 2016, the solvency ratio[32] of non-life insurance undertakings was 1.7, of life assurance undertakings – 2.2.

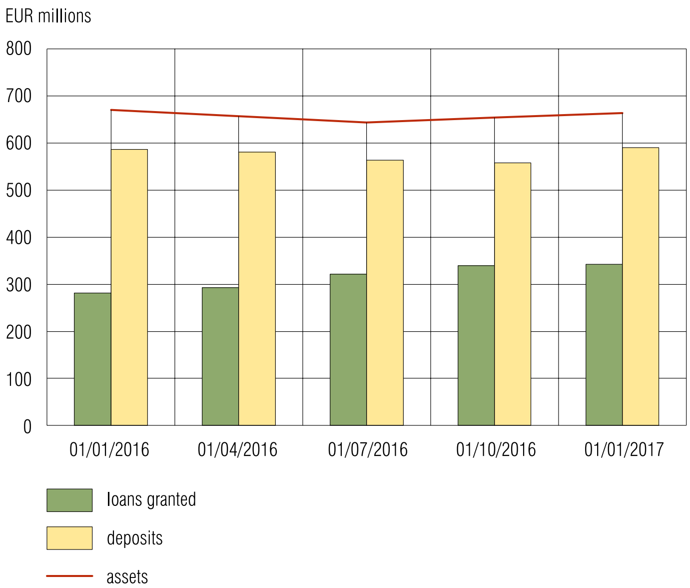
In the reporting period, the operations of 74 insurance brokerage firms were profitable – firms providing mediation services earned profits amounting to EUR 4.3 million. This is the largest profit earned over the last three years. Insurance brokerage firms acted as intermediaries in concluding 1.7 million insurance contracts – an increase of almost 14.8 per cent from the previous year. As many as 99.8 per cent of insurance contracts concluded via insurance brokerage firms were non-life insurance contracts. 29.5 per cent of total contracts concluded within the non-life insurance market were concluded this way. In 2016, insurance brokerage firms collected 18.9 per cent more insurance premiums than in 2015.

More information on the insurance market is available here.

Credit unions

As of 1 January 2017, 73 credit unions operated in Lithuania, with a total membership of 163.1 thousand. The main share of credit union assets consisted of loans, while their major funding source is accepted deposits. 2016 was a loss-bearing year for this sector.

Chart 29. Performance indicators of credit unions



Source: Bank of Lithuania calculations.

[32] *The solvency ratio was calculated as the ratio between the total sum of own funds eligible for covering the solvency capital requirement and the amount of the solvency capital requirement.*

According to data as at 1 January 2017, the assets of credit unions amounted to EUR 663.9 million[33], or 2.6 per cent of the total assets of the banking system. The sector's assets contracted by almost EUR 6.6 million over the year, such a change being driven by the withdrawal of AMBER credit union from the market.

Loans represented the largest share (51.5%) of credit union assets. The portfolio of granted loans expanded by a fifth in 2016, to EUR 342.2 million at the end of the year. The annual loan portfolio expanded due to more active crediting of natural persons, which also contributed quite significantly to certain changes in the composition of loans from this sector.

Credit union investment in securities decreased significantly – by almost two-thirds – over the year. It accounted for about 10 per cent of credit union assets at the end of the year. Reducing credit union securities portfolios and changing their composition by maturity is required by the provisions of the Regulations on Credit Union Investment in Non-Equity Securities.

Accepted deposits is the major funding source for credit unions. The bulk of them – as much as 97 per cent – consists of funds accumulated by natural persons. Irrespective of interest rate developments, residents choose deposits as an instrument for secure saving.

According to unaudited data, in 2016 the credit union sector bore almost EUR 39 thousand in losses (in 2015, the audited loss amounted to EUR 3.6 million). 48 credit unions operated profitably, 25 – at a loss; however, these results may change once the asset quality review process is completed.

With growth in credit union membership, the share capital increased as well. At the end of the year, it stood at EUR 58.3 million; however, only slightly more than 10 per cent of it was in compliance with the capital adequacy requirements. According to reported data, at the end of 2016 the capital adequacy ratio of the system of credit unions was 17.48 per cent, the liquidity ratio – 53.79 per cent.

More information on the activities of the sector of credit unions is presented in the Review of the Activities of Credit Unions.

The LCCU united 61 credit unions. As deposits grew, its assets stood at EUR 159.7 million at the end of 2016. The bulk of LCCU assets (60%) consisted of investment in debt securities; the funds of the LCCU held in an account with the Bank of Lithuania – 28 per cent, the loan portfolio – 10 per cent of the assets. According to unaudited data, the operating result of the LCCU was a profit of EUR 0.6 million.

For more information on the activities of the LCCU, see the Review of the Lithuanian Central Credit Union.

Credit union sector reform continues to be pushed through, its aim being encouragement of sustainable development of credit unions, financing of small and medium-sized business. The new Law on Credit Unions and the Law on Central Credit Unions have been approved: they repeal the provision that only one central credit union may operate in Lithuania; they also provide that, by 1 January 2018, all credit unions meeting the requirements of the laws on credit and which will decide to operate on a cooperative basis, will become members of central credit unions. Seeking to find

[33] This Review excludes the results of the credit union asset quality review conducted by the Bank of Lithuania.

out credit unions' financial position before a merger, a comprehensive, independent and standardised asset quality review (AQR) of credit unions in operation has been carried out; the obtained results are being coordinated with credit unions and will be made public in the near future. The data of credit unions which, after the asset quality review, will not comply with the set requirements or will not agree with the results of the review on a well-grounded basis, will be analysed in greater detail and individual supervisory decisions will be taken.

Other financial institutions

In 2016, the market saw interest in the possibilities for the establishment of payment institutions, electronic money institutions and in their activities. It stirred up growth in the participants of the market of payment and electronic money institutions. Management institutions, operating in accordance with the Republic of Lithuania Law on Collective Investment Undertakings Intended for Informed Investors, were actively established and sought licences.

Payment and electronic money institutions. As of 1 January 2017, 40 payment institutions and 12 electronic money institutions held licences to engage in their activities. In 2016, 3 payment institution licences and 6 electronic money institution licences were granted. Thanks to the Bank of Lithuania and other state institutions, which seek to make Lithuania an international centre for payment services and encourage development of innovative payment services in Lithuania, international financial technology companies (FinTech[34]) took a greater interest in the possibilities offered by Lithuania, which encouraged an increase in the number of payment and electronic money institution market participants. The plan is to attract even more companies providing financial services, operating on an international scale, to Lithuania in the near future, as interest in the opportunities in Lithuania, such as exclusive-in-Lithuania access to the infrastructure of the Single Euro Payments Area (SEPA) for payment and electronic money institutions, a faster licensing process, will continue to increase. Several payment institutions changed their payment institution licences into those of an electronic money institution: *AB Lietuvos paštas* expanded its business model with issuance of electronic money, providing the possibility for clients to open payment accounts, while 2 mobile network operators intend to provide to their clients the possibility to execute instant payments via mobile phone as early as this year.

As of 1 January 2017, all payment and electronic money institutions operated in compliance with legislative prudential requirements. The sectors' activities are presented in more detail in the reviews prepared by the Bank of Lithuania and are reflected in the indicators of payment and electronic money institutions.

Financial brokerage firms and management companies. As of 1 January 2017, 7 financial brokerage firms operated in Lithuania's market for financial instruments, of which 1 held an A category licence, 4 – B category licences, and 2 – C category licences of a financial brokerage firm; 10 management companies holding an authorisation and operating under the Republic of Lithuania Law on Collective Investment Undertakings and the Republic of Lithuania Law on the Supplementary Voluntary Accumulation of Pensions; 10 management companies operating under the Law of the Republic of

[34] *FinTech – new technological solutions, combining the most up-to-date information technologies and a wide range of financial services – from utility payments to lending or financing.*

Lithuania on Collective Investment Undertakings Intended for Informed Investors; and 10 investment companies.

In 2016, 1 C category financial brokerage firm licence, 4 authorisations of management companies operating under the Law of the Republic of Lithuania on Collective Investment Undertakings Intended for Informed Investors, and 6 investment company licences were granted; 1 management company extended its authorisation. The licence of 1 management company was revoked. This financial sector witnessed active changes in its shareholders.

As of 1 January 2017, all financial brokerage firms and management companies operated in compliance with legislative supervisory and capital adequacy requirements.

The sectors' activities are presented in more detail in the reviews prepared by the Bank of Lithuania and are reflected in the indicators of financial brokerage firms and management companies.

Financial services and markets, their supervision

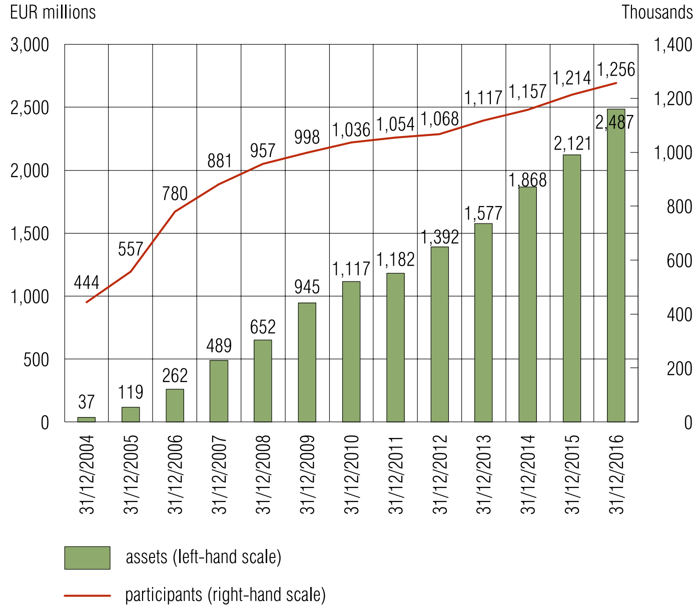
In 2016, the assets and membership of 2nd and 3rd pillar pension funds posted an increase. The unit value of 2nd pillar pension funds grew by an average 4.4 per cent, of 3rd pillar pension funds – by 4.9 per cent. Meanwhile the amount of credit (both more and less than EUR 290) granted by consumer credit providers (other than credit institutions) in 2016 halved compared to 2015. The secondary market trends are not to be viewed straightforwardly – OMX Vilnius Index increased by almost 15 per cent over the year; however, the total turnover of AB NASDAQ Vilnius *decreased by a third over the same period.*

Pension funds

At the end of last year, 21 2nd pillar and 12 3rd pillar pension funds operated in Lithuania, with 1.3 million participants accumulating their pension in them: the assets and membership of both types of pension funds grew in 2016.

At the end of 2016, 5 pension accumulation companies – 4 management companies and 1 life assurance undertaking – managed 21 2nd pillar pension funds. In 2016, the assets managed by 2nd pillar pension funds grew by EUR 366.32 million (17.27%), to EUR 2,487.16 million at the end of December. The membership of 2nd pillar pension funds rose by 3.48 per cent, to 1,256.0 thousand.

Chart 30. Dynamics of the membership and assets of 2nd pillar pension funds



The unit value of 2nd pillar pension funds grew by an average 4.4 per cent in 2016. The unit value of conservative investment pension funds posted the smallest gain (an average of 0.8%). Other funds, with at least some equity exposure, recorded higher increases in unit values: the unit values of small equity share pension funds rose by an average 2.5 per cent, medium equity share pension funds – 4.7 per cent, equity pension funds – 9.1 per cent.

Supplementary voluntary pension accumulation funds (12) operating in Lithuania are managed by 4 management companies. In 2016, assets managed by 3rd pillar pension funds expanded by EUR 17.96 million (29.18%), to EUR 79.50 million at the end of December. The membership of participants accumulating their pension in 3rd pillar pension funds increased by 9.02 per cent over 12 months, to nearly 52 thousand. For 3rd pillar pension funds, 2016 was successful: the unit value of the funds rose by an average 4.9 per cent. The unit values of pension funds exposed to the highest risk, indicating in their rules the possibility of investment in equity of up to 100 per cent, posted the largest increases – of an average 7.7 per cent. The rise in the unit values of mixed investment pension funds was less pronounced – 3.6 per cent, of bond pension funds – 2.5 per cent.

More information on the activities of pension funds is available in the latest Review of Lithuania's 2nd and 3rd Pillar Pension Funds and of the Market of Collective Investment Undertakings.

Collective investment undertakings

As of 31 December 2016, 7 management companies had established 14 CIUs in Lithuania (13 investment funds and 1 investment company with variable capital). **Assets managed by CIUs and the number of participants accumulating in them have declined over the year.** The funds' assets have declined by 16.34 per cent since the beginning of the year, to EUR 189.46 million at the end of the year, while their membership has almost halved, to EUR 7.4 thousand. The main reasons behind this contraction were the investment selling of two funds of *UAB SEB investicijų valdymas* and one fund of

UAB DNB investicijų valdymas, as well as settlement with the participants.

As of 31 December 2016, 11 management companies managed 39 CIUs intended for informed investors, of which 3 had no assets and participants. The total net value of these funds more than doubled over the year, to EUR 372.1 million at the end of the year. Only professional investors or persons with the status of informed investors may invest in CIUs intended for informed investors; the smallest possible investment is EUR 125 thousand.

Considering trends in the capital market development and in pursuit of an improvement in the investment climate as well as greater attractiveness of Lithuanian jurisdiction, especially in the Baltic region, the Bank of Lithuania sees a clear need to revise the existing legal regulation of CIUs. To this end, capital market participants are being consulted and amendments to the laws regulating the activities of CIUs and their managers are under preparation.

Primary and secondary markets

The OMX Vilnius Index rose by almost 15 per cent over the year; the total turnover of *AB NASDAQ Vilnius*, however, dropped substantially over the year – from EUR 145 million to EUR 96 million.

The total turnover of *AB NASDAQ Vilnius* dropped due to a drastic decline in trading in debt securities, as in implementing the Eurosystem's easing programme transactions were conducted outside the stock exchange. The primary equity market, as before, remained passive: compared to 2015, equity issues dropped in number, but the total value of all issues was higher, amounting to EUR 31 million. The activities on the primary bond market came to a full stop: in the second half of 2016, not a single issue was placed on the market, while the annual total nominal value of issues placed was four times lower than in 2015. Bond issuance is likely to recover in 2017 on account of changing credit conditions and the amendment to the Republic of Lithuania Law on Companies entitling private limited companies to public offering of bonds.

The number of issuers subject to supervision by the Bank of Lithuania dropped from 43 to 37 over the year. At the end of 2016, the Bank of Lithuania supervised 31 issuers whose securities are traded in regulated markets and 6 issuers whose securities are not traded in regulated markets. More information on the performance of issuers is available on the Bank of Lithuania website.

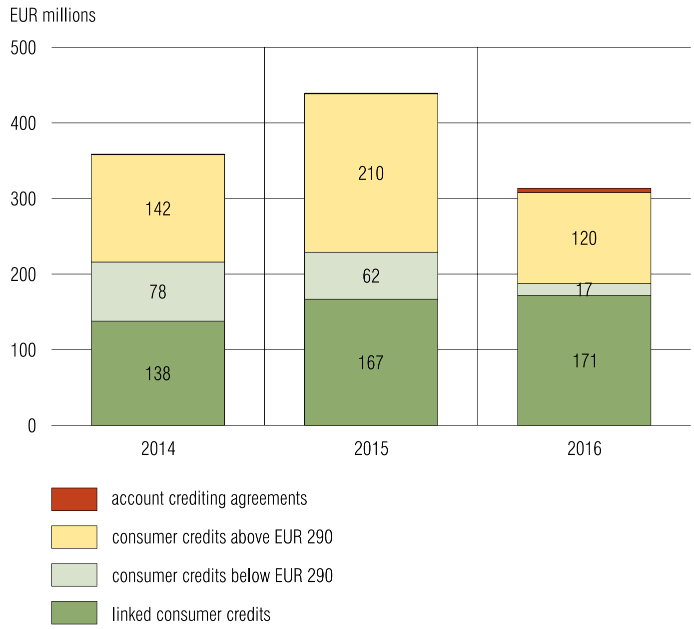
Consumer credit market

In 2016, consumer credit providers (other than credit institutions) reduced the volumes of provided credits; provision of payday loans both less and more than EUR 290 contracted in particular: the amount of credit granted (EUR 137 million) was 49.71 per cent lower than in 2015. The share of past due loans contracted as well: consumer credit borrower debt when payment was overdue for more than 90 consecutive days declined by 25.02 in number, while its amount – by 10.11 per cent in 2016.

As of 31 December 2016, the Public List of Consumer Credit Providers included 55 companies (other than credit institutions) authorised to provide consumer credits. Out of all companies on the List, 37 were actively engaged in their activities, while 3 operated as peer-to-peer lending platform operators. At the end of 2016, consumer credit providers (other than credit institutions), together with peer-to-peer lending platform operators, had granted 564.8 thousand consumer credits – a decrease of 10.11 per cent from late 2015. The amount of credits granted to consumer credit borrowers totalled EUR 387.45 million as at 31 December 2016. Compared to the end of last year, the credit portfolio expanded by 2.52 per cent.

New consumer credits granted to consumer credit borrowers fell in both number and amount: in 2016, consumer credit providers (other than credit institutions) granted two times less new credits than in 2015, while the amount of credits granted over the period fell by 28.6 per cent, mainly due to consumer credits exceeding EUR 290. They fell in number by as much as 59.3 per cent compared to 2015, while the amount of new credits extended declined by 42.8 per cent and the average amount of consumer credit was EUR 936. New small consumer credits fell in number and amount even more – by 77.2 per cent and 73.2 per cent respectively, while the average amount of consumer credit amounted to EUR 132.3. At the end of 2016, 507.6 thousand customers used the services of consumer credit providers, of which 14.6 thousand (2.9%) were individuals younger than 25.

Chart 31. Amount of new consumer credits provided



The share of past due loans contracted: the number of consumer credit borrower debt when the payment was overdue for more than 90 consecutive days decreased by 25 per cent in 2016, to 111.7 thousand at the end of the year; while their amount (including interest payments, penalties and other amounts payable under agreements) fell from EUR 80.6 million to EUR 72.4 million, or by 10.1 per cent. Defaulting on liabilities under consumer credit agreements exceeding EUR 290 and small consumer credit agreements is the most common; the credit portfolio share of credits overdue for more than 90 days accounted for 28 per cent and 45 per cent respectively at the end of the year.

Amendments to the Republic of Lithuania Law on Consumer Credit (hereinafter – LCC) came into effect on 1 February 2016, excluding the provisions of the Law regulating the List of Persons Regarding whom Requests not to Allow them to Conclude Consumer

Credit Agreements have been Submitted (which came into effect on 1 November 2016). Major amendments to the LCC, relevant to consumer credit borrowers, are the following: the total rate of charge for consumer credit has been reduced; forfeits will only be calculated for a limited time (in the event of payments overdue, they may be calculated for no more than 180 days); a cooling-off period has been set, i.e. a consumer credit borrower's right to renounce the consumer credit agreement within two days of the payment of funds under the consumer credit agreement concluded, without paying to the consumer credit provider any interest, compensation or other fees, and to return to the consumer credit provider only the amount of consumer credit it has granted; a possibility to submit a request not to allow to conclude consumer credit agreements has been provided, i.e. as of 1 November 2016, each natural person may submit a request to the Bank of Lithuania not to allow them to conclude any consumer credit agreements and to specify a period during which concluding them would not be allowed (296 persons had used this possibility at the end of the year). Moreover, the amendments to the LCC established the obligation for a consumer credit provider to refer to databases or collect from a user documentary proof to the information provided by the user in order to better assess the creditworthiness of the users.

More information on Lithuania's consumer credit market and its trends in 2016 is available in the Review of the Consumer Credit Market.

Settlement of disputes

In 2016, the Bank of Lithuania addressed 477 applications regarding claims that arose from contracts on financial services. Compared to 2015, when 474 applications regarding disputes were investigated, the number of applications remained almost unchanged in the reporting period. Most disputes (58%) arose with insurance undertakings; disputes with banks accounted for 28 per cent, other disputes (14%) were with other financial market participants.

In settling disputes, the Bank of Lithuania aims at ensuring that the parties to a dispute find a peaceful solution and reach an agreement. In 2016, in 70 cases, the parties to a dispute reached a peaceful agreement prior to taking a decision regarding the subject matter of the dispute – an increase of 29 per cent from 2015, when 50 disputes were settled peacefully.

In the reporting period, the Bank of Lithuania took more decisions regarding the subject matter of a dispute – 192 (compared to 2015, when 157 decisions were taken, their number picked up by 18%). 29 per cent of the decisions taken were in favour of consumers, i.e. consumer applications were satisfied fully or partially. Although the Bank of Lithuania decisions regarding the subject matter of a dispute are of recommendatory nature, 75 per cent of the decisions taken by the Bank of Lithuania were implemented.

The Bank of Lithuania publishes impersonal decisions regarding the subject matter of disputes addressed by the Bank of Lithuania on its website. The aim of the presented information is to introduce the public to the Bank of Lithuania's opinion regarding assessment of the circumstances ascertained during the settlement of disputes, thereby encouraging consumers to defend their rights which, in their opinion, have been violated, at the same time emphasising certain obligations of providers of financial services and users of financial services; to develop responsible and fair behaviour of providers and users of financial services; to encourage peaceful settlement of disputes; and to seek to reduce the number of potentially unreasonable disputes in the future.

Cooperation in the Eurosystem and international fora

As a member of the Eurosystem, the Bank of Lithuania mainly cooperated with the ECB and other NCBs, tackling not only issues related to euro area monetary policy but also other issues related to the functioning of the Eurosystem. In terms of international institutions, the Bank of Lithuania's cooperation with the IMF – when participating in the activities of the IMF Board of Governors, the Bank of Lithuania represents the Republic of Lithuania – and its active role in the process of Lithuania's accession to the OECD should be noted. Seeking to purposefully develop and strengthen influence in the international arena, the Bank of Lithuania approved the international cooperation policy priorities.

Participation in the Eurosystem and the European System of Central Banks

The Bank of Lithuania is a member of the Eurosystem, which consists of the ECB and NCBs of all EU Member States. On 1 January 2015, the Bank of Lithuania became a member of the Eurosystem (consisting of the ECB and euro area NCBs) and a member in the SSM. The SSM is a system of financial supervisors which currently comprises the ECB and Member States whose currency is the euro. The work of the Eurosystem and the ESCB is carried out through the participation of the representatives of the EU NCBs in the activities of the Governing Council and the General Council of the ECB, the Macroprudential Forum, the SSM Supervisory Board, as well as the ESCB committees and their working groups.

Eurosystem decisions are made at the meetings of the ECB Governing Council, where the Chair of the Board of the Bank of Lithuania participates. In 2016, 23 meetings of the ECB Governing Council took place: every six weeks (in eight meetings) decisions on euro area monetary policy were taken; during other meetings, other issues related to the functioning of the Eurosystem were discussed. The most important discussions held at the Governing Council in 2016 were related to the implementation of the expanded APP of the Eurosystem.

Governors of all EU Member State NCBs take part in the activities of the ECB General Council. The meetings of the ECB General Council are held four times a year; they generate discussion on the macroeconomic situation in the EU Member States, monetary and financial market developments. The General Council is a decision-making body of the ECB, which will be dissolved once all EU Member States have introduced the euro.

The daily work of the ESCB is underpinned by the participation of the representatives of the EU NCBs in the activities of the ESCB committees and their working groups. Representatives of the Bank of Lithuania, like other euro area Member State NCBs, participate in the activities of 17 Eurosystem and ESCB committees and their working groups – they tackle various issues related to the activities of central banks: monetary policy, market operations, accounting, financial stability, payment systems, euro banknotes, statistics, international relations, communication, etc.

The Bank of Lithuania is a member of the SSM. The SSM is the first important element of the European banking union, which aims to ensure the safety and soundness of the European banking system, as well as increase financial integration and stability in Europe. A representative from the Bank of Lithuania participates in the activities of the Supervisory Board, which usually meets twice per month. The Supervisory Board discusses various issues related to banks directly supervised by the ECB.

The Bank of Lithuania takes part in the Macroprudential Forum, comprising members of the ECB Governing Council and the SSM Supervisory Board, which operates as a platform for regular discussion on issues related to stability and resilience of the financial system and its individual participants. The Forum is held four times a year.

Participation in the activities of EU institutions and the European System of Financial Supervision

The Bank of Lithuania maintains close dialogue with the EU Economic and Financial Affairs (ECOFIN) Council and the European Commission and provides, within its competence, opinions and assessments when forming the position of the Republic of Lithuania on the issues discussed at the ECOFIN Council. The Chair of the Board of the Bank of Lithuania participates in informal ECOFIN Council meetings. The informal ECOFIN Council meetings, which took place in 2016, mainly focused on possibilities to change the current regulatory treatment of sovereign exposures, thus mitigating risk arising due to links between banks and sovereigns, as well as on strengthening of the Economic and Monetary Union on the fiscal front.

Representatives of the Bank of Lithuania participate in the activities of the Economic and Financial Committee (EFC), an advisory committee of the ECOFIN Council. The EFC meetings focused on ways of mitigating risk assumed by banks, including changes in the regulation of sovereign exposures, analysed progress on the implementation of banking union initiatives as well as negotiated positions on issues discussed at the IMF.

The Bank of Lithuania participates in the activities of the ESRB General Board and its Advisory Technical Committee. Most attention was devoted to continuous monitoring and identification of risks and threats arising in the EU financial system, as well as assessment of the impact of low interest rates on financial stability. Having identified potential threats, in autumn 2016, eight EU countries were issued warnings on vulnerabilities in their residential real estate sectors.

As the national resolution authority, the Bank of Lithuania participates in the activities of the single resolution mechanism and the Single Resolution Board, an EU-level resolution authority, thus ensuring full participation in the EU banking union, which strengthens the financial stability of the country, and in the SSM, which began functioning in autumn 2014.

In supervising the financial market, the Bank of Lithuania actively participates in the activities of the EU institutions responsible for microprudential supervision (European Banking Authority, European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA)), making decisions on issues relevant to the EU financial market and presenting the position of the Bank of Lithuania in a due manner.

International cooperation

The Chair of the Board of the Bank of Lithuania represents the Republic of Lithuania in the Board of Governors, the highest decision-making body of the IMF.

On 5–10 October 2016, the annual meetings of the IMF and the World Bank were held in Washington, during which governors of central banks and finance ministers of 189 IMF member countries aimed at consensus on coordinated actions that would mitigate new threats to global economic developments and stir economic growth.

IMF interim consultations with Lithuania under Article IV of the IMF Articles of Agreement were held on 6–12 September 2016. During the meetings with the heads and experts of the Government of the Republic of Lithuania and the Bank of Lithuania, representatives from the IMF discussed relevant issues related to the Lithuanian economy and key points of the upcoming 2017 Spring mission.

On 10 February 2016, the quota of the Republic of Lithuania was increased from 183.9 to 441.6 SDR; its voting power increased from 0.102 to 0.117 of total IMF votes respectively.

On 5 July 2016, Christine Lagarde, Managing Director of the IMF, was selected for a second five-year term.

In 2016, the Bank of Lithuania played an active role in the process of Lithuania's accession to the OECD. With the OECD assessing the compliance of Lithuania's legal regulation of policy and economics with OECD requirements, the Bank of Lithuania cooperated with the Financial Markets Committee, the Insurance and Private Pensions Committee, the Investment Committee, the Statistics Committee, and the Economic and Development Review Committee.

Seeking to purposefully develop and strengthen influence in the international arena, the Bank of Lithuania approved the international cooperation policy priorities. The Bank of Lithuania will not only strengthen institutional relations taking into account the links between Lithuania's economic and financial sectors, but also actively participate in spreading best practice and European values in Eastern Partnership countries.

III. ORGANISATION OF THE ACTIVITIES OF THE BANK OF LITHUANIA

In 2016, the top priority of the human resources management policy of the Bank of Lithuania continued to be development of performance efficiency following the highest standards and best practices, providing training and encouraging professional development, analysing processes as well as developing an attractive and healthy social environment and safe working conditions.

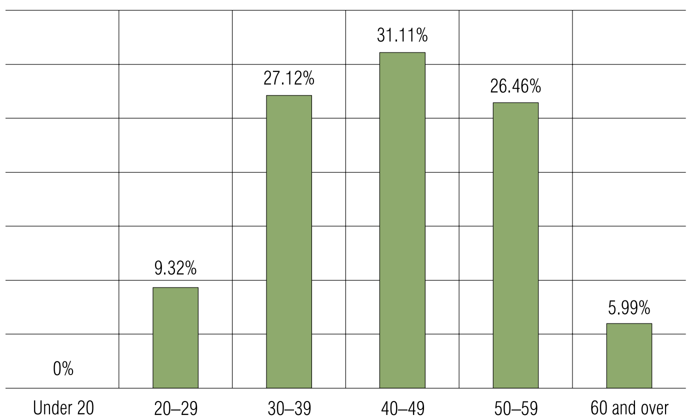
Staff

The Bank of Lithuania staff selection and employment policy aims at recruiting specialists holding relevant qualification, academic degrees as well as having analytical knowledge and skills related to processes within the banking system. At the end of 2016, the Bank of Lithuania employed a total of 588 employees[35], 20 of which had a PhD.

Specialists accounted for 80 per cent of Bank of Lithuania employees, support staff – 20 per cent. The share of female employees at the Bank of Lithuania amounted to 52.5 per cent. In terms of management-level positions, female employees constituted 31 per cent.

On a year-on-year basis, the average age of employees remained unchanged, standing at 44 years.

Chart 32. Bank of Lithuania employees by age



Source: Bank of Lithuania calculations.

[35] The number does not include 13 staff members who were on maternity/paternity leave or unpaid leave during their work at the ECB or IMF.

Working environment

The Code of Ethics of Employees of the Bank of Lithuania (hereinafter – Code) defines the principles of conduct to be observed by employees so that the reputation of the Bank and the employee would not be discredited. The provisions of the Code reflect the core values of the institution: adherence to public interests, competence and transparency of activities. The principles of conduct laid down in the Code have been established with a view to ensure the independence and good reputation of the Bank, increase public confidence in the institution, promote effective cooperation with the ECB and the ESCB, create a creative and benevolent working environment, and develop respect for co-workers and others.

In preparing the Bank of Lithuania strategy for 2017–2020, its employees agreed on and supported the core values, anchoring the decision-making process and activities of the institution – adherence to public interests, competence and quality, and transparency of activities.

Expert knowledge

Research and expert knowledge have been playing an increasingly notable role in the decision-making process of central banks. This has been motivated by a number of factors. Among these, the more inter-related nature of our economies, the global nature of economic and financial shocks and the new challenges faced by central banks are most prominent.

For this reason, the Bank of Lithuania actively expanded its research capacities in both applied and basic research. An international team of researchers at the Center of Excellence in Finance and Economic Research (CEFER), which had been established only two years ago, works on an increasing list of topics of relevance to Lithuania and the European Union.

In 2016, the papers of CEFER researchers were published in internationally-acclaimed journals: *Journal of Money, Credit, and Banking; Journal of Economic Behavior & Organization; Journal of Economic Dynamics and Control; The Economic Journal*, etc.

The CEFER and the Applied Macroeconomic Research Division regularly organise seminars on economic and financial issues and invite external researchers to present their scientific papers. In 2016, the Bank of Lithuania welcomed researchers from Norwegian Business School, the Robert Schuman Centre for Advanced Studies (European University Institute), European University Institute, University of Amsterdam, Chapman University, the central banks of France, Belgium, Spain, Ireland, England, Latvia, Slovakia, Germany and Italy, the European Central Bank and many other universities and institutions.

The Visiting Researcher Programme was developed – it saw active submissions from well-established European and US universities.

Together with the National Bank of Poland and CEBRA, the CEFER organised a global conference on trade and global value chains. The Bank of Lithuania analysts organised a research seminar series which presented novel methods and results from top researchers. The CEFER also offered the possibility for local PhD students to receive feedback on their ongoing projects and interact with Bank of Lithuania specialists.

Taking into account the importance of public awareness of scientific activities and technological innovations, seeking scientific integration, and closer connection between studies and practical application, the Bank of Lithuania signed a cooperation agreement with Kaunas University of Technology.

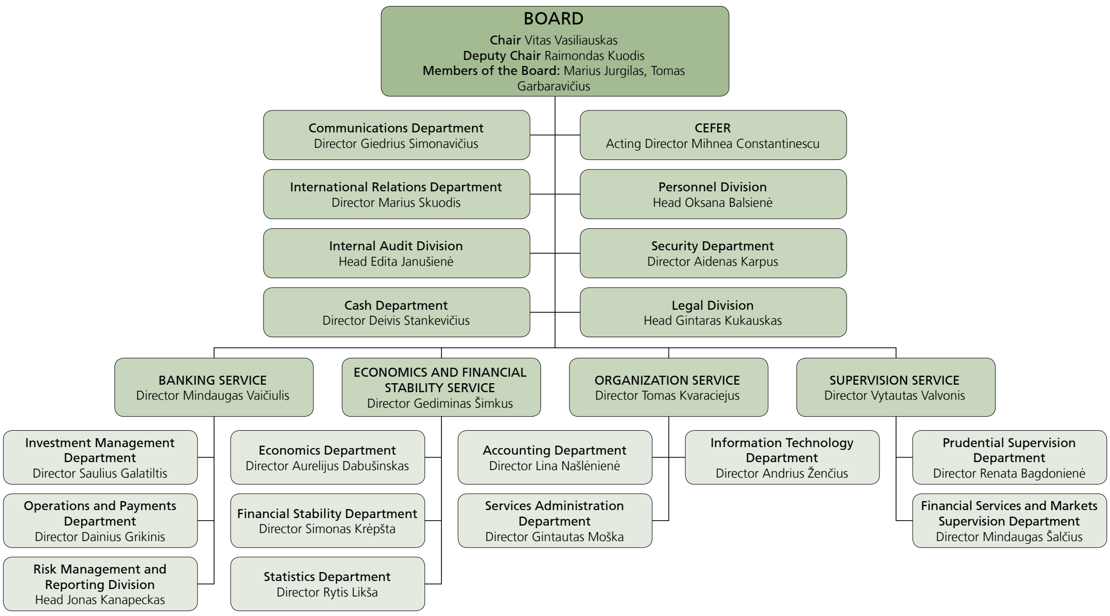
Constant broadening of Bank of Lithuania employee knowledge and improvement of their skills were focused on a policy tailored to organisational needs, seeking to efficiently fulfil the main organisational functions and implement the objectives set for the Bank.

In developing its staff professional skills and knowledge and aiming at better synergy in all areas of activity, the Bank of Lithuania strengthened international, inter-institutional and internal cooperation, encouraged employees to expand their expertise through practice, diversified education methods and improved their accessibility, as well as created a knowledge sharing culture. Seeking to develop the professional potential and competence of its employees as well as provide proper conditions for them to apply their expertise, the Bank of Lithuania initiated signing of cooperation agreements with the Competition Council of the Republic of Lithuania and the National Audit Office of Lithuania on a possibility to delegate employees from one institution to another for improving their qualifications. Such agreements are to be signed with the Ministry of Finance and the State Tax Inspectorate.

Five Bank of Lithuania employees had a unique opportunity to improve their skills in the field of central banking, as well as cooperate and exchange ideas and knowledge with top ECB experts as they left for secondments to the ECB under fixed-term contracts.

In 2016, 35 students interned at the Bank of Lithuania. They gained practical knowledge and skills in the field of monetary policy analysis, management of foreign investment, analysis of life assurance products, etc.

Chart 33. Organisational structure



Transparency of activities and provision of information to the public

Transparency of the institution's activities is ensured by implementing the Communication Policy of the Bank of Lithuania. It lays down the Bank of Lithuania communication objectives, principles, ways and channels, indicates target groups and communication participants. In 2016, the Bank of Lithuania implemented new information dissemination tools. The Bank of Lithuania created and actively used its Facebook page, sharing video content to introduce the latest news. The Bank of Lithuania began broadcasting its most important press conferences online. It also started publishing economic commentaries. Broad-based information campaigns contribute to enhancing the public's understanding of Bank of Lithuania functions and activities as well as maintain high levels of public trust in the central bank of the Republic of Lithuania. According to the data of the public opinion survey conducted by UAB Baltijos tyrimai*, in November 2016, 57 per cent of respondents stated that they trust the Bank of Lithuania.*

The primary channel of information on the Bank of Lithuania is its website (www.lb.lt). In the second half of 2016, the Bank of Lithuania intensively created and developed the content and design of the new website, taking into account user needs and seeking to implement innovative solutions, make the website mobile-compatible. Using more convenient navigation tools, visitors will be able to easily and quickly find relevant information. The new website will be launched in spring 2017.

Various information was regularly presented to the media. In 2016, the Bank of Lithuania published 191 press releases and organised 11 press conferences.

E-publications on the Bank of Lithuania activities, major economic phenomena, financial statistics, etc. were prepared and published. The Bank of Lithuania, as part of the ESCB, closely cooperates with the ECB and prepares ECB publications in Lithuanian. Electronic versions of all publications are available on the Bank of Lithuania website.

The Bank of Lithuania organised events targeted at specific groups. In 2016, the Bank of Lithuania organised Global Money Week, free-of-charge seminars on responsible management of personal finances held in Vilnius, Kaunas and Klaipėda, lectures at the Bank of Lithuania Money Museum in Vilnius, and the educational game *Euro Run* (an ECB and national central bank initiative introduced in 19 euro area countries). Presentations of new collector and commemorative coins for the general public were held in Vilnius, Kaunas and Palanga.

Financial education. At the end of 2016, structural changes were implemented at the Bank of Lithuania, aiming at more targeted activities in the field of financial education, which would be in line with the nature and role of the institution. In 2017, a new Bank of Lithuania financial education policy will be developed, setting specific measures for its implementation.

IV. ANNUAL FINANCIAL STATEMENTS OF THE BANK OF LITHUANIA

Independent auditor's report

To the Seimas of the Republic of Lithuania

Our opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Bank of Lithuania ("the Bank") as at 31 December 2016 and its financial performance for the year then ended in accordance with Guideline (EU) 2016/2249 of the European Central Bank (ECB) on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), adopted by the Governing Council of the ECB, the Law on the Bank of Lithuania and the Accounting Policy approved by the Board of the Bank of Lithuania.

What we have audited
The Bank's financial statements comprise:

- the balance sheet as at 31 December 2016;
- the profit and loss account for the year then ended;
- the notes to the financial statements, which include a summary of significant accounting policies.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the financial statements* section of our report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence
We are independent of the Bank in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and the Law on Audit of the Republic of Lithuania that are relevant to our audit of the financial statements in Republic of Lithuania. We have fulfilled our other ethical responsibilities in accordance with the IESBA Code and the Law on Audit of the Republic of Lithuania.

Responsibilities of management and those charged with governance for the financial statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with Guideline (EU) 2016/2249 of the European Central Bank (ECB) on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), adopted by the Governing Council of the ECB, the Law on the Bank of Lithuania and the Accounting Policy approved by the Board of the Bank of Lithuania, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Bank or to cease operations, or has no realistic alternative but to do so.

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Those charged with governance are responsible for overseeing the Bank's financial reporting process.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

On behalf of PricewaterhouseCoopers UAB

Rimvydas Jogėla
Partner
Auditor's Certificate No.000457

Vilnius, Republic of Lithuania
31 March 2017

BALANCE SHEET OF THE BANK OF LITHUANIA

EUR thousands

	Notes	31 December 2016	31 December 2015
ASSETS			
1. Gold and gold receivables	**1**	**205,508**	**182,309**
2. Claims on non-euro area residents denominated in foreign currency		**2,735,714**	**2,379,184**
Receivables from the IMF	**2**	175,044	174,803
Balances with banks and security investments, external loans and other external assets	**3**	2,560,670	2,204,380
3. Claims on euro area residents denominated in foreign currency	**4**	**137,272**	**115,603**
4. Claims on non-euro area residents denominated in euro	**5**	**71,439**	**317,066**
5. Lending to euro area credit institutions related to monetary policy operations denominated in euro	**6**	**303,000**	**345,700**
Main refinancing operations		–	–
Longer-term refinancing operations		303,000	345,700
Fine-tuning reverse operations		–	–
Structural reverse operations		–	–
Marginal lending facility		–	–
Credits related to margin calls		–	–
6. Other claims on euro area credit institutions denominated in euro	**7**	**365**	**21**
7. Securities of euro area residents denominated in euro		**6,836,895**	**3,423,859**
Securities held for monetary policy purposes	**8**	6,339,625	2,508,058
Other securities	**9**	497,270	915,801
8. General government debt denominated in euro		**–**	**–**
9. Intra-Eurosystem claims		**4,056,692**	**4,489,542**
Participating interest in the ECB	**10**	207,183	207,183
Claims equivalent to the transfer of foreign reserves	**11**	239,454	239,454
Net claims related to the allocation of euro banknotes within the Eurosystem	**12**	3,556,459	3,751,032
Other claims within the Eurosystem (net)	**13**	53,596	291,872
10. Items in course of settlement		**–**	**–**
11. Other assets		**117,010**	**77,450**
Tangible and intangible fixed assets	**14**	30,034	30,437
Other financial assets	**15**	3,355	3,355
Off-balance-sheet instruments revaluation differences	**16**	32,578	6,059
Accruals and prepaid expenses	**17**	50,108	36,714
Sundry	**18**	936	885
Total assets		**14,463,895**	**11,330,734**

	Notes	31 December 2016	31 December 2015
LIABILITIES			
1. Banknotes in circulation	**19**	**6,081,566**	**5,960,269**
2. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro	**20**	**2,481,461**	**2,841,656**
Current accounts (covering the minimum reserve system)		2,481,461	2,841,656
Deposit facility		–	–
Fixed-term deposits		–	–
Fine-tuning reverse operations		–	–
Deposits related to margin calls		–	–
3. Other liabilities to euro area credit institutions denominated in euro	**21**	**–**	**25,778**
4. Debt certificates issued		**–**	**–**
5. Liabilities to other euro area residents denominated in euro	**22**	**691,063**	**1,272,627**
General government		689,958	1,272,620
Other liabilities		1,105	7
6. Liabilities to non-euro area residents denominated in euro	**23**	**21,362**	**806**
7. Liabilities to euro area residents denominated in foreign currency	**24**	**372,947**	**191,972**
8. Liabilities to non-euro area residents denominated in foreign currency	**25**	**45,815**	**52,052**
9. Counterpart of special drawing rights allocated by the IMF	**26**	**174,924**	**174,677**
10. Intra-Eurosystem liabilities		**3,590,341**	**–**
Net liabilities related to the allocation of euro banknotes within the Eurosystem		–	–
Other liabilities within the Eurosystem (net)	**27**	3,590,341	–
11. Items in course of settlement	**28**	**1,300**	**2,832**
12. Other liabilities		**217,826**	**125,666**
Off-balance-sheet instruments revaluation differences	**16**	5,023	30,988
Accruals and income collected in advance	**29**	4,190	1,011
Sundry	**30**	208,613	93,667
13. Provisions	**31**	**105,728**	**49,690**
14. Revaluation accounts	**32**	**223,661**	**193,369**
15. Capital	**33**	**428,896**	**417,561**
Authorised capital		60,000	60,000
Reserve capital		368,896	357,561
16. Profit for the year	**44**	**27,004**	**21,779**
Total liabilities		**14,463,895**	**11,330,734**

PROFIT AND LOSS ACCOUNT OF THE BANK OF LITHUANIA

EUR thousands

	Notes	2016	2015
Interest income		34,240	22,547
Interest expense		(3,664)	(1,621)
1. Net interest income	**34**	**30,576**	**20,926**
Realised gains (losses) arising from financial operations		28,557	(891)
Write-downs on financial assets and positions		(6,390)	(16,307)
Transfer to provisions for risks		(56,500)	(15,800)
2. Net result of financial operations, write-downs and risk provisions	**35**	**(34,334)**	**(32,998)**
Fees and commissions income		6,028	5,395
Fees and commissions expense		(1,282)	(723)
3. Net income from fees and commissions	**36**	**4,747**	**4,672**
4. Income from equity shares and participating interests	**37**	**13,190**	**10,382**
5. Net result of pooling of monetary income	**38**	**47,924**	**46,963**
6. Other income	**39**	**1,207**	**7,176**
TOTAL NET INCOME		**63,310**	**57,121**
7. Staff costs	**40**	**(14,771)**	**(15,267)**
8. Administrative expenses	**41**	**(8,348)**	**(8,296)**
9. Depreciation of tangible and intangible fixed assets	**14**	**(2,102)**	**(2,786)**
10. Banknote production services	**42**	**(9,344)**	**–**
11. Other expenses	**43**	**(1,740)**	**(8,992)**
PROFIT FOR The YEAR	**44**	**27,004**	**21,779**

The Annual Financial Statements 2016 of the Bank of Lithuania were approved on 29 March 2017 by Resolution No 03-50 of the Board of the Bank of Lithuania.

Chairman of the Board Vitas Vasiliauskas

Director of the Organization Service
Accounting Department Lina Našlėnienė

EXPLANATORY NOTES

1. BASIS FOR PREPARATION AND PRESENTATION OF THE ANNUAL FINANCIAL STATEMENTS

As of 1 January 2015, Lithuania adopted the single currency of the EU – the euro – and became a member of the euro area.

The financial accounting of the Bank of Lithuania is managed and the Annual Financial Statements are prepared in accordance with Guideline (EU) 2016/2249 of the European Central Bank (hereinafter 'ECB') on the legal framework for accounting and financial reporting in the European System of Central Banks (ECB/2016/34), adopted by the Governing Council of the ECB (hereinafter 'Accounting Guideline'), the Law on the Bank of Lithuania and the Accounting Policy approved by the Board of the Bank of Lithuania. If a specific accounting treatment is not laid down in the Accounting Guideline and the Accounting Policy of the Bank of Lithuania and in the absence of decisions and instructions to the contrary by the ECB, the Bank of Lithuania shall follow the principles of the international accounting and financial reporting standards as adopted by the European Union, relevant to the activities and accounts of the Bank of Lithuania.

Due to rounding, the totals included in the Balance Sheet, Profit and Loss Account and Notes of the Bank of Lithuania may not equal the sum of the individual figures.

2. ACCOUNTING POLICY

2.1. GENERAL PRINCIPLES

In managing financial accounting, the Bank of Lithuania follows the following basic accounting assumptions: going concern basis, accruals principle, post-balance sheet events.

The qualitative characteristics in drawing up the financial statements of the Bank of Lithuania are as follow: economic reality and transparency, prudence, materiality, consistency and comparability.

Gold, marketable securities and other on-balance-sheet and off-balance-sheet assets and liabilities that comprise financial assets (hereinafter 'financial items') in financial accounting are recorded at acquisition cost (transaction price), and in the Annual Financial Statements are presented at market price (except for securities valued at amortised cost). Results arising from revaluation of marketable debt and equity securities (on a code-by-code basis) and derivatives (on an item-by-item basis) at market prices are accounted for separately.

In the Annual Financial Statements, financial items denominated in foreign currency are presented in euro at market rates.[1] Results arising from revaluation of gold and foreign currency (on a currency-by-currency basis) at market rates are accounted for separately.

Unrealised revaluation loss arising at the end of the financial year from revaluation of a separate financial item at market price or market rate and exceeding previous unrealised revaluation gain registered in a corresponding revaluation account is recognised as the expense of the reporting financial year. Unrealised loss taken to the Profit and Loss Account cannot be reversed in subsequent years against new revaluation gain of the same financial item resulting from changes in market price and market rate or offset by the revaluation gain of another type of financial item.

Unrealised revaluation gain arising at the end of the financial year from the revaluation of a separate financial item at market price and market rate is presented in revaluation accounts.

The average rate and average price method is used in order to compute the acquisition costs for gold, securities and foreign currency. Such acquisition costs are used for the purpose of calculating the realised and unrealised results.

Income and expense are recognised in the accounting period in which they are earned or incurred and not in the period in which they are received or paid. Income and expense in foreign currency are recognised in euro at market rates prevailing on the day of their recognition in accounting; they influence a respective foreign currency position on that date.

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[1] *Market rate – euro and foreign currency reference rate, based on the daily concertation procedure between central banks within and outside the ESCB, published by the ECB.*

2.2. FOREIGN CURRENCY

The market rates of the euro and foreign currency with which the Bank of Lithuania holds material positions

Foreign currency per euro

Currency	Code	31 December 2016	31 December 2015	Change (%)
Swiss franc	CHF	1.07390	1.08350	–9.0
US dollar	USD	1.05410	1.08870	–3.2
Japanese yen	JPY	123.400	131.070	–5.9
Special drawing rights (SDR)	XDR	0.78456	0.78567	–0.1
Chinese yuan renminbi	CNY	7.32020	7.06080	3.7
Canadian dollar	CAD	1.41880	1.51160	–6.1
British pound	GBP	0.85618	0.73395	16.7

The average rate of foreign currency is recalculated on a daily basis in case of an increase of a respective foreign currency position. When the foreign currency position decreases – the realised result is calculated.

In the event of the recognition of unrealised revaluation loss on a separate foreign currency at year-end, the average rate of that currency is correspondingly adjusted to the market rate on the last business day of the financial year.

2.3. GOLD

In the Annual Financial Statements, gold is presented in euro at the market price of one Troy ounce, prevailing on the last business day of the financial year.

In the event of the recognition of unrealised revaluation loss on gold at year-end, the average cost of gold is correspondingly adjusted to the gold market price prevailing on the last business day of the financial year.

Transactions related to gold swaps are accounted for in the same way as repurchase agreements.

2.4. MARKETABLE SECURITIES

Marketable debt and equity securities are recorded in on-balance-sheet accounts at acquisition cost on the settlement date.

Securities held for monetary policy purposes, as well as debt securities classified as held-to-maturity, are presented in the Balance Sheet at amortised cost subject to impairment. Other marketable securities are presented in the Balance Sheet at mid-market prices prevailing on the balance sheet date. Revaluation results of securities related with changes of the market price of securities and the market rate of the foreign currency are presented in separate revaluation accounts.

The average price of each issue of securities is recalculated at the end of the business day in consideration of all purchases of the same issue of securities made during the day and their average acquisition costs. Realised gain (loss) for the same day sales of these securities is calculated according to this new average cost.

A coupon purchased together with debt securities is presented in a separate Balance Sheet item as other assets and is not included in the acquisition cost of the securities.

Dividends, bought together with equity securities, are included in the acquisition cost of the securities. Dividends bought in the period when the dividend receivable is announced are presented in a separate Balance Sheet item as other assets.

The difference between the debt security acquisition cost and its par value – discount or premium – is recognised as income or expense according to the straight-line method on a daily basis from the purchase settlement date to the maturity date or sale settlement date. The nominal value of inflation-linked securities is indexed to the inflation index on a daily basis from the settlement date of the purchase transaction to the maturity date or settlement date of the sale transaction. The nominal value change is recognised as interest income or expense.

Discount on non-coupon bearing debt securities is amortised according to the internal rate of return (IRR), and discount or premium on coupon bearing debt securities is amortised according to the straight-line method.

If at the end of the financial year unrealised revaluation loss on valuation of a separate issue of securities is recognised as expense, the average cost of such issue of securities is adjusted according to its market price prevailing on the last business day of the financial year.

2.5. NON-MARKETABLE EQUITY INSTRUMENTS

Non-marketable equity instruments are long-term investments in equity instruments held for the specific purposes of the Bank of Lithuania in order to participate in the activities of a specific enterprise whose equity instruments are non-marketable and their price is not quoted in the market. They are recorded at acquisition cost subject to impairment.

2.6. INCOME AND EXPENSE

In the Profit and Loss Account, interest on a separate financial item or instrument is presented on a net basis (interest income is netted against interest expense on the same financial item or instrument).

Realised income and expense related to sold foreign currency, gold and securities are recognised in the income and expense accounts. Such income and expense are calculated considering the average rate or average price of the corresponding financial item.

Unrealised revaluation gain of financial items is not recognised as income and is presented in revaluation accounts. Unrealised revaluation loss, exceeding previous revaluation gain related to the corresponding financial item, is recognised as expense at the year-end.

Impairment losses are recognised as expense and are not reversed in subsequent years unless the impairment decreases and this decrease can be related to an observable event that occurred after the impairment was first recorded.

Dividends of marketable equity securities are booked upon their announcement, while dividends of non-marketable equity instruments are booked upon having been settled or having received a notification on their distribution.

2.7. REVERSE TRANSACTIONS

Reverse transactions are operations whereby the Bank of Lithuania buys or sells assets under a repurchase agreement or conducts credit operations against collateral.

Repurchase agreements are presented as collateralised deposits of the counterparty on the liabilities side of the Balance Sheet, while the financial asset that has been given as collateral (sold and repurchased under these agreements) remains on the asset side of the Balance Sheet for the period of transactions.

Reverse repurchase agreements are presented as collateralised loans on the asset side of the Balance Sheet. The collateral acquired during the transactions period is not reported in the Balance Sheet and is not revalued.

The difference between the purchase and repurchase price of the collateral acquired under reverse repurchase and repurchase agreements is recognised on a daily basis as interest income or expense over the remaining duration of the transaction.

2.8. FOREIGN EXCHANGE TRANSACTIONS

Foreign currency to be received or paid, under foreign exchange spot, forward and swap transactions, influences a respective foreign currency's position on the trade date and is recorded in off-balance-sheet accounts from the trade date to the settlement date.

The difference in the value at the spot and forward rates of the foreign exchange forward and swap transactions is recognised as interest income or expense and is accrued on a daily basis over the remaining duration of the transaction.

Non-deliverable foreign exchange forwards are recorded at notional amount calculated based on the forward exchange rate in the off-balance-sheet accounts from the trade date to the maturity date. In the Balance Sheet, the value of these transactions is presented at market prices prevailing on the last business day of the financial year. Unrealised loss recognised as expense at the end of the financial year is presented as off-balance-sheet instruments revaluation difference on the Balance Sheet liabilities side. The difference between the forward rate and the spot rate at the settlement date of the transaction, taking into account any accumulated impairment losses, is recognised as realised income or expense.

2.9. FORWARD TRANSACTIONS IN SECURITIES

Forward purchases or sales of securities are recognised in off-balance-sheet accounts from the trade date to the settlement date at the forward price of the transaction. In the Balance Sheet, the value of these transactions is presented at the forward market price prevailing on the last business day of the financial year.

On the settlement date of forward transactions in securities, the purchases or sales of the securities are recorded on the on-balance-sheet accounts at the actual market price, and the difference between this price and the forward price of the transaction is recognised as realised income or expense.

2.10. INTEREST RATE TRANSACTIONS

Interest rate futures are recorded in off-balance-sheet accounts at the nominal value of contracts from the trade date to the closing or maturity date. Daily changes in the variation margin of these contracts are recognised as realised income or expense.

Interest rate swaps are recorded in off-balance-sheet accounts at notional amount from the trade date to the closing or maturity date. In the Balance Sheet, the value of these transactions is presented at market prices, prevailing on the last business day of the financial year. Unrealised loss recognised as expense at the end of financial year is presented as off-balance-sheet instruments revaluation difference on the Balance Sheet liabilities side and is subject to straight-line amortisation till the maturity date of the transaction. Interest income and interest expense is accrued on a daily basis over the remaining duration of the transaction.

2.11. TANGIBLE AND INTANGIBLE FIXED ASSETS

Tangible fixed assets include such tangible assets whose useful life is longer than one year and whose acquisition cost (including VAT) is no less than EUR 2,000. Intangible fixed assets include items without physical substance whose useful life is no less than one year and whose acquisition cost is no less than EUR 2,000. Tangible and intangible fixed assets are recorded in the Balance Sheet at cost less accumulated depreciation (amortisation). The fixed assets under construction, pieces of art, museum stocks and tangible assets included in the list of cultural valuables (excluding buildings) are not depreciated (amortised). Depreciation (amortisation) of other fixed assets is calculated on a straight-line basis over the expected useful life of the assets.

Useful lives of tangible and intangible fixed assets

Fixed assets	Years
Tangible assets	
Buildings	45–59
Cash processing equipment	7–12
Computer equipment	3–8
Other inventories (furniture, office equipment and other)	5–30
Intangible assets	3–5

If there are indications that the market value of real estate has declined significantly, at the end of the financial year, the acquisition cost of such assets is reduced by the amount of impairment loss.

When fixed assets are sold, the difference between the value of sale and the value presented in the Balance Sheet is recognised as income or expense.

Maintenance and repair costs of fixed assets are recognised as an expense at the time they are incurred.

2.12. BANKNOTES AND COINS IN CIRCULATION

The euro area NCBs and the ECB, which together comprise the Eurosystem, issue euro banknotes.[2] The total value of euro banknotes in circulation is allocated to the Eurosystem central banks on the last business day of each month in accordance with the banknote allocation key.[3]

[2] *ECB Decision of 13 December 2010 on the issue of euro banknotes (recast) (ECB/2010/29), OJ L 35, 9.2.2011, p. 26, as amended.*

[3] *Banknote allocation key means the percentages that result from taking into account the ECB's share in the total*

The ECB is allocated a share of 8 per cent of the total value of euro banknotes in circulation, whereas the remaining 92 per cent is allocated to NCBs according to their weightings in the subscribed capital key of the ECB. The share of banknotes allocated to each NCB is disclosed in their Balance Sheet under liability item '1. Banknotes in circulation'.

The difference between the value of euro banknotes allocated to each NCB in accordance with the banknote allocation key and the value of euro banknotes that it actually puts into circulation is presented as remunerated intra-Eurosystem balance.[4] The interest income or expense on this balance is disclosed in the Profit and Loss Account item '1. Net interest income' (see Note 34).

Seeking to avoid fluctuations in monetary income after new members join the Eurosystem, the net intra-Eurosystem balances arising from the allocation of euro banknotes are adjusted by the compensatory amount, which is applied for the new entrants from the cash changeover year and gradually reduced over the following five years. For the Bank of Lithuania, the period for which the above-mentioned adjustments are applicable will terminate on 31 December 2020. As of 1 January 2021, the interest income will be calculated on the whole position of the net claims related to the allocation of euro banknotes.

The nominal value of euro coins issued into circulation by the Bank of Lithuania and litas coins remaining in circulation is presented in the Balance Sheet item '12. Other liabilities'. In accordance with the Accounting Guideline, litas banknotes at their nominal value are also included as of 1 January 2016 in aforementioned Balance Sheet item (as at 31 December 2015 it was disclosed in the Balance Sheet under liability item '1. Banknotes in circulation').

When assessed that the probability of return is negligibly low, the nominal value of such litas banknotes and coins is derecognised from the Balance Sheet. Provisions shall be formed for the assessed value of probable return. The difference between the nominal value derecognised and the provisions formed shall be recognised as income.

The sale price of collector, commemorative coins and other numismatic valuables is recognised as income.

The cost of printing banknotes and minting coins, as well as other expenses associated with the issue of banknotes and coins into circulation, are recorded as expenses when incurred, irrespective of when the coins and banknotes were put into circulation.

2.13. PROVISIONS FOR COVERING FINANCIAL RISKS AND LIABILITIES

Provisions for expected foreign exchange rate, interest rate, gold price and credit risks (hereinafter 'provisions for risks') are formed by the Board of the Bank of Lithuania, in order that the Bank of Lithuania would have sufficient financial resources to offset risk arising from the financial assets, including the financial assets acquired in connection with monetary policy operations of the Eurosystem, as well as the financial liabilities related to the management of these assets, and safeguard the Bank of Lithuania's capital and the real value of financial assets. These provisions are formed according to the rules established by the Board of the Bank of Lithuania. Provisions for risks may be used for the coverage of all or part of the net expenses related to financial assets operations (realised result, unrealised revaluation loss and impairment of the financial assets).

Provisions for termination benefits, payable for staff who will qualify for the state social insurance pension while working at the Bank of Lithuania, are assessed using actuary calculations. Their value is determined as termination benefits earned by the employee upon retirement and calculated based on the employee change dynamics and wage growth preconditions, discounted at using the long-term lending interest rates in the Republic of Lithuania.

Other provisions for liabilities, such as provisions for wages and salaries payable for annual leave, provisions for termination benefits or provisions related to the exchange of litas banknotes and coins, are not discounted due to the relatively short period from the formation of these provisions to their use.

Provisions for risks and liabilities are formed as at year-end and recognised as expense.

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euro banknote issue and applying the subscribed capital key to the NCBs' share in such total.

[4] *ECB Decision of 3 November 2016 on the allocation of monetary income of the national central banks of Member States whose currency is the euro (recast) (ECB/2016/36), OJ L 347, 20.12.2016, p. 26.*

3. FINANCIAL RISK AND ITS MANAGEMENT

3.1. MANAGEMENT OF FINANCIAL RISK RELATED TO MONETARY POLICY OPERATIONS

The risk related to monetary policy operations is managed within the Eurosystem on an integral basis. The Bank of Lithuania takes part in this risk management process by representation in the Risk Management Committee of the ECB, which is responsible for the management of financial risk related to monetary policy operations and to investment of foreign reserves of the Eurosystem.

If necessary, the Bank of Lithuania elaborates on specifying the assessment of financial risk, arising from monetary policy operations, as well as establishes additional limits on risk and controls their fulfilment within the scope of the mandate of the Bank of Lithuania.

For risk management of lending operations, requirements for counterparties, with which these operations can be executed, and the requirements for collateral and other risk control instruments are established. To mitigate the risk of securities purchase operations, requirements for securities, which can be acquired by the Eurosystem under adopted securities purchase programmes, and limits on acquisition are set.

3.2. MANAGEMENT OF FINANCIAL RISK RELATED TO THE INVESTMENT OF THE BANK OF LITHUANIA

Investments made by the Bank of Lithuania, not related to monetary policy operations, are exposed to market, credit, liquidity and settlement risks.

Value-at-risk is the basic tool for the management of market risk (interest rate, debt and equity securities price, and exchange rate), which cannot exceed the Board of the Bank of Lithuania-established risk budget for financial assets investments (excluding monetary policy operations), i.e. a maximum acceptable amount of EUR 100 million in negative return per annum with 95 per cent probability. The application of the risk budget ensures integral management of market risk, more flexible use of various investment strategies as well as one indicator for the overall assessment of both equity and debt securities risk. The model used for the calculation of value-at-risk considers past patterns and forecasted macroeconomic environment. As at 31 December 2016 the risk value amounted to EUR 66 million (as at 31 December 2015 – EUR 63 million).

In pursuit of a credible risk management system, other market risk management instruments are combined with the risk budget instrument.

For managing foreign exchange rate risk related to financial assets which do not correspond to liabilities in foreign currencies, limits for open currency positions are established alongside the risk budget. Exchange rate risk related to financial assets corresponding to liabilities in foreign currencies is eliminated by investing in the currency of liabilities.

Appropriate investment allocation plays an important role in financial risk management seeking to reduce the concentration of investment. In 2016, the Bank of Lithuania ensured diversification of investments by investing in debt securities of twelve countries and more than sixty issuers. The Bank of Lithuania also invests in exchange traded funds (ETFs) linked to well-diversified equity and debt securities market indexes.

For managing foreign exchange rate and interest rate risks, the Bank of Lithuania widely uses financial derivatives. All financial derivatives are included in the measurement of the market and credit risk of the Bank of Lithuania's financial assets investment.

Credit risk is managed by dealing only with investment grade financial institutions, investing only in investment grade financial instruments and diversifying investment by establishing limits on the liabilities to the Bank of Lithuania by issuers, counterparties and their groups.

Liquidity risk is managed by combining the duration of liabilities and corresponding investments.

Various account management instruments are applied to diminish settlement risks: the delivery-versus-payment principle, matching of debt and credit turnovers, ISDA Master Agreement.

4. FINANCIAL ACCOUNTING PRINCIPLES ON OPERATIONS RELATED TO PARTICIPATION IN THE EUROSYSTEM

This chapter covers the accounting principles of claims and liabilities as well as income, and expenses arising from operations related to participation in the Eurosystem.

4.1. PARTICIPATING INTEREST IN ECB CAPITAL

Shares of the national central banks in the subscribed capital of the ECB depend on the established key for ECB capital subscription, which is adjusted, in accordance with the provisions of the Statute of the European System of Central Banks (hereinafter 'ESCB') and of the ECB, every five years and every time when a new Member State joins the EU, on the basis of population and GDP data provided by the European Commission.

Participating interest of NCBs of the EU Member States in the ECB capital

Central bank	Capital key as at 31 December 2016, %	Paid-up capital as at 31 December 2016, EUR	Capital key as at 31 December 2015, %	Paid-up capital as at 31 December 2015, EUR
Nationale Bank van België / Banque Nationale de Belgique	2.4778	268,222,025	2.4778	268,222,025
Deutsche Bundesbank	17.9973	1,948,208,997	17.9973	1,948,208,997
Eesti Pank	0.1928	20,870,614	0.1928	20,870,614
Banc Ceannais na hÉireann / Central Bank of Ireland	1.1607	125,645,857	1.1607	125,645,857
Bank of Greece	2.0332	220,094,044	2.0332	220,094,044
Banco de España	8.8409	957,028,050	8.8409	957,028,050
Banque de France	14.1792	1,534,899,402	14.1792	1,534,899,402
Banca d'Italia	12.3108	1,332,644,970	12.3108	1,332,644,970
Central Bank of Cyprus	0.1513	16,378,236	0.1513	16,378,236
Latvijas Banka	0.2821	30,537,345	0.2821	30,537,345
Lietuvos bankas	0.4132	44,728,929	0.4132	44,728,929
Banque centrale du Luxembourg	0.2030	21,974,764	0.2030	21,974,764
Bank Ċentrali ta'Malta / Central Bank of Malta	0.0648	7,014,605	0.0648	7,014,605
De Nederlandsche Bank	4.0035	433,379,158	4.0035	433,379,158
Oesterreichische Nationalbank	1.9631	212,505,714	1.9631	212,505,714
Banco de Portugal	1.7434	188,723,173	1.7434	188,723,173
Banka Slovenije	0.3455	37,400,399	0.3455	37,400,399
Národná banka Slovenska	0.7725	83,623,180	0.7725	83,623,180
Suomen Pankki – Finlands Bank	1.2564	136,005,389	1.2564	136,005,389
Total (euro area central banks)	**70.3915**	**7,619,884,851**	**70.3915**	**7,619,884,851**
Българска народна банка (Bulgarian national bank)	0.8590	3,487,005	0.8590	3,487,005
Česká národní banka	1.6075	6,525,450	1.6075	6,525,450
Danmarks Nationalbank	1.4873	6,037,512	1.4873	6,037,512
Hrvatska narodna banka	0.6023	2,444,963	0.6023	2,444,963
Magyar Nemzeti Bank	1.3798	5,601,129	1.3798	5,601,129
Narodowy Bank Polski	5.1230	20,796,192	5.1230	20,796,192
Banca Națională a României	2.6024	10,564,124	2.6024	10,564,124
Sveriges Riksbank	2.2729	9,226,559	2.2729	9,226,559
Bank of England	13.6743	55,509,148	13.6743	55,509,148
Total (non-euro area central banks)	**29.6085**	**120,192,083**	**29.6085**	**120,192,083**
Total	**100.0000**	**7,740,076,935**	**100.0000**	**7,740,076,935**

The contribution of the Bank of Lithuania to ECB capital is presented in Note 10 'Participating interest in the ECB'.

4.2. FOREIGN RESERVES TRANSFERRED TO THE ECB

Pursuant to Article 48 and Article 30 of the Statute of the ESCB and of the ECB, the NCBs, when joining the Eurosystem, transfer their share of foreign reserves to the ECB, applying the ratio of the number of shares subscribed by the NCB concerned and the number of shares already paid up by the other NCBs.

The ECB's liabilities to the euro area, equivalent to the transfer of foreign reserves by the NCBs, comprised the amount of EUR 40,792,608 thousand. The share of foreign reserve assets, transferred to the ECB by the Bank of Lithuania, is reported under 'Claims equivalent to the transfer of foreign reserves' (see Note 11).

The remuneration of foreign reserves transferred to the ECB is calculated daily, at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations.

4.3. LENDING TO EURO AREA CREDIT INSTITUTIONS DENOMINATED IN EURO

Main refinancing operations. Main refinancing operations are executed through liquidity providing reverse transactions with a weekly frequency and a maturity of one week, normally by means of standard tenders. These operations play a key role in achieving the aims of the steering interest rate, managing market liquidity and signalling the monetary policy stance.

Longer-term refinancing operations. These operations aim to provide counterparties with additional longer-term refinancing. In 2016, operations with maturities equal to the reserve maintenance period and with maturities between 3 and 48 months were conducted. Additionally, in March 2016 the Governing Council of the ECB introduced a new series of four targeted longer-term refinancing operations. These operations have a four-year maturity, with a possibility of full or partial repayment after two years. The applicable interest rate for these targeted longer-term refinancing operations depends on the individual lending benchmark of the respective counterparty between the date of allotment and January 2018. The actual rate will be set in 2018 and will range between the main refinancing operations rate and the deposit facility rate at the time of the allotment. Since the actual rate will only be known in 2018 and a reliable estimate is not possible at this juncture, the deposit facility rate has been used for calculating the interest rate for these targeted longer-term refinancing operations for 2016, as this is deemed a prudent approach.

Fine-tuning reverse operations. Fine-tuning reverse operations aim to regulate the market liquidity situation and steer interest rates, particularly to smooth the effects on interest rates caused by unexpected market fluctuations. Owing to their nature, they are executed on an ad hoc basis.

Structural reverse operations. These are reverse open-market transactions through standard tenders to enable the Eurosystem to adjust its structural liquidity position vis-à-vis the financial sector.

Marginal lending facility. The marginal lending facility is a standing facility provided by the Eurosystem, which may be used by counterparties to obtain overnight liquidity from national central banks at a pre-specified interest rate against eligible assets.

Credits related to margin calls. They refer to cash paid to counterparties in those instances where the market value of the collateral exceeds an established trigger point implying an excess of collateral with respect to outstanding monetary policy operations.

In accordance with Article 32.4 of the Statute of the ESCB and of the ECB, losses from monetary policy operations, if they were to materialise, are shared in full by the Eurosystem NCBs, in proportion to the prevailing ECB capital key shares. With effect from 1 January 2014, the share of the Bank of Lithuania in the capital of the ECB is 0.4132 per cent. In 2016, no losses from monetary policy operations were incurred by the Bank of Lithuania and other NCBs.

Losses can only materialise if both the counterparty fails and the recovery of funds received from the resolution of the collateral provided by the counterparty is not sufficient. For specific collateral, which can be accepted by the NCBs at their own discretion, risk sharing has been excluded by the Governing Council of the ECB.

4.4. SECURITIES HELD FOR MONETARY POLICY PURPOSES

As at 31 December 2016, the securities held by the ECB and NCBs amounted to EUR 1,654,026 million; they were acquired within the scope of three covered bond purchase programmes, the Securities Markets Programme, the asset-backed securities purchase programme, the public sector asset purchase programme[5] and the corporate sector purchase programme.

[5] *Decision ECB/2015/10 of 4 March 2015 on a secondary markets public sector asset purchase programme, OJ L 121, 14.5.2015, p. 20.*

Purchases under the first and second covered bond purchase programmes and the Securities Markets Programme were completed by the end of 2012.

In 2016, the ECB and NCBs continued the purchase of securities under the third covered bond purchase programme, the asset-backed securities purchase programme and the public sector asset purchase programme. All these programmes constitute the expanded asset purchase programme, which in 2016 was supplemented with the corporate sector purchase programme as a fourth component. Under this programme, NCBs may purchase investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area.

From April 2016 until March 2017, the combined monthly asset purchase programme purchases in the Eurosystem increased from EUR 60 billion to EUR 80 billion on average. In December 2016, the Governing Council of the ECB decided to continue the net asset purchase programme purchases after March 2017 at a monthly pace of EUR 60 billion until the end of December 2017 or beyond, if necessary, and in any case until the Governing Council of the ECB sees a sustained adjustment in the path of inflation consistent with its inflation aim. If, in the meantime, financial conditions become inconsistent with further progress towards a sustained adjustment of the path of inflation, the Governing Council of the ECB intends to increase the programme in terms of size and/or duration. The net purchases will be made alongside reinvestments of the principal payments from maturing securities purchased under the asset purchase programme.

The securities holding of the Bank of Lithuania is presented in Note 8. 'Securities held for monetary policy purposes'.

Securities purchased under all of these programmes are valued on an amortised cost basis subject to impairment. Annual impairment tests are conducted on the basis of the estimated recoverable amounts as at the year-end.

4.5. LIABILITIES TO EURO AREA CREDIT INSTITUTIONS, RELATED TO MONETARY POLICY OPERATIONS DENOMINATED IN EURO

Deposit facility. Deposit facility is a liquidity absorbing standing facility provided by the Eurosystem, which counterparties can use to make overnight deposits with NCBs at the pre-specified rate.

Fixed-term deposits. These liabilities relate to liquidity-absorbing fine-tuning operations for a fixed term and with a fixed rate of interest.

Fine-tuning reverse operations. Fine-tuning reverse operations are liquidity-absorbing reverse operations used to offset high liquidity imbalances.

Deposits related to margin calls. They refer to cash received from counterparties in those instances where the market value of the collateral has fallen below an established trigger point implying a shortfall of collateral to cover the outstanding monetary policy operations.

4.6. PARTICIPATION IN TARGET2

Cross-border payments in the EU settled in TARGET2[6] give rise to bilateral balances in the TARGET2 accounts of EU central banks. These bilateral balances are netted out and then assigned to the ECB on a daily basis, leaving each NCB with a single net bilateral position *vis-à-vis* only the ECB. Intra-Eurosystem balances of the Bank of Lithuania *vis-à-vis* the ECB arising from TARGET2 are disclosed under the Balance Sheet items 'Other claims within the Eurosystem (net)' or 'Other liabilities within the Eurosystem (net)'.

4.7. ALLOCATION OF MONETARY INCOME

Monetary income of the Eurosystem, accruing to the NCBs in the performance of the ESCB's monetary policy functions, is calculated and allocated among the NCBs at the end of each financial year in proportion to the subscribed capital key in accordance with Article 32 of the Statute of the ESCB and of the ECB.

The amount of the NCBs' monetary income is determined by measuring actual income, which it derives from the earmarkable assets held against its liability base.

The earmarkable assets consist mainly of the following items: lending to euro area credit institutions related to monetary policy operations denominated in euro; securities held for monetary policy

[6] *The Trans-European Automated Real-time Gross settlement Express Transfer system.*

purposes; intra-Eurosystem claims equivalent to the transfer of foreign reserve assets to the ECB; net intra-Eurosystem claims resulting from TARGET2 transactions; net intra-Eurosystem claims related to the allocation of euro banknotes within the Eurosystem; accrued interest on monetary policy liabilities, the maturity of which is one year or longer; a limited amount of each NCBs' gold holdings in proportion to each NCBs' capital key share. Gold is considered to generate no income. Securities held for monetary policy purposes under both Decision ECB/2009/16 on the implementation of the covered bond purchase programme and Decision ECB/2011/17 on the implementation of the second covered bond purchase programme, as well as government securities under Decision ECB/2015/10 on the implementation of a secondary markets public sector asset purchase programme are considered to generate income at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations.

The liability base consists mainly of the following items: banknotes in circulation; liabilities to euro area credit institutions related to monetary policy operations denominated in euro; net intra-Eurosystem liabilities resulting from TARGET2 transactions; net intra-Eurosystem liabilities related to the allocation of euro banknotes within the Eurosystem. Any interest paid on liabilities included within the liability base is to be deducted from the monetary income to be pooled.

The difference between the NCBs' earmarkable assets value and its liability base value shall be offset by applying to the difference the latest available marginal rate for the Eurosystem's main refinancing operations.

After pooling of the annual monetary income of the Eurosystem and reallocation to NCBs in proportion to their subscribed capital keys, the differences between the NCBs' pooled monetary income and allocated in proportion to the capital key are settled among the NCBs' via TARGET2. The net result arising from the reallocation of monetary income for the Bank of Lithuania is disclosed in Note 38.

4.8. DISTRIBUTION OF THE ECB PROFIT

The net profit of the ECB is distributed pursuant to Article 33 of the Statute of the ESCB and of the ECB. The Governing Council of the ECB may decide to make transfers to the provision for foreign exchange rate, interest rate, credit and gold price risks. The remaining net profit is distributed to the shareholders of the ECB in proportion to the subscribed capital key.

Unless otherwise decided by the Governing Council of the ECB, the ECB distributes seigniorage income, which arises from the 8 per cent share of euro banknotes allocated to the ECB, as well as the income arising from the securities acquired under securities programmes (the securities markets programme, the third covered bond purchase programme, the asset-backed securities purchase programme and the public sector asset purchase programme), by means of an interim distribution of profit in January of the following year.[7] The result from ECB interim profit distribution is recorded by the Bank of Lithuania as income of the financial year when this income was accrued, not received.

After approval by the Governing Council of the ECB annual accounts, the ECB distributes the remaining part of the ECB profit (after interim profit distribution and transfer to the provision). The result from the ECB final profit distribution is recorded by the NCBs as income of the financial year when this income was received.

The received distribution of the ECB profit is disclosed in the Profit and Loss Account item '4. Income from equity shares and participating interests' (see Note 37).

5. NOTES ON THE BALANCE SHEET

Note 1. Gold and gold receivables

	31 December 2016	31 December 2015
Gold holdings in:		
Troy ounces	187,158	187,324
Kilograms	5,821	5,826
Price per one Troy ounce, EUR	1,098.046	973.225

[7] *Decision ECB/2014/57 of 15 December 2014 on the interim distribution of the income of the European Central Bank (recast), OJ J 53, 25.2.2015, p. 24., as amended.*

Value of gold, EUR thousands	205,508	182,309

Gold investment

Troy ounces

	31 December 2016	31 December 2015
Gold swaps	187,158	109,866
Fixed-term deposits	–	77,458
Total	**187,158**	**187,324**

The gold held by the Bank of Lithuania as at 31 December 2016 was invested in gold swaps.

Gold holdings in 2016, compared to 2015, decreased due to differences in the weight of gold bars arising on settlements of gold investment transactions.

The overall increase of the value of gold was caused by the rise of the gold price in financial markets in 2016.

Note 2. Receivables from the IMF

EUR thousands

	31 December 2016	31 December 2015
Balance in the Special Drawing Rights account with the IMF	175,000	174,759
Reserve tranche position in the IMF	44	44
Total	**175,044**	**174,803**

The major part of the SDR balance in the SDR account with the IMF, managed by the Republic of Lithuania, is comprised of SDR 137,239 thousand (EUR 174,924 thousand), allocated by the IMF in 2009, which is disclosed under the Balance Sheet of the Bank of Lithuania liability item '9. Counterpart of special drawing rights allocated by the IMF'. The Bank of Lithuania receives interest on balance in the SDR account with the IMF and pays interest on SDR allocated by the IMF.

Reserve tranche position in the IMF

SDR thousands

	31 December 2016	31 December 2015
Lithuania's quota in the IMF	441,600	183,900
Promissory notes of the government of the Republic of Lithuania	(429,238)	(180,630)
Cash funds in the IMF account with the Bank of Lithuania	(1,113)	(523)
Valuation adjustment	(11,215)	(2,713)
Reserve tranche position in the IMF	**34**	**34**

Pursuant to the Resolution adopted by the Board of Governors of the IMF on 15 December 2010, the quota of Lithuania in the IMF was increased by SDR 257,700 thousand on 10 February 2016. As at 31 December 2016, the value of the quota totalled SDR 441,600 thousand. 99.75 per cent of Lithuania's quota was paid in non-interest-bearing promissory notes of the government of Republic of Lithuania denominated in euro.

The reserve tranche position in the IMF is the difference between (a) Lithuania's quota in the IMF, and (b) non-interest-bearing promissory notes issued for the benefit of the IMF by the government of the Republic of Lithuania and the balance in the IMF account with the Bank of Lithuania for financial operations with the IMF. The difference incurred due to the change in the euro value against SDR is presented as the valuation adjustment. In 2016, the presentation of the reserve tranche position in the IMF was changed: currency valuation adjustment was separated from the value of promissory notes of the government of the Republic of Lithuania and from cash funds in the IMF account with the Bank of Lithuania. Accordingly, the comparative information for 2015 was reclassified.

SDR thousands

	31 December 2015 balance as published in 2015	Adjustment owing to reclassification	31 December 2015 balance as published in 2016
Promissory notes of the government of the Republic of Lithuania	(183,347)	2,717	(180,630)
Cash funds in the IMF account with the Bank of Lithuania	(519)	(4)	(523)
Valuation adjustment	–	(2,713)	(2,713)

Lithuania's quota in the IMF belongs to the Republic of Lithuania and reflects its voting power within the IMF, as well as determines the financial commitments of Lithuania to the IMF and how much it could borrow from the Fund.

The Bank of Lithuania performs the function of the depository of IMF funds.

Note 3. Balances with banks and security investments, external loans and other external assets denominated in foreign currency

This Balance Sheet item consists of the Bank of Lithuania's balances with credit institutions, investments in securities and reverse repurchase agreements of non-euro area residents denominated in foreign currency.

EUR thousands

	JPY	USD	CHF	CNY	CZK	Other	**Total**
31/12/2016							
Balances in current accounts	709,277	7,300	775,839	681	476,848	571	**1,970,515**
Debt securities	–	326,138	–	88,794	–	174,938	**589,870**
Reverse repurchase agreements	–	285	–	–	–	–	**285**
Total	**709,277**	**333,723**	**775,839**	**89,476**	**476,848**	**175,508**	**2,560,670**
31/12/2015							
Balances in current accounts	832,516	1,313	292	538	914,191	618	**1,749,468**
Debt securities	87,778	275,690	–	90,647	–	–	**454,115**
Reverse repurchase agreements	–	797	–	–	–	–	**797**
Total	**920,294**	**277,800**	**292**	**91,185**	**914,191**	**618**	**2,204,380**

At the year end the balances in current accounts were about three times higher than average during the year (EUR 558 million) due to short-term transactions conducted seeking to benefit from favourable conditions in the money market at the year end.

Breakdown of balances with banks and security investments, external loans and other external assets by the economic area of residence of the issuer and counterparty

EUR thousands

	31 December 2016	31 December 2015
Switzerland	775,839	292
Japan	728,247	922,988
Non-euro area EU Member States	595,391	953,645
USA	179,337	194,023
Canada	96,975	–
China	89,479	91,188
International financial institutions	65,657	13,423
Other countries	29,745	28,820
Total	**2,560,670**	**2,204,380**

Note 4. Claims on euro area residents denominated in foreign currency

EUR thousands

	USD	CHF	Other	**Total**
31/12/2016				
Balances in current accounts	127	0	0	**127**
Debt securities	137,145	–	–	**137,145**
Total	**137,272**	**0**	**0**	**137,272**
31/12/2015				
Balances in current accounts	597	1	1	**598**
Debt securities	103,242	11,764	–	**115,006**
Total	**103,838**	**11,765**	**1**	**115,603**

Note 5. Claims on non-euro area residents denominated in euro

This Balance Sheet item consists of the Bank of Lithuania's balances in current accounts and investments in securities of non-euro area residents denominated in euro.

EUR thousands

	31 December 2016	31 December 2015
Balances in current accounts	386	2,661
Debt securities	71,052	314,405
Total	**71,439**	**317,066**

Breakdown of claims on non-euro area residents denominated in euro by the economic area of residence of the issuer and counterparty

EUR thousands

	31 December 2016	31 December 2015
Non-euro area EU Member States	64,499	251,546
Japan	6,937	6,878
International financial institutions	3	31,144
Other countries	–	27,498
Total	**71,439**	**317,066**

Note 6. Lending to euro area credit institutions related to monetary policy operations denominated in euro

EUR thousands

	31 December 2016	Conducted in 2016	31 December 2015
Main refinancing operations	–	194,000	–
Longer-term refinancing operations	303,000	310,500	345,700
Marginal lending facility	–	697	–
Total	**303,000**	**505,197**	**345,700**

Descriptions of these operations are presented in the Explanatory Notes section '4.3. Lending to euro area credit institutions denominated in euro'.

Note 7. Other claims on euro area credit institutions denominated in euro

This item consists of the Bank of Lithuania's balances with credit institutions which do not relate to monetary policy operations. As at 31 December 2016, the balances in current accounts amounted to EUR 365 thousand (as at 31 December 2015 – EUR 21 thousand).

Note 8. Securities held for monetary policy purposes

This item consists of the Republic of Lithuania government and supranational securities acquired by the Bank of Lithuania within the scope of the public sector purchase programme (see Explanatory Notes section 4.4).

EUR thousands

	31 December 2016		31 December 2015	
	Amortised cost	Market value	Amortised cost	Market value
The Republic of Lithuania government securities	1,530,440	1,547,227	841,172	844,783
Supranational securities	4,809,185	4,786,705	1,666,886	1,666,435
Public sector purchase programme total	**6,339,625**	**6,333,932**	**2,508,058**	**2,511,218**

The market value of the securities presented in the table is not recorded on the Balance Sheet or in the Profit and Loss Account but is provided for presentation purposes only.

As a result of an impairment test conducted as at 31 December 2016 on securities purchased under the public sector purchase programme, the Governing Council of the ECB decided that all future cash flows on these securities were expected to be received. Consequently, in 2016, no impairment losses were recorded for these securities by the Bank of Lithuania.

Note 9. Other securities

This item presents the Bank of Lithuania's investments in debt and marketable equity securities by euro area residents.

EUR thousands

	31 December 2016	31 December 2015
Debt securities, excl. classified as held-to-maturity	153,417	430,819
Debt securities, classified as held-to-maturity	–	12,659
Marketable equity securities	343,854	472,324
Total	**497,270**	**915,801**

Debt securities, classified as held-to-maturity and held as at 31 December 2015, were redeemed at the beginning of 2016.

Marketable equity instruments are investments in exchange traded fund units, replicating corporate debt or equity securities indexes. As at the end of 2016, the market value of investments, which replicate the equity securities index, amounted to EUR 128,309 thousand (as at 31 December 2015 – EUR 122,678 thousand).

During 2016, the level of euro-denominated investments (excluding monetary policy operations) decreased due to low and continuously decreasing return on secure and most liquid investments in the euro area.

Note 10. Participating interest in the ECB

EUR thousands

	31 December 2016	31 December 2015
Contribution of the Bank of Lithuania to the ECB capital	44,729	44,729
Contribution of the Bank of Lithuania to the reserves of the ECB and to provisions, equivalent to reserves	162,454	162,454
Total	**207,183**	**207,183**

With effect from 1 January 2014, the share of the Bank of Lithuania in the subscribed and paid-up capital of the ECB comprises 0.4132 per cent or EUR 44,729 thousand.

The Bank of Lithuania, pursuant to Article 48.2 of the Statute of the ESCB and of the ECB, has contributed to the reserves of the ECB and to provisions, equivalent to reserves, EUR 162,454 thousand.

Note 11. Claims equivalent to the transfer of foreign reserves

Upon joining the Eurosystem, at the beginning of 2015, the Bank of Lithuania, pursuant to Article 48.1 of the Statute of the ESCB and of the ECB, transferred its share of foreign reserves to the ECB.

Claims equivalent to the transfer of foreign reserves of the Bank of Lithuania, shown in this Balance Sheet item, comprise EUR 239,454 thousand. These claims were determined by multiplying the amount of the foreign reserves already transferred to the ECB at historical exchange rates (31 December 1998) by the ratio between the number of shares subscribed by the Bank of Lithuania and the number of shares already paid up by the other NCBs.

Note 12. Net claims related to the allocation of euro banknotes within the Eurosystem

This item presents the claim of the Bank of Lithuania to the Eurosystem, related to the allocation of euro banknotes within the Eurosystem (see the Accounting Policy section '2.12. Banknotes and coins in circulation' and Note 19). The remuneration of this claim (see Note 34), adjusted by a compensatory amount (see the Accounting Policy section '2.12. Banknotes and coins in circulation'), is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations.

Note 13. Other claims within the Eurosystem (net)

EUR thousands

	31 December 2016	31 December 2015
Redistribution of monetary income	47,924	46,963
Interim profit distribution of the ECB	5,672	4,767
Balance in TARGET2 account	–	240,142
Total	**53,596**	**291,872**

Claim on the ECB in connection with the reallocation of monetary income comes from the difference between the amounts pooled and allocated by Eurosystem NCBs (see Note 38 'Net result of pooling of monetary income').

Following a decision of the Governing Council of the ECB, the amount due to euro area NCBs, with respect to the ECB's interim profit distribution, was EUR 966,235 thousand (see the Explanatory Notes section '4.8. Distribution of the ECB profit'). The amount due to the Bank of Lithuania amounted to EUR 5,672 thousand and was recognised as income of 2016 (see Note 37 'Income from equity shares and participating interests').

The remuneration of the TARGET2 balance is calculated daily at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations.

Note 14. Tangible and intangible fixed assets

EUR thousands

	Tangible assets				Intangible assets (including assets under construction)	**Total**
	Buildings and construction in progress	Cash processing equipment (including assets under construction)	Computer equipment (including assets under construction)	Other tangible assets (including assets under construction)		
Acquisition cost as at 31 December 2015	36,313	5,919	10,301	8,164	8,118	**68,814**
Additions in 2016	–	–	1,082	67	550	**1,699**
Disposals in 2016	–	–	(583)	(62)	(1,538)	**(2,183)**
Acquisition cost as at 31 December 2016	36,313	5,919	10,800	8,170	7,129	**68,331**
Accumulated depreciation as at 31 December 2015	(12,943)	(4,742)	(8,809)	(6,478)	(5,406)	**(38,378)**
Depreciation in 2016	(868)	(200)	(454)	(120)	(461)	**(2,102)**
Depreciation of disposed assets in 2016	–	–	583	62	1,538	**2,183**

continued

	Tangible assets				Intangible assets (including assets under construction)	**Total**
	Buildings and construction in progress	Cash processing equipment (including assets under construction)	Computer equipment (including assets under construction)	Other tangible assets (including assets under construction)		
Accumulated depreciation as at 31 December 2016	(13,811)	(4,941)	(8,680)	(6,537)	(4,328)	**(38,297)**
Net carrying amount as at 31 December 2016	**22,501**	**978**	**2,120**	**1,633**	**2,802**	**30,034**
Net carrying amount as at 31 December 2015	**23,369**	**1,177**	**1,492**	**1,686**	**2,712**	**30,437**

The Bank of Lithuania has not concluded any transactions with the mortgage of tangible assets of the Bank of Lithuania.

Note 15. Other financial assets

EUR thousands

	31 December 2016	31 December 2015
Bank for International Settlements shares	3,334	3,334
SWIFT shares	21	21
Total	**3,355**	**3,355**

The Bank of Lithuania is a member of the Bank for International Settlements (BIS), with 1,070 shares, the acquisition cost of which is EUR 3,334 thousand and the nominal value per share is SDR 5,000. The Bank of Lithuania received EUR 290 thousand in dividends for these BIS shares in 2016 (EUR 303 thousand in 2015).

The Bank of Lithuania holds seven SWIFT shares with the acquisition cost of EUR 20,741. Dividends are not paid for these shares.

Note 16. Off-balance-sheet instruments revaluation differences

Off-balance-sheet instruments revaluation differences represent the revaluation of off-balance-sheet accounted foreign exchange payables and receivables due to changes in the market rates and the revaluation of non-deliverable foreign exchange forward transactions, interest rate derivatives and forward transactions in securities due to market price movements.

EUR thousands

	31 December 2016		31 December 2015	
	Positive differences	Negative differences	Positive differences	Negative differences
Foreign exchange transactions	25,688	4,374	234	28,265
Non-deliverable foreign exchange forwards	6,178	649	5,327	2,723
Interest rate swaps	713	–	488	–
Forward transactions in securities	–	–	11	–
Total	**32,578**	**5,023**	**6,059**	**30,988**

Note 17. Accruals and prepaid expenses

EUR thousands

	31 December 2016	31 December 2015
Accrued interest income	44,335	23,727
On securities held for monetary policy purposes	34,506	12,656
On other securities	5,453	8,269
On financial derivatives	3,692	1,603
On accounts and deposits	663	721
On Intra-Eurosystem balances	21	345

continued

	31 December 2016	31 December 2015
On monetary policy operations	–	134
Other accrued interest	1	0
Debt securities coupon payment purchased	4,918	11,637
Other accruals	–	984
Prepaid expenses	856	366
Total	**50,108**	**36,714**

Note 18. Sundry

EUR thousands

	31 December 2016	31 December 2015
Loans to the staff of the Bank of Lithuania	492	635
Short-term assets	353	174
Advances and other receivables	91	76
Total	**936**	**885**

Pursuant to a resolution of the Board of the Bank of Lithuania, loans to the Bank of Lithuania's employees are no longer issued as of 2009.

Note 19. Banknotes in circulation

EUR thousands

	31 December 2016	31 December 2015
Euro banknotes	6,081,566	5,850,517
Euro banknotes issued by the Bank of Lithuania	2,525,107	2,099,484
Adjustment for banknote allocation in the Eurosystem	4,085,333	4,259,813
The ECB's share of euro banknotes in circulation	(528,873)	(508,781)
Lithuanian litas banknotes	–	109,752
Total	**6,081,566**	**5,960,269**

This item consists of the Bank of Lithuania's share of total euro banknotes in circulation according to the banknote allocation key (see the Accounting Policy section '2.12. Banknotes and coins in circulation'). As at 31 December 2016, the banknote allocation key was 0.5400 per cent. The nominal value of euro banknotes actually issued by the Bank of Lithuania in 2016 increased by 20 per cent from EUR 2,099,484 thousand as at 31 December 2015 to EUR 2,525,107 thousand as at 31 December 2016. As this was less than the allocated amount, the difference of EUR 3,556,459 thousand (compared to EUR 3,751,032 thousand as at 31 December 2015) is shown under the asset sub-item 'Net claims related to the allocation of euro banknotes within the Eurosystem' (see Note 12).

In accordance with the Accounting Guideline, with effect from 1 January 2016, the nominal value of litas banknotes in circulation is disclosed under the Balance Sheet item '12. Other liabilities'.

Note 20. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro

This item contains the balances on the current accounts of credit institutions with the Bank of Lithuania that are required to hold minimum reserves. Bank minimum reserve balances have been remunerated at the latest available marginal interest rate used by the Eurosystem in its tenders for main refinancing operations. The reserves held in excess of the minimum requirements are remunerated at a lower rate of either zero per cent or the deposit facility rate.

EUR thousands

	31 December 2016	Conducted in 2016	31 December 2015
Current accounts (covering the minimum reserve system)	2,481,461	–	2,841,656
Deposits related to margin calls	–	110,508	–
Total	**2,481,461**	**110,508**	**2,841,656**

Descriptions of other liquidity absorbing monetary policy operations are presented in the Explanatory Notes section '4.5. Liabilities to euro area credit institutions related to monetary policy operations denominated in euro'.

Note 21. Other liabilities to euro area credit institutions denominated in euro

As at 31 December 2016, the Bank of Lithuania had no other liabilities to euro area credit institutions denominated in euro. As at 31 December 2015, this item presented gold swaps concluded with euro area credit institutions, which amounted to EUR 25,778 thousand.

Note 22. Liabilities to other euro area residents denominated in euro

This item contains the balances on the current accounts of euro area residents with the Bank of Lithuania denominated in euro.

EUR thousands

	31 December 2016	31 December 2015
Liabilities to the general government	689,958	1,272,620
Other liabilities	1,105	7
Total	**691,063**	**1,272,627**

Note 23. Liabilities to non-euro area residents denominated in euro

This item presents balances in current accounts of international institutions with the Bank of Lithuania denominated in euro, with a total value of EUR 18,262 thousand as at 31 December 2016 (compared to EUR 806 thousand as at 31 December 2015), and other liabilities, the balance of which amounted to EUR 3,100 thousand as at 31 December 2016 (as at 31 December 2015, there were no such liabilities).

Note 24. Liabilities to euro area residents denominated in foreign currency

This item shows repurchase agreements and gold swaps concluded by the Bank of Lithuania with euro area financial sector residents, as well as liabilities to the general government, the main part of which consists of balances in current accounts of government institutions in foreign currency.

EUR thousands

	USD	XDR	JPY	GBP	Other	**Total**
31/12/2016						
Liabilities to the financial sector	372,720	–	–	–	–	**372,720**
Repurchase agreements	151,279	–	–	–	–	**151,279**
Gold swaps	221,441	–	–	–	–	**221,441**
Liabilities to the general government	184	44	–	–	–	**227**
Total	**372,903**	**44**	**–**	**–**	**–**	**372,947**
31/12/2015						
Liabilities to the financial sector	183,028	–	6,016	–	–	**189,044**
Repurchase agreements	102,069	–	–	–	–	**102,069**
Gold swaps	80,960	–	6,016	–	–	**86,975**
Liabilities to the general government	2,526	44	–	358	0	**2,928**
Total	**185,555**	**44**	**6,016**	**358**	**0**	**191,972**

Note 25. Liabilities to non-euro area residents denominated in foreign currency

This item presents repurchase agreements concluded by the Bank of Lithuania with non-euro area residents in US dollar with a total value of EUR 45,815 thousand as at 31 December 2016 (compared to EUR 52,052 thousand as at 31 December 2015).

Note 26. Counterpart of special drawing rights allocated by the IMF

This item presents liabilities to the IMF related to the allocation of SDR to all Member States carried out by the IMF in 2009. According to this allocation, SDR 137,239 thousand was allocated to Lithuania (see Note 2 'Receivables from the IMF').

Note 27. Other liabilities within the Eurosystem (net)

This item presents the intra-Eurosystem balance (net) of the Bank of Lithuania *vis-à-vis* the ECB arising from TARGET2 as at 31 December 2016 (see the Explanatory Notes section '4.6. Participation in TARGET2'). As at 31 December 2015, the balance of the Bank of Lithuania in TARGET2 account was presented in the Balance Sheet asset item as claim within the Eurosystem (net) (see Note 13).

Note 28. Items in course of settlement

The balance of this item consists of cash management operations with commercials banks in the course of settlement.

Note 29. Accruals and income collected in advance

EUR thousands

	31 December 2016	31 December 2015
Accrued interest expenses	2,466	291
On financial derivatives	1,782	244
On monetary policy operations	623	–
Other accrued interest expenses	62	47
Other accrued expenses	1,678	673
Income collected in advance	46	47
Total	**4,190**	**1,011**

Note 30. Sundry

EUR thousands

	31 December 2016	31 December 2015
Litas banknotes in circulation	97,508	–
Euro coins in circulation	78,181	60,489
Litas coins in circulation	32,341	32,613
Sundry	582	564
Total	**208,613**	**93,667**

Note 31. Provisions

EUR thousands

	31 December 2016	31 December 2015
Provisions for risks	102,420	45,920
Provisions for liabilities related to	3,307	3,770
Termination benefits, payable to staff who will qualify for the state social insurance pension while working at the Bank of Lithuania	1,426	1,908
Wages and salaries payable for annual leave	1,263	1,233
Termination benefits to the members of the Board as provided in the Law on the Bank of Lithuania	121	96
Termination benefits by agreements payable to the staff in the subsequent financial year	13	15
Provisions for exchanging derecognised litas banknotes and coins	484	517
Total	**105,728**	**49,690**

In 2016, the Board of the Bank of Lithuania changed the rules on establishing risk provisions. Pursuant to them, the target size for the risk provisions is equal to the assessed level of accounting risk, which is assessed annually in the context of the Financial Risks and Buffers Exercise for the Eurosystem and its members – central banks – in accordance with the methodology approved by the Governing Council of the ECB. The expected shortfall at a 99 per cent confidence level is used to define the target amount of risk provisions.

The Board of the Bank of Lithuania, based on this risk assessment, in 2016 made a decision to form an additional EUR 56,500 thousand of risks provisions.

Provisions for termination benefits, payable to staff who will qualify for the state social insurance pension while working at the Bank of Lithuania, decrease mainly due to the change in factors impacting actuary valuations, such as the decrease of the long-term lending interest rate in the Republic of Lithuania and the growth of the employee change dynamics. A change in these provisions is presented as a decrease in expenses in Note 40 'Staff costs'.

Provisions for the exchange of derecognised litas banknotes and coins are the provisions, formed in 2014, for covering the nominal value of derecognised litas banknotes and coins, which may be returned to the Bank of Lithuania for exchange into euro. EUR 34 thousand of these provisions were used in 2016 (compared to EUR 91 thousand in 2015).

Note 32. Revaluation accounts

Revaluation accounts present unrealised revaluation gains of foreign currency, debt and marketable equity securities, as well as off-balance-sheet financial instruments. Unrealised revaluation gains of financial items, which built up before joining the euro area, are shown separately from other revaluation gains.

EUR thousands

	31 December 2016	31 December 2015
Revaluation accounts		
Pre-system unrealised gains	164,456	164,456
Gold	23,357	–
Equity securities	14,585	9,206
Foreign currency	11,378	10,741
Financial derivatives	6,890	5,826
Debt securities	2,994	3,139
Total	**223,661**	**193,369**

Unrealised revaluation losses, recognised as expenses at the end of 2016 are presented in Note 35. 'Net result of financial operations, write-downs and risk provisions'.

Note 33. Capital

Statement of changes in equity for 2016

EUR thousands

	31 December 2016	2015 profit distribution	31 December 2015
Capital			
Authorised capital	60,000	–	60,000
Reserve capital	368,896	11,335	357,561
Total	**428,896**	**11,335**	**417,561**

The authorised capital of the Bank of Lithuania amounts to EUR 60,000 thousand and is fully formed.

Pursuant to the Law on the Bank of Lithuania, the Bank of Lithuania's reserve capital must not be lower than five amounts of its authorised capital and can be increased from the Bank of Lithuania's profit by an independent decision of the Board of the Bank of Lithuania, adopted taking into account risks and their likely impact. Reserve capital is used for the Bank of Lithuania's loss absorption.

In 2015, the Board of the Bank of Lithuania made a decision to increase the reserve capital up to a specified amount, providing that the annual rate of increase shall be proportionally close to the Bank of Lithuania's projected Republic of Lithuania GDP in the medium-term (calculated in comparative prices) annual average growth.

6. NOTES ON THE PROFIT AND LOSS ACCOUNT

Note 34. Net interest income

EUR thousands

	2016		2015	
	Interest income	Interest expense	Interest income	Interest expense
Monetary policy operations	17,091	(537)	4,553	–
Securities held for monetary policy purposes	10,791	–	2,575	–
Current accounts (covering the minimum reserve system)	6,296	–	1,838	–
Deposits related to margin calls	4	–	2	–
Main refinancing operations	0	–	1	–
Marginal lending facility	0	–	1	–
Longer-term refinancing operations	–	(537)	136	–
Debt securities	11,029	–	12,729	–
Balances in current accounts with the Bank of Lithuania	2,895	–	1,020	–
Foreign exchange transactions	2,829	–	2,785	–
Intra-Eurosystem claims/ liabilities	265	–	1,004	(11)
Claims related to the allocation of euro banknotes within the Eurosystem	192	–	902	–
TARGET2 balances	51	–	–	(11)
Foreign reserves transferred to the ECB	21	–	102	–
Interest rate swaps	–	(179)	–	(89)
The Bank of Lithuania’s balances in current accounts	–	(284)	–	(1,187)
Gold swaps	–	(994)	103	–
Repurchase agreements	–	(1,671)	–	(303)
Other	130	–	353	(31)
Total interest income (expense)	**34,240**	**(3,664)**	**22,547**	**(1,621)**
Net interest income	**30,576**		**20,926**	

In 2016, the net interest income increased by EUR 9,650 thousand, compared to 2015, mainly due to the growth in net interest income from monetary policy operations. This growth was related to continuing purchase of securities under the public sector asset purchase programme (see Note 8) and the decreasing (from –0.2 to –0.4 per cent) negative deposit facility rate. Also net interest expense on longer-term refinancing operations was incurred due to negative interest rates used for calculating interest of the second series of targeted longer-term refinancing operations (see Explanatory Notes section 4.3).

Interest income and expense for 2015 have been restated by EUR 882 thousand in line with the changes in the reporting of negative interest in 2016 (see the Accounting Policy section ‘2.6. Income and expense’) by aligning the provisions for negative and positive interest netting. The reclassification had no impact on the net total interest income for 2015.

Note 35. Net result of financial operations, write-downs and risk provisions

This item includes (a) net income (expense) related to the sale transactions of financial instruments, gold and foreign currency; (b) write-downs of financial items, which consists of unrealised revaluation loss as a result of the decline in market prices and rates on 31 December 2016 as compared to the average prices and rates of these items; and (c) additional provisions for foreign exchange rate, interest rate, gold price and credit risks, formed, by a decision of the Board of the Bank of Lithuania, based on the assessment of the level of accounting risk assumed.

EUR thousands

	2016	2015
Net realised gains (losses) arising from	**28,557**	**(891)**
Transactions in securities	46,200	8,662
Interest rate derivatives	(24,421)	(10,318)
Other transactions in gold and foreign currency	6,778	766
Write-downs on financial items	**(6,390)**	**(16,307)**
Securities	(5,705)	(10,837)
Financial derivatives	(649)	(2,723)
Foreign currency	(37)	(5)
Gold	–	(2,742)
Transfers to provisions for risks	**(56,500)**	**(15,800)**
Net result of financial operations, write-downs and risk provisions	**(34,334)**	**(32,998)**

Note 36. Net income from fees and commissions

EUR thousands

	2016	2015
Fees and commissions income	6,028	5,395
Contributions of supervised financial market participants	5,035	4,532
Settlement services	511	606
Other services	482	257
Fees and commissions expense	(1,282)	(723)
Financial instruments	(1,037)	(622)
Other	(245)	(101)
Net income from fees and commissions	**4,747**	**4,672**

Pursuant to the Law on the Bank of Lithuania, the costs of financial market supervision are funded by the contributions of supervised financial market participants and own funds of the Bank of Lithuania. In 2016, the Bank of Lithuania collected contributions amounting to EUR 4,781 thousand to cover the costs of financial market supervision (in 2015 – EUR 4,532 thousand).

In 2015, the Bank of Lithuania was assigned the function of financial institutions resolution. In 2016, the Bank of Lithuania collected the contributions of financial market participants amounting to EUR 254 thousand to finance the activity of the financial sector resolution authority (no contributions were collected in 2015).

Fees and commissions expense grew mainly due to the fees paid for the external management of the financial assets portfolio in 2016 (in 2015, the Bank of Lithuania had no such expense).

Note 37. Income from equity shares and participating interests

EUR thousands

	2016	2015
Dividend income from marketable equity securities	5,646	5,312
Income from distribution of the ECB profit	7,255	4,767
Dividend income from non-marketable equity securities	290	303
Total	**13,190**	**10,382**

In 2016, income from the distribution of ECB profit consisted of income from the final distribution of ECB profit for 2015 (EUR 1,583 thousand) and income from the interim distribution of ECB profit for 2016 (EUR 5,672 thousand). In 2015, respective income consisted only of income from the interim distribution of ECB profit for 2015.

Note 38. Net result of pooling of monetary income

EUR thousands

	2016	2015
Net monetary income pooled by the Bank of Lithuania	(10,233)	(5,754)
Net monetary income reallocated to the Bank of Lithuania	58,159	52,717
Adjustment for the monetary income of previous years	(2)	–
Net result of pooling of monetary income	**47,924**	**46,963**

Note 39. Other income

EUR thousands

	2016	2015
Income from sale of collector, commemorative coins and other numismatic valuables	801	3,589
Income from sale of scrap of litas coins withdrawn from circulation	144	3,450
Income from coin rolling services	59	–
Other miscellaneous income	203	137
Total	**1,207**	**7,176**

In 2016, income from the sale of collector, commemorative coins and other numismatic valuables decreased due to a decrease in the number of collector and commemorative coins.

Note 40. Staff costs

EUR thousands

	2016	2015
Expenses on wages and salaries	11,097	11,194
to the members of the Board	380	381
to the heads of structural divisions	763	814
to other staff of the Bank of Lithuania	9,954	9,998
Other emoluments	525	286
Contributions to the State Social Insurance Fund	3,578	3,534
Expenses on (income from) provisions related to liabilities to the staff	(429)	253
Total	**14,771**	**15,267**

Pursuant to the Law on the Bank of Lithuania, the Board of the Bank of Lithuania consists of: the Chair, two Deputy Chairs, and two Members.

As at 31 December 2016, four Services, four autonomous Departments and four autonomous Divisions operated in the Bank of Lithuania. As at 31 December 2016, the Bank of Lithuania employed 588 staff members (at the end of 2015 – 609) of which 19 (at the end of 2015 – 26) worked under a fixed-term labour contract. In addition, 13 employees were on parental leave or unpaid leave for the term of their contracts with the ECB and the IMF (at the end of 2015 – 10).

In 2016, the decreasing number of staff caused a decrease in expenses on wages and salaries together with a one-off increase in other emoluments, related to the termination benefits paid to staff members when terminating employment contracts with them.

Note 41. Administrative expenses

EUR thousands

	2016	2015
Administrative expenses		
Tangible assets maintenance	3,305	3,145
Information systems maintenance and information acquisition	1,414	1,440
Participation in international organisations fees	1,123	878
Business trips	760	837
Equipment and office supply	423	468
Training of the staff	347	415
Communication	236	282
Mail and telecommunication	222	186
Other	518	644
Total	**8,348**	**8,296**

Note 42. Banknote production services

The Bank of Lithuania participates in the production of euro banknotes together with other NCBs of the euro area. The Governing Council of the ECB sets the denominations of euro banknotes and their quantities that must be produced each year from euro area NCB funds. In 2016, the Bank of Lithuania incurred EUR 9,344 thousand of euro banknote production expenses that were necessary to supplement the Eurosystem's strategic reserve (in 2015, the Bank of Lithuania did not incur such expenses).

Note 43. Other expenses

EUR thousands

	2016	2015
Collector and commemorative coin minting expenses	593	1,896
Euro circulation coin minting expenses	447	7,035
Cash circulation expenses	56	59
Other miscellaneous expenses	644	2
Total	**1,740**	**8,992**

In 2016, the number of euro coins minted decreased due to the satisfied demand for euro coins in 2015. Other miscellaneous expenses were incurred in 2016 as a result of a performed assets quality review of credit unions in Lithuania.

Note 44. Distribution of the profit

Pursuant to Article 23 of the Law on the Bank of Lithuania, profit (loss) is distributable (coverable) as follows:

1) net distributable profit (loss), which consists of the profit (loss) for the last financial year and undistributed profit (if any) carried over from the previous financial periods, is distributed (covered) after the end of the financial year;

2) net distributable loss shall be covered from the reserve capital of the Bank of Lithuania. When the reserve capital is not sufficient to cover the net distributable loss, the remaining uncovered losses are carried forward to be covered by the distributable profit of the succeeding financial years;

3) net distributable profit shall be allocated in the following sequence:
- to cover the uncovered loss carried forward;
- for the authorised capital up to the amount specified in the Law on the Bank of Lithuania;
- for the reserve capital up to the amount independently established by the decision of the Board of the Bank of Lithuania, taking into account the potential impact of risks; however, this capital shall not be less than five amounts of the authorised capital of the Bank of Lithuania;
- to the State Budget as the profit contribution of the Bank of Lithuania. This contribution shall not exceed the amount corresponding to 70 per cent of the calculated average of the profit (loss) of the Bank of Lithuania of the last three financial years.

The surplus of the distributable profit after allocation shall be carried forward as undistributed profit and shall be distributed in subsequent financial years.

Profit distribution

EUR

	2016	2015	2014
Profit distribution			
Allocation to the authorised capital of the Bank of Lithuania	–	–	2,075,996
Allocation to the reserve capital of the Bank of Lithuania	15,493,621	11,334,686	10,724,178
Transfer to the State Budget	11,510,168	10,444,643	7,537,005
Total	**27,003,790**	**21,779,329**	**20,337,179**

7. OTHER NOTES

Note 45. Derivatives

As at 31 December 2016, the Bank of Lithuania had outstanding foreign exchange swaps, foreign exchange forwards, non-deliverable foreign exchange forwards, interest rate futures and interest rate swaps. All these transactions were conducted in the context of the management of the Bank of Lithuania's financial assets (excluding monetary policy operations).

Foreign exchange swaps and foreign exchange forwards

EUR thousands

	31 December 2016	31 December 2015
Claims	4,625,327	3,121,849
Liabilities	4,625,327	3,121,849

Non-deliverable foreign exchange forwards

EUR thousands

	31 December 2016	31 December 2015
Notional claims	184,298	472,443
Notional liabilities	181,131	473,468

Interest rate futures

EUR thousands

	31 December 2016	31 December 2015
Notional claims	1,590,705	248,016
Notional liabilities	320,300	326,804

Interest rate swaps

The notional value of interest rate swap transactions as at 31 December 2016 amounted to EUR 4,743 thousand (as at 31 December 2015 – EUR 36,741 thousand).

ANNEXES

Collector and commemorative coins issued into circulation in 2016

The €5 gold coin from the series 'Lithuanian Science' was issued on 29 March. The coin is dedicated to Physics. Diameter – 13.92 mm, weight – 1.244 g, quality – proof, mintage – 5,000 pcs.

Designed by Jolanta Mikulskytė and Giedrius Paulauskis.

Chart 1. €5 gold coin from the series 'Lithuanian Science'

The €20 silver coin dedicated to the XXXI Olympic Games in Rio de Janeiro was issued on 25 July. Diameter – 38.61 mm, weight – 28.28 g, quality – proof, mintage – 7,000 pcs.

Designed by Rūta Ničajienė and Giedrius Paulauskis.

Chart 2. €20 silver coin dedicated to the XXXI Olympic Games in Rio de Janeiro

The €20 silver coin dedicated to the 25th anniversary of the consolidation of Independence was issued on 8 September. Diameter – 38.61 mm, weight – 28.28 g, quality – proof, mintage – 4,000 pcs.

Designed by Rūta Ničajienė.

Chart 3. €20 silver coin dedicated to the 25th anniversary of the consolidation of Independence

The €2 commemorative coin dedicated to Baltic culture was issued on 3 May. The external part of the coin is made of a copper-nickel alloy, inner – of three layers: nickel-brass/nickel/nickel-brass.

Diameter – 25.75 mm, weight – 8.50 g. Mintage – 1,000,000 pcs, of which 10,000 are BU quality in a numismatic package.

National side of the coin designed by Jolanta Mikulskytė and Giedrius Paulauskis.

Common side designed by Luc Luycx.

Chart 4. €2 commemorative coin dedicated to Baltic culture

All coins bear the logo of the Lithuanian Mint.

Resolutions adopted by the Board of the Bank of Lithuania published in the Register of Legal Acts in 2016

In 2016, the Bank of Lithuania took active legislative actions, adopting regulatory Bank of Lithuania legal acts. In 2016, the Board of the Bank of Lithuania adopted 119 resolutions, regulating activities of banks and other financial market participants; they are publicly available on the Register of Legal Acts.

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