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Review of the Activities of Credit Unions

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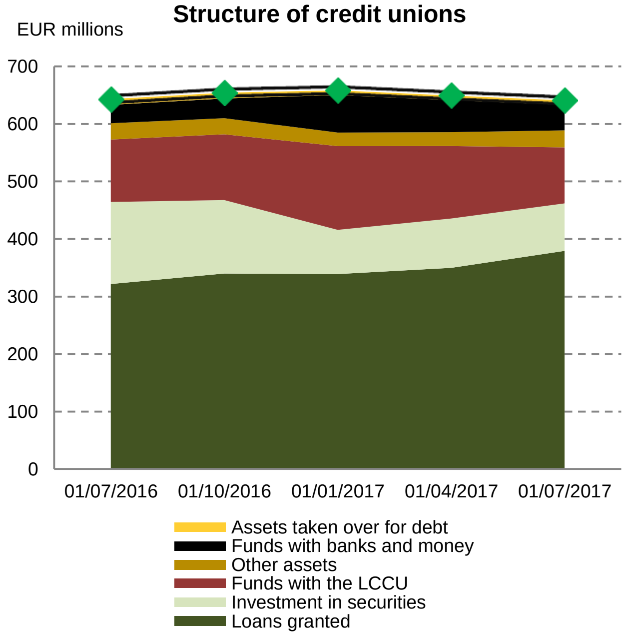
On 1 July 2017, 71 credit unions operated in Lithuania. As at the end of the previous quarter, the total membership on the reporting date was 162.8 thousand.

In Q2 2017, credit union assets shrank by 1.3 per cent and, according to the reported data as at 1 July 2017, amounted to EUR 641 million, or 2.4 per cent of the banking system's assets (a year ago – 2.7%). The change in the volume of the credit union sector assets was driven by the further decline in the deposits with credit unions uniting farmers.

As seen in the Chart, in Q2 2017 credit union funds with the LCCU and with banks, as well as their money and security investments decreased, while loans granted, which accounted for the largest asset share on the reporting date, were on the rise.

At the end of the reporting period, credit unions had granted to their members EUR 379.3 million in loans. In Q2 2017, loans granted by credit unions increased by EUR 29.5 million, or 8.4 per cent, while their share in the credit union sector assets – by 5.3 p.p., to account for nearly 60 per cent of the credit union sector assets. Loans granted by credit unions to members-natural persons expanded by EUR 23.6 million over the reporting period, yet the total growth of such loans was slower than that of loans to legal persons. The more rapid growth rate of loans granted to legal persons led to certain structural changes in the loan portfolio: the loan portfolio share of loans granted to associate members (mainly legal persons), which was on a downward path for a long period of time, increased, to stand at 19.5 per cent at the end of the quarter.

Structure of credit unions



Source: Bank of Lithuania.

Taking into account the results of the asset quality review, credit unions strengthened their loan collateral, recovered bad loans and took other measures that helped contracting specific provisions (for covering likely losses on loan impairment) by 4.5 per cent (to EUR 18.9 million). With the loan portfolio expanding and special provisions diminishing, the ratio of specific provisions to loans reduced by 0.5 p.p. (to 4.8**%**). The share of non-performing loans in the growing loan portfolio shrank as well, yet the amount of loans with debt obligations overdue for more than 60 consecutive days continued to increase. In the period under review, the stock of the before mentioned loans increased by EUR 3.2 million, while the ratio of these loans and assets taken over to total loans reduced by 0.2 p.p., amounting to 11.9 per cent at the end of the quarter. **This indicates that members of credit unions default on obligations, therefore, in the future credit unions may bear related costs should loans impair.**

Credit union investment in securities decreased and at the end of the period under review accounted for nearly 60 per cent of the last year's portfolio. In Q2 2017, credit union investment in securities dropped by EUR 3.2 million (to EUR 82.6 million), amounting to 12.9 per cent of total credit union assets. According to the reported data, the credit union securities portfolio was managed in compliance with the requirements laid down in the Regulations on Credit Union Investment in Non-equity Securities (hereinafter 'Regulations'). All credit unions complied with the Regulation's requirement regarding the share of the securities portfolio in the on-balance-sheet assets – at the end of the quarter, securities did not account for more than 35 per cent of their on-balance-sheet assets. Four credit unions failed to ensure compliance with other requirements established in the Regulations: one – for the average modified financial duration of a securities portfolio, concentration of lower-rated government securities of EU countries, and concentration in securities of a sole lower-rated issuer; three – for the average modified financial duration of a securities portfolio. As mentioned in the previous review, the securities portfolios of some credit unions were inadequately diversified by duration; as a result, after selling

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part of their holdings of securities, these credit unions may encounter difficulties (due to a limited supply of short-term securities) related to compliance with the requirement for the average modified financial duration. **Given that, as of 31 December 2017, the average modified financial duration of a securities portfolio is to exceed two years, some credit unions will have to change the composition of their securities portfolio to comply with the above-mentioned requirement.**

The main funding source for credit unions continues to be accepted deposits, with which they financed almost 90 per cent of their assets. As mentioned above, deposits accepted by credit unions declined by EUR 19.5 million (3.4%) in Q2 2017, to EUR 561.3 million as at 1 July 2017. This change in the deposit portfolio resulted from the increased financing needs of credit unions uniting farmers which were related to the agricultural season. The overall decline in the deposit portfolio in the period under review was due to a drop of EUR 22.5 million in sight deposits (to EUR 135.9 million). Fixed-term deposits, which at the end of the period comprised three-fourths of total deposits with credit unions, grew by EUR 3 million. According to the reported data, annual interest rates on deposits with a maturity of 12 months continued to be not above 0.8 per cent, yet some credit unions, aiming to accumulate funds for crediting or acquisition of securities, offered higher interest rates (1% or higher). As usual, deposits of natural persons accounted for the largest share of the deposit portfolio (96.9%), since residents, driven by their long-term habit, choose deposits as a means of saving and investing.

The share capital of credit unions increased by 1.2 per cent in Q2 2017, to EUR 57.9 million at the end of the quarter. The change in the share capital was led by the increase in the share capital of credit unions planning to become specialised banks. According to the data reported by credit unions, sustainable shares, with which losses incurred by a credit union are covered, accounted for 38.2 per cent of the share capital at the end of the quarter under review, an increase of 15 p.p. from 1 April 2017.

According to the reported data, in H1 2017 credit union operations were profitable. Since the start of the year, 48 credit unions have earned a EUR 2.9 million profit; however, 23 credit unions bore a loss of EUR 2.4 million, which minimised the overall profit to EUR 0.5 million (in H1 2016 credit unions earned EUR 0.3 million in profit). The better operating result for Q1 2017 was due to the fact that growth in the expenses borne by credit unions outpaced their income (year on year expenses borne dropped by 14%, while income received – by 12%). As usual, the largest share of credit union income (78%) was comprised of interest income, of which 95 per cent – on loans granted to members. Operating expenses accounted for the largest share (62%) of the credit union sector's expenses in the reporting period; year on year they dropped by 5.1 per cent. Although the share of these expenses in total expenditure contracted by 1 p.p., a larger share of diminishing income was used to cover them (compared to H1 2016, this share increased by 4.5 p.p. – to 59.1%). As most credit unions cut their interest rates on deposits, in H1 2017 the sector bore 13.4 per cent less interest expenses year on year; however, these expenses, as in the previous year, accounted for one-fourth of total expenses. **As income declines, it is crucial that credit unions assess expenses borne and seek a positive operating result, necessary for strengthening sustainable capital.**

According to the data as at 1 July 2017, the capital adequacy ratio of the credit union system stood at 19.29 per cent (minimum requirement – 13%), liquidity ratio – at 44.41 per cent (minimum requirement – 30%). On the reporting date, 11 credit unions did not comply with prudential ratios:

- Palanga credit union, *Vilniaus kreditas* credit union and *Centro taupomoji kasa* credit union did not comply with the capital adequacy and the maximum exposure for a single borrower requirements;
- *Sūduvos parama* credit union, Klausučiai credit union, *Moterų taupa* credit union, Trakai credit union, Kvėdarna credit union, Varėna credit union, *Namų* credit union and *Baltija* credit union – the maximum exposure for a single borrower requirement.

Non-compliance by the above-named credit unions with prudential requirements was a result of a lack of capital, which occurred (or increased) due to significant expenses incurred (in some cases – due to expenses related to asset quality). **Considering that the asset quality review is not completed in all credit unions, capital strengthening for some credit unions remains one of the major strategic goals.**

In Q3 2017, *Sūduvos parama* credit union, Varėna credit union, *Namų* credit union, Trakai credit union, Kvėdarna credit union and Palanga credit union reported that they had remedied the situation and are now in compliance with prudential requirements. Some of the credit unions were set individual deadlines for ensuring compliance with prudential ratios. Credit unions which are not in compliance with prudential requirements and have not taken action to ensure compliance are subject by the Bank of Lithuania to the enforcement measures provided for in the Republic of Lithuania Law on Credit Unions.

It should be noted that information on each credit union's key performance indicators for the year and each quarter as well as on their compliance with prudential ratios is published on the Bank of Lithuania website.

In 2017, credit unions must prepare for the entry into force of the provisions of the laws implementing the reform of the credit union sector as of 1 January 2018. One of the major steps in carrying out the credit union sector reform approved by the Seimas of the Republic of Lithuania, was the asset quality review of all credit unions, the results of which were published in April 2017, after receiving consent from 69 out of 72 credit unions, including the LCCU. The asset quality review results for each credit union, information about the capital adequacy ratio for 1 April 2017, reported by credit unions, and the status of the asset quality review process are available on the Bank of Lithuania website.

Considering that the implementation of the reform envisaged by the new laws mitigates risks arising within this sector, in April 2017 the Bank of Lithuania approved amendments to the Rules for Calculating the Capital Adequacy Ratio of Credit Unions, with which credit unions will have to comply until 31 December 2017. In June 2017, the Bank of Lithuania also approved the new prudential requirements for credit unions, in July – the new Rules for Calculating Capital Adequacy of Credit Unions and supervisory reporting forms. The new requirements will come into force on 1 January 2018.

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Annex. Dynamics of performance indicators of the credit union sector

Seq. No	Indicator	Amount, EUR millions 01/07/2016	01/04/2017	01/07/2017	Change (%) 2017 Q2	over the year
1	**Assets**	643.3	649.5	641.0	–1.3	–0.4
2	Money	3.6	3.8	3.7	–2.6	2.8
3	Funds with banks	28.4	51.9	40.7	–21.6	43.3
4	Funds with the LCCU	108.6	126.0	97.4	–22.7	–10.3
5	Government securities	142.7	85.8	82.6	–3.7	–42.1
6	**Loans granted**	321.7	349.8	379.3	8.4	17.9
7	Specific provisions against loans	18.9	19.8	18.9	–4.5	–
8	Ratio of specific provisions against loans to loans (%)	5.6	5.3	4.8	–	–
9	Debt to the LCCU	17.3	10.4	18.4	76.9	6.4
10	**Deposits**	563.9	580.8	561.3	–3.4	–0.5
10.1	Of members and associated members of credit unions	561.5	577.8	557.8	–3.5	–0.7
11	**Share capital**	57.8	57.2	57.9	1.2	0.2
12	Profit (loss) for current year	0.3	0.3	0.5	–	–

Source: Bank of Lithuania.

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