



LIETUVOS BANKAS

# Banking activity review

## 2<sup>nd</sup> Quarter of 2013

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In the second quarter of 2013,<sup>1</sup> banking activities remained stable, banks earned profit, complied with prudential requirements. In May, AS UniCredit Bank Lithuania Branch (hereinafter — UniCredit) cancelled its activities. However, this fact did not exercise major impact of the country's banking sector because the market share of the branch accounted only for 1.3 per cent. A part of this market share was divided among banks operating in Lithuania, the remaining portion of managed assets and liabilities was transferred to the head office operating in Latvia. The UniCredit Group in Lithuania did not give up its plans to continue provision of leasing services.

### Changes of the main indicators in the banking sector

Row. No.	Name of the indicator	Amount as of 01-01-2013, LTL millions (excl. Ūkio bankas)	Amount as of 01-04-2013, LTL millions (excl. Ūkio bankas)	Amount as of 01-07-2013, LTL millions (excl. Ūkio bankas)	Change Q2 2013, % (excl. Ūkio bankas)	Change in Q1, % (excl. Ūkio bankas)
1.	Assets	74,258.3	77,303.6	75,632.6	-2.2	1.9
2.	Debt securities	5,180.5	6,133.1	6,329.0	3.2	22.2
3.	Loans granted to customers	52,870.1	54,310.1	53,924.8	-0.7	2.0
3.1.	To private enterprises	24,000.7	24,244.8	23,613.8	-2.6	-1.6
3.2.	To financial institutions	2,843.9	3,172.1	3,424.3	8.0	20.4
3.3.	To natural persons	22,775.1	22,699.8	22,739.8	0.2	-0.2
3.3.1.	Housing loans	19,246.8	19,206.2	19,249.6	0.2	0.0
4.	Loan impairment	2,986.9	2,926.2	2,721.3	-7.0	-8.9
4.1.	Ratio of the loan impairment and granted loans, %	5.3	5.1	4.8	-	-
5.	Deposits and letters of credit	43,613.6	45,738.1	45,463.0	-0.6	4.2
5.1.	Of private enterprises	14,840.5	14,793.9	14,151.9	-4.3	-4.6
5.2.	Of financial institutions	1,068.6	1,195.1	991.7	-17.0	-7.2
5.3.	Of natural persons	24,379.9	26,521.3	26,753.6	0.9	9.7
6.	Shareholders' equity	7,070.4	7,265.1	7,463.7	2.7	5.6
7.	Profit (loss) for the current year	721.7	372.8	550.3	-	-

The withdrawal of UniCredit was one of the most important factors behind the LTL 1.7 billion shrinkage of assets managed by banks. The size of the banking system was further approaching levels before the economic overheating: as of 1 July 2013, the banks managed assets amounting to LTL 75.6 billion — the same volume as 6 years ago. The loan portfolio comprising the major part of assets, shrank over the reporting period by LTL 0.4 billion and as of 1 July accounted for LTL 53.9 billion. However, excluding the impact of UniCredit, the banking sector loan portfolio would have grown for the fifth quarter in turn. A rise of over LTL 200 million in bank liabilities to credit customers suggests further possible growth potential of the loan portfolio.

When the banks increased their investment into private enterprises and debt securities of foreign banks in the second quarter of 2013, the portfolio of debt securities managed by them expanded by LTL 195.9 million and as of 1 July amounted to LTL 6.3 billion. These changes did not have a significant impact on the composition of the debt securities portfolio: the largest part of the debt securities portfolio continued to be comprised by investment into securities of the Government of the Republic of Lithuania (LTL 4 billion), LTL 1.3 billion was invested by banks into debt securities of the European Union countries and LTL 0.3 billion — into debt securities of governments of the European Union countries.

Nearly the whole equity securities portfolio of LTL 1.1 billion held by banks is comprised of investment into subsidiaries. By recently emphasizing the application of the customer-friendly activity approach and regarding capital requirements becoming more stringent,

<sup>1</sup>The banking sector is comprised presently of 7 operating commercial banks and 9 foreign bank branches. In order for the data to be comparable, data of AB Ūkio bankas are eliminated from the analysis of the banking sector indicators when analysing performance indicators of the banking sector.

the banks are likely to optimise their management and curtail the portfolio of such investment, they will perform the activities of subsidiaries themselves. This is already happening presently: in the first quarter Swedbank, AB sold a life insurance company to the Swedbank group operating in Estonia, in the second quarter SEB BANKAS, AB announced that it would affiliate a leasing subsidiary.

In the second quarter, the bank funds held with the Bank of Lithuania contracted by more than one fourth (LTL 1 billion). The trend of these funds decreasing has been dominating since the beginning of the year. This particular behaviour of banks is partly driven by decisions taken to curtail the reserve requirement ratio, not to pay interest for funds held with the Bank of Lithuania.

Deposits held with banks decreased in the second quarter by LTL 275 million; however, individuals' deposits soared by more than LTL 200 million. In the absence of deposit increase features, they remain an unattractive means of saving. Regardless, a growing share of individuals' funds held with banks is increasing, while the share of time deposits is decreasing: in 2010, time deposits accounted for two thirds of total deposits of individuals, while in 2013 —54 per cent. Despite this structural change, further expanding volumes of individuals' funds held with banks demonstrate trust in the country's banking system.

In the second quarter, debt to parent banks shrank by LTL 0.6 billion to LTL 19.1 billion, funds of parent banks were used for financing one fourth of the bank assets. Net debt to parent banks (difference between liabilities to parent banks and funds in them) as of 1 July 2013 totalled LTL 11.3 billion. In the context of a decrease in these liabilities and banks obtaining more funds in the domestic market, the ratio of banking system loans and deposits also continued to improve. As of 1 July 2013, it reached 118.6 per cent, compared to over 200 per cent during the economic overheating period.

## BANK LOAN PORTFOLIO

In the second quarter of this year, the loan portfolio of operating banks shrank by 0.7 per cent and as of 1 July 2013 amounted to LTL 53.9 billion. The shrinkage of the bank sector loan portfolio was determined by the above mentioned withdrawal of UniCredit. Disregarding the size of the loan portfolio transferred to the Latvian head office of this branch, the loan portfolio of the banking system would have increased insignificantly.

Having decreased from the beginning of 2009, housing loans given by banks grew within the quarter by LTL 43.4 million or 0.2 per cent. After the withdrawal of the UniCredit Group, which was more active in the business customers segment, bank loans to businesses dropped most of all (LTL 0.6 billion) within the quarter. Having increased significantly in the first quarter, loans to public authorities contracted in the reference period by 2.7 per cent or LTL 75 million. In the second quarter, banks gave more credits to leasing companies as well as to state and municipality companies. The banks expanded segments of these loan portfolios by 8 and 2.1 per cent respectively. Regard should be given to the fact that if growth trends of the local government liabilities will not change, such a situation might provoke both, a rise of the banking sector credit risk and uncertainty surrounding general government finances (more about it see Financial Stability Review of 2012).

In the second quarter, indicators defining the loan portfolio quality improved somewhat. This stabilisation of indicators suggests that in the entire banking system uncertainty surrounding prospects of individual sectors after the economic downturn, assessments of the borrowers' position and forecasts is coming to an end. At the same time such a situation also shows that banks accomplishing exaction procedures begun during the crisis period and persisting for some time, i.e., having exhausted loan repayment possibilities, are eliminating bad loans from financial statements. The comparison with 2010 when the mentioned loan quality indicators reached their peak, reveals that the balance of both **non-performing loans** and formed special provisions in the banking system has dropped by more than one third. It should be noted that in Lithuania one of the most stringent definitions of bad loans has been used since 2008, but currently a draft on the application of a single definition at the European level has been prepared in Europe.

With a decrease of special provisions by 7 per cent in the second quarter, the ratio of special provisions to loan portfolio shrank by 0.3 percentage points and at the end of the quarter amounted to 4.8 per cent. The share of impaired loans in the loan portfolio contracted by 0.9 percentage points and totalled 9.7 per cent; the indicator of non-performing loans<sup>2</sup> shrank by 0.7 percentage points to 12.2 per cent. The ratio of loans overdue for more than 60 days (but unimpaired) was growing for the second quarter in turn. As of 1 July this ratio amounted to 2.5 per cent.

In the environment of a slight improvement of the financial state of households, the banks are rebuilding provisions formed for loans granted to natural persons. The quality of the housing loans portfolio remained better, the balance of provisions formed for the portfolio of these loans decreased to 3 per cent. The quality of consumer loans continues to be poor: the indicator of special provisions on consumer loans was 8.5 per cent as of 1 July 2013.

In the second quarter of this year, lending in litas was more active as in foreign currency. Loans in national currency increased within the quarter by LTL 479 million, whereas in foreign exchange — dropped by LTL 864 million. These changes were significantly

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<sup>2</sup> Non-performing loans include impaired loans and loans overdue for more than 60 days (but unimpaired).

impacted by the above mentioned withdrawal of UniCredit. However, loans in foreign currency (mainly in euro) continued to form the largest share of the loan portfolio (over two thirds).

In the banking system, bank loans to non-residents decreased by 2.7 per cent and accounted for LTL 373 million or 0.3 per cent from the total portfolio of loans.

## IMPLEMENTATION OF PRUDENTIAL REQUIREMENTS FOR BANKING ACTIVITIES

As of 1 July 2013, all banks complied with prudential requirements set for banking activities. Moreover, they would not be confronted with any difficulties in complying with changes in new capital adequacy and liquidity indicators, the application of which is provided in the new Capital Requirements Directive (CRD IV).

The banking system excelled itself by a high level of capital adequacy: in the second quarter of 2013, the capital adequacy ratio of the banking sector did not change and as of 1 July 2013 was equal to 15.6 per cent. As of 1 July 2013, the capital base, used in calculating the capital adequacy requirement, amounted to LTL 6.3 billion. Almost the whole capital base was formed by Tier I (the best quality) capital. The capital requirement of the banks did not change markedly over the quarter and amounted to LTL 3.3 billion. The largest share of the capital requirement (LTL 2.7 billion) was formed by capital required for the impact of credit risk. Capital to cover market and operational risks totalled LTL 0.3 billion and LTL 0.2 billion respectively.

The liquidity ratio as of 01 July 2013 accounted for 39.3 per cent and was by 9 percentage points higher than required. In addition, the banking sector had sufficient liquidity reserve to cover the financing gap: the liquidity reserve of banks amounted to LTL 16 billion, and the net financing gap — LTL 7.1 billion. Thus, the banks had formed their reserve of liquid funds 2.3 times larger than required.

As of 1 July 2013, the banking sector's maximum open position in foreign currencies and precious metals requirement was equal to 0.5 per cent.

## PROFITABILITY

In the first semi-annual period the banks and foreign bank branches earned LTL 550.3 million — 61 per cent more than in the first half-year of 2012. However, after the elimination of Swedbank, AB profit earned from the sale of its life insurance block of shares in the first quarter and the profit of other banks earned from subsidiaries, the banking sector profit before taxes and provisions contracted year on year by 12.7 per cent. This change occurred basically due to a decrease of net interest income and growth of operating expenses.

This year the activities of six banks and six branches of foreign banks was profitable, one bank and three foreign bank branches operated at a loss.

Net interest margin of banks showing the difference between interest rates received by banks for their invested assets and interest rates paid to creditors, stepped up a bit to 1.37 per cent in the second quarter but remained smaller than in 2011–2012. Due to this move, the main income of banks — net interest income — accounting for LTL 536.7 million in the first half-year of 2013, were by LTL 46.9 million or 8 per cent smaller compared to the first semi-annual period of 2012. Given the fact that in May 2013 the European Central Bank passed a decision to reduce the main refinancing operations fixed rate to 0.5 per cent, further decrease of interest income earned by banks from loans cannot be excluded because assets and liabilities of banks operating in Lithuania are matched so that in the case of a drop of interest rates net interest income of banks would also decrease.

In the context of decreasing net interest income, net income from services and commissions for banks increased somewhat, compared to the first half-year of this year this indicator rose by 12.6 per cent to LTL 327.2 million. Increase of the latter income was also affected by the fact that former customers of *AB Ūkio bankas* started to use services of other banks, therefore the volume of services in these banks grew. Not eliminating the *AB Ūkio bankas* factor, net income from services and commissions stepped up per annum 5.8 per cent.

This year, to compare with the first half-year of 2012, loan impairment costs to the bank profit exercised minimum influence: such bank expenses amounted to LTL 4.6 million, while in the first half year of 2012 they reached LTL 60.6 million.

Profit of banks was reduced by further increasing operating costs — in the first semi-annual period they rose year on year by 9.6 per cent to LTL 528.8 million. Staff costs grew by 5 per cent, general and administrative costs increased as well. Trying to curtail incurred operating expenses, banks are expected in the future to further stimulate the development of electronic banking, may cut the number of employees.