Banking Activity Review

1st Quarter of 2014

ISSN 2335-8319 (ONLINE)

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BANK ASSETS AND LIABILITIES

In Q1 2014 the operations of Lithuania's banking sector[1] were stable, usual trends were observed. As in previous years, the deposits of residents and private undertakings declined due to seasonal factors in Q1, the loan portfolio slightly contracted, and banks made profits. Further, in Q1 2014, annual financial audits were completed in all banks — no significant deficiencies or discrepancies were identified. Moreover, banks held ordinary general meetings with their shareholders, at which the decision was made to allocate the major part of the profits to strengthen the capital; thereby banks have strengthened their resilience to likely shocks and built a foundation for further development.

With the Capital requirements directive of the European Parliament and of the Council (CRDIV) and the Regulation (CRR) coming into force as of 1 January 2014, the regulatory environment for banking activities has changed substantially all over the European Union. This document is of direct implementation to all Member States and establishes uniform supervisory requirements for banks operating in them. The above-named document has enabled the supervisory authorities to establish other capital buffers for banks in addition to the minimum capital adequacy level (8%). It is currently projected that, as of 1 January 2015, a capital conservation buffer will be established for banks (2.5%). All Baltic States and Nordic countries are planning to apply this full-scope capital buffer earlier than projected in CDRIV/CRR. Upon implementation of this requirement, as of 2015 banks operating in Lithuania will have to observe the minimum capital requirement not of 8 per cent, but of 10.5 per cent.

Last year a decision was made to concentrate the *Nordea* group in Sweden, transferring all branches, including the *Nordea Bank Finland Plc* Lithuania branch, to the *Nordea* bank established in Sweden. With the completion of restructuring in Q1 2014, as of 1 April all assets, rights and obligations of *Nordea Bank Finland Plc* haver been appropriated by *Nordea Bank, AB* Lithuania branch, the supervision of which has become the responsibility of the Swedish Financial Supervisory Authority, and deposits are no longer insured in Finland, but in the deposit insurance scheme operating in Sweden.

Dynamics of the key indicators in the banking sector[2]

Seq. No.	Indicator	Amount as of 01/04/2013, LTL millions	Amount as of 01/01/2014, LTL millions	Amount as of 01/04/2014, LTL millions	Change in Q1 2014, %	Change over a year, %
1.	Assets	77,896.2	77,578.1	77,913.4	0.4	0.0
2.	Debt securities	6,139.4	7,877.7	7,477.6	–5.1	21.8
3.	Leasing	3,489.8	3,489.9	3,422.9	–1.9	–1.9
4.	Loans granted to customers	52,066.7	51,015.9	50,436.1	–1.1	–3.1
4.1.	To private enterprises	24,603.4	23,575.0	23,181.2	–1.7	–5.8
4.2.	To financial institutions	534.9	481.0	510.2	6.1	–4.6
4.3.	To natural persons	22,735.0	22,802.0	22,787.5	–0.1	0.2
4.3.1.	Housing loans	19,206.2	19,375.5	19,408.6	0.2	1.1
5.	Loan impairment	2,935.6	2,212.1	2,133.7	–3.5	–27.3
5.1.	Loan impairment to granted loans ratio, %	5.3	4.2	4.1	-	-
6.	Deposits and letters of credit	45,711.8	47,604.5	47,902.4	0.6	4.8
6.1.	Of private enterprises	14,793.9	16,062.1	15,724.3	–2.1	6.3
6.2.	Of financial institutions	1,168.8	803.6	915.5	13.9	–21.7
6.3.	Of natural persons	26,521.3	28,038.4	27,731.9	–1.1	4.6
7.	Shareholders' equity	7,423.1	8,029.6	7,981.9	–0.6	7.5
8.	Profit (loss) for current year	200.3	785.7	183.2	–	–

In Q1 2014, bank assets remained almost unchanged and on 1 April amounted to LTL 77.9 billion. Most of bank assets (LTL 53.9 billion, or 69%) consisted of the portfolio of loans granted to customers and leasing (on a net basis). A significant proportion of bank assets also consisted of liquid assets (cash, debt securities, funds with banks): as of 1 April — LTL 21.6 billion (28% of bank assets).

[1] The domestic banking sector consists of 7 commercial banks and 8 foreign bank branches currently operating in the country.

[2] The coming into effect of the Capital Requirements Regulation as of 1 January 2014 entailed the change in the consolidation volume of data collected for supervisory purposes (the controlled undertakings performing the assets management function or other ancillary functions that add to banks' key activities began to be consolidated); as a result, the data for Q1 is not quite comparable with the data from previous periods.

In Q1, cash, bank funds with the Bank of Lithuania and with other banks increased by LTL 1.2 billion (to LTL 14.2 billion), while the debt securities portfolio managed by banks contracted somewhat over a quarter — by LTL 0.4 billion (to LTL 7.5 billion). The decline in debt securities was driven by the commercial activities of one bank. Most of the debt securities portfolio managed by the banks is composed of Republic of Lithuania government securities (LTL 4.6 billion), other countries' government securities (LTL 0.7 billion) and bank debt securities of the European Union countries (LTL 1.3 billion).

On 5 May 2014, the Bank of Lithuania, seeking to reduce the excess liquidity of litas, which formed due to the temporary decrease in the amount of national cash in circulation before the euro adoption, revived time deposit auctions. The proposed time deposits at the Bank of Lithuania alternative will not only help regulate liquidity in the banking system, but will also prevent sudden fluctuations in the Bank of Lithuania's foreign reserve assets, while the funds held with the Bank of Lithuania are likely to increase.

The bulk of bank liabilities consisted of customer deposits attracted by banks in Lithuania: in Q1 2014, they grew by LTL 0.3 billion — to LTL 47.9 billion. Their growth was due to an increase in public sector deposits (LTL 0.8 billion), whereas the deposits of private undertakings and natural persons declined. The volume of the deposits of natural persons and private undertakings contracted due to seasonal factors and was in line with the long-term observation trends: following a decline in Q1, these deposits have been increasing in the remaining part of the year. With growth in the deposits and the loan portfolio not changing significantly, the ratio of loans[3] to deposits continued to decrease: as of 1 April 2014, it was 112 per cent.

Arrears to parent banks continued to be an important financing source for banks. They decreased by around LTL 100 million and as of 1 April amounted to LTL 19 billion. The funds of parent banks were used to finance a fourth of the banks' assets. As of 1 April 2014, the net indebtedness to parent banks (the differential between the liabilities to parent banks and funds with them) amounted to LTL 10 billion.

In early 2014, many banks more strengthened their capital with profits made in 2013 (bank profits in 2013 amounted to LTL 785.7 million, of which LTL 676.3 million were allocated for increasing their capital). Only two banks — *AB SEB bankas* and *AB Citadele bankas* — decided to pay part of their earned profits as dividends. For *AB SEB bankas*, this share amounted to nearly half of the profit earned (LTL 103.6 million); for *AB Citadele bankas* — 95 per cent of the profit earned (LTL 5.8 million). Even after the payment of dividends the capital adequacy measures of the two banks have been significantly in excess of the prudential requirement (even with the projected capital conservation buffer applied).

The liquidity ratio as of 1 April 2014 stood at 41.1 per cent and was more than 10 percentage points above the required minimum. The liquidity buffer of the banking sector designated to fill the financing gap, exceeded by almost three times the requirement. As of 1 January 2015, the currently applicable liquidity ratio will be replaced with the liquidity coverage ratio (LCR), while as of 2018 it is also projected to implement the net stable funding ratio (NSFR).

THE BANKS' LOAN PORTFOLIO

In Q1 2014, the banks' loan portfolio (on a net basis) contracted by almost LTL 580 million (or 1.1%) and as of 1 April 2014 amounted to LTL 50.4 billion. The leasing portfolio (on a net basis) decreased by LTL 67 million (1.9%) — to 3.4 billion. The major contribution to the contraction of the loan portfolio stemmed from a decline in loans to the public sector (a decline of LTL 0.2 billion) and the reasons of technical nature.[4] The loan portfolio[5] of business undertakings (on a net basis) shrank marginally (by LTL 48 million, or 0.2%).

The housing loans portfolio (on a net basis) increased for the fourth consecutive quarter, with a moderate growth rate of LTL 33 million, or 0.2 per cent in Q1 2014 and LTL 200 million, or 1.1 per cent over a year. Thus, the moderate rates of growth in the housing loans portfolio and the data of The State Enterprise Centre of Registers, suggest that about 30 per cent of housing deals concluded by natural persons were financed by pledging the assets being acquired, concludes that the currently observed housing market activity is financed with own funds rather than bank loans.

In Q1, the loan portfolio quality indicators continued to suggest trends of improvement: the ratio of specific provisions to the loan portfolio decreased by 0.1 p. p. quarter on quarter (to 4.1%), the loan portfolio share of impaired loans contracted by 0.2 p. p. (to 8.2%), while the indicator of non-performing loans — by 0.5 p. p. (to 10.5%). As previously, the loan quality indicators were influenced both by the improvement of the financial condition of borrowers and the reasons more of a technical nature (write-offs of bad loans).

The indicators defining the quality of the portfolio of housing and consumer loans granted to individuals improved somewhat as well. The improving quality of loans to individuals is driven by the improving condition of the domestic economy, lowering unemployment, growing real wages and salaries and the currently prevailing particularly low interest rates.

[3] When calculating this indicator, the loans consist of the amount of loans and leasing (on a net basis).

[4] Having eliminated the contribution of consolidation, the loan portfolio (on a net basis) would have contracted by LTL 234 million, or 0.5 per cent. As of 1 April 2014, banks' consolidated accounts do not include mutual transactions with consolidated undertakings (see also Footnote 2).

[5] Excluding bank subsidiaries.

PROFITABILITY AND EFFICIENCY OF OPERATIONS

In Q1 2014, banks' profits made amounted to LTL 183.2 million, a decline of LTL 17.1 million, or 8.5 per cent year on year. However, this decline was due to a one-off factor (income received last year from selling a subsidiary of one bank). The banking sector's profit before tax, before impairment and before specific provisions, and excluding the profit received from subsidiaries, for Q1 was 16 per cent higher year on year.

In Q1 2014, the activities of six banks and five foreign bank branches were profitable, while one bank and three foreign bank branches suffered losses.

The main income of banks — net interest income — increased by LTL 37.6 million (or 13.2 %) — to LTL 321.8 million — in Q1 year on year. Nearly all of the increase was due to LTL 35.5 million lower interest expenses for the banks. The above-named expenses in recent years have been gradually declining; however, nearly all possibilities to further reduce them have been explored, which in part is confirmed by the most recent data: the interest expenses in Q1 remained unchanged year on year. With the persistently low market interest rates and the loan portfolio not increasing, the banks' possibilities for boosting interest income are also limited — their quarterly interest income volumes have not been changing for more than a year already.

The growing domestic economy boosted the activity of domestic economic agents, and the demand for bank services and transaction volumes at the same time; as a result, the banks' net income from services and commissions grew by LTL 5.6 million (3.5%) — to LTL 164.6 million — in Q1 year on year.

The banks' operational expenditure remained almost unchanged year on year. In 2014, the operational expenditure for banks will increase due to the preparations for the adoption of the euro.

Banks also incurred LTL 19.6 million higher loan impairment costs, which in Q1 amounted to LTL 33.1 million.

Because of the lower operating profits of banks their performance indicators were somewhat lower than in Q1 2013: the banking sector's equity return was 8.9 per cent (9.2% a year ago), the return on assets ratio — 0.94 per cent (1.05% a year ago). The banks' net interest margin, which shows the difference between the interest banks earn on invested assets and the interest they pay to their creditors, in Q1 2014 grew to 1.6 per cent, the expenses-to-income ratio, defining banks' operating efficiency, increased by 3.5 p. p. over a year — to 53.7 per cent.