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Review of the Activities of Credit Unions

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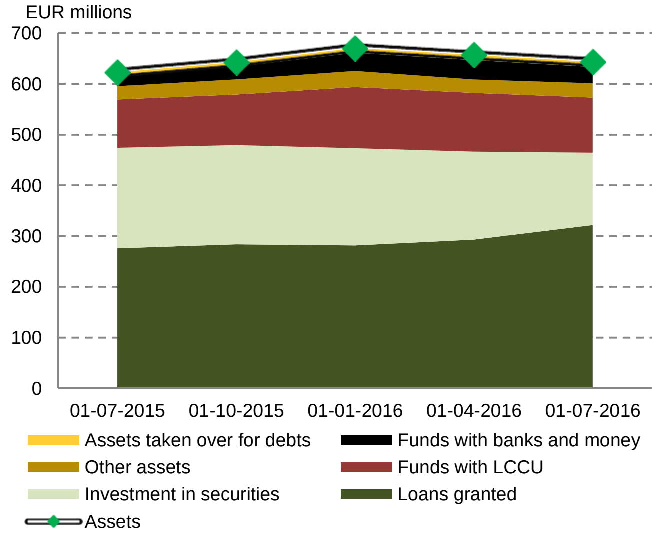
As of 1 July 2016, 74 credit unions were in operation. They united 160.5 thousand members (in Q2 2016, the membership increased by 1.6 thousand, whereas as of 1 July 2015 — by almost 7 thousand). Currently 61 credit unions are members of the Lithuanian Central Credit Union (LCCU), while 13 credit unions operate independently.

As credit unions continued to cut their deposit rates, the deposit portfolio, which had been contracting since the start of 2016, continued on its downward path; as a result, the assets of credit unions reduced as well. In the period under review, the assets shrank by 13.6 million and, according to data as of 1 July 2016, amounted to EUR 643.3 million or 2.7 per cent of the banking system's assets (a year ago — 2.8%).

The composition of credit union assets remained basically unchanged. As seen from the Chart, loans accounted for the major asset share on the reporting date. According to the data as of 1 July 2016, loans granted to members (EUR 321.7 million) accounted for 50 per cent of the assets. In Q2 2016, the loan portfolio of credit unions increased by EUR 28.7 million or by almost 10 per cent. It should be noted that the growth of the loan portfolio was driven by consistently growing crediting of natural persons: loans granted to these members boosted by EUR 27.3 million in the reference quarter (to legal persons — by EUR 1.4 million). In terms of crediting of natural persons, nine credit unions were the most active: they granted loans designated for consumption, housing, agriculture, acquisition of immovable and movable property or refinancing loans granted by other creditors. Changes in the composition of the loan portfolio of these credit unions also had a quite significant impact on certain changes in the composition of loans within the sector, i.e. on the contraction in the share of loans granted to associated members (mainly legal persons). The share of loans granted to associated members in the credit union sector's loan portfolio diminished by 1.5 p.p. — these loans accounted for 20.7 per cent of total loans.

Composition of credit union assets



Source: Bank of Lithuania.

As it was mentioned, the loan portfolio increased by a tenth; thus, given that credit unions wrote off loss-bearing loans totalling almost EUR 1 million and specific provisions (for covering likely losses on loan impairment) decreased by 0.5 per cent (to EUR 19.1 million), the ratio of specific provisions to loans reduced by 0.6 p.p. (to 5.6%) in the aforementioned period. Even though other indicators defining loan quality improved somewhat due to the growing loan portfolio[1], **the increasing volumes of non-performing loans (an increase of EUR 5.8 million) and expenses for the oversight and sale of assets taken over for debts, which are not usually used for the credit union needs, may dampen the financial situation of credit unions and negatively affect their capital.**

More than a fifth of credit union assets (EUR 142.7 million) consisted of decreasing investments in debt securities. In preparing to comply with the requirements of the Regulations on Credit Union Investment in Non-equity Securities (hereinafter 'Regulations'), credit unions reduced securities portfolios and changed their composition according to maturity. Over the reporting quarter, credit union investment in securities dropped by almost EUR 31 million and, according to the data provided, not a single securities portfolio accounted for more than 50 per cent of the credit union's on-balance-sheet assets. After analysing the investment in non-equity securities reports submitted by credit unions, it is seen that not all credit unions implemented the requirements of the Regulations due to the average modified financial duration of a securi-

[1] Indicators defining loan quality — the share of non-performing loans in the loan portfolio, and the ratio of loans overdue for more than 60 days and the assets taken over for debts to total loans.

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ties portfolio, concentration of lower-rating government debt securities of EU countries and concentration on securities of a sole lower-rated issuer. Thus credit unions continue to take certain measures to satisfy requirements regarding the investment portfolio. As mentioned in previous reviews, as of 31 December 2016 the investment portfolio must not amount to more than 35 per cent of the credit union's on-balance-sheet assets, while the securities portfolio's modified financial duration must not be longer than three years, and as of 31 December 2017 — no longer than two years. The Bank of Lithuania monitors changes in the composition of credit union assets and takes prudential measures if credit unions invest their funds received from securities sold in an insecure manner.

Accepted deposits remained the major funding source for credit unions — nearly 88 per cent of credit union assets were financed with them. It should be noted that in the period under review, the deposit portfolio contracted by almost EUR 17 million or 2.9 per cent, amounting to EUR 563.9 million on the reporting date. The seasonality of agricultural works had a considerable impact on the decline in the deposit portfolio, as the most significant decrease in deposits was seen in credit unions uniting farmers. According to the data of the submitted reports, over the reporting quarter credit unions were reducing interest rates on the most popular deposits with a maturity of 12 months in euro. At the end of the quarter, interest rates below 0.8 per cent on the afore-mentioned deposits were prominent in the credit union sector; however, residents continued to choose deposits as a saving means. In some credit unions, the volumes of fixed-term deposits, especially deposits of natural persons that accounted for the largest share of deposits (97.4%), expanded. The share of fixed-term deposits in the total credit union deposit portfolio accounted for 75.4 per cent, increasing by 1 p.p.

As the number of members of credit unions increased and they brought in additional shares, the share capital boosted by 5.9 per cent in Q2 2016 and amounted to EUR 57.8 million. Adjusted capital of credit unions, which is crucial in ensuring compliance by the majority of credit unions with prudential ratios and other legislative requirements, grew as well. In the reference quarter, adjusted capital increased by 9 per cent — up to EUR 60.5 million.

In the first half year of 2016, 42 credit unions, whose operations were profitable, earned EUR 2.6 million in profit; however, 32 credit unions operated at a loss. A loss of EUR 2.3 million incurred by them reduced the sector's profit to EUR 0.3 million (in the first half year of 2015 profit earned totalled EUR 0.1 million). Compared to the first half-year of the previous year, credit unions earned 22 per cent less income and incurred 24 per cent less expenses. According to the data as of 1 July 2016, the main share of the income of credit unions (68%) consisted of income from interest, mainly — on loans granted to members. Compared to 1 July 2015, the share of such income in total income increased by 11 p.p., since, with the reductions in securities portfolios, income received from securities operations dropped by more than two times, whereas their share in total income — by 13 p.p. Operating expenses accounted for the largest share (56%) of the sector's expenses in the first half-year of 2016. Year on year, such expenses increased by 12 per cent (staff costs — by 6.2%), and 55 per cent of the total income earned, or a year-on-year increase of 17 p.p., were used to cover them. **Given that, in order to accumulate sustainable capital, credit unions have to improve their operating results significantly, i.e. increase income and decrease expenses, they should link operating costs with income earned.**

According to the data of submitted reports, as of 1 July 2016 the capital adequacy ratio of the system of credit unions was 18.17 per cent (requirement — 13%). All credit unions complied with the requirement on the reporting date. The liquidity ratio of the credit unions system was 55.41 per cent (the required minimum is 30%[2]); however the liquidity ratios of two credit unions were below those that were applied to them (50%).

In addition, on the reporting date, the maximum exposure of three credit unions, including the above-named one not complying with the liquidity ratio, accounted for more than 25 per cent of the adjusted capital of a credit union. **Hence the major strategic goal for these credit unions is strengthening of their capital.**

After the reporting date, three credit unions provided information that they took measures to ensure compliance with the ratios and remedied the situation; for one credit union, an individual deadline to ensure compliance with the ratios was set. For credit unions that are not in compliance with prudential ratios and do not take any measures to ensure compliance with them, the Bank of Lithuania applies enforcement measures laid down in the Law on Credit Unions and gives relevant instructions in writing.

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

Following the adoption by the Seimas of the new **Republic of Lithuania Law on Credit Unions**, the restructuring of the credit union system was started. To ensure successful implementation of the restructuring, it is vital to establish the real value of the credit union assets, thus a thorough, independent and standardised asset quality review of operating credit unions is planned. Its aim is to identify the financial situation of credit unions before the merger, remove existing problems from the new system of credit unions, and ensure the system's viability and credibility. Assets of all credit unions operating in the country should be reviewed by the end of this year.

[2] For credit unions whose assets have been above EUR 4.34 million and the annual growth rate of deposits exceeds sustainable growth rates, the liquidity ratio of 40, 50 or 60 per cent respectively is applicable.

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Financial services regulation initiatives of relevance to credit unions. The draft **Republic of Lithuania Law on Credit Relating to Real Property** is still being coordinated; it implements Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (Mortgage Credit Directive, MCD) as well as national proposals on the improvement of legal regulation in the field of granting residential loans. The draft Law proposes to apply the MCD provisions to all credit agreements ensured not only by pledged residential property but also by other types of real estate, implement the procedure for the provision of pre-contractual information to the borrower established in the MCD, set requirements for credit agreements, require to clearly disclose the composition of interest rates and conditions for changing interest rates, prohibit the selling of the mandatory financial product package with the credit agreement, limit the size of the tax rate on the anticipatory credit repayment, etc.

The Seimas of the Republic of Lithuania approved the amendments to the **Law on Payments**, implementing Directive 2014/92/EU on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features (Payment Accounts Directive, PAD). The Law on Payments was supplemented with provisions implementing the goals of the above-named Directive; seeking to create more incentives for consumers to use electronic payment instruments instead of cash, the Law was also supplemented with provisions providing preconditions for reducing the price of the basket of operations usual for consumers down to that established by the Bank of Lithuania.

When amendments to the **Law on Consumer Credits** came into force on 1 February 2016, the List of persons, regarding whom requests not to allow them to conclude consumer credit agreements have been submitted (hereinafter 'List'), was established. From 1 November 2016, every natural person will be able to add themselves to the List. In addition, persons who, by a court decision (pursuant to an application by the person's spouse, parents, children that are considered adults, a care (custody) establishment or a prosecutor), are forbidden to conclude consumer credit agreements will be added to the List for a period indicated in a court decision. Consumer credit lenders and peer-to-peer lending operators, in making the decision on the granting of a consumer credit, will have to check whether the person wishing to get a consumer loan is not on this List, since the consumer credit agreement concluded with a person included in the List will be deemed invalid. Currently all draft legal acts regulating the activities of those included in the List are prepared and being coordinated with institutions concerned and consumer credit market participants.

The Bank of Lithuania has prepared a **proposal on improving personal warranty measures** and submitted it for public discussions (http://www.lb.lt/pasiulymas_del_asmeninio_uztikrinimo_priemoniu_reguliavimo_tobulinimo). The document proposes to ensure that credit institutions would not be able to require warranty from natural persons for the amount of loan, which exceeds the value of that person's unencumbered assets, i.e. natural persons would only warrant loans in an amount which is adequate to their financial situation. When a borrower is unable to repay a loan, it is also proposed to provide the possibility for the warrantor to pay contributions for the borrower from revenue being earned rather than repaying all credit from his/her assets in one go.

The currently-developed **Project on the Bank of Lithuania's Rights and Obligations** implements the provisions of Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs), requiring Member States to designate competent authorities, responsible for carrying out supervision and exercising other functions under this Regulation; the project also establishes enforcement measures for violations of provisions of the Regulation. In addition, the Project will also establish common legal regulation for certain parts of the financial market supervision process, ensuring equal position of financial market participants in this process and greater legal clarity. In order to properly implement the objectives of the Project, it has been proposed to update the key status of the Bank of Lithuania and the legal act regulating its activities — the Law on the Bank of Lithuania — as well as other legal acts necessary for it.

Settlement of disputes between consumers and credit unions. The Bank of Lithuania still receives applications from members of credit unions requiring obliging credit unions to credit members' additional contributions of shares in order to pay the last loan tranches. Given that in such cases two-sided legal relationships (relating to loans and participation in the credit union capital) develop among the applicants and credit unions, the Bank of Lithuania refuses to settle such disputes. According to the Bank of Lithuania, the parts of the applicants' complaints, related to the request to settle a consumer dispute over the validity of a credit union's refusal to credit the contributions of shares for paying the last loan tranches, should be settled in ordinary courts in line with the procedures laid down in legal acts.

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Annex. Dynamics of performance indicators of the credit unions sector

Seq. No	Indicator	Amount, EUR millions 01/07/2015	01/04/2016	01/07/2016	Change (%) Q2 2016	over the year
1	**Assets**	**622.8**	**656.8**	**643.3**	**–2.1**	**3.3**
2	Money	3.9	3.8	3.6	–5.3	–7.7
3	Funds with banks	18.5	34.2	28.4	–17.0	53.5
4	Funds with the LCCU	95.1	115.6	108.6	–6.1	14.2
5	Government securities	198.2	173.4	142.7	–17.7	–28.0
6	**Loans granted**	**275.8**	**293.0**	**321.7**	**13.7**	**16.6**
7	Specific provisions against loans	20.7	19.3	19.1	–0.5	–7.7
8	Ratio of specific provisions against loans to loans (%)	7.0	6.2	5.6	–	–
9	Debt to the LCCU	15.6	16.7	17.3	3.6	10.9
10	**Deposits**	**541.7**	**580.8**	**563.9**	**–2.9**	**4.1**
10.1	Of members and associated members of credit unions	538.1	578.6	561.5	–3.0	4.3
11	**Share capital**	**53.4**	**54.6**	**57.8**	**5.9**	**8.2**
12	Profit (loss) for current year	0.1	0.2	0.3	–	–

Source: Bank of Lithuania.

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