LIETUVOS BANKAS

Review of the Activities of Credit Unions and the Central Credit Union of Lithuania

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Credit unions. As of 1 July 2013, 74 credit unions, uniting over 145 thousand members, were operating in Lithuania (on 9 May 2013 the Board of the bank of Lithuania revoked the operating licence for *Laikinosios sostinės kreditas* credit union). The Central Credit Union of Lithuania (CCUL) included 63 credit unions, 11 operated independently.

Restrictions applied to the operations of some credit unions and the tightened prudential requirements that came into effect reduced irresponsible lending, and the development of the system of credit unions became more sustainable. Key performance indicators of the system of credit unions were also affected by a decline in their number.

In the second quarter of this year, the amount of deposits contracted somewhat, the growth rate of loans decelerated, and growth in the membership of new credit unions weakened as well. The number of new members of credit unions, which usually used to increase by 3 thousand, grew by approximately 1 thousand in the reporting quarter and by 7.5 thousand over the year (compared to 1 July 2012).

At the beginning of their establishment, credit unions focused on bringing together entities residing in a certain location or engaged in similar activities, planning to accept deposits from some entities and grant loans to others, to satisfy the economic and social needs of their members. While part of credit unions (especially those in the regions of the country) have been further operating on a cooperative basis, some of them (mostly in large cities) have recently deviated from the classical definition of credit union by offering the highest market interest rates on time deposits and applying various marketing programmes. Strong growth in the membership of these credit unions suggests greater reliance on the state deposit insurance scheme than on the principles of mutual confidence among credit union members.

Moreover, as owners of credit unions, barely interested in their successful operation, they do not participate in the process of their management, do not show the initiative to contribute to the improvement of the financial position of those operating at a loss, despite that at some of them, the size of uncovered loss is quite significant.

In the second quarter of 2013 credit union assets remained almost unchanged, increasing, however, by 9.8 per cent compared to the 1 July 2012 data. As of 1 July 2013, they amounted to LTL 2 billion, or 2.7 per cent of the assets of the banking system (compared with 2.4% a year ago).

Dynamics of some performance indicators of the system of credit unions

No.	Indicator	Amount 01-07-2012, LTL million	Amount 01-04-2013, LTL million	Amount 01-07-2013, LTL million	Change in Q2 2013, %	Change over year, %
1.	**Assets**	**1, 849.2**	**2, 029.6**	**2, 030.6**	**0**	**9.8**
2.	Funds with banks	104.2	48.6	34.7	-28.6	-66.7
3.	Funds with the CCUL	252.7	339.9	263.0	-22.6	4.1
3.1.	Time deposits	131.3	144.9	126.6	-12.6	-3.6
4.	Government securities	343.7	456.5	529.3	15.9	54.0
5.	**Loans granted**	**1, 046.2**	**1, 050.4**	**1, 059.1**	**0.8**	**1.2**
6.	Specific provisions for loans	30.0	32.1	29.8	-7.2	-0.7
7.	Ratio of specific provisions for loans to loans (%)	2.8	3.0	2.7	–	–
8.	Debt to the CCUL	64.6	54.3	63.3	16.6	-2.0
9.	**Deposits**	**1, 589.7**	**1, 767.8**	**1, 754.6**	**–0,7**	**10.4**
9.1.	of members and associated members of credit unions	1, 578.0	1, 756.8	1, 741.7	-0.9	10.4
10.	**Share capital**	**198.9**	**208.0**	**203.4**	**–2,2**	**2.3**
11.	Profit (loss) for current year	-2.5	-11.8	-7.3	–	–

According to the 1 July 2013 data, the assets of the 10 largest credit unions represented more than half of the assets of all credit unions. Credit union *Vilniaus taupomoji kasa* (with its assets accounting for 17.6% of the assets of all credit unions) remains the largest within the system of credit unions.

The change in the composition of credit union assets was insubstantial both in the reporting quarter and over the year. Seeking to accumulate high quality liquid assets necessary to ensure compliance with the liquidity coverage ratio and the differentiated liquidity ratio, credit unions increased their investment in government securities. After rising to LTL 529.3 million, credit union investments in government securities accounted for 26.1per cent of credit union assets as of 1 July 2013. As was previously the case, the bulk of them (62%) consisted of the Republic of Lithuania government securities portfolio, which increased by 1.9 per cent in the second quarter of 2013 — to LTL 329.1 million. However, stronger growth in the reporting quarter was recorded in investments in European Union member state and European Economic Area government securities. These investments grew by 50 per cent in the reporting quarter (to LTL 200.2 million) and accounted for 38 per cent of the government securities portfolio. As credit unions kept increasing their investment in government securities, in the second quarter of 2013 the holdings of funds with banks and the CCUL contracted, accounting for 14.7 per cent of credit unions' total assets on the reporting date.

Loans represented the largest share (52.2%) of credit union assets. The increase in the loan portfolio was insubstantial in the second quarter of 2013, and since 1 July 2012 alike, amounting to LTL 1.1 billion. Weak growth in the loan portfolio was driven by limits on lending imposed to some credit unions, formed specific provisions for loans and faster amortisation of loans. In the second quarter of 2013 a change in the the loan portfolio composition trends was observed — the amount of loans granted to natural persons increased, whereas the amount of loans to associated members (legal persons), which grew for a long time, contracted in the reporting period. The decline in the loan portfolio share of loans to associated members is likely to have been driven by the coming into effect of the differentiated capital adequacy ratio: a higher capital adequacy ratio was established for credit unions with a large share of their loan portfolio represented by loans granted to associated members. While these riskier loans, meant mainly for financing business, following elimination of the *Laikinosios sostinės kreditas* credit union data, contracted by LTL 7.6 million in the reporting period, as of 1 July 2013 they represented over 30 per cent of total loans. A considerable share of business loans continues to go to credit unions in operation in Vilnius area.

After withdrawal from the credit union market of *Laikinosios sostinės kreditas* credit union in bankruptcy, the ratio of specific provisions for loans to loans and the loan portfolio share of non-performing loans shrank in the reporting quarter. According to the 1 July 2013 data, the above indicators were better than those of the banking system, accounting for 2.7 per cent and 15.1 per cent respectively. **While the indicators characterising the loan portfolio quality are better in the system of credit unions than in the banking system, for some credit unions, the possibilities of the repayment of loans granted are assessed with insufficient conservativeness.** The specific provisions formed by credit unions are insufficient to amortise the likely losses on loan impairment, thus the Bank of Lithuania, seeking that credit unions adequately assess the risks assumed, has approved the Regulations for the Assessment of Loans of Credit Unions (to come into effect as from 1 January 2014), regulating loan assessment and formation of specific provisions. In addition, the Provisions for Organizing the Internal Control and Assessment (Management) of the Risk of Credit Unions are under preparation, current documents for the regulation of loan assessment and risk management are being updated.

Offering higher interest rates on deposits than banks, credit unions are attractive to the population. According to the data of submitted reports, as of 1 July 2013 the interest rates of 2 to 3 per cent on the most popular deposits in national currency with a maturity of 12 months dominated credit unions (some of them offered higher interest rates), thus the volumes of deposits with individual credit unions expanded. On the scale of the system of credit unions, a decline in deposits has been observed for the second consecutive quarter, though. In the second quarter of 2013 the deposit portfolio of credit unions contracted by 0.7 per cent (LTL 13 million) and accounted for LTL 1.75 billion as of 1 July 2013. Deposits of natural persons accounted for the largest share of total deposits (97.2%). It should be noted that credit union depositors, mostly interested in higher interest rates, do not take an interest in the credibility of credit unions, as, under favourable terms and conditions of deposit insurance, in the case of bankruptcy of the credit union, they suffer the least (losing only their share, where their deposit does not exceed the amount insured).

Weaker growth in the membership of credit unions and in their loan portfolio had a negative influence on the credit unions' share capital — after a drop of 2.2 per cent in the second quarter of 2013, it amounted to LTL 203.4 million as of 1 July 2013. This confirms the statement that **share capital accumulated through loan extension is unstable**, because, after repayment of a loan or part of it, such share contributions are often repaid. Moreover, when in a difficult situation, the members of a credit union, who are also the owners of it, are not willing to pay extra contributions to the capital and assume the responsibility for the operating performance of the credit union.

According to the data of submitted reports, from the beginning of the year, 47 credit unions earned a profit of LTL 6.4 million, but 27 of them operated at a loss, which amounted to LTL 13.7 million and led to loss incurring activities of the system of credit unions, with their losses amounting to LTL 7.3 million in the first half of 2013 (LTL 2.5 million in the same period a year ago).

The main cause for operating at a loss was the loan impairment costs incurred by credit unions in the first half of 2013 (LTL 17.7 million), 26 per cent higher than in the same period a year ago. Given that some credit unions still assess credit risk insufficiently conservatively and form insufficient specific provisions against likely loan impairment losses, these expenses are likely to keep growing in the system of credit unions. With the expansion of the government securities portfolio, in the first half of 2013 the loss was reduced by income earned from securities transactions, which amounted to LTL 6 million (3.4 times higher than in the first half of the previous year).

According to the data of submitted reports, as of 1 July 2013 the capital adequacy ratio of the system of credit unions was 20.15 per cent, the liquidity ratio — 56.01 per cent. It should be noted, however, that after tighter capital adequacy and liquidity requirements came into effect on 1 April 2013, the capital adequacy ratios of **three credit unions**, a large share of whose loan portfolio on the previous reporting date was made up of loans extended to associated members (legal persons), and the liquidity ratios of **two credit unions**, the deposit growth rates of which exceeded sustainable growth rates, **were below the requirement.** Credit unions had accumulated LTL 396.2 million of high quality liquid assets and the net outflow of cash stood at LTL 16.6 million, i.e. the reserve of high quality liquid assets was sufficient to cover the net outflow of cash. On the reporting date, **7 credit unions did not ensure** compliance with the maximum exposure for a single borrower requirement. For 27 credit unions, 25 per cent of the amount of whose recalculated capital makes more than LTL 500 thousand, the maximum exposure requirement (LTL 500 thousand) was relevant. It should be noted that, in breach of this requirement, new loans have not been extended.

Some credit unions took action and presented information to the Bank of Lithuania that in July 2013 they were already complying with prudential requirements, while for several (mainly after their performance inspections), the dates by which they were obligated to comply with the requirements, were established. Given the above, in the near future it is not intended to apply new enforcement measures to credit unions for non-compliance with prudential requirements; however, for those that will fail to comply with them by the established dates, the enforcement measures laid down in the Law of the Republic of Lithuania on Credit Unions will be applied. 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 requirements is published on the website of the Bank of Lithuania.

With the aim of ensuring identification of the risks involved in credit union operations and their more effective management, the regulations, covering the processes of organization of credit union internal control and risk assessment (management), are under preparation. In addition, a working group (comprising representatives from the Ministry of Finance, the Bank of Lithuania, associations uniting credit unions and the CCUL) has prepared draft laws for the regulation of the activities of credit unions with the aim of ensuring their safe and sound operation through establishing an adequate balance between the development of credit unions and their possibilities to amortise risk assumption-related losses.

The Central Credit Union of Lithuania. As of 1 July 2013, the CCUL united 63 credit unions.

After a decline of LTL 67.7 million in the second quarter of 2013, as of 1 July 2013 the assets of the CCUL amounted to LTL 334.7 million. The main reason behind the decline was contraction in the deposit portfolio of credit union members of the CCUL. Credit union deposits, which contracted by nearly one-fourth in the reporting quarter (to LTL 246.9 million), continued to be the main source of financing of CCUL assets (74% of CCUL assets are financed with them). Investments in securities of the Government of the Republic of Lithuania accounted for the largest share of CCUL assets (the CCUL does not hold government securities of other countries), they equalled LTL 221.7 million. After halving in the reporting quarter (to LTL 7.2 million), the funds of the CCUL with banks represented an inconsiderable share of its assets (2.2%).

The portfolio of loans granted to CCUL members expanded slightly in the reporting quarter, amounting to more than LTL 63 million as of 1 July 2013. Subordinated loans granted to credit unions represented a significant proportion of the CCUL's loan portfolio (46%). According to the reports submitted on 1 July 2013, the quality of the loan portfolio remained good: no specific provisions for loans were formed; there were no loans with regular payments overdue for more than 60 days either. Under the agreement signed between the CCUL together with 57 credit unions and the manager of the Entrepreneurship Promotion Fund (INVEGA) on the management of an LTL 50 million worth micro crediting project, credit unions were granted LTL 33.2 million of loans from the Entrepreneurship Promotion Fund for financing small businesses.

The CCUL's Liquidity Maintenance Reserve (formed from contributions of CCUL members) increased to LTL 16.1 million in the second quarter of 2013, and the Stabilisation Fund — to LTL6.1 million. As was mentioned in the previous reviews, **the volume of funds accumulated in the Stabilisation Fund is insufficient** for implementing the CCUL's main functions — to ensure liquidity and solvency of its members (credit unions) and maintain stability within the system of credit unions, against a background of impairment of the quality of loans granted by credit unions and increasing related losses. **Therefore, this Fund must be increased by credit union contributions.**

In the reporting quarter, after redemption by credit unions of supplementary shares, the CCUL's share capital increased by LTL 1.5 million, amounting to LTL 31.6 million as of 1 July of 2013.

In the first quarter of 2013 the CCUL earned LTL 953 thousand of profit (LTL 463 thousand in the same period of 2012). The greatest influence on the CCUL's operating performance was made by interest income received from investment in government securities.

The CCUL continued to comply with the liquidity and capital adequacy ratios holding a significant reserve.