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Review of the Activities of Credit Unions

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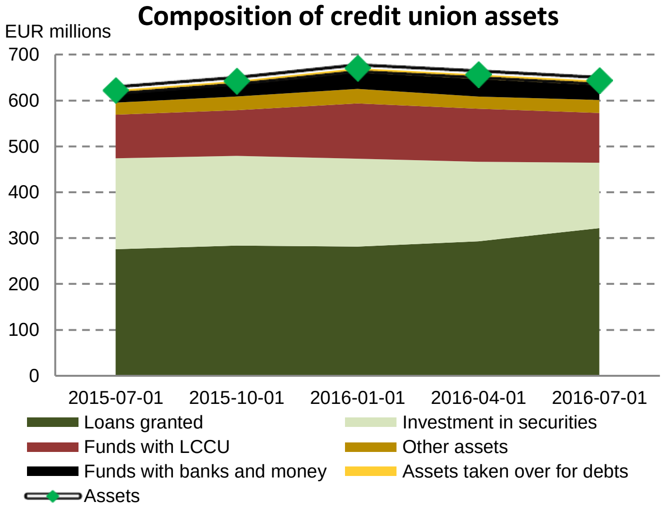
As of 1 October 2016, 74 credit unions were in operation. They united 162.3 thousand members (in Q3 2016, their membership increased by 1.8 thousand, whereas as of 1 October 2015 – by almost 7 thousand). Following the initiation of bankruptcy proceedings against AMBER credit union in October 2016, credit unions decreased to 73 in number. Currently 61 credit unions are members of the Lithuanian Central Credit Union (LCCU), while 12 credit unions operate independently.

The assets of credit unions, after an increase of EUR 11.1 million in Q3 2016, according to the data as of 1 October 2016, amounted to EUR 654.4 million[1], or 2.6 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 October 2016, credit unions had granted EUR 339.9 million in loans to their members, which accounted for 52 per cent of their assets. In Q3 2016, the loan portfolio of credit unions increased by EUR 18.2 million, or almost 6 per cent. Growth in the loan portfolio was driven by consistently growing crediting of natural persons: loans granted to these members boosted by EUR 17.8 million in the reference quarter (to legal persons – by EUR 0.4 million). In terms of crediting of natural persons, ten credit unions were the most active: they granted loans 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 quite a significant impact on certain changes in the composition of loans within the sector, i.e. on a contraction in the share of loans granted to associated members (mainly legal persons). The share of loans granted to associate members in the credit union sector's loan portfolio contracted by 1 p.p. in the reference period – to 19.7 per cent.

Composition of credit union assets



Source: Bank of Lithuania.

As mentioned above, in Q3 2016 the loan portfolio posted growth; thus, as credit unions wrote off EUR 2.2 million in loss-bearing loans and specific provisions (for covering likely losses on loan impairment) decreased by 3.7 per cent (to EUR 18.4 million) over this period, the ratio of specific provisions to loans reduced by 0.5 p.p. (to 5.1%). Other indicators[2] defining loan quality improved marginally as well, as was the case in the past quarter, due to the growing loan portfolio; however, non-performing loans grew (by EUR 0.8 million) and assets taken over for debts increased in credit unions. This signals that members of credit unions do not meet their obligations. **In the future, due to loans outstanding and the sale of assets taken over for debts, credit unions may incur significant losses that will negatively affect their capital.**

Credit union investment in securities continued to shrink. Securities shrank by EUR 15 million in the reporting quarter and, according to the data as of 1 October 2016, amounted to EUR 127.7 million, or 19.5 per cent of credit union assets. Implementing the requirements of the Regulations on Credit Union Investment in Non-equity Securities (hereinafter 'Regulations'), credit unions reduced their securities portfolios and changed their composition according to maturity. According to provided data, all credit unions complied with the Regulations' requirement for the size of the securities portfolio share in on-balance-sheet assets: securities did not account for more than 50 per cent of their on-balance-sheet assets; however, after analysing the reports on investment in non-equity securities provided by credit unions, it turns out that it was more difficult for them to comply with other requirements (for the average modified financial duration of a securities portfolio,

[1] In this Review, credit union sector data includes the data of *AMBER* credit union.

[2] 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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concentration of lower-rated government debt securities of EU countries and concentration on securities of a sole lower-rated issuer). As mentioned in previous reviews, as of 31 December 2016 the investment portfolio will not have to account for more than 35 per cent of a credit union's on-balance-sheet assets, while the securities portfolio's average modified financial duration will not have to be longer than three years, and as of 31 December 2017 – no longer than two years. As a result, **some credit unions will have to take additional action to achieve compliance with all requirements set for the investment portfolio.**

Accepted deposits remained the major funding source for credit unions – nearly 90 per cent of credit union assets were financed with them. In the period under review, the deposit portfolio contracted by almost EUR 6 million, or 1 per cent, to EUR 558 million on the reporting date. The contraction of the deposit portfolio was due to the recognition of AMBER credit union as insolvent. Upon the occurrence of this insured event and related entitlement of the depositors of this credit union to insurance claims (about EUR 17 million), the credit union became indebted to the state enterprise *Indėlių ir investicijų draudimas*, and this amount was eliminated from the credit union's deposit portfolio. The total contraction in the deposit portfolio was mitigated by sight deposits. With an increase in the inflows into the accounts of members of credit unions due to seasonal factors, sight deposits grew by about EUR 11 million, to 27 per cent of total deposits at the end of the quarter. According to the data of submitted reports, most credit unions, as at the beginning of the quarter, paid an interest not higher than 0.8 per cent on deposits in euro with a maturity of 12 months. As usually, most deposits (96.8%) were those of natural persons: disregarding low interest rates, they choose deposits as an instrument of secure saving.

As the membership of credit unions increased and members of credit unions, especially those who credited most actively, brought in additional shares, the share capital boosted by 1.9 per cent, to EUR 58.9 million, in Q3 2016. **According to the data as of 1 October 2016 provided by credit unions, only 10 per cent of the share capital consists of main shares that meet the requirements for sustainable capital set as of 1 January 2017.** The main share of the share capital (90%) consisted of additional shares acquired by members of credit unions that do not meet the requirements for sustainable capital under the Law on Credit Unions (hereinafter 'Law') currently in effect, as the Law does not provide for the possibility to use them for covering credit union losses incurred. **Hence, once a recast of the Law comes into force as of 1 January 2017, credit unions will have to take additional action to achieve an increase in the share of their capital that would meet sustainable capital requirements.**

While the share capital increased in the period under review, the adjusted capital of credit unions – which is relevant for the enforcement of compliance with most prudential requirements and requirements contained in other legal acts – dropped by 6.7 per cent (to EUR 56.5 million) due to losses incurred.

According to the data of submitted reports, since the beginning of the year 48 credit unions earned EUR 3.7 million in profit, but 26 of them operated at a loss, incurring losses of EUR 8.1 million, which determined loss bearing activities of the credit union sector for the nine months of 2016: EUR 4.4 million in losses were incurred (during the same period in 2015, EUR 1.7 million in profits were earned).**The loss-bearing activities were due to a further decline in the income and an increase in the expenses of credit unions:** the income earned over the nine months of 2016 was by 17 per cent less year on year; however, almost 4 per cent more expenses were incurred. According to the data as of 1 October 2016, the main share of credit union income (68%) consisted of interest income (mainly – on loans granted to members); however, the interest income earned dropped by a tenth year on year The drop in interest income was mostly due to half the size of interest income earned on securities (as a result of credit unions reducing their securities portfolios). Moreover, with the contraction of securities portfolios, the income earned on securities transactions halved. Operating expenses accounted for the largest share (55 %) of the sector's expenses over the nine months of 2016. Year on year these expenses rose by more than a third (staff costs rose by 6.2%), while 65 per cent of total income received went to cover them, a year-on-year increase of 25 percentage points. Impairment costs – that were the reason for the loss-bearing activities of some credit unions – dropped by 40 per cent year on year, to less than 10 per cent of the sector's total expenses. **With income earnings decreasing, credit unions should reduce their incurred expenses accordingly; however, the Bank of Lithuania has been observing the reverse trends – individual credit unions spend profusely (e.g. have purchased luxury *Porsche* or *Bentley* cars).**

According to the data of submitted reports as of 1 October 2016, the capital adequacy ratio of the system of credit unions was 16.6 per cent (the requirement is 13%), the liquidity ratio – 52.99 per cent (the required minimum is 30%[3]). On the reporting date, six credit unions did not comply with prudential ratios.

- *AMBER* credit union, bankruptcy proceedings against which have been initiated, did not comply with the capital adequacy, liquidity, and the maximum exposure to a single borrower ratios;
- *Pajūris* credit union – the capital adequacy, maximum exposure, and the maximum open position in foreign currency (open position in one currency – USD) ratios;

[3] 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.
A uniform liquidity ratio of 30 per cent for all credit unions will come into force as of 31 December 2016.

- *Centro taupomoji kasa* credit union and *Vilniaus kreditas* credit union – the capital adequacy and the maximum exposure to a single borrower ratios;
- *Palanga* credit union – the maximum exposure to a single borrower ratio (an individual deadline has been set for this credit union to ensure compliance with this ratio);
- *Pareigūnų* credit union – the liquidity ratio.

Given that non-compliance by nearly all credit unions with prudential requirements is related to a lack of capital, accumulation of sustainable capital is one of the major strategic goals for credit unions, because, as mentioned above, only 10 per cent of the credit unions' share capital consists of capital meeting capital sustainability requirements.

Pareigūnų credit union provided information after the reporting date that it had remedied the situation and had already been in compliance with the liquidity ratio. *Vilniaus kreditas* credit union also provided information after the reporting date that it had already been in compliance with the capital adequacy ratio; however, because of non-compliance by it with the maximum exposure to a single borrower ratio, the issue of the application of enforcement measures, established in the Law on Credit Unions, and/or giving written instructions to it, as well as to *Pajūris* credit union and *Centro taupomoji kasa* credit union, that do not comply with prudential requirements and have not taken action to ensure compliance with them, will be addressed.

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 website of the Bank of Lithuania (http://www.lb.lt/pagrindiniai_kredito_uniju_sektoriaus_veiklos_rodikliai).

A new Republic of Lithuanian Law on Credit Unions, passed by the Seimas of the Republic of Lithuania, has laid a foundation for the restructuring of the system of credit unions, which is aimed at the solution of issues accumulated in this financial sector. **For successful implementation of this restructuring, the assessment of asset quality has been started.** It should be completed by the end of this year. It is expected that the results of the asset quality assessment will reveal the actual value of credit union assets and their financial condition the further outlook for the operation of credit unions will depend on.

The Bank of Lithuania prepares legal acts related to credit union reform and the establishment of central credit unions and specialised banks. Draft Regulations on Granting the Authorisation to Carry out Restructuring of a Credit Union has already been prepared and agreed with market participants; they will be submitted to the Board of the Bank of Lithuania for discussion in the near future. In addition, draft Regulations on the Licensing of Banking Activities have been prepared and submitted to market participants.

Some signs of preparations for the reform have also been observed in the credit union sector. Some credit unions, at extraordinary general meetings of their members, apart from other things, have been discussing the issues of the amendment of their articles of association, related to the transfer of their registered office from their region or city/town to Vilnius. This raises concerns for the Bank of Lithuania as, once the address of a credit union has been changed, the current members of the credit union will no longer meet the new membership criteria set, losing the possibility to use the services provided by the credit union at the same time. The Bank of Lithuania has been closely monitoring such processes and its assessment is critical.

Financial services regulation initiatives of relevance to credit unions. The adopted **Law on Amendments to the Law on Payments** implements Directive 2014/92/EU on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features. The aim of the Directive and the amendments to this Law was to provide the possibility for users to compare the fees applied by different payment service providers and to transfer an individual's account from one service provider to another in a simple way, etc. The amendments are also aimed at providing the conditions for users to use their basic payment account for a decent price. Credit institutions (banks, credit unions) will have to provide basic payment services (opening of an account, issuance of a payment card, payments with a payment card, unlimited crediting of funds to an account, a certain number of credit transfers, withdrawal of a certain amount of cash, electronic banking, etc.) for a price not higher than established by the Bank of Lithuania. The provisions contained in the Law related to the basic payment account and the transfer of an account will come into force on 1 February 2017.

A **draft Republic of Lithuania Law on Credit Related to Real Estate** has been submitted to the Seimas of the Republic of Lithuania for discussion. It implements Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (hereinafter 'Directive') as well as national proposals on the improvement of legal regulation in the field of granting housing loans. The daft provides for a wider application of the provisions of the Law than provided for in the Directive, and will cover all credit agreements secured not only by collateralised housing, but other real estate as well. In order to facilitate the possibilities for users to compare in a simple way the proposals of several providers or intermediaries, and to choose the most acceptable one, credit issuers or intermediaries will have to provide the user with information on credit standards in a standard form. It is also proposed to draw a list of mandatory terms and conditions of credit agreements, require to explicitly reveal the composition of an interest rate, and the terms of the change of an interest rate. The daft provides for a 30-day period before signing an agreement, during which the borrower would be able to closely compare, weigh and assess the credit proposals as well as his/her possibilities. Moreover, within 14 days of the conclusion of an agreement, the borrower will be able to relinquish the credit agreement already concluded. It is provided that, in the case of an advance credit repayment, the compensation due to the credit issuer, usually called an advance credit repayment fee, will not be able to exceed 3 per cent of the credit amount being repaid before maturity. It is also provided that the amount of penalty for the default on liabilities applied by the credit issuer to the user will not be able to exceed 0.05 per cent of the amount overdue for each day of delay. The Law was adopted on 10 November 2016.

A **List of Persons Regarding Whom Requests not to Allow Them to Conclude Consumer Credit Agreements** (hereinafter 'the List') has been drawn up; each natural person who is not willing to get a consumer credit has the possibility to be put on it as of 1 November 2016. Moreover, a person can be put on the List by court ruling, when his/her relatives (spouse, parents, and adult children), a care institution or a prosecutor will apply to court regarding putting that person under the ban to conclude consumer credit agreements. A person shall be put on the List for a period specified in his/her request, i.e. chosen by the person, or specified in the court ruling, while if the period is not specified in the person's request – for 2 years. According to the data available to the Bank of Lithuania, when this possibility occurred, the first persons willing not to be credited for a certain period (some for 30–40 years and more) have already put themselves on the List.

Before taking a decision on granting a consumer credit to a person, credit unions shall be obliged to check whether that person, willing to get a consumer credit, has not been put on the List. Credit unions shall be prohibited from granting a consumer credit to a person included in the List, whereas the consumer credit agreement concluded with such a person will be considered invalid. As of 1 November 2016, consumer credit grantors sent inquiries about persons willing to get consumer credits (regarding some persons, there were several inquiries).

Settlement of disputes between consumers and credit unions. In the third quarter of 2016, the Bank of Lithuania received 5 applications regarding disputes that arose between credit unions and consumers. One of these disputes ended having reached a peaceful agreement between the consumer and the credit union, others have still been settled. No decisions regarding the subject matter of a dispute have been taken. As previously, the issue of the reimbursement of credit union shares was relevant in the period under review. The Supervision Service of the Bank of Lithuania receives applicant requests to oblige credit unions to credit additional contributions of shares in order to pay the last loan tranches. The Bank of Lithuania, considering the arising double legal relationship between applicants and credit unions in such cases – consumer loans and participation in the capital of the credit union – refuses to settle disputes of this nature as, in order to settle a dispute of an applicant, as a consumer, over the fulfilment of a loan agreement materially, the issue of the applicant's membership in the credit union and the use of a share, as a security, proving the person's participation in the capital of the credit union, should first be resolved, whereas such disputes are only settled in courts of general jurisdiction.

Annex. Dynamics of performance indicators of the credit unions sector

Seq. No	Indicator	Amount, EUR millions			Change (%)	
		01/10/2015	01/07/2016	01/10/2016	2016 Q3	over the year
1	**Assets**	**642.8**	**643.3**	**654.4**	1.7	**1.8**
2	Money	3.5	3.6	3.9	8.3	11.4
3	Funds with banks	21.5	28.4	30.2	**6.3**	40.5
4	Funds with the LCCU	99.6	108.6	114.4	**5.3**	14.9
5	Government securities	195.6	142.7	127.7	–10.5	–34.7
6	**Loans granted**	**283.7**	**321.7**	**339.9**	**5.7**	**19.8**
7	Specific provisions against loans	20.4	19.1	18.4	–3.7	–9.8
8	Ratio of specific provisions against loans to loans (%)	6.7	5.6	5.1	–	–
9	Debt to the LCCU	15.2	17.3	17.6	1.7	15.8
10	**Deposits**	**559.5**	**563.9**	**558.0**	**–1.0**	**–0.3**
10.1	Of members and associated members of credit unions	556.9	561.5	555.3	–1.1	**–0.3**
11	**Share capital**	**54.2**	**57.8**	**58.9**	**1.9**	**8.7**
12	Profit (loss) for current year	1.7	0.3	–4.4	–	–

Source: Bank of Lithuania.

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