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Banking Activity Review

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In the second quarter of 2017, the assets of Lithuania's banking system kept growing and the system operated profitably. Both new potential market participants and members of the credit union sector under reform continued taking an active interest in the possibilities for obtaining a specialised banking licence. According to the submitted data, all banking market participants met the regulatory capital and liquidity coverage requirements. Lending development remains robust and the domestic economy is in the phase of an economic upswing; however, with this pace of lending remaining unchanged, the risks to the financial system will increase. The banking sector continues to be characterised by the trend of deposit growth. Most banks earned profits in the first half of 2017 and profits rose significantly within the entire banking system. The recovery of the value of this year's loans along with last year's atypical factors, which determined lower profits for the previous year, contributed weightily to that. Banks also managed raising income from their main activity – lending and financial mediation.

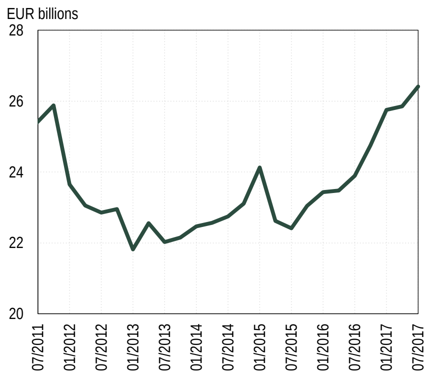
1. BANKING SECTOR DEVELOPMENTS

A merger of two banks is expected to come to an end this year; potential new market players take an active interest in obtaining a licence of a specialised bank. In the first half of 2017, six banks and eight foreign bank branches[1] operated in the country; their number remained unchanged over the second quarter. The merging process of the banks *DNB ASA* and *Nordea Bank AB* in the Baltic States has been proceeding; the transaction must be approved by the respective supervisory authorities. According to the data from these banks, the European Commission should provide its decision on the merger by 14 September, while the end of the transaction date, according to the most recent data, should be shifted from the third quarter to the fourth one.

Once the opportunity of establishing a specialised bank came as of this year, the Bank of Lithuania has been encountering a steady flow of potential market participants who are interested in this opportunity. The flow includes both foreign representatives and members of the credit union sector under reform. The Bank of Lithuania has so far not been officially applied for establishing a specialised bank; however, *Mano unija* credit union, which has obtained permission for restructuring, is likely to shortly submit documents for obtaining a specialised bank licence.

Chart 1. Assets of the banking sector

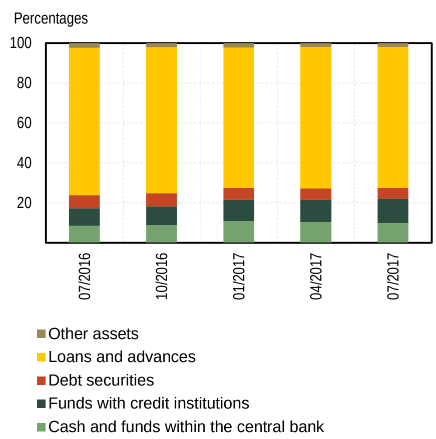
(1 July 2011–1 July 2017)



Source: Bank of Lithuania.

Chart 2. Asset composition

(1 October 2015–1 July 2017)



Source: Bank of Lithuania.

2. ASSETS AND LIABILITIES

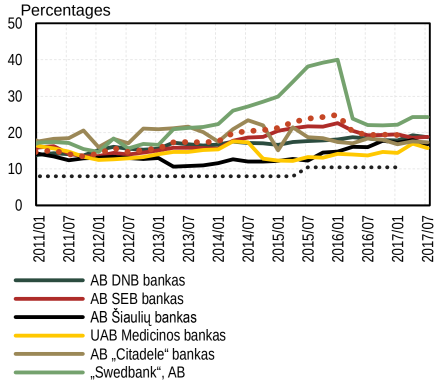
Expansion in the loan and deposit portfolios as well as one bank's inter-group transactions contributed to banks' balance sheet items. At the end of the first half-year, the assets of the banking system amounted to EUR 26.4 billion, an increase of EUR 559 million (2.2%) over the second quarter. Asset developments for the last few quarters have been driven by the increase in the value of bank loan portfolios and funds with credit institutions. Bank loan portfolios rose by EUR 333 million in value, the amount of funds with credit institutions, which are mainly comprised of funds with parent banks, – by EUR 361 million over the second quarter. Developments in other asset items were less pronounced and did not have a major contribution to the structural changes in bank assets.

At the end of the first half of 2017, bank liabilities stood at EUR 24.2 bil-

[1] Reports from seven branches are received for supervisory purposes, as the branch of *Telia Finance AB* in Lithuania, *Telia Finance Lietuva*, is not engaged in operations so far.

Chart 3. Capital adequacy ratios of banks

(1 January 2011–1 July 2017)



Source: Bank of Lithuania.

Table 1. Capital adequacy ratios of banks

	Capital adequacy ratio, %	
	Q1 2017	Q2 2017
AB DNB bankas	19.3	18.8
AB SEB bankas	18.6	18.8
AB Šiaulių bankas	18.0	16.8
UAB Medicinos bankas	17.0	15.7
AB Citadele bankas	17.6	17.3
Swedbank, AB	24.3	24.3
Banking system	**20.0**	**19.9**

Source: Bank of Lithuania.

Table 2. Bank of Lithuania capital adequacy ratio requirements

	Requirement, %
AB DNB bankas	Set by the ECB
AB SEB bankas	Set by the ECB
AB Šiaulių bankas	12.9
UAB Medicinos bankas	13.9
AB Citadele bankas	14.5
Swedbank, AB	Set by the ECB

Note: The Bank of Lithuania and the ECB, which carry out supervision, assess and define the requirements on an annual basis. Capital ratio requirements set by the ECB, which carries out direct supervision, are not publicly released by decision of the ECB.

Source: Bank of Lithuania.

Table 3. Liquidity coverage ratios of banks

	Liquidity coverage ratio, %	
	Q1 2017	Q2 2017
AB DNB bankas	184.9	181.5
AB SEB bankas	175.5	174.9
AB Šiaulių bankas	368.7	282.8
UAB Medicinos bankas	879.8	724.9
AB Citadele bankas	164.6	156.4
Swedbank, AB	295.4	308.7
Banking system	**264.0**	**259.5**

Source: Bank of Lithuania.

lion, expanding by EUR 486 million (2.0%) over the second quarter. Customer deposits comprise the largest share of bank liabilities (77%), although both in the second quarter and the first half-year they were not the main driver of the banking system's growing liabilities. These liabilities rose by EUR 125 million over the quarter. Liabilities to credit institutions accounted for the largest share of the change, posting an increase of EUR 492 million over the reporting period. The change during the quarter was due to the growing liabilities to the parent bank of one banking market participant, related to inter-group transactions. The inter-group transactions of the same bank also determined the balance sheet assets side – an increase in funds held with credit institutions.

3. COMPLIANCE WITH REQUIREMENTS

According to the submitted data, the banking sector's capitalization continues to be sustainable and the ratios complied with. As at 30 June 2017, the overall capital adequacy ratio of the banking sector stood at 19.9 per cent. The value of the banking system's capital adequacy ratio fell by 19 basis points over the quarter. In the second quarter, capital adequacy measures of most banks fell, yet these changes were insignificant and did not contribute negatively to bank stability. Bank's regulatory reports submitted to the Bank of Lithuania show that in the second quarter of 2017 all banks complied with the minimum capital adequacy ratio requirement (8.0%), the Pillar II capital requirement (which is set for each bank on an individual basis), and the combined buffer requirement. The latter is currently comprised of the capital conservation requirement (2.5%), the countercyclical capital buffer requirement (0%), and the capital buffer of other systemically important institutions requirement (0.5–2.0%). The capital requirements for banks (see Table 2) will be in effect in 2017 until the Bank of Lithuania, after conducting a supervisory review and evaluation process, takes new supervisory decisions. By decision of the ECB, the individual capital ratios set for the three major banks in Lithuania are not published; however, they are set following the same principles, and these banks comply with them with a sufficient margin. The Bank of Lithuania further sticks to the position that, for local capital banks, the issue of strengthening their capital is still a priority.

As, in the second quarter of 2017, growth in the loan portfolio outpaced growth in customer deposits, banks reduced somewhat their buffers of liquid assets; they, however, continued to be sufficiently large and the liquidity level remained high. Banks' liquid assets were comprised of very high quality and liquidity financial instruments: cash, funds with the Bank of Lithuania, and securities of the governments of EU countries. Having attracted funds from parent banks and with an increase in customer deposits, banks' funding basis expanded. In monitoring the liquidity situation in banks and in order to be sure that they ensure compliance with liquidity requirements, the Bank of Lithuania assesses on a permanent basis the values of the liquidity coverage ratio (LCR) – the key indicator of liquidity, set in Capital Requirements Directive IV and in the Capital Requirements Regulation. According to the data submitted by banks, the value of this indicator is high across all banks operating in the country, and this ratio is met with a sufficient margin – as at 31 December 2017, the banking sector's LCR was 259.9 per cent (the required minimum in Lithuania is 100%). The LCR values declined somewhat for nearly all banks in the second quarter after banks reduced marginally their buffer of liquid assets.

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4. THE LOAN PORTFOLIO[2]

Developments in the loan portfolio

Both enterprises and households borrowed in the second quarter. The net value of the portfolio of loans granted to bank customers[3] (hereinafter 'loan portfolio value') increased by EUR 333 million (1.8%) over the second quarter of 2017 – to EUR 18.6 billion[4]. Growth in lending both to households and enterprises – the major credit taking parties – was similar; their loan portfolio value accounts for 92 per cent of banks' entire loan portfolio. The value of loans to households grew by EUR 204 million (2.5%) over the reporting period. The value of housing loans, which account for the major share of loans within this group, grew by EUR 132 million (2.0%), while the value of loans for consumption – by EUR 20 million (3.3%); the remaining share of the growth consisted of borrowing by household sector entities (e.g. sole proprietorships, home owners associations, etc.). The value of loans granted to enterprises increased by EUR 225 million (2.6%). The major contribution to this change stemmed from a rise in the value of real estate, manufacturing and transport enterprise liabilities. The liabilities of financial institutions and general government agencies dropped by EUR 9.6 million (1.4%) and EUR 86 million (10.8%) respectively in value.

Annual growth rates were as follows: for total loans to customers – 5.8 per cent, for loans to households – 8.4 per cent, for loans to enterprises – 5.1 per cent. Loans for house purchase grew by 7.5 per cent in value.

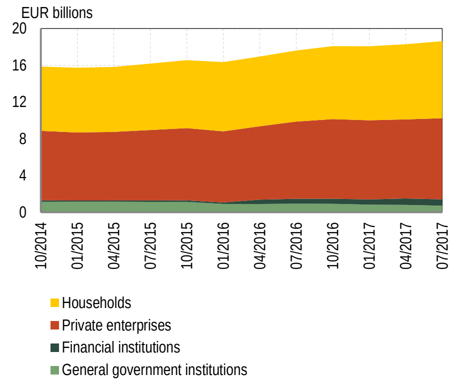
Loan market development remains robust, the economy is in the phase of an economic upswing and, if the current growth rate of lending remains unchanged, the risks to the financial system will increase. So far the Bank of Lithuania is monitoring the market situation and, if the development does not decelerate or accelerate, changing the countercyclical buffer rate may be considered, to increase the resilience of the financial system.

Loan portfolio quality

Banks kept reducing balances of loans with features of heightened risk, especially within the portfolio of loans granted to enterprises. The share of non-performing debt instruments contracted by 0.3 p.p. – to 3.48 per cent, while the balance of such loans contracted by 6.8 per cent quarter on quarter. Loan write-off accounted for 2 per cent of the balance of non-performing loans at the beginning of the quarter. Due to favourable economic conditions and new loans as banks have been addressing the issue of distressed loans, the balances of non-performing loans issued to households and businesses over the second quarter of the year contracted by 3.6 and 9.2 per cent, to 4.34 per cent and 5.46 per cent of the total value of this loan portfolio. The balance of household loans past due for more than 90 days decreased by 4.4 per cent, to 2.8 per cent of the total value of loans granted to households at the end of the quarter. The balance of loans to businesses past due contracted by 10.3 per cent of the portfolio of business loans, to 3.38 per cent.

Chart 4. Bank loan portfolio net value

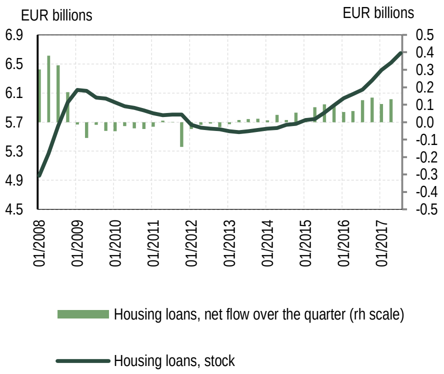
(1 October 2014–1 July 2017)



Source: Bank of Lithuania.

Chart 5. Housing loan portfolio net value

(1 January 2008–1 July 2017)

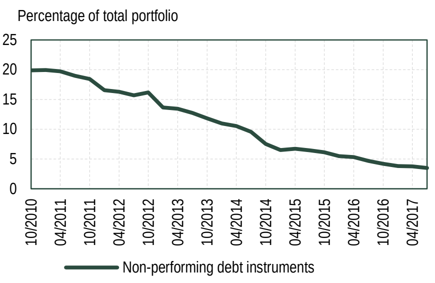


Note: As of 1 October 2014, housing loans also include loans granted to households designated for investment in one's house for one's own needs or rent, including construction and repair; therefore, the data are not fully comparable to the line of previous data.

Source: Bank of Lithuania.

Chart 6. Loan quality

(1 October 2010–1 July 2017)



Source: Bank of Lithuania.

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[2] Including the leasing portfolio.
[3] The financial statements present loan value, which is calculated by adding up the balances of loans and interest accrued and subtracting provisions formed and charges accrued.
[4] The annual growth of bank and credit union loans to the domestic economy in July 2017 was as follows: for the entire portfolio of loans to the non-financial private sector– 6.4 per cent, for loans to households – 7.9, enterprises – 4.8, for housing loans – 8.0 per cent. MFI balance sheet statistical data used herein is adjusted for the elimination of MFIs under bankruptcy from statistics and other technical factors. For more information, see Annex 2 "MFI loan portfolio adjustment for technical factors" of the December 2014 Lithuanian Economic Review (http://www.lb.lt/lithuanian_economic_review_december_2014).

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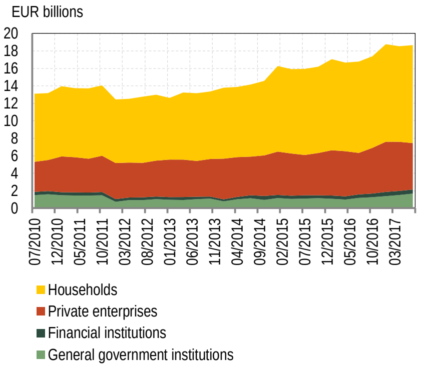
Chart 7. Amount of deposits

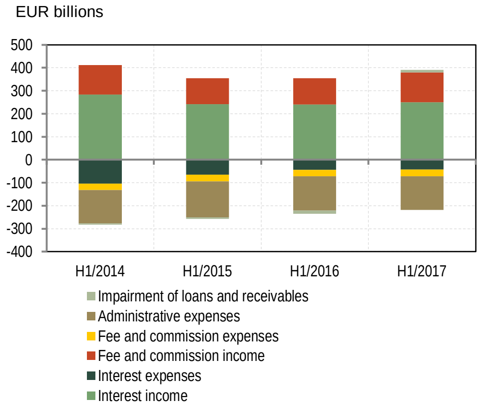
(1 July 2010–1 July 2017)



Source: Bank of Lithuania.

Chart 8. Main items of income and expenses

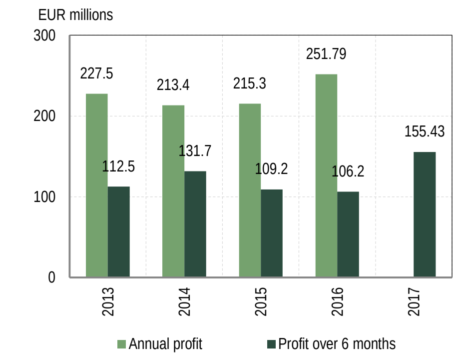
(2014, 2015, 2016 and H1 2017)



Source: Bank of Lithuania.

Chart 9. Profit of the banking sector

(1 January 2013–1 July 2017)



Source: Bank of Lithuania.

Table 4. Comparison of the growth rates of banks' income and expenses

	change over the year	
	2016	H1 2017
Interest income	1.6%	3.8%
Interest expense	–23.1%	–5.3%
Net interest income	**9.4%**	**5.8%**

Source: Bank of Lithuania.

5. DEPOSITS WITH BANKS

Bank deposit developments follow their long-term trend. As at 1 July 2017, customer holdings of deposits with banks stood at EUR 18.7 billion, increasing by EUR 125 million (0.7%) from the end of the first quarter of 2017. The amount of deposits diverged slightly from the historically highest levels observed at the end of 2016. However, the growth trend continues and there is a low probability that it will change in the long-term, although short-term fluctuations might be observed. The largest increase over the quarter was recorded in the deposit amount of households (EUR 271 million, or 2.5%) and general government enterprises (EUR 161 million, or 10.7%), whereas the deposit amount of private companies contracted (EUR –311 million, or –5.5%). Developments in the same direction and of a similar size could also be observed in the second quarters of previous years. Year on year the amount of deposits with banks continues growing fast: it rose by EUR 1.9 billion (11.2%); all types of customer deposits posted growth.

Deposits are the major share of bank liabilities to customers, and a financing source as well. The improving economic situation – rising wages, enterprise activity, and crediting at the same time – provide conditions for the amount of deposits to increase, although interest rates are particularly low. However, the average rate of growth in deposits with small non-Scandinavian capital banks is somewhat stronger because these banks offer higher interest rates on deposits.

6. PROFITABILITY AND OPERATING EFFICIENCY

The key performance indicators of banks in Lithuania improved, with the largest contribution to their profit growth stemming from the recovery of loan value along with the fact that no atypical losses were incurred any more. Over the first half of 2017, banks and foreign bank branches earned EUR 155.4 million in profits, a year-on-year increase of EUR 49.3 million (46.4%). The recovery of bank loan value amounted to EUR 24.3 million, thereby contributing to a significant share of the profit change. 11 banks and foreign bank branches operated at a profit and only 2 market participants bore losses.

Both the first quarter and the first half of 2017 were successful for banks, the main items of bank income and expenses improved further, posting an increase both in net interest income and net income from fees and commissions. Despite these developments, banks' net operating profit was lower in the first half-year by EUR 14.9 million (–4.4%) year on year, as last year several market participants earned atypical profits related to the revaluation of their holdings of financial assets.

Nevertheless, bank profits were on the rise. Administrative expenses declined gradually (EUR –2.4 million, or –1.6%), the largest contribution to profit growth stemming, however, from the above-named recovery of loan value in the first half-year by a number of banks. In addition, this year, unlike in the same period in 2016, one bank did not incur an atypical loss related to the disposal of long-term assets.

Due to the above-named one-off factors the profits for 2016 contracted by some EUR 17 million. Thus, profit changes this year seem to be less pronounced, whereas the activities of the banking system could be best assessed by income from its key business areas – lending and financial mediation services.

In the first half-year, bank lending supported net interest income growth more than in 2016. Interest income of banks augmented by EUR 9.0 million (3.8%) in the first half-year of 2017, to EUR 249.5 million. Interest expenses fell by EUR 2.4 million (–5.3%) – to EUR 42.1 million, over the reporting period. Net interest income increased by 11.4 million (5.8%), to EUR 207.3 million. Compared to 2016, the net income growth structure changes slightly this year (see Table 4). In 2016, a decline in interest expenditure exerted a significant influence. This was related to a smaller deposit insurance premium than in 2015, which led to a contraction of interest expenditure in 2016 of 23.1 per cent, i.e. a much more substantial contraction than it is this year. On the other hand, interest growth is more robust this year than it was in 2016. It can be concluded that in the first half-year net interest income growth was more strongly affected by income from the lending activity. In the second half of the year the situation will change again, because the Ministry of Finance of the Republic of Lithuania set a lower deposit insurance premium tariff as of 1 July 2017. It was reduced from 0.3 per cent to 0.1 per cent of the insured deposit amount.

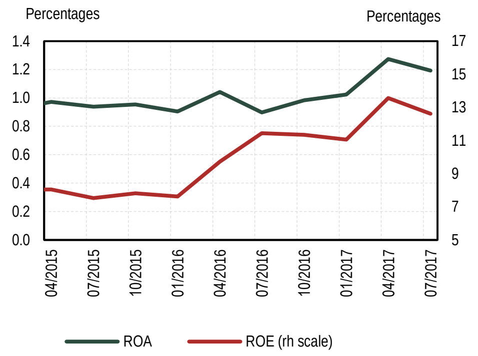
Income from bank services and commissions increased by EUR 16.5 million (14.6%), to EUR 130.0 million. Respective expenditure increased by EUR 2.6 million (9.3%), to EUR 30.4 million. Net income from fees and commissions rose by EUR 14.0 million (16.3%), to EUR 99.7 million. It is likely that the growing volumes of services and changes in the pricing of some services were contributing to that in the recent few quarters. Evaluating the contribution of these developments will be possible when the data from a longer period is available.

Banks' profitability continues to be high, providing a basis for the financial system to remain sustainable. In the second quarter of 2017, banks' return on assets was 1.2 per cent, return on equity – 12.6 per cent.[5] The indicators rose by 0.3 p.p. and 1.2 p.p. respectively over the year. Banks' efficiency indicator, illustrating the bank cost (administrative expenses and depreciation)-to-net operating income ratio was 47.8 per cent in the reporting period, rising by 1.8 p.p. over the year. Although a long-term trend suggesting banks' higher operating efficiency can be observed, at the end of the second quarter banks' operating efficiency indicator deteriorated year on year, as a result of lower net operating income than the year before (see the beginning of Chapter 6).

Lithuania's banking system, compared to banks of the whole of the EU[6], is much more effective – the respective indicator is much below the EU average (63.8%). Accordingly, banks in Lithuania are more profitable compared to the EU, where the return on equity is 6.9 per cent, return on assets – 0.4 per cent; but they do not stand out significantly among many countries because the common average is subject to the impact of the loss-bearing or barely profitable banking systems of Greece, Cyprus and Portugal. An effective and profitable banking system is the basis for a stable financial system; hence, in this respect, Lithuania's banking system can be seen as sustainable.

Chart 10. Bank profitability ratios and net interest margin

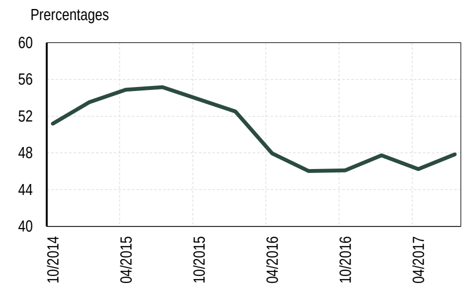
(1 April 2015–1 July 2017)



Source: Bank of Lithuania.

Chart 11. Bank efficiency indicator (cost-to -income ratio)

(1 April 2015–1 July 2017)



Source: Bank of Lithuania.

7. REGULATORY ENVIRONMENT

Protection of consumer rights

In the second quarter of 2017, the Bank of Lithuania was applied 62 times regarding settlement of disputes with banks and their branches in operation in Lithuania. The figure is 24 times less year on year. Comparison of

[5] As of Q1 2017 the asset, equity and efficiency indicators used by the Bank of Lithuania, seeking comparability at the EU level, are calculated according to the methods of the European Banking Authority; therefore, they cannot be directly compared to indicators previously used for analysis.
[6] Comparable data of the European Banking Authority for Qi 2017: http://www.eba.europa.eu/risk-analysis-and-data/risk-dashboard

the data for the reporting period and for the second quarter of 2016 reveals a fall in the number of settled disputes between banks and consumers. In the second quarter of 2017, a total of 26 disputes were settled and 9 decisions regarding the subject matter of a dispute were adopted; whereas in the second quarter of last year 31 disputes were settled and 14 decisions regarding the subject matter of a dispute were adopted. In the settlement of disputes by the Bank of Lithuania over the reporting period, in 8 cases consumer requirements were rejected, in one case – satisfied in part. Thus, the share of consumer claims rejected remains sufficiently large (89%) and is by 10 p.p. larger than in the second quarter of 2016. In the second quarter of 2017, 5 disputes, settled by the Bank of Lithuania, ended in reaching a peaceful agreement between the parties (in Q2 2016, 2 disputes were settled peacefully). Most disputes that were settled by the Bank of Lithuania arose from the provision of payment services, also from credit services, deposit and other financial services.

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Annex. Key indicators of the banking sector

Table 5. Main items of balance sheet statement

Seq. No	Indicator	01/07/2016	01/04/2017	01/07/2017	Change Q2	Change over the year
		Amount, EUR millions			(%)	
1.	**Assets**	**23,893.4**	**25,855.6**	**26, 415.0**	**2.2**	**10.6**
1.1.	Debt securities	1,604.4	1,509.9	1, 475.7	**–2.3**	**–8.0**
1.2.	Equity securities	47.8	55.4	54.1	–2.3	13.2
1.3.	Financial derivatives	147.9	132.7	111.9	–15.7	–24.4
1.4.	Cash	408.9	439.9	448.4	1.9	9.6
1.5.	Funds with central banks	1,601.8	2,236.2	2,147.3	–4.0	34.1
1.6.	Funds with credit institutions	2,098.3	2,857.0	3,217.9	12.6	53.4
1.7.	Loans to customers (incl. leasing)	17,609.6	18,291.3	18,624.1	1.8	5.8
1.7.1.	to general government agencies (incl. leasing)	934.7	800.6	714.2	–10.8	–23.6
1.7.2.	to other financial corporations (incl. leasing)	532.1	696.9	687.3	–1.4	29.2
1.7.3.	to non-financial corporations (incl. leasing)	8,405.7	8,610.6	8,835.7	2.6	5.1
1.7.4.	to households (incl. leasing)	7,737.1	8,183.2	8,386.7	2.5	8.4
1.7.4.1	o/w loans for house purchase	6, 149.1	6,518.3	6,650.4	2.0	8.2
1.8.	Other asset positions	374.6	333.2	335.7	0.7	–10.4
2.	**Liabilities and equity**	**23,893.4**	**25,855.6**	**26,415.0**	**2.2**	**10.6**
2.1.	Deposits of central banks	319.0	303.0	303.0	0.0	–5.0
2.2.	Liabilities to credit institutions	4,149.7	4,318.2	4,815.8	11.5	16.1
2.3.	Financial derivatives	135.7	122.3	110.5	–9.7	–18.5
2.4.	Deposits	16,779.6	18,536.7	18,661.3	0.7	11.2
2.4.1.	of general government agencies	1,176.6	1,508.7	1,669.6	10.7	41.9
2.4.2.	of other financial corporations	399.4	463.4	466.5	0.7	16.8
2.4.3.	of non-financial corporations	4,751.2	5,623.5	5,312.7	–5.5	11.8
2.4.4.	of households	10,452.3	10,941.0	11,212.4	2.5	7.3
2.5.	Debt securities issued	30.9	5.9	1.7	–70.6	–94.4
2.6.	Other positions of liabilities	402.4	428.4	307.9	–28.1	–23.5
2.7.	Equity	**2,076.2**	**2,141.1**	**2,214.8**	**3.4**	**6.7**

Source: Bank of Lithuania.

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Table 6. Main items of the profit (loss) account

Seq. No	Indicator	01/07/2016	01/04/2017	01/07/2017	Change Q2	Change over the year
		amount, EUR millions			(%)	
3.	**Profit for current year**	**106.2**	**82.2**	**155.4**	_	**46.4**
3.1.	Net interest income	195.9	103.5	207.3	_	5.8
3.2.	Net income from fees and commissions	85.7	47.6	99.7	_	16.3
3.3.	Administrative expenses	148.9	71.3	146.5	_	–1.6
3.4.	Impairment costs of loans and receivables	16.1	–7.3	–9.3	_	–157.8

Source: Bank of Lithuania.

Table 7. Other performance indicators of banks

Seq No	Indicator	01/07/2016	01/04/2017	01/07/2017	Change Q2	Change over the year
		%			p.p.	
4.	Capital adequacy ratio	19.3	20.0	19.9	–0.2	0.5
5.	CET1 capital adequacy ratio	19.1	19.7	19.5	–0.3	0.4
6.	Liquidity coverage ratio	_	264.0	259.5	–4.5	_
7.	Leverage ratio	8.5	8.6	8.5	–0.1	0.0
8.	Net interest margin	1.69	1.60	1.59	0.0	–0.1
9.	Return on assets*	0.90	1.27	1.19	–0.1	0.3
10.	Return on equity*	11.45	13.56	12.62	–0.9	1.2
11.	Cost-to-income ratio*	46.0	46.3	47.8	1.6	1.8
12.	Non-performing debt instruments	4.7	3.8	3.5	–0.3	–1.2

Source: Bank of Lithuania.

As of Q1 2017 the asset, equity and efficiency indicators used in Bank of Lithuania reviews are calculated according to the methods of the European Banking Authority; therefore, they cannot be directly compared to the indicators used in previous reviews.

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