Banking activity review

Q3 2014

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In nine months of 2014 the banking sector[1] operated in a stable manner, positive trends prevailed: the activities of banks were profitable, deposits grew, the loan portfolio slightly increased as well. Most bank assets (69%) consisted of the portfolio of loans granted to customers and leasing (on a net basis), while most of bank liabilities consisted of attracted customer deposits (71%). With growth in deposits and the loan portfolio not changing significantly, the loan (together with leasing)-to-deposit ratio continued to decrease: on 1 October 2014 it was 109 per cent (120% a year ago).

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

Seq. No	Indicator	Amount on 01/10/2013 LTL millions	Amount on 01/01/2014 LTL millions	Amount on 01/07/2014 LTL millions	Amount on 01/10/2014 LTL millions	Change in Q3 2014, %	Change over 9 months, %	Change over a year, %
1.	Assets	76,468.1	77,578.1	78,530.2	79,788.6	1.6	2.8	4.3
2.	Debt securities	6,297.1	7,877.7	7,631.3	7,457.3	–2.3	–5.3	18.4
3.	Leasing	3,482.8	3,489.9	3,473.3	3,363.9	–3.1	–3.6	–3.4
4.	Loans granted to customers	51,741.2	51,015.9	51,037.0	51,395.7	0.7	0.7	–0.7
4.1.	To private enterprises	24,304.6	23,575.0	23,538.6	23,145.7*	–	–	–
4.2.	To financial institutions	421.1	481.0	592.8	546.4*	–	–	–
4.3.	To natural persons	22,831.1	22,802.0	22,925.4	23,816.9*	–	–	–
4.3.1.	Housing loans	19,309.3	19,375.5	19,552.8	20,018.7*	–	–	–
5.	Loan impairment	2,419.4	2,212.1	1,975.3	1,992.0	0.8	–9.9	–17.7
5.1.	Loan impairment to granted loans ratio, %	4.5	4.2	3.7	3.7	–	–	–
6.	Deposits and letters of credit	46,108.5	47,604.5	48,876.4	50,303.4	2.9	5.7	9.1
6.1.	Of private undertakings	14,855.3	16,062.1	15,256.6	16,012.4*	–	–	–
6.2.	Of financial institutions	792.7	803.6	1,189.0	1,575.4*	–	–	–
6.3.	Of natural persons	26,669.2	28,038.4	28,507.5	29,446.4*	–	–	–
7.	Shareholder equity	7,854.3	8,029.6	8,261.5	8,489.5	2.8	5.7	8.1
8.	Profit (loss) for the current year	605.0	785.7	454.6	618.7	–	–	–

*Implementation of the Regulation as of 1 October 2014 entailed changes in the classification principles of customer group categories, thus the loan and deposit data by customer group are not directly comparable to the data of previous periods.

With the coming into effect of the Capital Requirements Directive, adopted by the European Parliament and by the Council, and the Regulation from the beginning of the year, the regulatory environment for banking activities has changed substantially in all of the European Union (EU). The Regulation is a document of direct relevance, designated for all Member States; it lays down uniform supervisory requirements for banks operating in them. While compared to the previous regulation of banking activities the new one is stricter, the prudential ratios of banks operating in Lithuania continued to be well above minimum levels: on 1 October the capital adequacy ratio of banks was 20.7 per cent[3] (the requirement is 8%), the liquidity coverage ratio (LCR) and the net stable funding (NSFR) ratios were 345 per cent and 150 per cent respectively (the requirement is 100% for both).[4] It should be noted that on 1 October the Republic of Lithuania government securities position in US dollars of *AB Citadele bankas* exceeded the Bank of Lithuania's established minimum limit (25%); however, the bank took urgent action and sold part of these securities; as a result, the limit to large exposure declined to 21.8 per cent (according to the data as of 13 November 2014).

After Lithuania joins the euro area, the banks operating in Lithuania from 1 January 2015 will become part of the Single Supervisory Mechanism, which means that the three largest banks operating in Lithuania (*AB SEB bankas, Swedbank, AB,* and *AB DNB bankas*) will be subjected to direct supervision by the European Central Bank (ECB) in cooperation with the Bank of Lithuania. As in other euro area countries, prior to becoming the supervisor of these banks, the ECB, assisted by the Bank of

[1] The domestic banking sector consists of 7 commercial banks and 8 foreign bank branches currently operating in the country.
[2] Consolidated data. As Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (hereinafter — Regulation) came into force as of 1 January 2014, there were changes in the consolidation volume of data collected for supervisory purposes (controlled undertakings performing the asset management or other ancillary functions, which supplement their key activities, began to be consolidated) and, therefore, the data are not fully comparable with those of the previous data.
[3] The Bank of Lithuania also publishes the capital adequacy ratios (http://www.lb.lt/2014_q2_3) of individual banks.
[4] It is projected to apply the minimum LCR and NSFE levels in the European Union in the future. In Lithuania, the LCR requirement will be applicable as of 1 January 2015, while NSFR — from 2018.

Lithuania, carried out an in-depth analysis of the quality of these banks' assets and stress tested their resilience to likely shocks (more detailed information is available in the section "The Loan Portfolio of Banks"). The supervision of smaller banks operating in Lithuania will further be performed by the Bank of Lithuania, while the ECB will perform their indirect supervision in reviewing and systematising information on the supervision of small banks in the euro area countries, promoting convergence of supervisory practices (the ECB will also have the right to take over the direct supervision of any bank under certain circumstances).

THE LOAN PORTFOLIO OF BANKS

In Q3 of this year the loan portfolio of banks (on a net basis, i.e., after specific provisions) expanded by LTL 359 million (or 0.7%) and amounted to LTL 51.4 billion on 1 October 2014. The leasing portfolio contracted by LTL 109.4 million (3.1%) — to LTL 3.1 billion. At the end of Q3 the portfolio of bank loans granted to the private sector was by LTL 452.1 million (or 1%) larger than at the end of Q2 (with the change in the classification principles for customer group categories, the quarterly data by customer groups are not directly comparable).

The instability of the international political environment did not have any greater negative influence on the loan portfolio quality: while specific provisions increased at *UAB Medicinos bankas*, the banks' loan impairment ratio remained unchanged and was 3.7 per cent in Q3.

In Q3, the Bank of Lithuania, in cooperation with the ECB, completed the asset quality review of the three largest banks operating in Lithuania. In Lithuania, this review was carried out according to the ECB's quite stringent methodology at the same time as at all 18 largest euro area banks. Once it was carried out, no significant comments on the loan quality review at the banks operating in Lithuania were presented. In addition, the preparedness of these banks to act in the event of the adverse scenario of a three years' duration was assessed according to the common methodology of euro area countries; in constructing this scenario, among other things, the bank's sensitivity to loan portfolio quality changes was also taken in account. After testing it turned out that banks operating in Lithuania held sufficient capital to be able to absorb all losses likely to be incurred during the adverse scenario, including those due to the major — credit risk.

It should also be noted that a new definition of non-performing loans, common to all countries, will be applied in the EU from 2015. Therefore, already from the next quarter the loan quality indicators of banks operating in Lithuania will be published according to new requirements. As the methodology for the calculation of indicators currently being published by the Bank of Lithuania is rather stringent and close to the new methodology, the values of current indicators are not likely to change significantly; however, they are likely to become more convenient in analysing the loan quality of banks operating in Lithuania.

PROFITABILITY AND EFFICIENCY OF OPERATIONS

In nine months of 2014 banks earned LTL 618.7 million — 2 per cent more than in the respective period of the previous year. The activities of six banks and six foreign bank branches were profitable, while one bank and two foreign bank branches operated at a loss.

Banks' profitability improved mainly due to net interest income; however, impairment costs and higher operational expenditure resulted in a relatively insignificant profit growth as compared to the result for the nine months of 2013. It should be noted that the largest share of impairment costs during nine months of 2014 was incurred by *UAB Medicinos bankas.* After repeated valuation of the taken over assets of subsidiaries and of the assets pledged against riskier loans, this bank recorded LTL 43 million of expenses related to the change in the value of pledged assets.

Banks' net interest income for nine months of 2014 picked up by LTL 65 million (7.3%) — to LTL 954.6 million year on year. As in previous periods, this growth was driven by lower interest expenditure of banks. Over the year, banks' interest expenditure contracted more than 15 per cent, while their interest income — 2 per cent. Banks' quarterly interest income has not been changing much for nearly two years already; while without significant growth in the loan portfolio and amid the prevailing low interest rates environment the possibilities for banks to increase their interest income have been limited as well.

Over nine months of this year banks' net income from services and commissions increased by LTL 19 million (4.1%) year on year, as further growth in the volumes of bank services and operations entailed a pick-up in banks' income from transfer, settlement and payment operations. In addition, there was an LTL 17 million (21%) increase in the income of bank-founded financial services centres that provide services to the group's banks abroad, received from account management, credit operation administration and other services.

Banks' operational expenditure declined marginally over nine months of 2014 year on year; however, growth in staff costs is being observed. It was driven by the recently growing volume of the activities of the above-named bank-founded financial service centres. This year banks have been paying particular attention to the improvement of their operating performance, thereby incurring one-off restructuring expenditure because of the decreasing of the number of customer service divisions, establishment of self-service centres; thus the impact of the above-named factors on banks' profitability next year is likely to be higher than this year.

With a slight increase in banks' profitability, banks' performance indicators changed just a little: the banks' net interest margin, which shows the difference between the interest banks receive on invested assets and the interest they pay to their creditors, rose by 0.1 percentage point — to 1.57 per cent over the year; the return on assets indicator of the banking sector remained unchanged over the year and was 1.05 per cent, while their return on assets ratio decreased by 0.6 per cent — to 10.1 per cent over the year.