LIETUVOS BANKAS
EUROSISTEMA

Banking Activity Review

2018 / Q1

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In early 2018, Lithuania's banking sector continued the previously initiated consolidation processes; meanwhile, the sector's situation remained stable. Bank assets in the first quarter were further boosted by the increasing loan portfolio. After an upswing, which is usually observed at the end of the year, the amount of deposits naturally dropped in the first quarter, but deposits are still on a clear growth trend in a longer-term perspective. According to the data reported by banks, the supervisory capital and liquidity requirements were complied with in the first quarter; however, capital strengthening remains a priority for domestic banks. The loan market continued to expand, while the quality of the loan portfolio was good. After coming into effect at the beginning of the year, International Financial Reporting Standard (IFRS) 9 enabling a more precise estimation of credit losses due to lending exposures had no significant impact on banks' specific allowances. As a result of the recent quite active bank lending, the Bank of Lithuania is prompted to adopt stricter macroprudential policy measures and increase the countercyclical capital buffer rate. The first quarter of 2018 was profitable for banks: the major share of profits resulted from the main banking activities; however, internal processes are being automated and more efficient operational management models are being introduced by banks in order to improve efficiency.

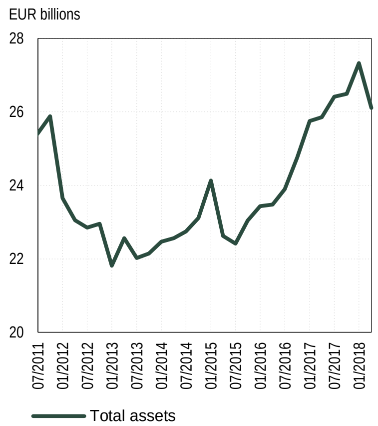
1. BANKING SECTOR DEVELOPMENTS

Consolidation and greater concentration processes were further observed in the banking sector. The consolidation of the bank Luminor Bank AB at the level of the Baltic countries continued into the first quarter of this year. It is envisaged that separate Luminor banks operating in the Baltic region will merge into a single bank by the end of the year, with its head office being established in Estonia. Consequently, Luminor Bank AB operating in Lithuania would become a branch of the bank established in Estonia. In April 2018, the Danish bank Danske Bank informed that it had reviewed its business strategy in the Baltic countries and had no future plans to expand its banking and financial service activities, but would rather focus on the activities of two service centres – global services and IT – currently operating in Lithuania. Seeking to gain operational efficiency and following digitisation trends, banks proceed with automating processes and introducing more efficient operational management models. Six banks and seven foreign bank branches[2] operated in the banking sector in the first quarter of 2018.

With the entry into force of amendments to the Republic of Lithuania Law on Banks on 1 January 2017, there is a possibility of establishing a specialised bank. The Bank of Lithuania continues its active interaction with potential new participants of the banking sector. In the light of the recent processes in the banking sector, the Bank of Lithuania encourages new market participants to enter the Lithuanian market in the hope that this would reduce concentration in the market and related systemic risk.

Chart 1. Assets of the banking sector

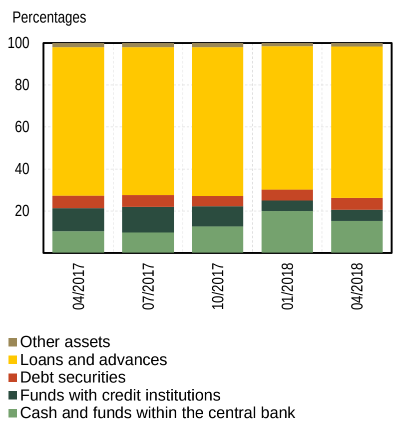
(1 July 2011-1 April 2018)



Source: Bank of Lithuania.

Chart 2. Asset composition

(1 April 2017-1 April 2018)



Source: Bank of Lithuania.

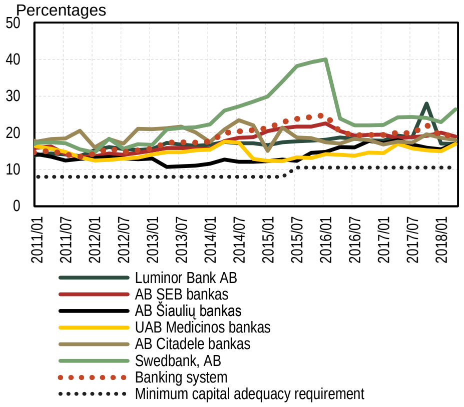
2. ASSETS AND LIABILITIES

At the beginning of the year, bank assets declined significantly, which is virtually the result of asset management decisions taken by one bank group. In the first quarter of 2018, assets amounted to €26.1 billion and over the first three month of this year depreciated by

[1] Should system participants adjust their statements for this or other important reasons, the data of the review after this date may be revised.
[2] Reports from six branches are received for supervisory purposes as the Lithuania branch of Telia Finance AB, Telia Finance Lietuva, does not carry out any activities yet.

Chart 3. Capital adequacy ratios of banks

(1 January 2011-1 April 2018)



Source: Bank of Lithuania.

Table 1. Capital adequacy ratios of banks

	Capital adequacy ratio, %	
	2017 Q4	2018 Q1
Luminor Bank AB	17.1	17.0
AB SEB bankas	20.0	19.0
AB Šiaulių bankas	15.5	17.1
UAB Medicinos bankas	15.0	17.0
AB Citadele bankas	18.6	18.0
Swedbank, AB	22.9	26.4
Banking system	**19.1**	**19.6**

Source: Bank of Lithuania.

Table 2. Capital adequacy ratio requirements set by the Bank of Lithuania

	Requirement, %
Luminor Bank AB	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

Notes: The Bank of Lithuania and the ECB, which carry out supervision, assess and define the requirements on an annual basis. Capital adequacy 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, %	
	2017 Q4	2018 Q1
Luminor Bank AB	157.7	134.1
AB SEB bankas	266.0	203.6
AB Šiaulių bankas	313.4	279.8
UAB Medicinos bankas	730.6	477.8
AB Citadele bankas	242.6	248.6
Swedbank, AB	474.2	348.2
Banking system	**282.2**	**248.9**

Source: Bank of Lithuania.

€1.2 billion (4.5%). More specifically, the assets of the banking system decreased significantly as Swedbank, AB had repaid to its parent bank funds borrowed from it for a short term at the end of 2017. Larger fluctuations in liabilities to parent banks in recent years were due to increasingly intense relations between undertakings within a group in managing the group's reserves, in particular liquidity buffers. Loans granted to customers continued to grow, going up by €216 million over the quarter (for more information, see Section 4), whereas funds with credit institutions, which primarily consist of bank funds held in parent banks, slightly shrank (by €3.3 million). Funds held in the central bank's accounts decreased by nearly €1.5 billion, mainly due to the abovementioned reasons, i.e. management of liquid asset reserves at banking group level.

After the usual increase at the end of the year, in the first quarter there was a slight drop in customer deposits with banks. In the first quarter of 2018, bank liabilities fell by €1.1 billion (4.4%) to €23.7 billion. Nearly all liabilities of Lithuanian banks (95%) comprise customer and parent bank deposits. And the latter brought about significant changes – debt to parent credit institutions decreased by €1.2 billion over the quarter as a result of the said decisions by one bank group relating to asset allocation and liquidity buffer management. After a hike, which is usually observed at the end of the year, the amount of customer deposits in the first quarter contracted by €243 million (for more information, see Section 5).

3. COMPLIANCE WITH REQUIREMENTS

The state of the banking sector's capital remains stable. The overall capital adequacy ratio of the banking sector stood at 19.6% at the end of the first quarter of 2018. Compared to the end of 2017, this overall ratio increased by 0.5 percentage point as banks strengthened their capital base by including in it their profits earned last year. The biggest increase (nearly 3.5 percentage points) was in the capital adequacy ratio of Swedbank, AB, which can also be explained by a significant decrease in its assets when the short-term deposit was paid back to the parent bank. The capital adequacy ratio of AB SEB bankas declined by 1 percentage point due to dividends paid to the parent bank at the beginning of the year.

According to the data reported by banks, the established capital requirements were complied with. Based on reports submitted for supervisory purposes, in the first quarter of 2018, all banks operating in Lithuania complied with the minimum capital adequacy requirement (8.0%), Tier 2 additional capital requirement (Pillar II, established for each bank), and the combined buffer requirement. The latter is currently comprised of the capital conservation buffer requirement (2.5%), the countercyclical capital buffer requirement (0%), and the other systemically important institution buffer requirement (0.5-2.0%). The capital requirements established for banks (see Table 3) will be effective in 2018 until a new supervisory review and evaluation process is carried out. By decision of the ECB, the individual capital ratio requirements of the three major banks in Lithuania are not published; however, they are established in accordance with the same principles and these banks comply with the requirements with a sufficient margin. The Bank of Lithuania maintains its position that the issue of capital strengthening remains a priority for domestic capital banks.

In the first quarter of 2018, the liquidity level of banks remained high, while their liquidity buffers were sufficient. With banks optimising their operations and repaying their excess debt to parent financial institutions over the first quarter, their liquidity buffer also decreased, yet it remained well above the established minimum requirement.

The value of the main indicator reflecting the liquidity situation, namely the liquidity coverage ratio (LCR), at the end of the first quarter of 2018 was

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high. The LCR of banks stood at 249% and was well above the minimum requirement of 100% established in Lithuania and Europe (see Table 3). Two banks stood out in the first quarter: UAB Medicinos bankas (its LCR declined as a result of the increased liquidity outflow) and Swedbank, AB (its LCR deteriorated considerably due to one-off decisions, after greater-than-usual improvement at the end of 2017).

4. THE LOAN PORTFOLIO[3]

Loan portfolio developments

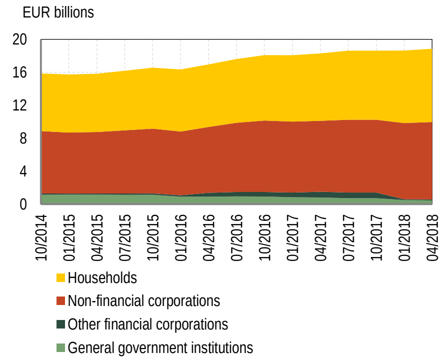
The growth rate of loans at the beginning of the year was robust. The net value of the portfolio of loans granted to bank customers[4] (hereinafter 'the loan portfolio value') increased by €216 million (1.2%) to €18.9 billion in the first quarter of 2018. The change in the loan portfolio value was largely affected by corporate lending and, albeit to a lesser extent compared to the same period last year, household loans; loans granted to financial corporations also increased, while the portfolio of loans to general government institutions remained on the declining path of recent years. The value of the portfolio of loans to non-financial corporations increased by €140 million (1.5%) during the period under review, to households – by €91 million (1.0%), and to other financial corporations – by €26 million (27.0%). The value of the portfolio of loans to non-financial corporations appreciated on the back of increased liabilities of companies engaged in manufacturing, professional, scientific and technical activities, as well as administrative and support service activities. The value of the household loan portfolio, as usual, was raised by housing loans, which grew by €81 million (1.2%) during the period under review.

The growth of the loan portfolio, except for the housing segment, decelerated compared to the previous year. The total portfolio recorded an annual increase of 3%; the value of household loans grew at the fastest pace – by 7.6%, and corporate loans went up by 2.4%.[5]

In good financial and economic times, amid further credit growth, a decision was taken at the end of 2017 to set the countercyclical capital buffer rate at 0.5%, which, given the favourable conditions for building capital buffers, was increased to 1% (to apply from 30 June 2019), thereby strengthening the resilience of the financial sector.

Chart 4. Net value of the bank loan portfolio

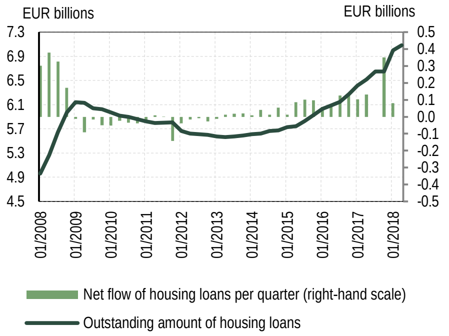
(1 October 2014-1 April 2018)



Source: Bank of Lithuania.

Chart 5. Net value of the housing loan portfolio

(1 January 2008-1 April 2018)



Source: Bank of Lithuania.

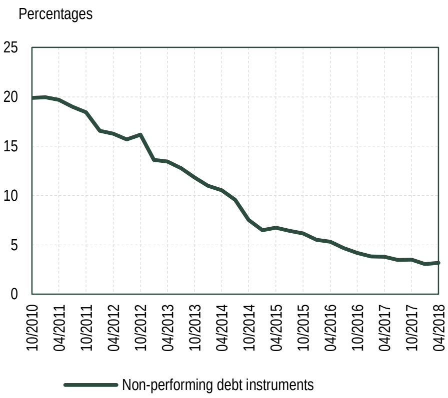
Note: As of 1 October 2014, housing loans also include loans granted to households for the purpose of investing in houses for own use or rental, including construction and refurbishments; therefore, the data is not fully comparable to the row of past data.

Loan portfolio quality

The share of the loan portfolio with signs of increased risk slightly increased. The share of non-performing debt instruments went up by 0.13 percentage point to 3.18%, while the outstanding amount of such loans was 1.4% higher than at the beginning of the year. The volume of bad loan write-offs was lower than in previous periods and accounted for 0.7% of the outstanding amount of non-performing loans at the beginning of the year (a similar result was recorded during the same period last year when this indicator stood at 0.5%). Due to the favourable economic environment, new lending, and with banks dealing with distressed loans, the volume of non-performing loans granted to businesses decreased by 2.4% and accounted for 4.9% of the total value of this loan portfolio. By contrast, a different result of the quarterly change was recorded in the household loan portfolio where the volume of non-performing loans increased by

Chart 6. Loan quality

(1 October 2010-1 April 2018)

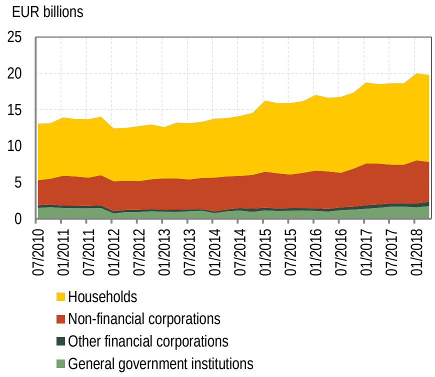


Source: Bank of Lithuania.

[3] Including the leasing portfolio.
[4] The loan value indicated in the financial statements, which is calculated by adding up the outstanding amounts of loans and interest accrued and subtracting provisions made and charges accrued.
[5] According to adjusted FINREP data, taking into account the leasing portfolio of UAB NORDEA FINANCE LITHUANIA which is consolidated in reports for supervisory purposes at the end of 2017 and having assessed its impact on the comparison of the annual change in loans of the banking system.

Chart 7. Amount of deposits

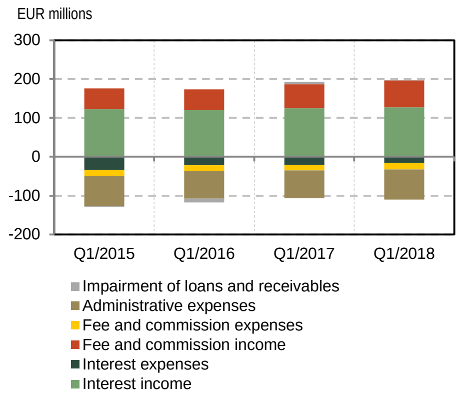
(1 July 2010-1 April 2018)



Source: Bank of Lithuania.

Chart 8. Main items of income and expenses

(Q1 2015, 2016, 2017 and 2018)



Source: Bank of Lithuania.

Chart 9. Profit of the banking sector

(1 January 2013-1 April 2018)

Source: Bank of Lithuania.

5.6% and accounted for 3.8% of the total value of this loan portfolio. Nevertheless, the outstanding amount of household loans past due for more than 90 days decreased by 3.9% and at the end of the quarter accounted for 2.2% of the total value of loans granted to households. The outstanding amount of past due corporate loans fell by 9.7% to 2.6% of the loan portfolio.

The ratio of the impairment of loans (specific allowances) to the loan portfolio increased by 0.06 percentage point to 1.16%, while the value of allowances was 1.6% higher than at the beginning of the year. As of 1 January 2018, the incurred loss recognition model set out in International Accounting Standard 39 *Financial Instruments: Recognition and Measurement* was replaced by a more future-oriented expected financial asset impairment recognition model set out in IFRS 9 *Financial Instruments*. The transition to the estimation of allowances in accordance with the requirements of IFRS 9 had no significant impact on the classification and measurement of financial instruments and impairment, whereas the impact of the application of these changes on a decrease in banks' equity amounted to around €8 million.[6] This indicates that the previous provisioning practice in the banking system was fairly conservative.

5. DEPOSITS WITH BANKS

As in the previous years, deposits with banks in the first quarter slightly diminished due to seasonal influence. On 1 April 2018, customer deposits with banks amounted to €19.8 billion, i.e. €243 million (–1.2%) less than at the end of 2017. The largest decrease was in corporate deposits with banks. As usual, the amount of customer deposits contracts at the beginning of the year, after showing a higher-than-usual increase at the end of the year. This reflects an increase in both turnovers of businesses and earnings of residents as a result of supplementary payments towards the end of the year and a decline in the activity of residents and businesses at the beginning of the year.

Although customer deposits diminished in the first quarter, they remain on a growth track in the long term. The amount of customer deposits with banks increased by €1.3 billion (6.8%) year-on-year in the first quarter of this year. The growth of deposits was sustainable, driven by increasing deposits of residents on account of rising income. This growth is also boosted by rather active bank crediting processes. Furthermore, customers are rather conservative, they trust banks and hold their funds with them despite particularly low interest rates. Alternative investment and savings instruments still seem to be not so popular. Due to low interest rates, a considerable share of customer funds is held in current accounts – at the end of the reporting period households held 72% and corporations – 94% of all funds held as deposits with banks.

6. PROFITABILITY AND OPERATIONAL EFFICIENCY

The banking sector was profitable in the first quarter of 2018, but the profit growth rate decelerated markedly compared to the same period last year. Over the first three months of 2018, banks and foreign bank branches earned €83.8 million in profits, i.e. a year-on-year increase of €1.5 million (1.9%). Ten banks and foreign bank branches were profitable, with two market participants making losses. Net interest income remained the main income source for banks; it grew by €7.2 million (6.9%) year-on-year in the first quarter of 2018, but a considerable share of income consisted of net fee and commission income, which rose by €5.6 million

[6] The value is estimated based on banks' non-consolidated financial data.

(11.8%). Administrative expenses of banks increased by €6.3 million (8.8%) during the same period.

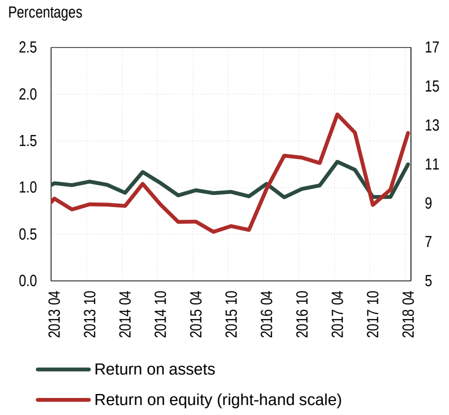
Growth in banks' net income was also supported by a further decline in the cost of funding. Banks' interest income increased by €2.3 million (1.9%) in the first quarter of 2018 and amounted to €127 million. Interest expenses contracted by €4.8 million (–22.9%) during the period under review, to €16.4 million. Net interest income rose by €7.2 million (6.9%) to €110.7 million. Although banks quite actively increased the volume of loans, more income did not come from increasing credits but rather from cheaper funding as the price of borrowed funds is not rising due to still particularly low interest rates.

Bank fee and commission income increased by €7.6 million (12.3%) and amounted to €69.5 million. Respective expenses grew by nearly €2 million (14%) to €16.2 million. Net fee and commission income rose by €5.6 million (11.8%) to €53.3 million.

Profitability and efficiency indicators of banks remain good. In the first quarter of 2018, banks' return on assets was nearly 1.3% and return on equity – 12.6%. Banks' return on assets remained nearly unchanged over the year, whereas changes in return on equity were significantly affected by a slight year-on-year decrease in banks' equity. The efficiency indicator of banks showing their cost-to-income ratio stood at 46.6% during the period under review, rising by 0.4 percentage point over the year. There is a long-term trend indicating improvement in the operational efficiency of banks. This is linked to not only growing profits of banks but also the optimisation of operations and organisational structures by banks – they seek to improve efficiency through the automation of processes and the introduction of more efficient management models.

Chart 10. Bank profitability ratios

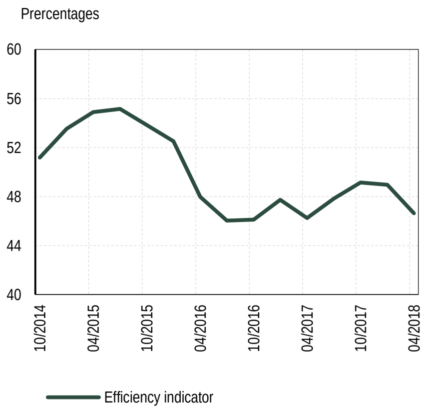
(1 April 2013-1 April 2018)



Source: Bank of Lithuania.

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

(1 October 2014-1 April 2018)



Source: Bank of Lithuania.

7. REGULATORY ENVIRONMENT

Protection of consumer rights

There were markedly fewer consumer disputes with banks in the first quarter than the year before. In the first quarter of 2018, the Bank of Lithuania received 19 applications relating to consumer disputes with banks, which accounts for 14% of all the requests received for the settlement of disputes between consumers and financial market participants. Compared to the first quarter of 2017, when 30 applications were received, disputes with banks decreased by 39%. Out of 17 disputes examined, decisions on the substance of the dispute were taken in seven cases: in one case, the consumer claim was satisfied in part (the bank implemented the recommendation), in six other cases, consumer claims were found to be unsubstantiated, and one dispute resulted in an amicable settlement. Consumers mostly applied to the Bank of Lithuania in the event of disagreement concerning payment services, namely the validity of orders debiting money from a bank account or of the application of fees.

Annex. Key indicators of the banking sector[7]

Table 4. Main items of balance sheet statement

Seq. No	Indicator	01/04/2017	01/01/2018	01/04/2018	Change in Q4	Annual change
		EUR millions			Percentages	
1.	**Assets**	**25,854.8**	**27,323.8**	**26,104.8**	**-4.5**	**1.0**
1.1.	Debt securities	1,509.9	1,427.6	1,471.2	3.1	-2.6
1.2.	Equity securities	55.4	37.6	38.3	1.8	-30.9
1.3.	Financial derivatives	132.7	70.3	47.8	-32.0	-64.0
1.4.	Cash	439.9	467.6	446.7	-4.5	1.5
1.5.	Funds with central banks	2,236.2	4,983.2	3,533.4	-29.1	58.0
1.6.	Funds with credit institutions	2,857.0	1,379.6	1,376.3	-0.2	-51.8
1.7.	Loans to customers (incl. leasing)	18,290.5	18,640.3	18,856.5	1.2	3.1
1.7.1.	to general government agencies (incl. leasing)	800.6	485.4	443.7	-8.6	-44.6
1.7.2.	to other financial corporations (incl. leasing)	696.9	97.7	124.1	27.0	-82.2
1.7.3.	to non-financial corporations (incl. leasing)	8,609.9	9,252.3	9,392.5	1.5	9.1
1.7.4.	to households (incl. leasing)	8,183.0	8,804.9	8,896.2	1.0	8.7
1.7.4.1.	o/w loans for house purchase	6,518.3	7,000.8	7,081.9	1.2	8.6
1.8.	Other asset positions	333.2	317.8	334.7	5.3	0.5
2.	**Liabilities and equity**	**25,854.8**	**27,323.8**	**26,104.8**	**-4.5**	**1.0**
2.1.	Deposits of central banks	303.0	303.0	303.0	0.0	0.0
2.2.	Liabilities to credit institutions	4,318.2	3,982.8	2,767.1	-30.5	-35.9
2.3.	Financial derivatives	122.3	67.3	42.1	-37.4	-65.6
2.4.	Deposits	18,536.7	20,034.6	19,791.2	-1.2	6.8
2.4.1.	of general government agencies	1,508.7	1,566.3	1,741.3	11.2	15.4
2.4.2.	of other financial corporations	463.4	540.5	606.5	12.2	30.9
2.4.3.	Non-financial undertakings	5,623.5	5,934.3	5,484.7	-7.6	-2.5
2.4.4.	of households	10,941.0	11,993.5	11,958.7	-0.3	9.3
2.5.	Debt securities issued	5.9	20.5	20.4	-0.6	248.2
2.6.	Other positions of liabilities	428.4	351.0	737.4	110.1	72.1
2.7.	Equity	2,140.3	2,564.6	2,443.6	-4.7	14.2

Source: Bank of Lithuania.

Table 5. Main items of the profit (loss) account

Seq. No	Indicator	01/04/2017	01/01/2018	01/04/2018	Change in Q4	Annual change
		EUR millions			Percentages	
3.	**Profit**	**82.2**	**239.7**	**83.8**	–	**1.9**
3.1.	Net interest income	103.5	404.5	110.7	–	6.9
3.2.	Net fees and commission income	47.6	204.5	53.3	–	11.8
3.3.	Administrative expenses	71.3	292.6	77.6	–	8.8
3.4.	Impairment of loans and receivables	-7.3	-3.6	0.7	–	-109.6

Source: Bank of Lithuania.

[7] Should system participants adjust their statements for this or other important reasons, the data of the review after this date may be revised.

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Table 6. Other performance indicators of banks

Seq. No	Indicator	01/04/2017	01/01/2018	01/04/2018	Change in Q4	Annual change
		Percentages			Percentage points	
4.	Capital adequacy ratio	20.0	19.1	19.6	0.5	-0.4
5.	CET1 capital adequacy ratio	19.7	18.8	19.3	0.5	-0.4
6.	Liquidity coverage ratio	265.2	282.2	248.9	-33.3	-16.3
7.	Leverage ratio	8.60	8.10	8.60	0.6	0.0
8.	Net interest margin	1.60	1.53	1.66	0.1	0.1
9.	Return on assets*	1.27	0.90	1.25	0.4	0.0
10.	Return on equity*	13.6	9.7	12.6	2.9	-1.0
11.	Cost-to-income ratio*	46.3	49.0	46.6	-2.3	0.4
12.	Non-performing debt instruments	3.8	3.1	3.2	0.1	-0.6

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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