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Review of the Credit Union Sector

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In the second quarter of 2018, credit unions continued to operate in accordance with the new rules of this reformed sector. According to the data provided by credit unions, at the end of the first half-year, the supervisory capital and liquidity requirements were complied with and the sector operated profitably.

The credit union sector faced no significant changes over the first half-year. In the second quarter of 2018, three credit union groups operated within the credit union sector: the Lithuanian Central Credit Union (LCCU) group, the United Central Credit Union (UCCU) group, and credit unions undergoing restructuring into specialised banks. The LCCU group further comprised 51, and the UCCU – 11 credit unions.

Amendments to the laws implementing reform within this sector came into force as of 1 January 2018. They provide for the possibility for central credit unions (CCU) to not only provide financial services but also the obligation to maintain liquidity of their member credit unions, ensure their solvency as well as monitor and check their risks assumed. Credit unions that have chosen membership of the LCCU or the UCCU have the possibility to work with partners that share a common business vision and to develop a common business model acceptable for all members. Central credit union groups (CCU groups) are able to strengthen cooperative banking activities and develop the provision of financial services to households and businesses.

According to the reports submitted, credit union market assets amounted to €662.5 million as at 1 July 2018. As can be seen in Chart 1, LCCU group assets, as before, accounted for the largest credit union market share (56%), while the assets of the UCCU group and of credit unions under restructuring – for the remaining share (almost equal shares).

Central credit unions. After the end of the second quarter 2018, reports of the CCU groups were submitted.

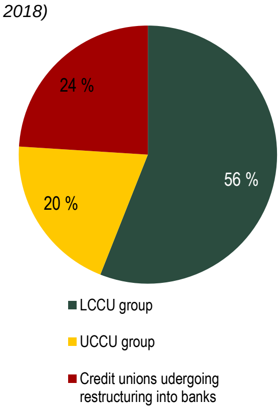
The common assets of the LCCU and the UCCU, most of which (88%) were those of the LCCU, after decreasing by €30.1 million in the second quarter of 2018, amounted to €123.1 million as at 1 July 2018. The decline in assets was due to deposits (mainly of credit unions that are members of the LCCU and the UCCU), which shrank by €33.1 million (to €89.9 million). The main reason behind the contraction in deposits was seasonal factors (funds in accounts of credit unions, uniting agricultural workers, decreased). As before, investments in debt securities comprised the major share of assets (60%). On the reporting date, most of the liabilities (84%) were comprised of CCU liabilities to credit institutions (credit union fixed-term deposits and funds in bank accounts).

While the activities of the CCU were loss-bearing during the period under review and the losses borne stood at €0.5 million, the capital adequacy ratio was met with a fair margin. As the Republic of Lithuania Government contributed a share (€8.88 million) thus increasing the LCCU's share capital, the overall capital adequacy ratio was 49.76% (the requirement is 10.5%; see Table 1). The CCU liquidity coverage requirement was also met with a margin and stood at 121.11% (the requirement is 100%; see Table 2).

At the end of the second quarter of 2018, the LCCU and the UCCU's stabilisation fund amounted €1.7 million and €0.35 million respectively. It should

Chart 1. Market structure of Lithuanian credit unions in terms of assets

(as of 1 July 2018)



Source: Bank of Lithuania.

Table 1. Capital adequacy ratios for Central Credit Unions

	Capital adequacy ratio, % 2018 Q1	Capital adequacy ratio, % 2018 Q2	Requirement, %
LCCU	59.79	46.48	17.53
UCCU	63.52	85.63	10.5
Total	**60.16**	**49.76**	**–**
LCCU group	20.60	20.10	10.5
UCCU group	14.89	14.08	10.5
Total	**18.65**	**18.02**	**–**

Source: Bank of Lithuania.

Table 2. Liquidity coverage ratios for Central Credit Unions

	Liquidity coverage ratio, % 2018 Q1	Liquidity coverage ratio, % 2018 Q2	Requirement, %
LCCU	145.8	122.7	100
UCCU	105.7	113.2	**100**
Total	**133.8**	**121.1**	**–**
LCCU group	1,016.7	599.9	**100**
UCCU group	372.2	201.7	100
Total	**707.5**	**415.5**	**–**

Source: Bank of Lithuania.

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be noted that the funds accumulated in the Stabilisation fund for one of the main functions of CCU – ensuring of credit union solvency – are rather scarce (the requirement is to accumulate and hold at least 1% of the assets of the LCCU, UCCU, and their member credit unions). According to the data as at 1 July 2018, the stabilisation fund of the LCCU accounted for 0.45%, of the UCCU – 0.26% of the respective group's assets. Hence, in order to properly perform the assigned function, CCU will have to increase the Stabilisation fund to the required amount.

Funds accumulated by the LCCU in the liquidity support fund that a CCU forms on a voluntary basis amounted to €5 million, those accumulated by the UCCU – €1.3 million at the end of the quarter under review.

At the end of the first half-year, the assets of the CCU groups amounted to €504.6 million, which is 2.6% less than in the previous quarter. Their major share (70%) was comprised of loans, mainly granted by credit unions to their members. Almost a fourth of the assets were comprised of the CCU groups' investments in debt securities, the other share (7%) – of funds with the Bank of Lithuania and other assets. Deposits continued to be the main financing source for CCU group assets; nearly 88% of these assets were financed with them.

Both CCU groups operated at a profit in the second quarter of 2018. During the period under review, the LCCU group earned €1.4 million, the UCCU group – €0.14 million profits.

The CCU groups complied with the capital adequacy and liquidity coverage requirements with a fair margin: the overall capital adequacy ratio was 18.02% (The requirement is 10.5%; see Table 1), the liquidity coverage ratio – 415.5% (the requirement is 100%; see Table 2). This high liquidity level, as in the previous quarter, was due to the accumulated liquid assets by the LCCU, UCCU and their member credit unions that exceeded by more than four times the overall money outflows. The CCU groups' liquid assets were further comprised of very high quality and liquidity financial instruments: cash, funds with the Bank of Lithuania, and securities of the governments of EU countries.

Credit unions. As at 1 July 2018, similarly to the previous reference period, 67 credit unions, with total membership of 158.5 thousand, operated in Lithuania.

As was already mentioned, 62 credit unions were CCU members, while five of them (Mano unija, LTL, Taupa, Rato credit union and Saulėgrąža) embarked on a business restructuring process, having decided to develop their activities according to the bank model and obtained consent from the Bank of Lithuania. These credit unions must, within five years, reorganise their activities so as all requirements for banks are satisfied. It should be noted that the European Central Bank is investigating the application for a banking licence of one out of five above credit unions.

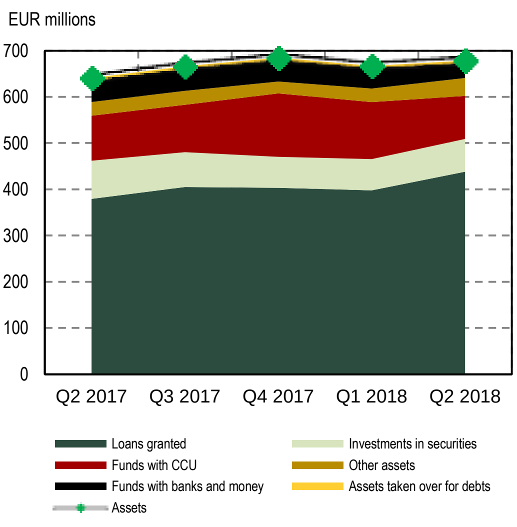
In June 2018, four credit unions were asked to inform the Bank of Lithuania about the progress of the plans for restructuring, after assessing the operating performance for the first half-year of 2018. Having analysed the information from these credit unions, a conclusion should be derived that all of them managed to achieve the planned business volumes, yet their profitability projections on 2017 were overoptimistic.

In the second quarter of 2018, credit union assets grew by 1.7% and, according to the reported data as at 1 July 2018, amounted to €678.5 million, or 2.5% of the banking system's assets (a year ago – 2.4%). The change in the sector assets volumes resulted from an increased debt to the LCCU and the UCCU of credit unions uniting agricultural workers due to seasonality factors as well as credit unions' intensified peer-to-peer lending.

In the quarter under review, growth was recorded in most asset positions: loans granted (10.2%), investment in securities (4.7%), funds with credit unions (121.7%) (see Chart 2).

As at 1 July 2018, loans granted to members (€438.1 million), similarly to previous periods, represented the largest share of credit union assets (64.6%)[1]. The credit unions' loan portfolio expanded by a tenth over the period under review (10.2%), to account for a 5 percentage points larger asset share on the reporting date than at the beginning of the period. The growth of the loan portfolio was due to intensified crediting of natural persons: in the reporting period, loans granted to these members increased by more than €31 million (to legal persons – €9 million); however, they grew at a slower pace than loans to legal persons. As a result, the loan portfolio share of loans

Chart 2. Composition of credit union assets
(1 July 2017–1 July 2018)



Source: Bank of Lithuania.

[1] *The financial statements present loan value, which is calculated by adding up the balances of loans and interest accrued and subtracting specific provisions formed.*

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granted to associate members (mainly legal persons) continued expanding marginally, to more than a fifth of the loan portfolio at the end of the period (20.55%).

Specific provisions formed by credit unions (for covering likely losses on loan impairment) kept declining. They declined by 1.4% over the reporting period (to €13.9 million), leading to a decrease in the ratio of specific provisions to loans of 0.3 percentage points (to 3.1%). While growth in lending and decreasing specific provisions have had a positive impact on other indicators defining the quality of loans within the credit union sector[2], there was, however, an increase in loans, whose debt obligations are overdue for more than 60 consecutive days, in the loan portfolio of a number of credit unions. This signals of potential future losses in relation to the recovery of bad loans these credit unions may incur.

Following last year's contraction in credit union investment in securities, investment swelled by 4.7% in the second quarter of 2018 (to €70.9 million), to slightly more than a tenth of credit union assets. According to the submitted reports, all credit unions, as before, operated in compliance with the Regulations on Credit Union Investment in Non-equity Securities (hereinafter 'Regulations') requirement for the amount of the securities portfolio share in the on-balance-sheet assets: at the end of the quarter, securities accounted for no more than 35% of their on-balance-sheet assets. Most credit unions complied with other requirements of the Regulations; however, some of them faced challenges in satisfying the requirement for the average modified financial duration of the securities portfolio (in 11 of them, the duration was longer than 2 years). A recast of the Regulations entered into force as of 1 May 2018. It lays down the requirements for the LCCU and UCCU member credit union investment in non-equity securities policy-making and supervisory requirements for CCU, investment risk management requirements for LCCU and UCCU member credit unions and credit unions obtaining consent from the Bank of Lithuania for implementing restructuring. Under the recast Regulations, average modified financial duration of securities portfolios shall be no longer than three and a half years. One credit union is not meeting the above requirement. It has also encountered difficulties in meeting other requirements of the Regulations (for concentration of lower-rating government debt securities of EU countries and concentration on securities of a sole lower-rated issuer).

Accepted deposits continue to be credit unions' main funding source, accounting for the largest share of credit union liabilities (93%). At the end of the period under review, nearly 86% of assets were financed with them. As was mentioned above, financial requirement in relation to the seasonality of agricultural works entailed a decline in the deposit portfolio of credit unions uniting agricultural workers. Deposits accepted by credit unions decreased by €10.3 million (1.7%) in the second quarter of 2018, standing at €582.6 million as at 1 July 2018. The overall growth in the deposit portfolio in the reporting period was due to a decline of €24.7 million in sight deposits (to €141.9 million). It should be noted that, with a view to satisfying the increased financial requirements, credit unions raised interest rates on fixed-term deposits. According to the submitted reports, at the end of the second quarter of 2018, most credit unions' annual interest rates on deposits in euro with a maturity of 12 months were no lower than 0.8 %, thus fixed-term deposits swelled by €14.4 million (to €440.7 million) over the reporting quarter, to over three-fourths of credit unions' total accepted deposits at the end of the period. Deposits of natural persons who still choose deposits as a means of funds saving and investment further accounted for the largest deposit portfolio share (96%).

Even though credit unions' indebtedness to CCU and other credit unions accounted for less than a tenth of their liabilities on the reporting date, these rising positions, as mentioned above, led to a change in their assets. On account of increased financial requirements entailed by the seasonality of agricultural works in the period under review, credit unions' indebtedness to the LCCU and the UCCU grew by almost 86% (to €26.7 million). This indebtedness was comprised of loans for working capital and subordinated loans. Credit unions' peer-to-peer lending more than doubled over the same period (to €15 million): they borrowed to add up to their working capital.

Most credit unions applied to the Bank of Lithuania for permission to reduce their share capital in the reporting quarter. Upon obtaining such permission, they returned to persons their contributions of shares and additional shares. Although, upon return of the contributions of shares, the share capital of part of credit unions contracted, the share capital of some of them increased, leading to an increase in the sector's share capital of 2.6% (to €47.5 million). According to the submitted reports, sustainable shares of credit unions the losses incurred by a credit union are covered with rose 7.1% in the reporting period (to €40.7 million), to account for nearly 86% of the share capital. Unsustainable additional shares comprising the other portion of share capital, as of 1 January 2018, are not included in a credit union's adjusted capital, which is used for the calculation of capital related prudential requirements, can be returned to members who apply for their return. **Growth in sustainable income suggests that credit unions aim at ensuring compliance with the laws implementing the credit union sector reform, which came into force as of the beginning of the year.**

According to the submitted reports, the credit union sector's operating result for the first half of 2018 was a €2.3 million profit. 47 credit unions that operated profitably earned a €2.9 million profit, while 20 credit unions incurred a €0.6 million loss. In the first half of 2017, credit unions earned a €0.5 million profit.

[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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Higher profit for this year's first half year on year was earned having recovered loan value. The recovered credit union loan value amounted to €1.4 million, determining a significant profit share. Credit unions managed to cut their operating costs (rental and advertising, as well as marketing), which was also conducive to the sector's activities. Moreover, credit unions' enhanced lending activities contributed to an improvement in the main items of income and expenses: both net interest income and net income from fees and commissions posted growth. As usual, the largest share of credit unions' income in the period under review (79%) was comprised of interest income, of which 97% – on loans granted to members. Operating expenses borne by credit unions accounted for the largest share of their expenses (65%), decreasing by 4.4% year on year.

According to the reported data as at 1 July 2018, the capital adequacy ratio of the system of credit unions stood at 13.46% (in 2018, the required minimum for LCCU and UCCU member credit unions – 5.25%, and for those undergoing restructuring into a specialised bank – 7.30%; the liquidity ratio – 40.62% (the required minimum – 30%). All credit unions complied with the above ratios.

A capital adequacy ratio of 10.5% has been established for LCCU and UCCU member credit unions. The above-named credit unions will have to ensure compliance with this ratio no later than as of 1 January 2028. For credit unions undergoing restructuring into specialised banks, a capital adequacy ratio of 14.5% has been set; its implementation will have to be ensured within a shorter time frame – by the end of 2023.

It should be noted that three credit unions encountered difficulties in complying with the maximum exposure for a single borrower requirement; however, in the third quarter of 2018, they informed that they had remedied the situation and are now in compliance with the requirement.

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.

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Annex. Key performance indicators of the credit union sector

Table 1. Main items of the balance sheet statement of central credit unions and groups of central credit unions (data as at 30 June 2018)

Seq. No.	Indicator	Amount, € millions					
		LCCU	UCCU	Total	LCCU group	UCCU group	Total
1.	**Assets**	**108.7**	**14.4**	**123.1**	**371.2**	**133.4**	**504.6**
1.1.	Debt securities	63.2	10.8	74.0	92.0	25.2	117.2
1.2.	Equity securities	1.2	–	1.2	1.2	–	1.2
1.3.	Cash	–	–	–	2.4	0.9	3.3
1.4.	Funds with central banks	6.0	2.1	8.1	6.0	2.3	8.3
1.5.	Funds with credit institutions	27.7	0.6	28.3	5.6	3.0	8.6
1.6.	Loans to customers	8.8	0.8	9.6	249.1	99.5	348.6
1.6.1.	Non-financial undertakings	4.7	–	4.3	43.1	12.3	55.4
1.6.2.	Households	4.1	0.8	4.9	206.0	87.2	265.0
1.6.2.1.	o/w loans for house purchase	0.7	0.1	0.8	60.0	29.0	80.6
1.7.	Other asset positions	1.8	0.1	1.9	14.9	2.5	17.4
2.	**Liabilities and equity**	**108.7**	**14.4**	**123.1**	**371.2**	**133.4**	**504.6**
2.1.	Liabilities to credit institutions	76.7	11.6	88.3	2.1	–	2.1
2.2.	Deposits	1.6	–	1.6	323.0	118.2	441.2
2.2.1.	Other financial undertakings	0.6	–	0.6	0.6	–	0.6
2.2.2.	Non-financial undertakings	1.0	–	1.0	12.0	6.2	18.2
2.2.3.	Households	–	–	–	310.4	112.0	422.4
2.3.	Other positions of liabilities	15.3	0.4	15.7	9.5	3.2	12.7
2.4.	Total equity	15.1	2.4	17.5	36.6	12.0	48.6
2.4.1.	Profit (loss) for the current year	–0.07	–0.4	–0.5	1.4	0.14	1.5
3.	**Number of credit unions (CCU members)**	**–**	**–**	**–**	**51**	**11**	**62**

Source: Bank of Lithuania.

Table 2. Dynamics of performance indicators of the credit union sector

Seq. No	Indicator	Amount, € millions			Change (%)	
		01/07/2017	01/04/2018	01/07/2018	2018 Q2	over a year
1.	**Assets**	**641.0**	**667.1**	**678.5**	**1.7**	**5.9**
2.	Money	3.7	3.5	3.5	**0**	–5.4
3.	Funds with banks	40.7	39.6	28.1	–29.0	–31.0
4.	Funds with the CCU	97.4	123.4	93.1	–24.6	–4.4
5.	Government securities	82.6	67.7	70.9	4.7	–14.2
6.	**Loans granted**	**379.3**	**397.7**	**438.1**	**10.2**	**15.5**
7.	Specific provisions against loans	18.9	14.1	13.9	**–1.4**	**–26.5**
8.	Ratio of specific provisions against loans to loans (%)	4.7	3.4	3.1	–	–
9.	Debt to the CCU	18.4	14.4	26.7	85.4	45.1
10.	**Deposits**	**561.3**	**592.9**	**582.6**	**–1.7**	**3.8**
10.1.	Of members and associated members of credit unions	557.8	589.4	579.1	**–1.7**	3.8
11.	**Share capital**	**57.9**	**46.3**	**47.5**	**–2.6**	**–18.0**
12.	Profit (loss) for the current year	0.5	1.8	2.3	–	–

Source: Bank of Lithuania.

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