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In 2018, Lithuania's banking sector continued the previously-initiated consolidation processes; meanwhile, the sector's financial health remained stable. In the second quarter of 2018 bank assets were further boosted by the expanding loan portfolio. The amount of deposits increased by almost €0.6 million, which confirms their sustainable growth trend in the long-term. According to the data reported by banks, banks not only complied with capital and liquidity requirements, but also carried out profitable operations and issued capital instruments, thus strengthening their capital base. The quality of the loan portfolio remained good. As previously, the major share of profits was earned from main banking activities; however, as clients were more eager to use banking services, commission income became a significant source of income. Seeking to gain operational efficiency, banks proceeded with automating processes and introducing more efficient business management models.

1. BANKING SECTOR DEVELOPMENTS

The banking sector continued its consolidation and greater concentration processes. Consolidation of Luminor Bank AB in the Baltic region continued into the second quarter of this year and is planned to end at the start of 2019. AB Citadele bankas, a subsidiary bank of Citadele Banka, AS, informed about the decision of the Latvian parent bank to reorganise the bank, which will continue its activities in the domestic market as a branch bank. Danske Bank, AS informed that it had reviewed its business strategy in the Baltic region and had no future plans to expand its banking and financial service activities, but would rather focus on its service centres opened in Lithuania. It will continue to provide banking services only to the clients of Danske Bank, AS and local public authorities.

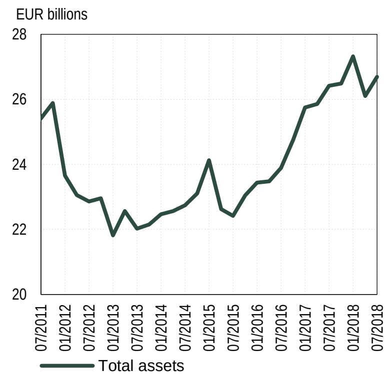
In the second quarter of 2018, 6 banks and 7 foreign bank branches[2] operated in the banking sector.

Amendments to the Republic of Lithuania Law on Banks, which entered into force on 1 January 2017, provide for the possibility of establishing a specialised bank. In order to reduce concentration in the banking sector, the Bank of Lithuania has been actively seeking to attract new market participants. To this end, it maintains close dialogue with potential entrants of the banking sector.

Currently, the Bank of Lithuania is assessing 4 applications for a specialised bank licence. Specialised banks must comply with all requirements set for banks; however, they are subject to a lower minimum capital requirement (€1 million) and limitations in terms of investment service provision.

Chart 1. Assets of the banking sector

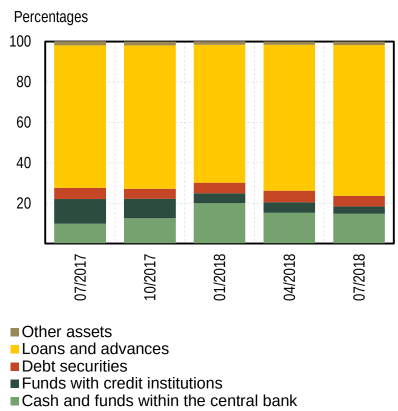
(1 July 2011-1 July 2018)



Source: Bank of Lithuania.

Chart 2. Asset composition

(1 July 2017-1 July 2018)



Source: Bank of Lithuania.

2. ASSETS AND LIABILITIES

Asset growth was mainly driven by the increasing loan portfolio. In the second quarter of 2018, the assets of the banking system grew by €551 million (2.1%), to stand at €26.7 billion. This was underpinned by the

[1]Should system participants adjust their statements, the data of the review after this date may be revised.
[2]The Bank of Lithuania receives reports for supervisory purposes from 6 branches given that the branch of Telia Finance AB in Lithuania – Telia Finance Lietuva – has not been carrying out any activities yet.

significant increase in the loan portfolio (for more information, see Section 4). Loan growth was financed with new deposits and previously attracted funds. Thus funds with credit institutions shrank by €423.5 million over the quarter. The amount of funds held in the central bank's accounts remained largely unchanged (decreased by €26.2 million). The structure of assets of the banking system remained unchanged – its main bulk (75%) was comprised of loans granted to customers.

The second quarter of 2018 saw a rather significant upswing in deposit growth: over the quarter, the amount of deposits increased by €575 million, with household and government deposits recording most noticeable increases (€356 million and €175 million respectively). Deposits remain the main source of bank financing – at the end of the quarter they were used to finance 76% of assets. Liabilities to credit institutions (mostly parent banks) account for an increasingly smaller share of bank liabilities.

Banks operating in Lithuania finance their activities with deposits attracted in the domestic market. Funds of non-resident clients account for an insignificant share of total deposits (2.7%).

The retail deposit market is still a priority for banks. Resident deposits with banks have continued to grow despite the zero or close to zero interest rates. However, specialised banks, which intend to pay higher than average interest on deposits, might intensify competition in the banking sector. It should be noted that bank crediting is also one of the factors behind the increasingly faster deposit growth.

3. COMPLIANCE WITH REQUIREMENTS

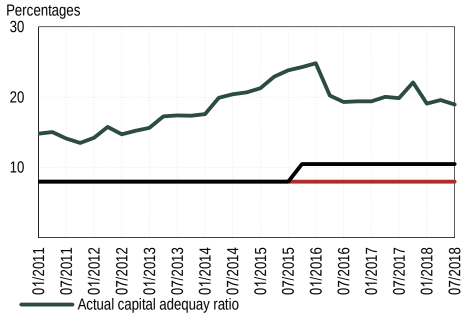
The state of the banking sector's capital continues to be stable. The overall capital adequacy ratio of the banking sector stood at 19.0% at the end of the second quarter of 2018. With banks actively engaged in crediting, the capital adequacy ratio of the banking system decreased by 0.6 percentage point over the quarter. Swedbank, AB saw the largest decline (1.7 percentage points) in its capital adequacy ratio. Even though individual capital adequacy ratios also decreased, banks continued to maintain a rather high level of capital adequacy. Their profitable activity is one of the preconditions for future growth in capital base. Taking into account the Bank of Lithuania's call to strengthen capital bases, in the second quarter of 2018 the smallest bank in the country – UAB Medicinos bankas – announced a €3 million public bond issue.

According to the data reported by banks, the established capital requirements were complied with. Based on reports submitted for supervisory purposes, in the second quarter of 2018 all banks operating in Lithuania complied with the minimum capital adequacy requirement (8.0%), Pillar II additional capital requirement, which is set on an individual basis, 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 set for banks (see Table 3) will be effective until a new supervisory review and evaluation is carried out. By decision of the ECB, the individual capital requirements of the three major banks in Lithuania are not publicly available; however, they are set following the same principles. These banks comply with their requirements with a sufficient margin.

Given the still stable financing base, the liquidity level of banks remained high, while their liquidity buffers were sufficient. With banks optimising their operations and acceleration in crediting over the second quarter, banks' liquidity buffer decreased, yet it remained well above the

Chart 3. Capital adequacy ratios of banks

(1 January 2011-1 July 2018)



Source: Bank of Lithuania.

Table 1. Capital adequacy ratios of banks

	Capital adequacy ratio, %	
	2018 Q1	2018 Q2
Luminor Bank AB	17.0	16.7
AB SEB bankas	19.0	18.7
AB Šiaulių bankas	17.1	16.2
UAB Medicinos bankas	17.0	16.2
AB Citadele bankas	18.0	18.8
Swedbank, AB	26.4	24.7
Banking system	**19.6**	**19.0**

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

Note: The Bank of Lithuania and the ECB, which carry out supervision, assess and define the requirements on an annual basis. Capital adequacy 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, %	
	2018 Q1	2018 Q2
Luminor Bank AB	134.1	119.5
AB SEB bankas	203.6	193.2
AB Šiaulių bankas	279.8	230.7
UAB Medicinos bankas	477.8	616.9
AB Citadele bankas	248.6	302.4
Swedbank, AB	348.2	329.9
Banking system	**248.9**	**229.0**

Source: Bank of Lithuania.

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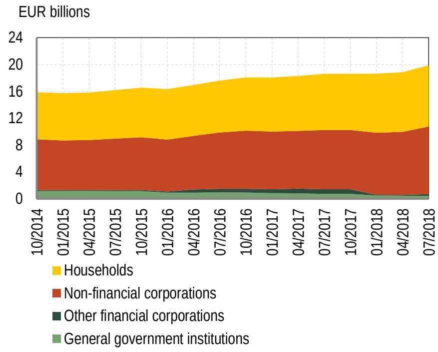
established minimum requirement.

At the end of the second quarter of 2018 the main indicator reflecting the liquidity situation, namely the liquidity coverage ratio (LCR), was high. Banks' LCR stood at 229% and was well above the minimum requirement of 100% (see Table 3). The LCR of UAB Medicinos bankas decreased as a result of the decline in cash outflows.

As before, banks' liquid assets were comprised of very high quality and liquidity financial instruments: cash, funds with the Bank of Lithuania, and EU government securities. The funding base was stable – customer deposits comprised 82.5% of liabilities, while reliance on public financing remained neglible.

Chart 4. Net value of the bank loan portfolio

(1 October 2014-1 July 2018)



Source: Bank of Lithuania.

4. THE LOAN PORTFOLIO[3]

Developments in the loan portfolio

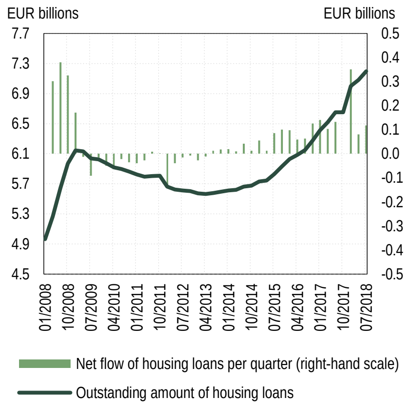
In the second quarter of 2018, growth in the loan portfolio was mainly driven by corporate lending. The net value of the portfolio of loans granted to bank customers (hereinafter 'loan portfolio value') increased by €1 billion (5.5%) over the second quarter of 2018 – to €19.9 billion. This was largely influenced by additional lending to corporates and big business clients. Household crediting, including housing loans, was also on a rise. The value of the portfolio of corporate loans increased by €684 million (7.3%), of household loans – €242 million (2.7%) over the quarter. The value of the portfolio of loans to other financial corporations grew by €133 million over the year (2.1 times), although this only accounted for 1% of the total loan portfolio and was mainly linked to lending reforms in one of the banking groups. The value of the portfolio of loans to general government institutions dropped by €15 million (-3.4%) over the second quarter of 2018.

On a year-on-year basis, the growth of the loan portfolio was more robust (the housing segment remained on a rather stable path). Over the year the loan portfolio increased by 6.6%, the household loan portfolio – 7.8%, the portfolio of corporate loans – 6.6%.[4]

Given the economic and financial upswing, ongoing credit growth, active real estate market and the current financial health of banks, in June 2018 the Bank of Lithuania took a decision to increase the countercyclical buffer rate from 0.5% to 1% (with effect from 30 June 2019), thereby strengthening the resilience of the financial sector.

Chart 5. Net value of the housing loan portfolio

(1 January 2008-1 July 2018)



Source: Bank of Lithuania.

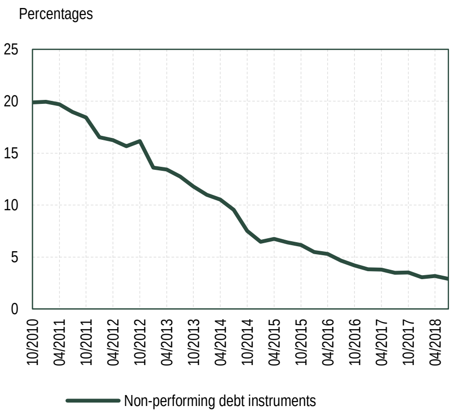
Note: As of 1 October 2014, housing loans also include loans granted to households for the purpose of investing in houses for own use or rental, including construction and refurbishments; therefore, data is not fully comparable to the row of past data.

Quality of the loan portfolio

The share of the loan portfolio with signs of increased risk gradually declined. The share of non-performing debt instruments decreased by 0.3 percentage point to 2.9%, while the outstanding amount of such loans was 6.7% lower than at the start of the quarter. Bad loan write-offs accounted for 2% of the outstanding amount of non-performing loans at the beginning of the quarter (same as during the same period last year). Due to the favourable economic environment, new lending, and with banks dealing with distressed loans, the outstanding amount of non-performing loans granted to households and businesses over the second quarter of the year contracted by 5.4% and 7.3% respectively, to account for 3.6% and 4.2% of

Chart 6. Loan quality

(1 October 2010-1 July 2018)



Source: Bank of Lithuania.

[3] Including the leasing portfolio.
[4] Based on revised 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 annual change in bank loans.

the total value of respective loan portfolios. The outstanding amount of household loans past due for more than 90 days contracted by 4.2% at the end of the quarter and accounted for 2% of the total value of loans granted to households. Similarly, the outstanding amount of past due corporate loans fell by 1.4%, to 2.4% of the corporate loan portfolio.

The loan impairment ratio (specific provisions to the total loan value) decreased by 0.1 percentage point, to 1.3% (the ratio of corporate loans amounted to 1.5%, of household loans – 1.1%).

5. DEPOSITS WITH BANKS

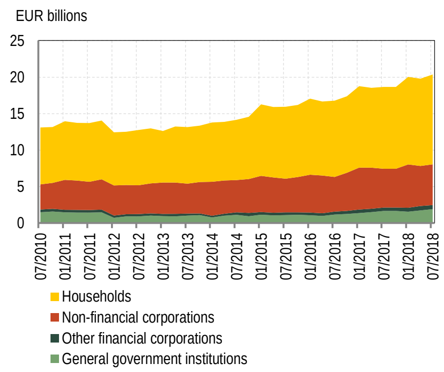
Changes in customer deposits held with banks in 2018 were in line with trends observed in recent years: following the usual contraction in deposits at the start of the year, the amount of deposits increased rather significantly during the second quarter of 2018. As at 1 July 2018, customer deposits with banks amounted to €20.4 billion, i.e. €575 million (2.9%) more than on 1 April 2018. Household deposits recorded the highest increases. This was driven by rising household and business income at the beginning of the year.

Year on year the amount of customer deposits with banks increased by €1.7 million (9.1%). Growth of deposits in Lithuania's banking sector was sustainable. Deposits with banks remain on a growth track in the longer term – such a trend has been observed for more than five years. Deposit growth was also driven by rising household income and bank crediting processes. In terms of investment, customers are rather conservative, thus alternative investment and saving instruments have still not gained traction. Clients trust banks and hold their funds with them despite particularly low interest rates.

However, due to low interest rates, a considerable share of customer funds is held in current accounts, where at the end of the reporting period households held 73%, businesses – 94% of all deposited funds.

Chart 7. Amount of deposits

(1 July 2010-1 July 2018)



Source: Bank of Lithuania.

6. PROFITABILITY AND OPERATIONAL EFFICIENCY

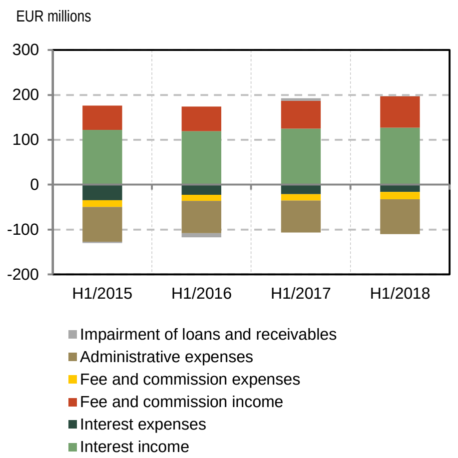
Over the first half of 2018, operations within the banking sector were profitable: banks and foreign bank branches earned almost €180 million in profit, a nearly 16% increase year on year.

11 banks and foreign bank branches operated at a profit and only 1 market participant incurred a loss. Net interest income remained the main source of income for banks – on a year-on-year basis it grew by €19 million (9.2%); however, a considerable share of income consisted of net fee and commission income, which rose by €11.4 million (11.4%). A survey conducted by the Bank of Lithuania revealed that bank fee and commission income generated from payment services increases as a result of more avid use of banking services – the year 2017 saw a rise in payment card settlements, cross-border transfers and the use of e-accounts. In the second quarter of 2018, administrative expenses of banks increased by €9.9 million (6.7%) year on year.

Growth in banks' net income was more strongly affected by the recent rise in bank loans. Compared to the results of the first half of 2017, banks' interest income increased by €8.6 million (3.5%) year on year and amounted to €258 million. Interest expenses contracted by €10.3 million (24.5%) over the reporting period, to almost €32 million. Net interest income rose by €19 million (9.1%), to €226 million. The greatest contribution

Chart 8. Main items of income and expenses

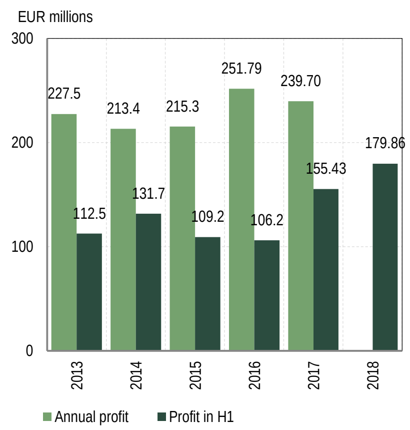
(H1 2015-H1 2018)



Source: Bank of Lithuania.

Chart 9. Profit of the banking sector

(2013-H1 2018)



Source: Bank of Lithuania.

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to net interest income growth stemmed from active crediting. As before, bank profitability was boosted by low funding costs – the price of borrowed funds has not been rising due to persistently low interest rates.

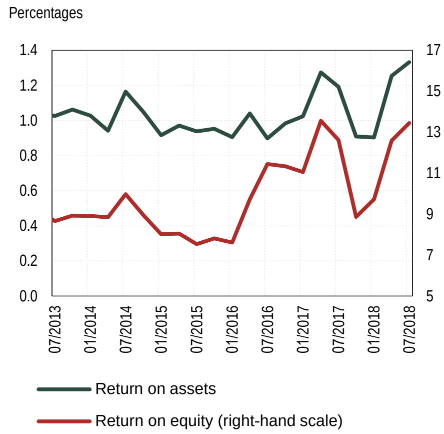
Fee and commission income increased by €14.4 million (11.1%), to €144.5 million. Respective expenditure grew by €3 million (9.8%), to €33.4 million. Net fee and commission income rose by €11.4 million (11.4%), to €111.1 million.

Profitability and efficiency indicators of banks remain good. In the second quarter of 2018, banks' return on assets was 1.33%, return on equity – 13.5%. Over the year banks' return on assets increased by 0.14 percentage point, whereas changes in return on equity were significantly affected by a slight year-on-year decrease in banks' equity. The efficiency indicator of banks, which shows their cost-to-income ratio, stood at 45.1% during the period under review, decreasing by an annual 2.7 percentage points. This was mainly driven by the rise in administrative expenses, which increased by €10 million, or 6.7%, year on year.

Currently there is a long-term trend indicating improvement in banks' operational efficiency. This is linked not only to growing profits of banks but also the optimisation of operations and organisational structures – seeking higher efficiency, banks automate their processes and introduce more efficient management models.

Chart 10. Bank profitability ratios

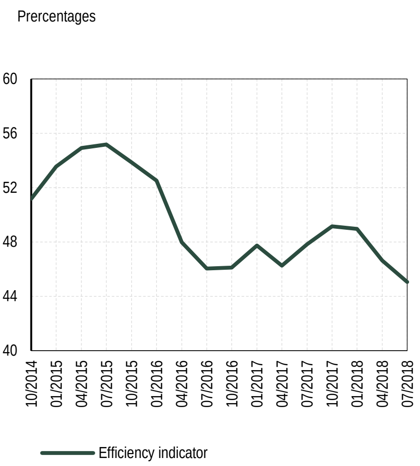
(1 July 2013-1 July 2018)



Source: Bank of Lithuania.

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

(1 October 2014-1 July 2018)



Source: Bank of Lithuania.

7. REGULATORY ENVIRONMENT

Protection of consumer rights

In the second quarter of 2018, the Bank of Lithuania settled 24 consumer disputes with banks, which accounted for 17% of all disputes settled. Compared to the second quarter of 2017, when 26 disputes were settled, the overall number of consumer disputes with banks remained basically unchanged. The majority of disputes with banks were over payment (14) and crediting (6) services, for example, service fees, validity of debits from bank accounts, house credit agreements. Taking into account the rise in the number of chargebacks and cash repayments, the Bank of Lithuania issued a public warning about a new form of fraud.

Decisions on the substance of the dispute were taken in 5 cases: 1 consumer claim was satisfied (the bank implemented the recommendatory decision of the Bank of Lithuania), 4 consumer claims were found to be unsubstantiated. 4 disputes ended in reaching a peaceful settlement.

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Annex. Key indicators of the banking sector[5]

Table 4. Main items of the balance sheet statement

No	Indicator	01/07/2017	01/04/2018	01/07/2018	Change in Q2	Annual change
		EUR millions			Percentages	
1.	**Assets**	**26,414.0**	**26,104.8**	**26,655.9**	**2.1**	**0.9**
1.1.	Debt securities	1,475.7	1,471.2	1,408.1	-4.3	-4.6
1.2.	Equity securities	54.1	38.3	39.4	3.0	-27.1
1.3.	Financial derivatives	111.9	47.8	86.9	81.9	-22.3
1.4.	Cash	448.4	446.7	449.7	0.7	0.3
1.5.	Funds with central banks	2,147.3	3,533.4	3,507.2	-0.7	63.3
1.6.	Funds with credit institutions	3,217.9	1,376.3	952.8	-30.8	-70.4
1.7.	Loans to customers (incl. leasing)	18,623.5	18,856.5	19,899.8	5.5	6.9
1.7.1.	to general government agencies (incl. leasing)	714.2	443.7	428.6	-3.4	-40.0
1.7.2.	to other financial corporations (incl. leasing)	687.3	124.1	257.0	107.1	-62.6
1.7.3.	to non-financial corporations (incl. leasing)	8,835.3	9,392.5	10,076.2	7.3	14.0
1.7.4.	to households (incl. leasing)	8,386.6	8,896.2	9,138.0	2.7	9.0
1.7.4.1	o/w loans for house purchase	6,650.4	7,081.9	7,199.3	1.7	8.3
1.8.	Other asset positions	335.7	334.7	312.0	-6.8	-7.0
2.	**Liabilities and equity**	**26,414.0**	**26,104.8**	**26,655.9**	**2.1**	**0.9**
2.1.	Deposits of central banks	303.0	303.0	185.0	-38.9	-38.9
2.2.	Liabilities to credit institutions	4,815.8	2,767.1	2,832.0	2.3	-41.2
2.3.	Financial derivatives	110.5	42.1	76.1	80.7	-31.2
2.4.	Deposits	18,661.3	19,791.2	20,366.3	2.9	9.1
2.4.1.	of general government agencies	1,669.6	1,741.3	1,916.3	10.1	14.8
2.4.2.	of other financial corporations	466.5	606.5	556.5	-8.2	19.3
2.4.3.	Non-financial undertakings	5,312.7	5,484.7	5,579.2	1.7	5.0
2.4.4.	of households	11,212.4	11,958.7	12,314.3	3.0	9.8
2.5.	Debt securities issued	1.7	20.4	20.4	0.1	1,085.0
2.6.	Other positions of liabilities	307.9	737.4	636.8	-13.6	106.8
2.7.	Equity	2,214.2	2,443.6	2,539.3	3.9	14.7

Source: Bank of Lithuania.

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

No	Indicator	01/07/2017	01/04/2018	01/07/2018	Change in Q2	Annual change
		EUR millions			Percentages	
3.	**Profit**	**155.4**	**83.8**	**179.9**	–	**15.7**
3.1.	Net interest income	207.3	110.7	226.3	–	9.1
3.2.	Net fee and commission income	99.7	53.3	111.1	–	11.4
3.3.	Administrative expenses	146.5	77.6	156.4	–	6.7

Source: Bank of Lithuania.

[5] Should system participants adjust their statements, the data of the review after this date may be revised.

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Table 6. Other performance indicators

No	Indicator	01/07/2017	01/04/2018	01/07/2018	Change in Q2	Annual change
		Percentages			Percentage points	
4.	Capital adequacy ratio	19.8	19.6	19.0	-0.6	-0.9
5.	CET1 capital adequacy ratio	19.5	19.3	18.7	-0.6	-0.8
6.	Liquidity coverage ratio	260.3	248.9	229.0	-19.9	-31.3
7.	Leverage ratio	8.6	8.6	8.4	-0.2	-0.1
8.	Net interest margin	1.59	1.66	1.70	0.04	0.1
9.	Return on assets*	1.19	1.25	1.33	0.1	0.1
10.	Return on equity*	12.63	12.58	13.45	0.9	0.8
11.	Cost-to-income ratio*	47.8	46.6	45.1	-1.6	-2.8
12.	Non-performing debt instruments	3.5	3.2	2.9	-0.3	-0.6

Source: Bank of Lithuania.

*As of Q1 2017 the asset, equity and efficiency indicators used in Bank of Lithuania reviews are calculated in line with the methodology of the European Banking Authority; therefore, they are not directly comparable to the indicators used in previous reviews.

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