ACTIVITIES OF FINANCIAL MARKET PARTICIPANTS

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Review of the Activities of Credit Unions and the Central Credit Union of Lithuania

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Credit unions. As of 1 October 2013, 75 credit unions, uniting over 147.7 thousand members, were operating in Lithuania (in the reporting quarter the credit union *Saulėgrąžą* received a license and began operating). The Central Credit Union of Lithuania (CCUL) included 63 credit unions, 12 operated independently.

Credit unions are founded under the principal that they are financial institutions voluntarily established by an individual on a cooperative basis, pooling the funds of their members for their member's household and social needs, by providing member loans. Part of credit unions are currently performing their mission — their operations are on a cooperative basis, however some of credit unions (mostly in large cities), having chosen an aggressive strategy, move away from the classic cooperation-based classical credit union operation model. These credit unions, in applying various marketing programs and offering large interest on deposits, draw in new members who are interested in the personal benefits they can receive from the credit union; **however they barely care about the credit union's successful operation (they do not participate in the process of their management and do not contribute to the improvement of the financial position of those operating at a loss). Especially worrying is the fact that the growth of the share capital of credit unions is insufficient.**

The Bank of Lithuania implemented stricter prudential requirements for the operations of credit unions and for some certain credit unions the operational limitations led to more sustainable growth of credit unions. In the third quarter of this year, the growth of deposits and assets decelerated, and growth in the membership of new credit unions weakened as well. The number of credit union members, which usually used to increase by 3 thousand, grew by approximately 2.4 thousand in the reporting quarter. On 1 October 2012, over the year, there were 6.2 thousand new members.

In the third quarter of 2013 credit union assets increased by 1.7 per cent, while compared to 1 October 2012 data — by 3.5 per cent, and according to 1 October 2013 data amounted to LTL 2.1 billion, or 2.7 per cent of the assets of the banking system (compared to 2.6% a year ago).

Dynamics of some performance indicators of the system of credit unions

Line No.	Indicator	Amount 01-10-2012, LTL millions	Amount 01-07-2013, LTL millions	Amount 01-10-2013, LTL millions	Change in Q3 2013, %	Change over year, %
1.	**Assets**	**1,995.0**	**2,030.6**	**2,065.5**	**1.7**	**3.5**
2.	Funds with banks	84.3	34.7	28.7	–17.3	–66.0
3.	Funds with the CCUL	283.0	263.0	267.8	1.8	–5.4
3.1	Time deposits	143.0	126.6	132.0	4.3	–7.7
4.	Government securities (GS)	368.8	529.3	573.1	8.3	55.4
5.	**Loans granted**	**1,141.9**	**1,059.1**	**1,042.5**	**–1.6**	**–8.7**
6.	Specific provisions for loans	28.6	29.8	39.6	32.9	38.5
7.	Ratio of specific provisions for loans to loans (%)	2.4	2.7	3.7	–	–
8.	Debt to the CCUL	63.5	63.3	65.2	3.0	2.7
9.	**Deposits**	**1,709.3**	**1,754.6**	**1,799.6**	**2.6**	**5.3**
9.1	Of which members and associated members of credit unions	1,697.9	1,741.7	1,787.6	2.6	5.3
10.	**Share capital**	**224.3**	**203.4**	**203.6**	**0.1**	**–9.2**
11.	Profit (loss) for current year	–0.4	–7.3	–14.1	–	–

Over the quarter under review, the downward trend of credit union concentration remained. According to the 1 October 2013 data, the assets of the 10 largest credit unions represented more than half of the assets of all credit unions, almost 49.1 per cent. This drop was due to the decrease in the assets of the credit union *Vilniaus taupomoji kasa* (with its assets accounting for 15.7% of the assets of all credit unions), although it remains the largest within the system of credit unions. This credit union over the period set by the Bank of Lithuania did not remove the violations of legal acts and deficiencies in its operation identified during the inspection, therefore a protocol of administrative law violation and a fine was written out for the head of the administration, and operational limitations on the credit union continued to be applied.

The change in the composition of credit union assets was insubstantial both in the reporting quarter and over the year. Their investment into government securities (GS) intensified. After rising to LTL 573.1 million, credit union investments in GS accounted for 27.7 per cent of credit union assets as of 1 October 2013. As was previously the case, the bulk of them (61%) consisted of the Republic of Lithuania GS portfolio, which in the third quarter of 2013 increased by 5.4 per cent to LTL 347 million. However, stronger growth was recorded in investments in European Union member state and European Economic Area GS. These investments grew by 12.9 per cent in the reporting quarter (to LTL 226.1 million) and accounted for 39 per cent of the GS portfolio. As credit unions kept increasing their investment in GS, the holdings of funds with banks and the CCUL accounted for 14.4 per cent of credit unions' total assets at the end of the quarter. **It should be noted that active investment in GS was especially increased by credit unions not belonging to the CCUL, this way most likely accumulating assets for larger loans meant for financing significant-risk projects (using the European Union's funds) in the future. The Bank of Lithuania will actively monitor where the funds, drawn and accumulated from depositors, but not used for crediting, are used.**

The loan portfolio represented the largest share (50.5%) of credit union assets. The loan portfolio on 1 October 2013 amounted to LTL 1 billion — having decreased from 1 October 2012 it dropped in the third quarter of 2013 as well. This was driven by limited crediting for some credit unions and formed specific provisions against loans. The decrease in the loan portfolio was influenced by the restrictions on large loans, because since 1 February 2013, with the maximum exposure for a single borrower requirement coming into effect, one credit union member's loan could not exceed LTL 500 thousand. The aforementioned factors and the application of stricter capital adequacy requirements had an impact on the decrease of loans to legal persons. These significant-risk loans, mostly meant for financing businesses, in the reporting quarter decreased by LTL 16.5 million, while a share a year ago (1 October 2012) having amounted to more than 33 per cent, on 1 October 2013 decreased to 30 per cent of the loan portfolio. Loans to legal entities could have decreased because the CCUL performs a secondary status assessment of debtors who have filed applications for credit union (CCUL members) loans, larger than LTL 300 thousand. According to the CCUL's information, until 1 October 2013 the status of 53 debtors was assessed. Due to the high risk for the credit union, 11 debtors, 5 of which were legal entities (LTL 3.3 million) were not given loans. With the decrease in some credit unions of loans to legal entities, the size of capital adequacy standards applied decreased as well. A considerable share of business loans continues to go to credit unions in operation in the Vilnius area.

After credit unions began to slightly more conservatively assess the credit risk, in the reporting quarter the ratio of specific provisions to loans increased, as well as the share of non-performing loans in the loan portfolio. According to data of 1 October 2013, the ratio of specific provisions to loans reached 3.7 per cent; however, taking into account that not all credit unions conservatively assessed loan portfolios and made the necessary specific provisions, it is likely that the loan portfolio quality is much lower. **The deterioration of the credit union system's loan portfolio quality indicators of (as well as inspection results) raises concerns regarding the possibility of some credit unions to recover loans, and also reveals both irresponsible lending performance results in previous years and generally insufficient attention given to loan risk assessment before granting a loan.** With the aim of ensuring identification of the risks involved in credit union operations and their more effective management, the Bank of Lithuania prepared a credit union internal control and risk assessment (management) rules project, which is currently coordinated with associations uniting credit unions and their members, as well as the CCUL.

Having limited opportunities to expand the spectrum of their offered services, although paying higher interest rates on deposits than banks, credit unions are attractive to the population. According to the data of submitted reports, as of 1 October 2013 the interest rates of 1.5–2.5 per cent on the most popular deposits in national currency with a maturity of 12 months dominated credit unions (some of them offered higher interest rates), therefore in the first half-year of 2013 the volumes of deposits decreased, but then in the reporting quarter expanded by 2.6 per cent (LTL 45 million) and on 1 October 2013 amounted to LTL 1.8 billion. Deposits of natural persons accounted for the largest share of total deposits (97.2%). It should be noted that credit union depositors, mostly interested in higher interest rates, do not take an interest in the credibility of credit unions, as, under favourable terms and conditions of deposit insurance, in the case of bankruptcy of the credit union, they suffer the least (losing only their share, where their deposit does not exceed the amount insured).

Weaker growth in the membership of credit unions and in their loan portfolio had an influence of the credit union’s share capital. In the third quarter of 2013, the share capital grew and on 1 October 2013 amounted to LTL 203.6 million. This confirms the statement that share capital accumulated through loans is unstable, because, after repayment of a loan or part of it, such share contributions are often repaid. Moreover, when in a difficult situation, the members of a credit union, who are also the owners of it, are not willing to pay extra contributions to the capital and assume the responsibility for the operating performance of the credit union. It should be noted that in the case of a credit union’s insolvency, members who have loans from credit unions often suffer the most — they would lose their share, which amounts to less than a tenth of the loan amount.

According to the data of submitted reports, from the beginning of the year, 43 credit unions earned a profit of LTL 7.4 million, but 32 of them operated at a loss, which amounted to LTL 21.6 million and led to loss incurring activities of the system of credit unions, with their losses amounting to LTL 14.1 million in nine months of 2013 (LTL 0.4 million in the same period a year ago). **The largest loss (LTL 9.3 million) was experienced by the credit union *Vilniaus taupomoji kasa.* It should be noted that this credit union, according to reporting data from 1 October 2013, still hadn’t removed the violations of legal acts and deficiencies in its operations; therefore, having executed the instructions and formed the necessary specific provisions, the financial results would change accordingly.**

The main cause for operating at a loss was the loan impairment costs incurred by credit unions (LTL 27.5 million), 41.6 per cent higher than in the same period a year ago. With the expansion of the GS portfolio, the loss was reduced by income earned from securities transactions, which amounted to LTL 6.5 million (35% higher than in that same period last year).

It should be noted that most credit unions modify their activities in a way that enforces tighter prudential norms. According to the data of submitted reports, as of 1 October 2013 the liquidity ratio of the system of credit unions was 57.37 per cent. All credit unions ensured the execution of these requirements and had liquid reserve assets sufficient to cover the net outflow of cash (high quality liquid assets amounted to LTL 407.5 million, while the net outflow of cash stood at LTL 15 million). The credit union system’s capital adequacy ratio’s reporting data amounted to 19.76 per cent, however, **for two credit unions**, the major share of the loan portfolio in the previous reporting period was made up of loans to associated members (legal entities) and the capital adequacy **measures were less than the required ones**. **Eight credit unions** in the reporting period did not ensure the execution of requirements for the maximum exposure to a single borrower.

Some credit unions took action and presented information to the Bank of Lithuania that in October 2013 they were already complying with prudential requirements, while for several (mainly after their performance inspections), the dates by which they were obligated to comply with the requirements, were established. Credit unions, systemically not performing prudential requirements or not ensuring their implementation on the established dates, are subject to enforcement measures laid down in the Republic of Lithuania Law on Credit Unions. It should be noted that 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.[1]

A working group (comprising representatives from the Ministry of Finance, the Bank of Lithuania, associations uniting credit unions and the CCUL) has prepared draft laws for the regulation of the activities of credit unions with the aim of ensuring their safe and sound operation through establishing an adequate balance between the development of credit unions and their possibilities to amortise risk assumption-related losses. The work-

[1] The Bank of Lithuania presents information received from the financial reports of the credit unions themselves.

ing group's members unanimously decided that credit unions shall form capital acting in accordance to the capital formation policy, based on the Bank of Lithuania's credit union capital formation rules. In addition, taking into account the changes occurring in the credit union sector and seeking to improve the credit union regulated and supervised environment, a working group was formed at the Bank of Lithuania to deal with credit union issues.

The Central Credit Union of Lithuania. As of 1 October 2013, the CCUL united 63 credit unions.

After a growth in the third quarter of 2013, as of 1 October 2013 the assets of the CCUL amounted to LTL 339.5 million. The main reason for this asset increase — 2 per cent (up to LTL 251.8 million) growth in CCUL member deposits, which continued to be the main source of financing of CCUL assets (74% of CCUL assets are financed with them). Investments in securities of the Government of the Republic of Lithuania accounted for the largest share (63.1%) of CCUL assets (does not hold GS of other countries), according to data from 1 October 2013 they equalled LTL 214.3 million. After decreasing by 4.6 times in the reporting quarter (to LTL 1.6 million), the funds of the CCUL with banks represented an insignificant share of its assets.

The portfolio of loans granted to CCUL members expanded slightly in the reporting quarter, amounting to more than LTL 65 million as of 1 October 2013. Subordinated loans granted to credit unions continued to represent a significant proportion of the CCUL's loan portfolio (45%). According to the reports submitted on 1 October 2013, the quality of the loan portfolio remained good: no specific provisions for loans were formed; there were no loans with regular payments overdue for more than 60 days either. Under the agreement signed between the CCUL together with 57 credit unions and the manager of the Entrepreneurship Promotion Fund (INVEGA) on the management of an LTL 50 million worth micro crediting project, credit unions were granted LTL 33.4 million in loans from the Entrepreneurship Promotion Fund for financing small businesses.

The CCUL's Liquidity Maintenance Reserve (formed from contributions of CCUL members) in the third quarter of 2013 remained almost unchanged and amounted to LTL 16 million. The stabilisation fund in the aforementioned period grew by LTL 0.9 million, to LTL 7 million. It should be noted that having a fund of that size, the CCUL is unable to solve larger issues of credit union solvency.

In the reporting quarter, after returning to the Republic of Lithuania Government the supplementary capital shares acquired at the end of 2011, the CCUL's share capital decreased by LTL 0.2 million, amounting to LTL 31.4 million as of 1 October of 2013.

The results of the CCUL's nine-month activities in 2013 — LTL 1.3 million in profit, the greatest influence on which was made by interest income received from investment in GS (in 2012 in the same period the profits earned amounted to LTL 759 thousand).

The CCUL continued to comply with the liquidity and capital adequacy ratios holding a significant reserve.