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Review of the Activities of Credit Unions and the Central Credit Union of Lithuania of 2015

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Gedimino pr. 6, LT-01103 Vilnius, Lithuania
Tel. +370 (5) 268 0029, fax +370 (5) 268 0038

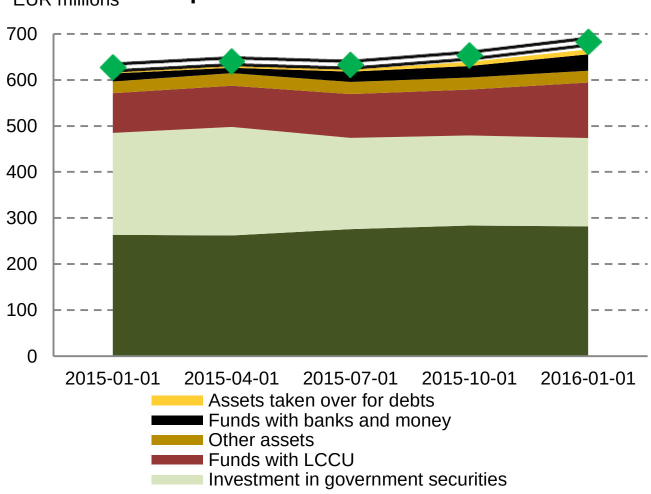
www.lb.lt
info@lb.lt

Credit unions. As of 1 January 2016, 74 credit unions were in operation. They united 157.51 thousand members (in Q4 2015 the membership increased by 1.6 thousand, in 2015 — by more than 7 thousand). Currently 61 credit unions are members of the Lithuanian Central Credit Union, while 13 credit unions operate independently. Once Lithuania joined the electronic euro payments area, the so-called SEPA, encompassing 34 countries on 1 January 2016, six credit unions were put on the list of direct participants in the Bank of Lithuania's retail payment system SEPA-MMS.

With the expansion of the deposits portfolio in 2015, especially sight deposits, the assets of credit unions grew by more than EUR 55 million and, according to the data as of 1 January 2016, amounted to EUR 672.6 million, or 2.9 per cent of the assets of the banking system (up from 2.7% a year ago).

The composition of credit union assets remained basically unchanged. As seen from the Chart, in 2015 loans accounted for the major asset share. According to the data as of 1 January 2016, loans granted to members (EUR 281.9 million) accounted for 41.9 per cent of the assets. While the loan portfolio of credit unions contracted in Q4 2015, loans granted by credit unions boosted by EUR 18.4 million from the beginning of the year. It should be noted that annual growth in the loan portfolio was driven by more active crediting of natural persons: loans granted to these members boosted by EUR 17.2 million (to legal persons — by EUR 1.2 million) over the year. The volumes of loans granted by ten credit unions to natural persons, designated for consumption, housing, agriculture, acquisition of immovable and movable property or for refinancing loans granted by other creditors, posted the most significant increases. Changes in the composition of the loan portfolio of these credit unions also had quite a significant influence on certain changes in the composition of loans within the sector — on a contraction in the share of loans granted to associated members (mainly legal persons). The share of loans granted to associated members in the credit union sector's loan portfolio over the year diminished by 1.2 p.p. — at the end of the year, these loans accounted for 23.5 per cent of total loans.

Composition of credit union assets



Source: The Bank of Lithuania.

Once credit unions (three in particular) assessed real possibilities for recovering some of their loans in 2015, specific provisions for covering likely losses on loan impairment rose, while the ratio of specific provisions to loans increased by 0.5 p.p. from the beginning of the year (to 6.7%). It is likely that credit unions have devoted more attention to compliance with the requirements of the Regulations of Credit Unions for the Assessment of Loans**:** in granting loans, they assessed more closely the financial status of borrowers and credited financially more viable members of credit unions, as the amount of loans overdue for more than 60 days declined in 2015. With the improvement in loan repayment, writing off part of loss-bearing loans by credit unions and taking over assets pledged for debts, non-performing loans declined by more than 13 per cent in 2015, while their share in the expanding loan portfolio dropped by 5 p.p. (to 21.3%). Despite the improvement in some indicators defining loan quality, loans overdue for more than 60 days and the ratio of assets taken over for debts, which more than tripled, to loans increased by 1 p.p. (to 13.2%). **Given that credit unions normally do not use assets taken over for debts for their needs, they will have to recognise the expenses of the oversight and sale of these assets in the future.**

According to the data as of 1 January 2016, nearly a third of credit union assets (EUR 191.8 million) consisted of investments in debt securities. In 2015, preparing to comply with the requirements of the Regulations on Credit Union Investment in Non-equity Securities (hereinafter 'Regulations') (from 31 December 2015, their investment portfolio will not have to account for more than 50 per cent of their on-balance-sheet assets, while the average modified financial duration of a securities portfolio will not have to be longer than five years), credit unions reduced securities portfolios and changed their composition according to maturity. Since the beginning of the year, credit union investment in securities has dropped by

EUR 29.5 million and, according to the data provided by credit unions, as of 1 January 2016, the securities portfolios of only two credit unions accounted for more than 50 per cent of their on-balance-sheet assets. These credit unions, having reduced their securities portfolios in January, complied with the above-named requirement of the Regulations. **Given that, as of 31 December 2016, the investment portfolio will not have to account for more than 35 per cent of a credit union's on-balance-sheet assets and the average modified financial duration of a securities portfolio will not have to be longer than three years (as of 31 December 2017 — no longer than two years), credit unions, being aware of investment portfolio requirements in advance, should adequately prepare to meet them.** The Bank of Lithuania monitors changes in the composition of credit union assets and takes measures where credit unions invest their funds received from securities sold in an insecure manner.

Accepted deposits, the major share of which (97%) consists of deposits of natural persons, have remained the major funding source for credit unions. According to the data as of 1 January 2016, 87 per cent of credit union assets were financed with them. In 2015, the deposit portfolio expanded by almost EUR 52 million, or 9.7 per cent, to EUR 587 million at the end of the year. Time deposits, on which credit unions pay higher interest rates than banks, grew by EUR 21 million (5%) over the year. Acceptance of these deposits entailed a fall in the profitability of part of credit unions, as some credit unions, not having where to securely invest expensive time deposits, held the funds with the Bank of Lithuania, banks and the LCCU, receiving almost no income from them. Sight deposits, on which no interest is payable (except for some credit unions paying low interest), grew by EUR 31 million (25.7%). It should be noted that the rise in sight deposits, as usually, was seasonality driven, as the deposits posted the most significant rise in Q4 2015, when members of credit unions uniting farmers received funds from agricultural production sold. This shows that the deposit acceptance service provided by credit unions is not only used when seeking an interest but also as a guarantee of the security of funds.

With an increase in credit union membership, the share capital increased by EUR 3.5 million in 2015 and, according to the data as of 1 January 2016, amounted to EUR 54.9 million. In the aforementioned period, the adjusted capital of credit unions, which is crucial in ensuring compliance by the majority of credit unions with prudential ratios and other legislative requirements, grew by 5 per cent (to EUR 57.7 million) as well. It should be noted that growth in the adjusted capital of some of the credit unions was driven by their profitable activities; however, some credit unions strengthened their adjusted capital with non-repayable funds or subordinated loans granted by the LCCU.

According to unaudited data, 51 credit unions, whose operations in 2015 were profitable, earned EUR 3.2 million in profit, while 23 credit unions operated at a loss, incurring EUR 3.8 million in losses. **The losses incurred in Q4 2015 (EUR 2.3 million) led to the sector's negative annual performance — EUR 0.6 million in losses** (down from a profit of EUR 0.6 million earned in 2014). The major reason behind the loss-bearing activities was asset impairment costs incurred (EUR 5.6 million, o/w EUR 4.2 million — of three credit unions). As mentioned before, credit unions, having assessed the possibilities for loan recovery, formed specific provisions. It should be noted that, in 2015, credit unions earned 12.4 per cent less income than a year ago, although, compared to the previous year, the expenses incurred were lower by 8.7 per cent as well. The main share of the income of credit unions (63.6%) consisted of interest income, mainly — on loans granted to members. In 2015, this income accounted for nearly a half of total income, an increase of 6 p.p. from 2014. Operating (46%) and interest (24%) expenses accounted for the largest share of the sector's expenses.

As mentioned before, in 2015, the credit unions' adjusted capital grew, while the loan portfolio share of loans granted to associated members shrank: credit unions prepared for complying with the capital adequacy ratio, calculated in line with the new Rules for Calculating Capital Adequacy Ratio of Credit Unions, approved by the Board of the Bank of Lithuania in 2015. According to the requirements of these Rules, which came into force on 30 September 2015, higher capital requirements are calculated for riskier assets, i.e. for loans issued to associated members, subject to their loan portfolio share.

According to the data of submitted reports, as of 1 January 2016 all credit unions complied with the liquidity ratio — the liquidity ratio of the system of credit unions was 63.46 per cent (the required minimum is 30%[1]). On that date, the capital adequacy ratio of the credit unions system was 18.31 per cent (the ratio being 13%); however, the capital adequacy ratios of two credit unions were below the required minimum (13%). One of them complied with the capital adequacy ratio, calculated according to the requirements of previously effective regulations, while the other one did not comply with the capital adequacy ratio even under the previously effective regulations. All credit unions will have to comply with the capital adequacy ratio (13%), calculated according to the currently existing regulations, no later than from 31 March 2016.

It should be noted that, on the reference date, credit unions did not comply with other prudential requirements either: the open position in one foreign currency (US dollar) of one credit union was above the established maximum (15%), while the maximum exposure to a single borrower of three credit unions, including the above-named ones not complying with other prudential requirements, accounted for more than 25 per cent of the adjusted capital of a credit union.

[1] For credit unions, whose assets have been above EUR 4.34 million and annual growth rate of deposits exceeds sustainable growth rates, the liquidity ratio of 40, 50 or 60 per cent respectively is applied.

In January 2016, some credit unions provided information that they took measures to ensure compliance with the ratios and remedied the situation. For credit unions that are not in compliance with the prudential ratios, the Bank of Lithuania applies the enforcement measures laid down in the Law on Credit Unions and gives relevant instructions in writing.

Given that prudential requirements were not complied with by credit unions, which had not accumulated sufficient capital, strengthening of capital, as in previous periods, has remained a major task for some credit unions.

Seeking to set legal preconditions for the implementation of the Conception for Sustainable Operation of Credit Unions, which was approved by the Committee on Budget and Finance of the Seimas of the Republic of Lithuania, draft legal acts of the Republic of Lithuania, necessary for implementing the scheduled credit union sector's systemic reform, were also prepared and provided to the Seimas of the Republic of Lithuania in 2015. One of them — the draft Law on Credit Unions of the Republic of Lithuania — lays down that a thorough, independent and standardised asset quality review (AQR) of operating credit unions should be conducted before the date of coming into force of this Law, by invoking audit companies, asset valuators or other persons with adequate qualifications. The aim of this review is to identify the financial standing of credit unions as early as before the merger, remove existing problems from the new system of credit unions, and ensure the system's viability and credibility.

Financial services regulation initiatives of relevance to credit unions. Amendments to the Law on Consumer Credit came into force on 1 February 2016; their purpose is to reduce credit availability for consumers that borrow irresponsibly and to ensure a proper balance between parties to a credit relationship. These amendments lay down tighter requirements for advertising consumer credit agreements, certain obligations and requirements for consumer credit lenders, grant new rights and provide possibilities for credit users not to use this service.

The Republic of Lithuania Law on Credit Relating to Real Property has been drafted and submitted to the Ministry of Finance of the Republic of Lithuania Ministry of Finance for coordination; it implements Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (Mortgage Credit Directive, MCD) as well as national proposals on the improvement of legal regulation in the field of granting residential loans.

The drafted Law on Payments implements Directive 2014/92/EU on the comparability of fees related to payment accounts, payment account switching and access to payment accounts with basic features (Payment Accounts Directive, PAD). The draft law proposes to supplement the above-named law with provisions that would provide preconditions for reducing the price of the basket of operations usual for consumers down to that which is not higher than the region's average.

Settlement of disputes between consumers and credit unions. In 2015, the Bank of Lithuania received applications from 14 applicants regarding the actions of credit unions that may have violated their rights. Part of the applicants, when applying, indicated the circumstances and raised requirements relating to requests to obligate credit unions to credit an additional contribution of shares in order to pay the last loan tranche. In addition, due to violations of legal acts made, in the opinion of consumers, by credit unions, it was asked more than once to carry out inspections of the credit unions and apply enforcement measures to them. It should be noted that the Bank of Lithuania makes a decision to commence an inspection having evaluated the soundness of information about the violation of legal acts and identified sufficient grounds to suspect a violation of the requirements of the legal acts.

The Lithuanian Central Credit Union[2]. As of 1 October 2015, the LCCU united 62 credit unions.

The assets of the LCCU grew by EUR 1.1 million — to EUR 118.7 million in Q3 2015. The increase in the assets was due to an increase of 2.1 per cent (to EUR 95.3 million) in deposits (mainly of credit unions members of the LCCU), which continued to be the main source of financing of LCCU assets (80% of LCCU assets are financed with them).

The bulk of LCCU assets (65.6%) consisted of investments in debt securities, which grew by almost 40 per cent in the reporting quarter and, according to data as of 1 October 2015, amounted to EUR 77.9 million. Government of the Republic of Lithuania securities comprised the major part of these investments (88.6%); the remaining part was comprised of debt securities of the governments of other European Union countries (Latvia, Croatia, Hungary, Romania and Bulgaria) and of debt securities of one Estonian enterprise.

For the acquisition of debt securities, the LCCU used the funds held with the Bank of Lithuania. LCCU funds on the account with the Bank of Lithuania halved in the reference period, amounting to EUR 19.1 million, or 16 per cent of LCCU assets. LCCU funds with banks (EUR 0.9 thousand) accounted for an insignificant asset share.

The LCCU loan portfolio as of 1 October 2015, as at the beginning of the quarter, amounted to EUR 18.8 million, though its composition changed slightly. Loans granted to credit unions in the reference quarter contracted by EUR 0.5 million (to EUR 15.2 million), with a rise in loans granted to credit union members (natural and legal persons) accordingly.

The LCCU liquidity support reserve, once the excess funds required to be held in this fund were returned to credit unions, contracted by EUR 0.4 million, amounting to EUR 4.6 million as of 1 October 2015. The funds in the stabilisation fund

[2] Due to the later date of presenting the LCCU's reports, the review of the LCCU activities for Q3 2015 is provided.

(EUR 1 million) designated for restoring the solvency of credit unions (LCCU members) remained unchanged in the aforementioned period: as many credit unions paid contributions for 2015-2017 in advance, the contributions paid to this fund were insignificant in Q3 2015.

The share capital of the LCCU has remained unchanged since the beginning of the year, amounting to EUR 9.4 million as of 1 October 2015. The operations of the LCCU for the nine months of 2015 bore losses (the loss stood at EUR 0.1 million), as the net operating income did not offset administrative and depreciation expenses. Over the same period in 2014, a profit of EUR 0.3 million was earned.

Since 1 January 2016, the LCCU has been put on the list of direct participants in the Bank of Lithuania’s retail payment system SEPA-MMS, while the credit unions members of the LCCU have been indirect participants of this system.

Annex: Dynamics of performance indicators of the credit unions sector

Seq. No	Indicator	Amount, EUR millions			Change (%)	
		01/01/2015	01/10/2015	01/01/2016	2015 Q4	over a year
1	**Assets**	**617.2**	**642.8**	**672.6**	**4.6**	**9.0**
2	Money	5.2	3.5	3.4	–3.0	–35.0
3	Funds with banks	12.2	21.5	32.3	50.2	2.7 times
4	Funds with the LCCU	86.2	99.6	120.5	21.0	39.8
5	Government securities	221.3	195.6	191.8	–2.0	–13.3
6	**Loans granted**	**263.5**	**283.7**	**281.9**	**–1.6**	**7.0**
7	Specific provisions against loans	17.3	20.4	20.2	–1.0	16.8
8	Ratio of specific provisions against loans to loans (%)	6.2	6.7	6.7	–	–
9	Debt to the LCCU	18.6	15.2	12.2	–48.0	–35.2
10	**Deposits**	**535.0**	**559.5**	**587.0**	**4.9**	**9.7**
10.1	Of members and associated members of credit unions	532.2	556.9	584.5	5.0	9.8
11	**Share capital**	**51.4**	**54.2**	**54.9**	**1.2**	**6.8**
12	Profit (loss) for current year	0.6	1.7	–0.6	–	–

Source: The Bank of Lithuania.