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Banking and the Financial Services Sector

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Introduction

As with any sector in an emerging economy, the financial services sector has undergone massive change in recent years and this change is far from over. All three of the countries in the Baltic States are small; Lithuania is the largest of the three but still only has a population of some 3.7 million. This makes some aspects of change easier but other aspects more difficult.

It remains a common misconception that the Lithuanian currency (litas) is in some form restricted. This is not the case – the litas has been fully convertible for some years.

Banks

At the end of 2002 the Lithuanian banking sector had some 10 banks (including the new VB Mortgage Bank), four foreign bank branches and two bank representative offices. The three largest banks still account for a market share of 74 per cent, despite the fact that this continues to decline slowly due to increased competition. As at 1 January 2003 total assets in the banking system grew 12.2 per cent from the previous year and amounted to 17.2 billion litas, continuing the solid growth in recent years.

As evidenced by the continual growth in banking assets, the number of bank accounts and outstanding loans continues to grow. Loans to individuals increased by 63 per cent to 1.16 billion litas in the first 11 months of 2002; this is expected to grow by a further 40 per cent in 2003.

All of the main Lithuanian banks have now been privatized with the last three, Lietuvos Taupomasis Bankas, the Lithuanian Agricultural



Bank and the Lithuanian Development Bank, being sold in 2002 to Estonian, German and Scandinavian buyers respectively. Partly as a result of the privatizations, registered share capital in the sector continued to grow as did the percentage owned by foreign investors – up from only 16 per cent in 1996 to 88 per cent at the end of 2002. Capital adequacy in the system is good at 14.75 per cent easily exceeding the 10 per cent required by the Central Bank.

As in other countries in this region many of the banks are competing in the same sector and many of the banks initially focused on foreign companies operating in Lithuania and the larger local corporates. Competition has been fierce and has resulted in a number of the banks widening their focus and looking at smaller corporates and the retail sector where competition is also now very fierce.

Given the close proximity of Scandinavia, the Finnish and Swedish banks have had quite a lot of influence on the banking sector although this has not been as pronounced as it has been in Estonia and Latvia. Their influence is obvious and can be seen in the growth and sophistication of electronic banking, back office systems, customer service and other areas.

Overall, the banking sector is both well developed and sophisticated and offers the vast majority of products and services that would be expected in any developed market economy. Telephone and Internet banking is widely available from the majority of banks although at this stage it has not been taken up by many Lithuanians.

The provision of leasing services has become very popular with the market increasing by 56 per cent in 2002 to a total market of 1.7 billion litas. This is on top of growth of some 60 per cent in 2001; the market is forecast to grow by a further 35 per cent in 2003.

One part of the banking sector that until recently has been quite slow to make much progress is the provision of residential mortgages but this market is now growing very quickly. It is undoubted that this market will become very important in the future but due to factors, such as legislation, that make it difficult for the lender to repossess the property in need and the lack of long-term loans it has taken a while to gather momentum. However, all this is beginning to change and most of the bigger commercial banks are now competing aggressively to promote residential mortgages and are experiencing very rapid growth in the size of their mortgage portfolios (albeit from a low starting point). This competition is leading to the availability of longer-term loans and lower interest rates which in turn increases demand still further. Indeed residential mortgages represented more than 85 per cent of all new loans to individuals in 2002.

Another part of the banking sector that has been relatively slow to take off, but is now doing so, is the debit and credit card market. The majority of Visa cards and Mastercards are actually debit cards rather

than credit cards as in the UK, but the number of transactions in which these cards have been used is now rapidly increasing.

Financing trade and projects

Approximately 90 per cent of all trade in the European Union (EU) is conducted on an open account basis although many companies have some form of credit insurance. Trade with Lithuania has not as yet reached this level but continues to move towards it.

Over the years there have been many successful projects financed on a non-recourse project finance basis. These have been structured both with and without assistance from the British Export Credit Guarantee Department (ECGD) and other export credit agencies. In recent times the ECGD has changed its policy on financing projects in the region in order to secure more business; this means that projects that were previously unable to obtain cover can now do so. Perhaps the most important change is that the ECGD no longer needs a Government guarantee in certain circumstances but will sometimes consider municipality or large local corporate risk and this practice is spreading to include countries such as Lithuania. In addition, the private insurance market has an increasing appetite for risk in the Baltic States.

The trend towards financing major projects by way of partnerships established between central and/or local Government and private companies has not been ignored in Lithuania although they have not made very much progress on this front and are some way behind many of their neighbours. However, as recognition grows regarding the impact that public-private partnerships (PPPs) can have in developing infrastructure such as roads, rail, water treatment plants and many other large projects, it is expected that momentum will start to build shortly.

In order to make these projects happen, typically laws need to change and attitudes and ideas need to become more flexible. However PPPs offer the most realistic way to finance many of the projects required and, as this becomes more widely understood, the number of PPP projects in the country will increase dramatically. As Britain and British-based firms are world leaders in this type of finance, the development of this sector in Lithuania should be seen as offering many opportunities in the future.

Investment funds

A small number of investment funds and providers of private equity have been active in Lithuania for many years; their role is however continuing to expand as the country's economic growth continues. In

an effort to promote the sector the European Bank for Reconstruction and Development (EBRD) has invested in a number of the funds although it is true to say that the majority of equity funds have their roots in either Scandinavia or the USA. In very simple terms the preferred scenario for a fund is to invest between US \$1 million and US \$5 million in a joint venture company with a local partner and a foreign strategic investor. Clearly this is over-simplified and, for the right project, both smaller and much larger funds can be found. In theory, any commercially sound project can attract funds.

A number of the locally based funds are effectively subsidiaries of the more global funds or linked to banks. As the market continues to mature and stabilize the growing demand for this type of funding is being met by the creation of new funds and the expansion of existing ones. The sector remains difficult given the constraints in which it operates but steady growth is expected to continue.

Insurance

Life insurance, as in all the emerging markets, is very underdeveloped in comparison to Western Europe or the USA, as is the private pensions industry. However the market has now started to grow quite quickly. During the first 11 months of 2002 non-life insurance premiums totalled 675 million litas and life insurance premiums for the same period amounted to 115 million litas – both figures comfortably exceeding the forecasts for the entire year. Newly introduced tax incentives and a flow of new products are expected to ensure that the life insurance market continues to grow strongly during 2003. At the end of 2002 over 10 life insurance companies operated in Lithuania of which Lietuvos Draudimas, ERGO Lietuva, Preventa and IF Draudimas were the largest.

The development of private pensions is also now taking hesitant steps forward. As with every country there is an urgent need to move away from the provision of pure state systems and legislation has been changed to allow the implementation of the second pillar (mandatory contributions to a private pension fund) and the third pillar (voluntary contributions to a private pension fund).

The non-life and general insurance sector is, in general, reasonably well developed but the sector has been hampered by the difficulties in assessing real claims and the low level of payouts made in the past. Third-party motor insurance was made compulsory in April 2002 and this, together with a number of other changes, has stimulated growth in the non-life sector. There are now over 20 general insurance companies present, of which the strongest are Lietuvos gyvybes draudimas, ERGO gyvybes draudimas, VB gyvybes draudimas and Commercial Union Lietuvos gyvybes draudimas (a British company).

Legal system

There is a complete section of this book dedicated to legal issues, but given the impact of legislation on doing business in the financial services sector it is considered appropriate to include a very brief outline here.

The legal sector, or more correctly the law, has perhaps undergone more change than any other sector. A number of international law firms are present and many have been instrumental in adapting old legislation and writing new laws. As the Lithuanian economy moves ever closer to a market driven economy, the need for legislation to change to allow the economy to expand and foreign companies to invest and trade in a safe environment becomes ever greater. The scope and depth of these changes has increased significantly as EU membership beckons.

It is true that many of the laws are not directly comparable with UK or EU legislation but much progress has been made. However, implementing new legislation is only one aspect of changing laws. It is widely recognized that the interpretation of new laws can, on occasion, be questionable and it is also generally recognized that there remains an element of corruption that in some cases can undermine the system as a whole. In addition, the judicial system is lacking in experience although this will of course improve over time.

Accountancy

One of the requirements for any company wishing to raise debt or equity funding, trade finance, or establish any form of partnership with a foreign party has been the need to produce accounts to international accounting standards. Lithuanian accounts are often not very transparent, rather brief and open to interpretation and, as such, not very reliable.

All the large foreign accountancy firms are present and the trend towards international accounts continues to move down towards ever-smaller companies. A separate chapter elsewhere in this book considers these issues in more detail.

Stock exchange

As is common with most of the stock markets in the emerging markets, the stock exchange is not very liquid and only has a limited number of companies listed; this can impact on many other aspects of the financial services sector. For example, the limited market restricts the activities of insurance and pension fund asset managers, does not encourage long-term savings which in turn reduces the possibilities of the provision of

long-term loans and is not able to act as a provider of fresh capital to fund growth of local companies.

There is a cooperation agreement in place with the London Stock Exchange, and one Lithuanian company (AB Lietuvos Telekomas) is actually listed in London.

Corporate governance

The way in which business is conducted, the transparency of transactions and relationships, minority shareholder rights and general financial management are some of the main concerns behind corporate governance. As with many aspects of the financial services sector in Lithuania, much has been done but more needs to be done. Much effort is now being put into addressing many aspects of corporate governance, and this is expected to become even more of an issue as Lithuania prepares to join the EU.

Regulation

The banking sector is regulated by the Bank of Lithuania which has received considerable praise recently for the progress made in all aspects of its role. The insurance sector is supervised by the State Insurance Supervisory Authority under the Ministry of Finance and the Stock Exchange and other capital markets are supervised by the Securities Commission.

Regulation and supervision of the various parts of the financial services sector is generally regarded as being relatively good and continues to improve although it is recognized that the lack of experienced professionals is a limiting factor.

Summary

The financial services sector has been totally transformed over the last 10 years and although mistakes have been made and there is still more to be done, the progress made has been remarkable and many of the past mistakes have already been recognized and rectified.