JEL-classification G21

J. Jasevičienė, Doctor, Lecturer,
Vilnius University

LITHUANIAN BANKING DEVELOPMENT AND CHALLENGES IN IMPLEMENTING BASEL III

Стаття аналізує головні тенденції розвитку Литовської банківської справи, їх важливість для економіки та фінансової системи країни. Вона аналізує прямий та непрямий вплив всесвітньої фінансової кризи на банківський сектор, а також роль Банку Литви – закладу, що контролює банки, – у досягненні безпеки та значення функціонування банків. Обговорюються також виклики банків у здійсненні Базеля III, а також аспекти міжнародного співробітництва в галузі фінансової стійкості та кризового управління.

Ключові слова: фінансова криза, розвиток Литовського банківського сектору, Базель III, нагляд.

Статья анализирует главные тенденции развития Литовского банковского дела, их важность для экономики и финансовой системы страны. Она анализирует прямое и косвенное воздействие всемирного финансового кризиса на банковский сектор, а также роль Банка Литвы – учреждения, контролирующего банки, – в достижении безопасности и значения функционирования банков. Обсуждаются также вызовы банков в осуществлении Базеля III, а также аспекты международного сотрудничества в области финансовой устойчивости и кризисного управления.

Ключевые слова: финансовый кризис, развитие Литовского банковского сектора, Базель III, надзор.

The article analyses the main tendencies of the development of the Lithuanian banking, their importance to the economy and the financial system of the country. It analyses the direct and indirect impact of the worldwide financial crisis on the banking sector as well as the role of the Bank of Lithuania – the institution supervising the banks – in achieving the safe and sound functioning of banks. The banks' challenges in implementing Basel III are also discussed, and so are the international cooperation aspects in the area of financial stability and crisis management.

Keywords: (financial crisis, Lithuanian banking development, Basel III, Supervision).

The Bank of Lithuania annually publishes annual reports covering the implementation of its functions, as well as the analysis of macroeconomic and trends of banking market. In accordance with the Republic of Lithuania Law on the Bank of Lithuania, the same information is provided to the Parliament of the Republic of Lithuania. A significant importance is given to the prevention of crisis in the banking sector. The Financial Crisis Prevention and Management Plan was approved by the Resolution {7} of the Government of the Republic of Lithuania on 24November 2008. The Plan provides stages of crisis prevention, taking into account risk factors, which can lead to the financial crisis. The Bank of Lithuania adopted the same legislation in 2009. Great attention is paid to the implementation of Basel III. Discussions are on-going with banks considering that a significant part of the banks is ruled by foreign banks, the Cooperation with Authorities of Supervision of Credit Institutions and of Other State is predicted in the Republic of Lithuania legal acts. It shall have the right to conclude agreements on cooperation with the institutions of other states. Main objective is- analyses the banking system and concentration, banking activities before the global financial crisis, measures to overcome the crisis, international cooperation in crisis management and other areas is discussed. The potentiality of implementation of Basel III is detected

Banking system, Concentration. Lithuania has a number of different financial market institutions such as banks, credit unions, leasing and insurance companies, capital market players, but in the financial system in Lithuania, from the beginning of the development of banking in the country, it has been the banks that always have possessed the highest degree of significance, covering the largest part of the financial system. In recent years this share has accounted for more than 80 percent. At the end of 2011, Lithuania's banking system consisted of eight commercial banks (of which four were wholly owned subsidiaries of foreign banks), and twelve foreign bank branches [1, p. 31], which brings us to yet another feature of the Lithuanian banking system – the dependency on foreign banking, particularly that which comes from the Scandinavian countries. At the end of 2011, foreign banks owned a 87.7 percent share capital of the banking system. Foreign banks are dominating the banking system both in terms of assets, and loans and deposits, and the three largest banks' market share concentration by the end of the year 2011 had grown to more than two-thirds of the market: The assets during the year increased by 69 percent, the share of loans to 68 percent and the deposit segment to 71 percent. Foreign bank branches have been strengthening their position in all segments due to their increased competitive edge on the market, because as per EU requirements they have to satisfy fewer prudential risk-restricting requirements, because their supervision is done by the country of origin. On 1 January 2012, branches of foreign banks accounted for almost 20 percent of the banking system's assets. Furthermore, in the light of the Lithuanian banking system's evolution in 2011 it is necessary to highlight one significant event occurred on 7 December 2011: Bank SNORAS, the fifth-largest bank with a market share of about 10 percent was subjected to bankruptcy proceedings [1, p 30], which has led to foreign banks and their branches dividing up the bank's market share.

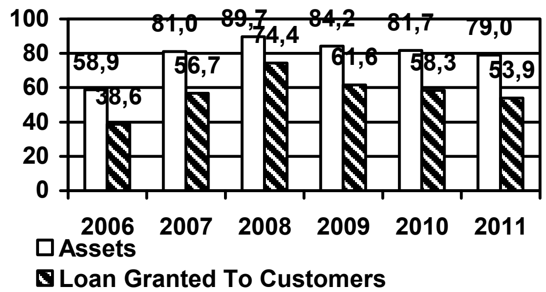

Fig. 1. Lithuanian Banking System. Assets and Loan portfolio; in billion of Litas (created by author)
Source : The Bank of Lithuania.

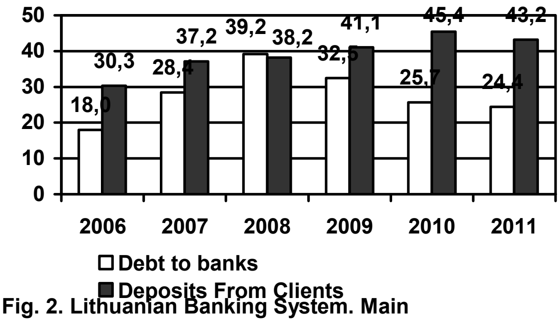

Fig. 2. Lithuanian Banking System. Main Financial sources; in billion of Litas (created by author)
Source: The Bank of Lithuania.

Banking activities before the global financial crisis. Just like in the neighboring Baltic countries, in Lithuania, too, the rapid economic growth in 2003-2007 was the result of not only the advantages of integration into the EU the favorable tax environment for investment, and the aggressive drive and risky rate at which the private sector was borrowing from commercial banks as well. Before the global financial crisis, the banking system had been growing very rapidly: during the 2003 – 2007 period, the banking system's assets rose by 37 percent on average annually, with the highest annual growth recorded in 2005, when the assets grew by 54 percent. The main sources that fuelled the growth of the banks were deposits from the clients (which in the same period increased by 26 percent annually), and financial resources from foreign banks (mostly parent companies) that during this period grew by an average of 67 percent annually and at the end of 2008 reached 47 percent of balance sheet liabilities.

The attracted money was mainly used by the banks to grant loans to customers. The banking system's loan portfolio in 2003 – 2007 grew by an average of 47 percent each year and at the end of 2008 accounted for the major portion – 80 percent – of the banking system's assets . The fastest growth was reported in the volumes of bank loans to individuals and private companies. Loans granted to private individuals within the five years rose by 12 times to 28.6 billion litas, (The official fixed exchange rate 3.4528 litas per 1 euro) with the individuals borrowing primarily for housing acquisition and real estate reconstruction. The growing real income of individuals (the increasing salaries) and sometimes inadequate decisions to take a mortgage loan (without considering potential future recessions and being too optimistic about the future real income of the family) have driven the real estate market upwards, with the prices growing drastically. Real estate development by private individuals has also influenced and stimulated, to some extent, private companies to develop more projects to provide more real estate development--related services, which has led to private firms borrowing from banks also gaining quite a big momentum. Loans to private companies over the reporting period increased by more than 4 times. Most banks were lending to companies engaged in production and real estate development [2, p 58]. In 2007, Lithuania widened the gap between VILIBOR and EURIBOR (the euro zone index EURIBOR shows interest rates in euro, while VILIBOR in litas) interest, and as a result loan portfolios were dominated by loans in foreign currency (mainly in euro). Of course, even at its high pace of growth, the loan portfolio in Lithuania stood at 62 percent the GDP in early 2008, whereas in other Baltic countries it was much higher, amounted to 106 percent of the GDP in Latvia, and 98 percent in Estonia. Compared to the neighboring countries, the volume of mortgage loans issued in Lithuania was significantly lower as well. The growth of banking activity affected the growth in net interest income, which was positively influenced by the profitability of the banking system and the rate of return ratios. A record-breaking profit of 1.2 billion litas was earned by the Lithuanian banking system in 2007.

The crisis period: indirect and direct impact on the banking system. In 2008, in the light of the global financial crisis, the impact was felt in all countries, including Lithuania. In fact, many experts predicted that the direct impact of the crisis in the financial system of Lithuania would not be substantial, because the Lithuanian banks are not closely related to U.S. financial institutions, and also, the country's financial market is quite small, with shares or bonds not being significant investment sources. In addition, most of the banking market is controlled by Scandinavian banks and the global crisis in these countries was relatively small and short-lived, so that had some positive effect on the Lithuanian banking system. However, the indirect impact of the crisis came through the interest rate rise on the global markets. With the volumes of production and consumption in Europe on the decline, Lithuania was faced with a drop in export volumes. In particular, the economic downturn affected the construction and transport sectors the most. Consumption went down in Lithuania and the banks severely restricted access to credit, becoming more careful about issuing loans and tightening the lending conditions (especially on loans for land acquisition and construction financing), raising the collateral requirements for loans and the residual amount of borrowers' income after the loan has been serviced. Banks, and foreign-owned banks in particular, in late 2008 began to structure a potential impairment of the loan portfolio.

Fig. 3. Banking System Profit (Losses), Billion of Litas (created by author)

Source : The Bank of Lithuania

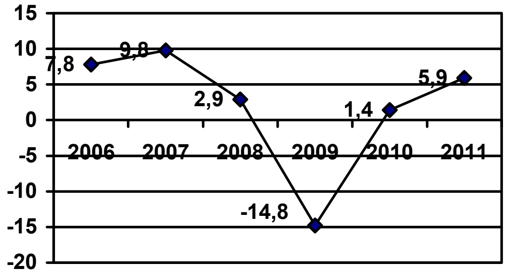

Fig. 4. Changes of GDP, In percentage (created by author)

Source : Lithuanian Statistics Department

The decline of economic activity, the drop in real estate prices, the increase in the number of corporate bankruptcies, the growing unemployment, the lower wages and the conservative loan portfolio have resulted in a significant deterioration in the loan quality, while the increasing credit risk of borrowers has caused the banks to structure a sizeable loan portfolio impairment (amounting to 3.5 billion litas in 2009) [4, p. 4]. It can be argued that the assumption of risk has been underestimated and accepted by both sides – both by the lenders and the consumers of the financial services – and the consequences of the crisis were quite dire: – the Lithuanian banking sector in the years 2008 – 2009 had to endure the effects of the global financial crisis, the country's economic decline was 14.7 percent of the

GDP (2009), and the banking system reported a record of loss of nearly 3 billion litas.

Measures to overcome the crisis. The European Commission in October 2008 adopted an action plan titled *From Financial Crisis to Recovery. European Framework for Action* [9]. This document emphasizes the need to create a new financial structure, strengthen the application of the risk management and crisis prevention system, as well as to reinforce the international cooperation among the financial supervision authorities. Also, an emphasis was placed on the need to deal with the effects of the crisis on the real economy and the application of crisis prevention measures. The paper also focused quite heavily on the flexibility of employment relations to prevent unemployment. In order to overcome the crisis, many countries have spent huge sums to rescue the banking system. Meanwhile, the Lithuanian banking system has made do without government and central bank support. It had been recommending repeatedly for several years that banks should make profit allocations for the reserves to cover activities risk. Banks have carried out the Internal Capital Adequacy Assessment Process (ICAAP): they assessed the exposure to significant risks and the estimated capital requirements to cover it. Banks have set themselves a higher internal capital requirements ceiling (between 9.5 and 10 percent); when this ceiling is approached, the banks will look for ways to either raise capital or reduce the risk of the assets. In its own turn, the Bank of Lithuania has undergone a Supervisory Review and Evaluation Process (SREP) [8]. The SREP is followed by annual general and targeted inspections. In order to assess the liquidity problems of each bank better, the banks are now required to submit additional information about the changes in the assets and liabilities structure on a daily basis. If any major fluctuations in the structure of assets or liabilities are spotted, the banks are requested to explain their causes and provide measures to be taken to cover the potential liquidity risks. Lithuania has taken further steps in crisis prevention. In 2009, the Bank of Lithuania approved the financial crisis prevention and phase management setting and information exchange procedures, which involved performing and ongoing risk assessment of the banking sector. A Financial Stability Act was adopted to provide for measures of state intervention in the financial sector. The Nordic and Baltic cooperation agreement was signed, laying down detailed cooperation processes in the context of the EU memorandum of understanding on crisis management (envisaging effective communication, assessment of the situation and the financial burden-sharing), and work was carried out at the EU level to identify systematic risks and establish measures to overcome them, as well as to coordinate the support measures [3 ,p.47]. According to the Financial Sustainability Act, banks will be covered by the following financial stability arrangements: the state guarantee, repurchase of the bank's assets, public participation in the bank's capital and the taking of the bank's shares for the public needs. One important role in strengthening the confidence in the banking sector has been played by the changes in the deposit insurance system, whereby the amount of insured deposits was increased up to 100.000 euro for an indefinite period. Lately, the financial sector supervisory authorities have carried out some other important work to buffer the potential risks in the banking sector. The Bank of Lithuania has approved the Responsible Lending Requirements. The requirements include the newly established loan to value (LTV) ratio and debt to income (DTI) ratio. In order to optimize the regulation and coordination of processes in the financial sector and the management of systematic risks, and to apply the one-stop-shop principle across the players of the financial market, consolidation of the supervisory bodies was carried out this year. The supervision of credit institutions, insurance companies, securities markets, financial services, consumer rights now converges on one institution – the Bank of Lithuania. Also, discussing about the possibility of differentiating the system of deposit insurance by types risks is being considered. This means that the deposit amount paid by credit institutions will depend on the risk level of the specific institution.

Recently, the real GDP has been growing rapidly in Lithuania, and so the economic growth outlook was expected to remain relatively favorable in 2012. However, the recent developments call for a more careful assessment of the economic development and the uncertainty associated with the forecasts for the coming years has increased further. Most of it is due to the faster-than-expected deterioration of the situation abroad, because efforts to resolve the debt problems of some euro area countries have been futile for quite a while. The domestic demand on foreign markets is decreasing, which has led to a drop in the volumes of sales of Lithuanian products and a slower rate of increase in the amounts of both exports of Lithuanian origin and total exports. Therefore, individuals and businesses are more conservative about the next period than they were a few months ago. The SNORAS bankruptcy is another reason for the less-well regarded economic development in the coming quarters. Although, in terms of the total economy, the total amount of uninsured funds held at the bank was relatively small and the direct impact on private consumption and investments should be minimal, this still might have a potential indirect effect of a drop in the level of confidence in commercial banks. This may result in increased savings (which will reduce the public consumption), and reduced incentives for firms to invest. However, it is expected that the effect of the bank's bankruptcy on the economy will be short-lived and, considering both its direct and indirect effects, it should not thwart the annual GDP growth by more than 0.5 percentage points. The liquidity in the banking sector has also remained under constant surveillance. To reduce dependence on one source of finance, banks are not also required to diversify their sources of liquidity, carry out liquidity risk testing under potentially adverse scenarios, and, based on the results of test evaluation, prepare business continuity plans.It should be noted that the bankruptcy of the aforementioned bank has revealed certain supervisory gaps. The bank had been riddled with issues before, which were exacerbated still by the crysis. However, supervision was not adequate or done when due, resulting in negative reverberations across both the banking market, and the public.

Situation in the banking system and it prospects [5, p.1]. After one bank was declared bankrupt at the end of 2011, the country's banking system has proven to be ready and able to cope with stressful situations. Banks had accumulated enough liquid assets that could be used to repay deposits. In November 2011, when the bank was announced bankrupt as mentioned before, a drop in the deposits amount in the banking system was registered, yet in December the amount of operating assets of and deposits at banks increased. This was the result of the transfer of some 4 billion litas to the banking system as the insurance benefit for the deposit-holders of the bank gone bankrupt. About 77 percent of the funds was transferred to bank accounts of private individuals and companies, and merely 23 percent was paid in cash (as indicated by the continued public confidence in the banking system). In 2011, the loan portfolio quality improved – banks viewed borrowers as less risky, reducing the volumes of provisions made the year before by 18 percent.The liquidity situation of banks improved at the end of 2011, with the liquidity ratio climbing to 44.04 percent, the peak figure for the past eighteen months (the Bank of Lithuania's requirement for the liquidity ratio is 30 percent). In 2011, banks maintained a high level of capital adequacy (on 1 January 2012, the adequacy of the banking system amounted to 14 percent). All banks based in Lithuania pursue have been operating in compliance with the Bank of Lithuania's prudential norms, but in order to prepare to face the potential risks, some banks with lower capital adequacy ratios still find the matter of bolstering their capital base quite relevant.

After the losses of 2009-2010, in 2011 banks earned a whopping 1.1 billion litas. Last year, profits were very close to the record margin that the banking sector made during the period of the economy growing back in 2007, but unlike the period of economic growth, the main catalyst for the growth in profit last year was not the growing revenue levels of banks, but rather the decrease in the cost of specific provisions (relating to revaluations of loans and investments in subsidiaries) and the drop in interest expenses.

Basel III. As mentioned before, the Lithuanian banking sector is dominated by wholly owned subsidiaries of EU countries, and cooperation with foreign supervisory agencies and membership in supervisory boards will remain to be a matter of relevance for the purposes of further bank supervision as well. The need for increasing the cooperation levels is spurred still by the implementation of the CRD IV Directive (Basel III) provisions – a priority goal. The international financial crisis has highlighted the gaps caused by insufficient supervisory regulatory, has revealed the need for systematic regulation, and therefore these changes will affect subsidiaries of foreign banks and, for branches of foreign banks, will reduce the extent of supervision on the host country's part. It is estimated that the Lithuanian banking system has a strong tier one capital, which is used to buffer operating losses, and although the new standards require that this capital should be reduced for the amount of deferred tax, the banks nonetheless stand in compliance with the new requirements: the adequacy of banks' Common or Core Tier I equity in Lithuania on 1 January 2011 stood at 7.4 percent, and the Tier I capital adequacy ratio was about 11 percent. [11]A lot of focus is being placed on the liquidity risk. CRD IV provides for two new liquidity ratios – the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). Calculation of the LCR will take account of high-quality liquid assets of banks, the projected costs and revenues over the shorter term and to meet the NSFR, banks will have to balance their asset and liability structure better and to extend their liabilities. of the new liquidity ratios, the LCR of the Lithuanian banking system currently stands at 252 percent (compared to the required value of 100 percent); based on the current figures, the NSFR of Lithuanian banks would be below the minimum requirement of 100 percent, yet there are plans to achieve it by the time the requirements of Basel III are met. [7, p.7-13].

International cooperation in crisis management and other areas. In the process of supervising the activities of banks which are doing business in different countries whilst belonging to the same financial group, the Bank of Lithuania continues its cooperation with the EU Member States' financial sector supervisory authorities, working vigorously with the supervisory authorities in Latvia, Norway, Finland as well as the Swedish Financial Supervisory Authority. In 2011, meetings of supervisory colleges focused on the assessments of different types of risks that were carried out by individual countries for the financial groups that they supervise, and on discussing the process of making the decision on capital adequacy [1, p. 31]. There is a certain amount of coordination of actions in the field of crisis management, especially with the supervisory authorities in the home countries of parent banks.

Conclusion. Before the global crisis the country's economy and banking system had been growing very rapidly. The somewhat fast growth of the lending volumes has been a factor in the formation of the real estate bubbles. The measures that were applied have prevented both in the domestic economy and in the banking sector from incurring significant losses from the crisis. In recent years, the country's economy, along with the banking sector is displaying a positive trend, but with the situation in other EU countries vague, there are still reasons to be very carefully when judging the development country's economy. The banking system is facing new challenges in meeting the Basel III requirements, yet they will be most likely be fulfilled on time through intensive preparation.

1. Bank of Lithuania / Notification of the fulfillment of the Bank of Lithuania's key objectives, functions, and the state of the banking system, p. 30 – 31 / http://www.lb.lt/pranesimas_teikiamas_lietuvos_respublikos_seimui. 2. Bank of Lithuania / Financial Stability Review 2009, p. 58 / http://www.lb.lt/periodicals 3. Bank of Lithuania / Financial Stability Review 2011 / Basel III liquidity requirements and standards for banks, p. 47 / http://www.lb.lt/financial_stability_review 4. Bank of Lithuania / Operations of Credit Institutions in 2009, p 4 / http://www.lb.lt/operations_of_credit_institutions_in_2009_1 5. Bank of Lithuania / Operations of Credit Institutions in 2011. p 1 http://www.lb.lt/operations_of_credit_institutions_in_2011_1 6. Bank of Lithuania / Annual Report of the Bank of Lithuania 2010 / http://www.lb.lt/annual_report 7. Basel III :Global regulatory framework for more resilient banks and banking system p.2009, p.7-13. 8. Capital Requirements Directive /2006/48 EC and 2006/49 EC eur-lex.europa.eu/ 9. Commission of the European Communities / Communication from the Commission / From financial crisis to recovery: European framework for action / Brussels, 29.10.2008, COM(2008) 706 final. 10. Vasiliauskas V., Chairman of the Board of The Bank of Lithuania / International Conference "The EU Financial Sector after the Storm" Vilnius, 08.09.2011 / "Towards responsible banking: CRD IV – No Time for Delay" / http://www.lba.lt/go.php/eng/Events/2467/2/268 11. Valvonis V. 2009: Credit Strategy to the Bank. / Applied Economics: Systematic Research, Book 3, No. 2.

Надійшла до редколегії 05.05.12