

## The Development of Universal Banking in Lithuania

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**Abstract.** The integration of Lithuania to the European Union increases openness of its economy and gives an impulse to create financial and legal system aligning with the leading European countries. The universal German banking market conditioned more universality in Lithuanian banking system. Initially securities and insurance business was partly restricted for banks in Lithuania, but restrictions are gradually diminishing.

Formation of universal banking system in Lithuania raises a question: is the choice of universal banking under conditions of complicated economical situation and the weak legal basis right? This paper analyses the main positive and negative effects of commercial banks expansion into securities and insurance market. This paper discusses how should universal banks be supervised to ensure stability and reasonable profitability of banking activities.

**Key words:** universal banking, investments, securities market, insurance market, non-traditional banking activities.

### Introduction

Universal banking is basically a European concept of one holding company umbrella under which several types of financial services providers are combined (Ioannou, 1992). The universal banking system is widespread in Western European countries. Second Banking Co-ordination Directive allows all European Union banks to engage in securities activities. There are not much opponents of universal system and disputes are made only about partial restrictions of non-traditional banking activities. The main object of disputes: did universality of the banks and pressure on their clients' effect the development of securities market negatively? German banks control firms using own and their clients voting rights and banks can make pressure on the firms preventing them from the use of securities market instruments. Purrucker (1983) finds that 95% of private shareholders do not use their rights to instruct a bank to vote on their behalf. Bank gets the right to vote upon their own will using clients voting rights. Banks control firms in such a way and can force them to take loans and refuse new securities emissions.

At present one of the most specialized banking systems exists in US. The supporters of specialized banking claim that such system provides with more financial stability and

lower opportunities for arising conflicts of interests between banks and their clients. The opponents of specialized banking system claim that limited activities of financial institutions diminish their competitive power in international financial markets and cause consumers losses because of artificially reduced competition in the national financial market.

Researches reveal (Cable, 1995) that profitability and productivity of firms grow in those countries where banks have no investment restrictions. The analysts of banks and firms relations claim that the tighter and more permanent relations are the higher is the productivity and the lower costs of supervision. By offering a larger number of services, a universal bank develops more points of contact with firms. As a result, the bank has more instruments to consider in the design of financial contracts, and more leverage over firms' managerial discretion, which reduces agency costs. Furthermore, it becomes easier to gather information and monitor the borrowing firms.

Dittus and Prowse (1995) analyses what type of financial market would be better for Central and East European (CEE) countries. They propose financial market with restricted banking activities in securities market and motivate it by the weak, non-competitive and state controlled CEE countries banking system. I think such arguments for specialized system are out of dated as situation changes rapidly in the CEE countries financial markets. Attention should be concentrated on the creation of strong and flexible supervision system that would be able to prevent abuse of power in all areas of financial system and to provide equal opportunities to all financial intermediaries. I would like to point out the following reasons that justify the expansion of universal banking system in Lithuania:

1. Lithuanian banks are restricted from the investments into shares if such investments exceed 40% of eligible bank capital (last year restrictions were lowered from 10% to 40% of eligible capital). Lithuanian banks have not enough funds to be able to gain monopolistic power to control Lithuanian joint stock companies.
2. Lithuania is planning to join the European Union as soon as possible. Local legal system should be adjusted considering the EU directives regulating investment activities. According to EU directives financial institutions (so the banks) should create securities portfolio under the strict portfolio structure / quality requirements.
3. The supervision of Lithuanian banking system is constantly improving and the last one state owned bank is under privatization process.

Recently discussions and researches about the advantages of banking activities diversification have increased. The banking activities diversification is often reviewed under the broader sense: what is the influence of non-traditional banking activities on their results and on the stability of financial system. Various methods and indices were used in those researches although no one could be thought as absolutely exact.

Methods that were used to evaluate the effectiveness of the non-traditional banking activities are as follows:

- Wall and Eisenbeis (1984) and Litan (1985) compared the generalized results from the banking activities and securities market mediation activities.

- Stover (1982) evaluated profitability of individual banks and financial institutions. Boyd and Graham (1988) modelled merges of bank holding companies and other financial companies and evaluated changes of profitability and risk.
- Kwast (1989) compared the correlation of results from the banks activities in securities market and other financial activities. The results of researches of universal European and Lithuanian banks could be very different from the results of Kwast research because of restrictions on the US commercial banks activities in securities market.
- Kwan (1998) compared results of banks and their securities subsidiaries. Kwan research has not revealed clear profitability trends. The banking subsidiaries activities were more risky comparably to banks, although the correlation was low and suggests the possible benefits of banking activities diversification.

Kraujalis (2000) compared the effectiveness of Lithuanian banks' activities in traditional and securities market. The results of his research should encourage Lithuanian banks to penetrate into securities market. The investment services are inherent activities of universal banks. The universal commercial banks cannot bear the risk to lose their client: the latter can turn to competitor to receive additional services. Banks own investments are the potential tool for better diversification of assets.

### **The Development of Non-traditional Banking Activities in Lithuania**

The number of banks and their branches increased rapidly after the restoration of Lithuania's independence in 1990 (Fig. 1, created according to the data of the Bank of Lithuania). The process of banking system formation was chaotic. The supervising institution had no relevant experience and power to adequately control banks under the new market conditions. The first edition of the Law of Commercial Banks (1992) had many shortcomings, especially concerning the audit of bank results. Until the end of 1996 commercial banks were engaged mainly in traditional activities: deposits, loans, currency exchange and payments services. The narrow specialization of commercial banks was conditioned by some factors:

- The high profitability of traditional banking activities, especially from currency exchange.
- The slow development of main securities market institutions. The National Securities Exchange of Lithuania (NSEL) began activities only at the end of 1993. The turnover of listed shares began to increase more rapidly only in 1997.
- The lack of competition from foreign banks in Lithuanian financial market. The low values of traditional concentration indices in Lithuanian banking market did not reveal the real competitive situation. The majority of banks were weak and badly capitalized, created by individual persons or firms with an aim to attract as

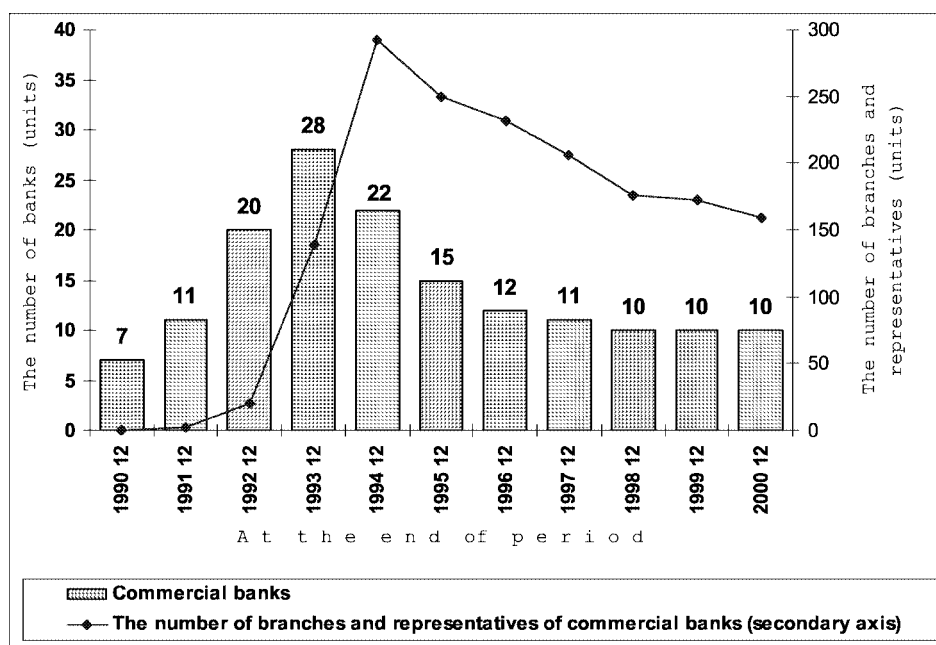


Fig. 1. The changes in the number and branches of Lithuanian commercial banks.

much funds as possible for their own business. The banks promising economically unjustified interest on deposits met with the problems and bankrupted. The rest of the banks competed more aggressively to expand their market power. At present foreign financial intermediaries have obtained large share of Lithuanian financial market.

In 1992–1994 the spread between the interest rates on deposits and loans in Lithuania was 20%–35%. Such situation stimulated banks to expand their activities in traditional market. The profitability of banking activities was highly unstable: some banks announced the profits more than twice exceeding share capital and the next year suffered the losses more than twice exceeding share capital (mainly because of the reserves for bad loans). The spread between the interest rates on deposits and loans stabilized on the 8% level since the end of 1996 (Fig. 2, calculated according to the data of the Bank of Lithuania).

Investment (privatization) vouchers were the main securities in Lithuania until the creation of NSEL. The number of investment companies accumulating vouchers from the individual holders grove rapidly. Banks were not permitted to participate actively in privatization process and to establish investment companies. The capitalization and turnover of NSEL reveals the changing situation in Lithuanian securities market (Fig. 3, created according to the data of the Bank of Lithuania). Lithuanian securities market is distinguished by the large fluctuation and growth trends. The turnover and capitalization was low at the beginning of NSEL activities. At the end of 1994 capitalization was LTL

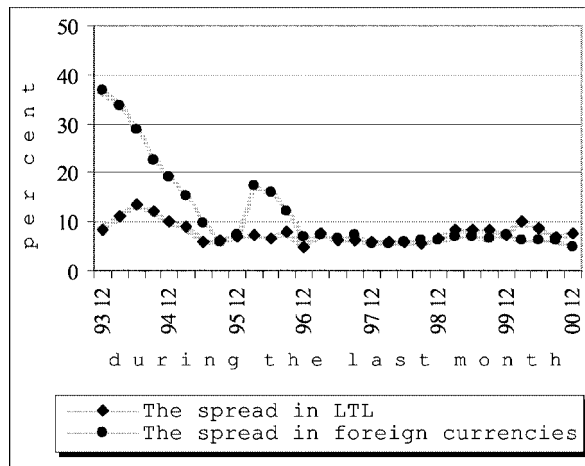


Fig. 2. The spread between the interest rates on deposits and loans in Lithuania.

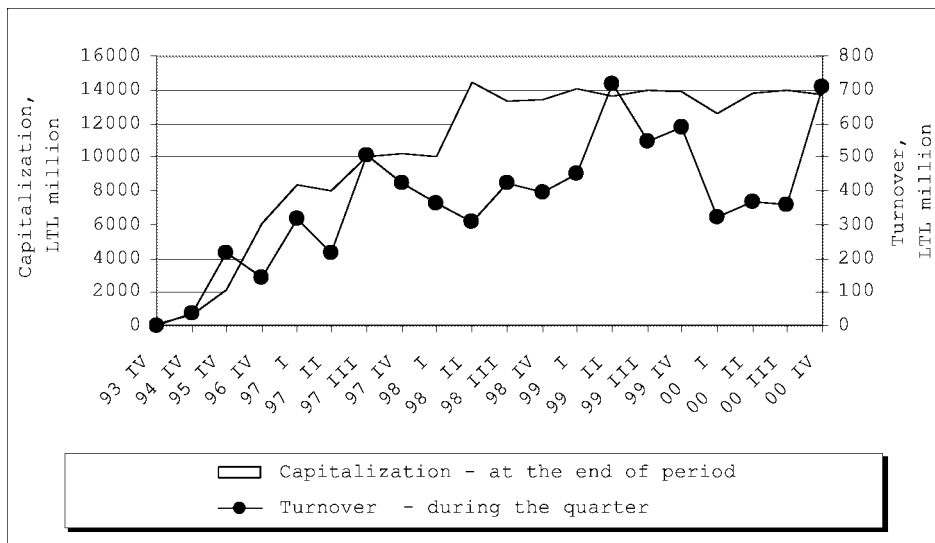


Fig. 3. The capitalization and turnover of the National Stock Exchange of Lithuania.

635 million, turnover was LTL 36.9 million. In 1995 the more rapid growth began. During 1995, capitalization increased by LTL 2636 million, turnover increased by LTL 178.2 million (583%). During 1996, turnover decreased by LTL 74.6 million, capitalization increased by LTL 3940 million (282%). As of 1997, the activity of foreign investors induced the constant growth of securities turnover and the growth of Lithuanian banks activities in securities market.

The most promising Lithuanian firms widely use securities market instruments to finance the expansion of their activities. This caused the constant growth of the NSEL

capitalization in time of 1993–2000.

The development of Lithuania's Government securities market was an important factor that induced non-traditional activities of Lithuanian banks. The first emission of Lithuania's Government securities took place in the second half of 1994 and since then commercial banks of Lithuania were the most active investors and intermediaries in Lithuania's Government securities market. Fig. 4 (based on the data of the Bank of Lithuania) reveals distribution of investors in Lithuania's Government securities market.

Investments into Lithuania's Government securities promised similar return as of loan making from the beginning of 1995 to the middle of 1996 and from the beginning of 1998 to the end of 1999 (Fig. 5, based on the data of the Bank of Lithuania). It was a paradox in Lithuania when Lithuania's Government securities interest rate exceeded the interest rate on the loans. In July 1995 Lithuania's Government securities interest rate 1.3 times exceeded average interest rate on loans, in February 1996 it exceeded almost 1.8 times.

Lithuanian banks established many subsidiaries/associated companies for the expansion of non-traditional activities. Such organizational form is suitable for commercial banks as well as for supervising authorities. The advantages of the activities through the individual companies are as follows:

- The possibility to attract supplementary capital from the local and foreign partners.
- It makes easier to evaluate the results of non-traditional activities.
- Such organizational form is more acceptable for clients as it leaves fewer opportunities to arise the conflicts of interests. The bank has close relations with its subsidiary/associated company but it is supposed that individual company has less informational relations with the bank in comparison to bank subdivision.

Securities Brokerage Companies (SBC) or Departments (SBD) serves securities trading in Lithuania. All Lithuanian banks provide their clients with at least minimal ser-

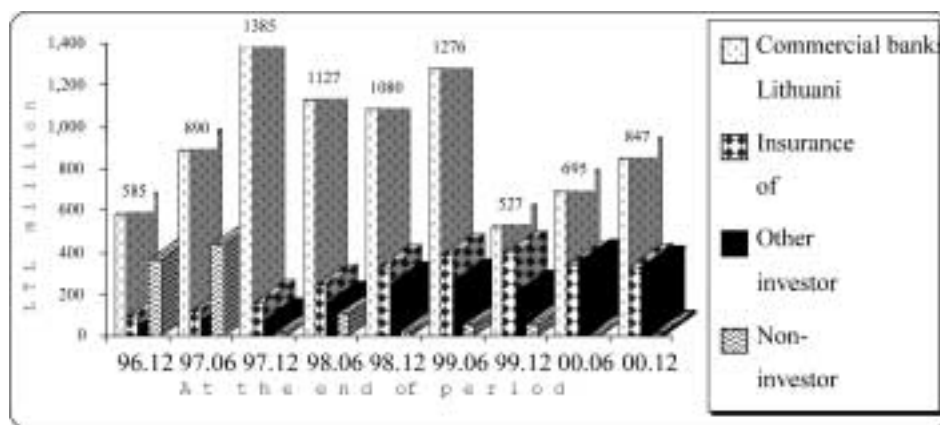


Fig. 4. Investors in Lithuania's Government securities.

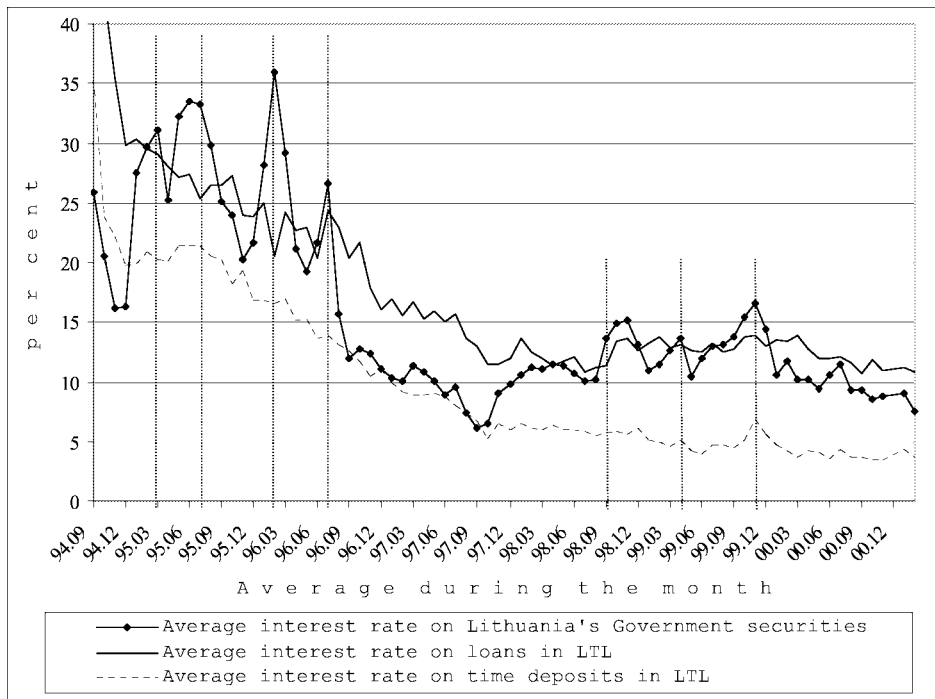


Fig. 5. The comparison of the average interest rate on deposits and loans in Lithuania with the interest rate on Lithuania's Government securities (the vertical dotted line indicates the periods when average interest rate on Government securities was higher than the interest rate on loans).

vices in securities market. Such services are usually provided through banks' subdivisions – SBD. Banks have widely used subsidiaries for expansion of their own investment activities, provision of consulting services in securities market and organization of new share and bond emissions for their clients. Investments of Lithuanian banks in investment/insurance subsidiaries and associated companies are calculated and presented in Fig. 6 (according to the data provided in annual reports of Lithuanian commercial banks). Lithuanian banks became the leaders serving clients in securities market. The non-banking institutions have been controlling the insurance market until now. The strong positions of "Lietuvos draudimas" in insurance market and the slower entrance of Lithuanian banks in insurance market cause it.

Investments of Lithuanian banks in subsidiaries/associated companies providing non-traditional services began to grow from 1997. This is not a casual process as it coincides with the growing activity of foreign investors and financial intermediaries in Lithuania's market and the increase of financial market stability. Investments of Lithuanian banks in subsidiaries/associated companies acting in securities market have been constantly growing. Lithuanian banks' activity in insurance market diminished in the period of 1998–1999. Vilnius and "Hermis" banks investment in Lithuanian Export Import Insurance Company and their withdrawal in 1998 cause this. The subsidiary "Hermio Draudimas" began its independent activities after the merge of Vilnius and "Hermis" banks in 1999.

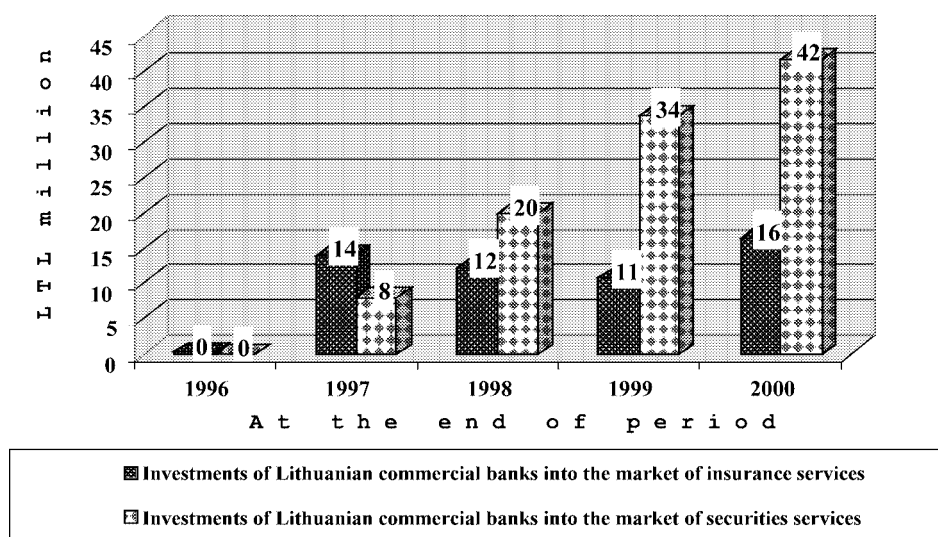


Fig. 6. Investments of Lithuanian banks into subsidiaries/associated companies providing services in insurance and securities market.

Activities in securities market are related to the services for the clients and the use of assets. Insurance payments that banks receive in insurance market are related to the liabilities and off balance items. Specific risk exists in securities as well in insurance market and the bank employees should acquire relevant qualifications and professional experience. The expansion of non-traditional activities is inevitably related to additional costs to enter the market. The banking subsidiaries providing services in securities and insurance market should compete with the companies that entered the market earlier. New companies providing non-traditional banking services may suffer the losses during the first years of activities. The expansion of non-traditional banking activities is the investment of the banks in their future prosperity. Non-traditional banking activities helps to improve bank services and to retain strong and competitive positions in financial market.

## Conclusions

As worldwide banking experience suggest, universal banking has good development prospects, increases economical welfare and contributes to expansion of the financial market. The universal banking system is appropriate for the developing countries, however the developing countries should adequately prepare for the liberalization of financial market and implement the modern measures of banking supervision.

I have evaluated the development and peculiarities of Lithuanian financial market. I would forecast further expansion of Lithuanian banks in non-traditional markets. Until now, the increase of Lithuanian banks investments into subsidiaries/associated companies providing non-traditional services has been more related to the establishment of new companies. Further expansion should be based on the increase of the share capital of



earlier established companies. Lithuania's pension system should be reformed and individuals/firms should be stimulated to invest more funds in Lithuanian capital market. Lithuanian banks were the first financial institutions to begin penetration to this market and they have good prospects to fortify their positions and to compete with the foreign financial intermediaries. Lithuanian banks should further expand the life insurance market as the life insurance services are more closely related to the traditional banking. On the other hand, the whole package of insurance services ensures complexity of financial mediation, therefore the non-life insurance services could also be provided by commercial banks.

Universal Lithuanian banks provide high-quality services and they can successfully compete with foreign financial intermediaries in non-traditional market. I am of the opinion that Lithuanian banks will maintain their competitive power and good profitability results after Lithuania's integration into the European Union.

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## **Universalios Lietuvos bankų sistemos kūrimas**

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Lietuvos integracija į Europos Sąjungą skatina ekonominių sprendimų politizavimą bei finansų ir teisinės sistemos kūrimą pirmaujančių Europos šalių pavyzdžiu. Vokietijos pavyzdys sąlygojo Lietuvos bankų sistemos universalumą. Lietuvai atgavus nepriklausomybę bankų veikla vertybinių popierių ir draudimo rinkose buvo iš dalies ribojama, tačiau pastaruoju metu šie apribojimai mažinami. Universalios bankų sistemos kūrimas Lietuvoje iškėlė klausimą, ar, esant sudėtingai ekonominei situacijai ir silpnam teisiniam pagrindui, toks pasirinkimas yra teisingas. Šiame straipsnyje siekiama išsamiai įvertinti teigiamas ir neigiamas bankų veiklos vertybinių popierių ir draudimo rinkoje ypatybes. Taip pat straipsnyje diskutuojama kokių papildomų priežiūros priemonių gali tekti imtis ir kokios įprastinės reguliavimo priemonės padeda užtikrinti bankų sistemos stabilumą ir veiklos rezultatyvumą.