Building a healthy financial sector

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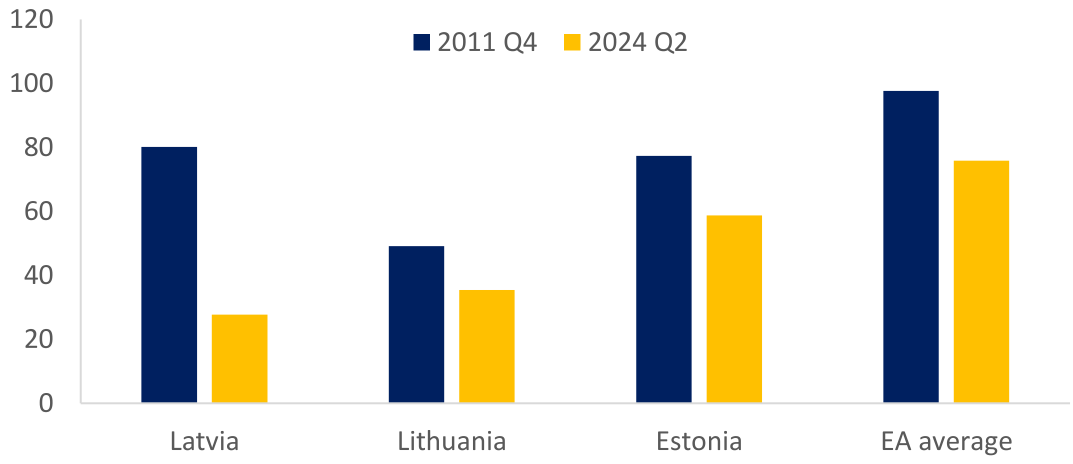
Smooth access to finance is an integral part of a healthy economy. It channels savings to fund investment and drive economic growth. A modern financial system consists of various intimately intertwined elements, each playing a crucial role. From venture capital that fuels innovation and growth in new businesses, to banks that help established businesses grow and become more resilient, to capital markets that are crucial for businesses to scale up and reach new heights. The financial sector is like maintaining a balanced diet and exercise routine: each has its own role, but only a combination of the two leads to the best results.

The financial systems of Latvia, Lithuania, and many other Central and Eastern European economies, after an initial and often overly optimistic outburst of financial deepening during the early 2000s, have not managed to find a solid path towards this balanced routine, particularly in the aftermath of the global financial crisis (GFC). Our financial markets are small, and underdeveloped. The role of venture capital and capital markets is often marginal. Financial systems are dominated by banks, making the general health of the economy heavily reliant on developments in bank lending.

In Latvia, after a significant credit boom-bust cycle, worsened by the ensuing GFC, bank lending to households and non-financial corporations is now a third of what it was in 2011 – down from nearly 80% of gross domestic product (GDP) to just 28% in the second quarter of 2024. The deleveraging process has run too deep, and for too long, despite broad institutional improvements (e.g., improved insolvency regimes, efficient credit registers, euro area membership) and increasingly stronger balance sheets of households and corporates. While deleveraging has been less dramatic in Lithuania, the current situation is only marginally better (see chart 1).

In recent years, there have been some notable improvements and deleveraging has stopped; however, lending activity remains timid and the bank loans-to-GDP ratio in these two Baltic economies remains less than half the euro area average.

Chart 1. Outstanding bank loans to non-financial corporations and households (% of GDP)



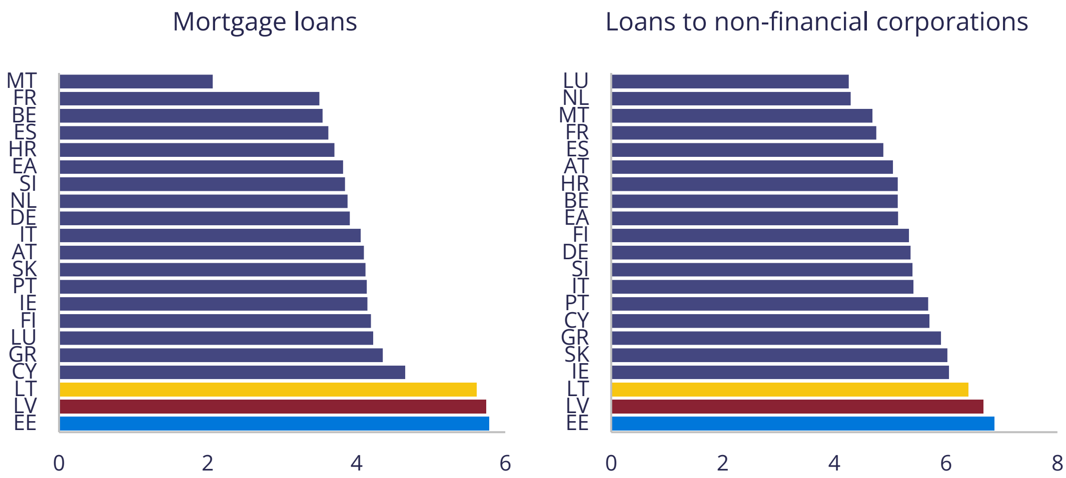
Source: ECB, EUROSTAT

It is clear that post-GFC, the Baltic banking sector has become exceedingly risk-averse. It is well capitalized. It is efficient. It is profitable. In other words, it is prudent. This cautious approach has undoubtedly made the whole financial system safer. While being important, does it lead to results where the current circumstances are healthy in all respects? The answer is an unequivocal 'no'. Banking cannot be riskless. Effective banking is about finding a balance between taking risks and managing the price of risks properly. This requires a willingness to weigh the risks against the opportunity to meet the needs of the economy. This dynamism is essential for driving economic growth, while ensuring that the financial sector can truly serve the broader economy.

The reasons for this cautious mindset and excessive deleveraging are numerous. Households and companies have been scarred by the GFC and our economies have been hit by a series of global shocks such as Covid 19, Russia's invasion of Ukraine, and a sharp rise in global inflation and interest rates. However, several tell-tale signs point to issues on the supply side. Business surveys indicate that a larger share of companies in Latvia and Lithuania are dissatisfied with the availability of loans compared to most other EU economies, with the main sources of dissatisfaction being stringent collateral requirements, and a high cost of borrowing.

Data supports this view. Collateral requirements are demanding, with it being common for a business loan to have a collateral valued at more than 150% (and in nearly half of the cases even more than 200%) of the value of the loan. Additionally, lending rates in the Baltic countries (see chart 2) have consistently remained among the highest in the euro area across all lending segments despite the share of non-performing loans converging to one of the lowest levels in the euro area. Moreover, bank services and pricing models are often simplistic and overly rigid. For instance, more than 90% of loans issued have floating rates, while fixed-rate longer-term loans are expensive and rare to come by. This implies that with recent monetary policy tightening lending rates for outstanding loans and new lending having shot up sharply, and the borrowers are more exposed to higher interest rates than in most other euro area economies. In contrast, ample liquidity has left competition for deposits low, creating a large net interest income windfall for banks.

Chart 2. Interest rates on new mortgage loans and new loans to non-financial corporations in euro area countries (%, average for the first half of 2024)



Source: ECB

All this is, of course, just an outcome of the structural issues which the Latvian and Lithuanian financial sectors face. Post-GFC, our banking sectors have become more concentrated, and competition has weakened. The unfortunate interplay of all these factors have resulted in bad equilibrium. Yet, the silver lining is that succeeding to push the system out of this subpar equilibrium may unlock considerable potential to fund economic growth and improve society's living standards and wellbeing.

This is exactly why over recent years, Latvijas Banka and Lietuvos Bankas have focused their activities on improving access to financial services. Much has been done to identify problem areas, improve information transparency, foster competition, and improve financial literacy. Through various measures, bank loan mark-ups for mortgage loans in Latvia have decreased from an average of 2.4% in 2020 to 1.6% in 2024. Mark-ups have also gone down in Lithuania. Moreover, recent easing of the mortgage refinancing process in Latvia should encourage customers to be regularly shopping around, while ensuring that banks and other lenders are also always on the lookout for how to attract more customers, leading to a more competitive lending market. In Lithuania, similar changes are being considered by Parliament.

New market players are attracted to the market gaps and high profitability. Latvia has seen growth in the small bank segment and the entry of a newly established local bank into the market. In Lithuania, several new players entered the banking sector in recent years, but the impact on lending is yet to be seen. Similarly, several foreign banks have shown interest in setting up a foothold in Lithuania to service the entire Baltic market, while EIB and Nordic Investment Bank already have a foothold in the Baltics and are seeking to expand their activities. This evolving landscape is not limited to traditional banks. Lithuania, for example, has built up a thriving fintech ecosystem. A recent decision by the ECB's Governing Council to grant non-banks access to central bank payment systems is expected to further support the deepening of the financial services sector.

Much has been done, but there is more to do. Our aim is to create an environment that fosters a healthy financial sector which is safe (i.e., well-capitalized, profitable, sound financial literacy), accessible (i.e., services are reasonably priced, with adequate regional coverage), modern (i.e., state-of-the-art services, a diverse market ecosystem), and internationally competitive (i.e., innovative, attracts foreign companies, generates export revenue). Just as it takes time to build a healthy and resilient body through a balanced diet and exercise, it will take time to develop a healthy and competitive financial system. The benefits from such a transformation are immense. Join us at Latvijas Banka and SUERF Economic Conference 2024 "Financing a Better Future" and let us expound on how to build a healthy financial sector!