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# Lithuania economy briefing:
# FinTech sector brings rewards and risks to Lithuania

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## FinTech sector brings rewards and risks to Lithuania

The COVID-19 pandemic has accelerated the move from cash-based transactions to digital and contactless payment methods. In turn, this opened for exploitation of new sources of revenue through e-retail and other services delivered by clicking online. The easiness and the speed of financial transactions have become a comparative advantage for the national economies vying for faster returns on capital under the quarantine. Those countries that opened up their markets for the alternative financial service providers that introduced innovative solutions to deliver the electronic transactions outside traditional banking institutions benefited from the rising demand in digital payments due to the pandemic. Lithuania has been at the forefront of the countries where financial technologies has become the talk of the day and even the subject of national pride.

The upbeat mood about the worry-free possibilities of the FinTech sector growth in the country changed on 17th May, when a financial fraud story broke out, involving a significant funnelling of funds from one FinTech company via another one licenced by the Bank of Lithuania. Last June, the Financial Times reported that Wirecard, the German financial payment company, was declared insolvent after the company announced that 1,9 billion in cash was missing from its balance sheets. In the run-up to the insolvency, the prosecutors established that an alleged culprit transferred over 100 million euros through a FinTech company in Vilnius. The case has put Lithuania's regulator under scrutiny and the questions have been raised managing the risks.

Below is a brief outline of the main aspects of the development of the FinTech sector, considering the main drivers which facilitated the emergence of this service sector and its current growth. It looks at the strategy adopted by the financial regulator to balance the risks involved and assess the benefits that the country can reap from becoming one of the most open jurisdictions among the Eurozone countries for licensing the FinTech companies to operate across the EU from Lithuania.

Two major factors contributed to the emergence of the FinTech sector in Lithuania a decade ago. First, the oligopoly of the banking sector; from 2005 to 2012, three major banks (all being fully controlled subsidiaries of the Nordic banks) owned about 68 per cent of assets, loans, and deposits. Secondly, the 2008-2009 global financial crisis; according to the estimates in 2012, the crisis thrust the country's economy backwards for 5-6 years on average. Over just a year, Lithuania lost about 15 per cent of its gross domestic product (GDP). To recover the economy required to find a new way of attracting working capital to the enterprises and spurring domestic consumption through credit and financial incentives. The major banks had suffered major losses in their domestic markets during the global financial crisis and were reluctant to provide riskier forms of capital.

The alternative solutions, offered by the financial technology companies, often staffed by the personnel made redundant from the IT department of the major banks, filled the niche by becoming the market makers. The first FinTech initiatives came from the major banks which contributed to the development of the startup ecosystem as part of nurturing the potential business customers and testing consumer behaviours. A breakthrough though came in October 2016, when the Bank of signed a memorandum of understanding with Revolut Limited, a London-based financial services and payments company. Revolut entered Lithuania and started offering global services - e-transfers, currency exchange, card payments and cash withdrawals – using the Bank of Lithuania's managed payment system, creating an important point of reference for Lithuania.

On 13 December 2018, the Bank of Lithuania issued an electronic money institution license to the Lithuanian subsidiary of Revolut Limited to allow serving its customers across the European Economic Area after Brexit. At the same time, the European Central Bank issued a specialized bank license to Revolut Bank to be established and function from Lithuania.

The introduction of a specialised bank concept has become the key to boosting the growth of the alternative banking sector in Lithuania. The specialised bank concept was introduced in Lithuania at the beginning of 2017 to ease the consolidation of the local banking market. It was aimed primarily to support the reform of the national credit unions (the first specialized banking license was indeed issued to a local credit union). Yet where it really took off was in the FinTech sector.

A specialised banking license provides several benefits that are especially well-suited for the providers of electronic payment services. Firstly, a minimum capital requirement is lowered from 5 million euros, which is applicable to the standard banking licence, to 1 million euros. Secondly, a specialised bank can receive deposits, lend funds, transfer funds and provide other standard banking services, except providing investment. Thirdly, a specialised bank licence is valid across the European Economic Area (EEA), thus enabling access to the EEA financial services market. Fourthly, the minimum number of staff when applying for a licence can be as few as 9 – 10 individuals, thus allowing the entity to decrease the personnel costs and, or operate from different jurisdictions. Fifthly, all deposits for any one individual up to EUR 100,000 are insured under the deposit insurance scheme. Hence, the licensees can provide guarantees to the account holders risk-free on the same level as any other standard bank. It is important to note that all other type of FinTech operators, including electronic money institutions, payment institutions, crowdsourcing and crowdfunding, are not covered by the deposit insurance scheme.

The advantages of the specialized banking license include diversifying financing sources and reducing costs. The license allows accepting the deposits from retail deposit markets, including non-bank financial institutions are often financed by their shareholders or via non-retail focused capital market instruments. A brief introduction from an established legal advisory firm explains that “a specialised bank licence can serve as an attractive tool for the organic development of a payment or electronic money institution’s business activity if it seeks to extend the scale of its activity to lending services”.

Apart from the specialized banking licensees, most of the FinTech sector is comprised of the electronic money institutions and payment institutions. An electronic money institution is a market participant licensed by the Bank of Lithuania, which has the right to issue electronic money. Electronic money is pre-paid monetary value issued into circulation by an electronic money institution, held on electronic devices, which can be used for payment purposes. An electronic money institution may also perform money remittances, payment transactions, provide cash deposits and withdrawal services, perform direct debit or credit transfers. Google Payment Lithuania, a local subsidiary of one of the major international companies, which entered the online payments market in 2015 as a digital wallet platform and online payment system to pay for Google products and in-store purchases, received an e-money institution licence in Lithuania in December 2018.

By the end of 2020, the Bank of Lithuania supervised 132 FinTech companies, including 80 electronic money institutions (including six telecommunication companies with restricted e-money licenses) and 52 payment institutions. Though the sector has almost tripled during 2016-2020, its annual turnover on aggregate remains relatively modest. The total income from the e-money issuance and payment services in 2020 amounted to 114,4 million euros (these publicly available figures are unaudited). It is only slightly more than the sum that, as reported, had been siphoned off Wirecard via one of the FinTech companies in Lithuania.

The Bank of Lithuania has imposed very strict requirements for obtaining the licenses for new entrants into the e-money institution and payment institution market. The strategy announced last year by the central bank calls for prioritizing the quality over the quantity. In October 2020, the government approved the establishment of the Centre of Excellence for Anti-Money Laundering in Lithuania, a unique private-public partnership initiative to “mobilise public and private efforts in combating money laundering and terrorist financing”. However, the initiative requires a serious involvement of the law enforcement agencies, which, as reported, lack resources to roll out more comprehensive controls of the FinTech market participants. Only few fines have been issued and two licenses removed from the total of 132 licensees, which continue being inspected ad hoc by the central bank. Thus, the political consensus has been reached in the parliament to strengthen the policing of the sector to decrease the risks by enforcing the regulations more pro-actively.

The hearings have been held in the parliament concerning the overall situation with the regulatory oversight. The concerns have been raised that the national economy is not getting enough economic benefits from the growing sector and, thus, there is a need to assess the added value created by the sector to the consumer markets at home. So far, the publicly released financial data about the e-money and payment license holders show that their operations are sub-optimal in terms of the efficiency of working capital in this particular sector. The data available for 2018 show that the operating margin ratio (operating income / net sales) of the e-money license holders was only about 12,8 per cent. This ratio is twice lower if compared, for example, with the average net margin operating ratio of the US financial sector (about 22-25 per cent). It shows that despite the hype the FinTech sector has not been operating very efficiently, hence, the revenue received by the state through taxes is only 10 million euros, as reported by the central bank. Hence, the politicians are calling for a more rigorous reassessment of the value created by the sector in order to identify and support the growth of those which have the best potential for higher added value creation for the national economy.

The Bank of Lithuania has dismissed the accusations made in the international business media that somehow the regulatory oversight was not stringent enough to detect and preclude a fraudulent case. The central bank representatives emphasized the rigorous licensing process and overseeing licensees' activities, pointing to more than 100 applications rejected in 2020 and 18 permits revoked in the past three years. On 26 May, the Bank of Lithuania presented to the Parliament’s Committee on Budget and Finance the measures taken by the central bank in 2020 to ensure regulatory oversight, which consists of screening the origin of capital and its nature. The central bank reported that the main electronic money flows incoming from abroad originate from the People’s Republic of China, including Hong Kong, Singapore and, to a lesser extent, from the UK, Israel and the US. The main payment corridors, according to the amounts of payments made, are Germany (15 per cent), UK (11 per cent), Poland (5 per cent), Romania (5 per cent), France (5 per cent). It shows that the FinTech industry is not a stand-alone sector but an addition to the global supply chains. Hence, to adequately, timely address the risks, a cooperation is needed with the countries of origin of incoming capital.

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