



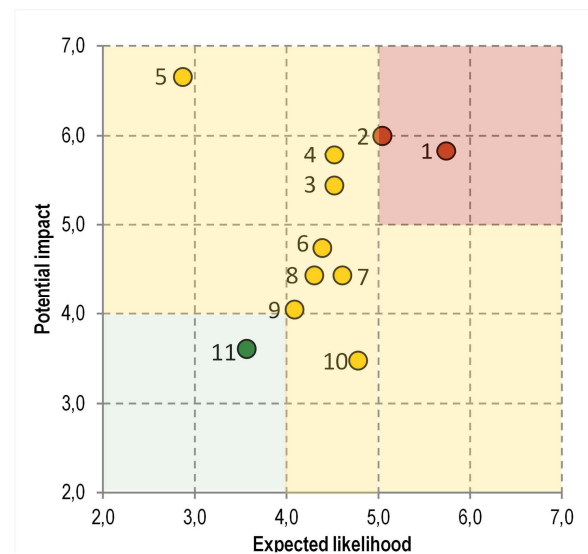
## Risk Survey, 2<sup>nd</sup> half of 2011

Seeking to assess the view of Lithuania's financial institutions to the stability of the domestic financial system and possible challenges to its sustainable development in the future, the Bank of Lithuania conducted in October 2011 the second Risk Survey. Banks, insurance companies and other financial market institutions assessed sources of the main risks to Lithuania's financial system, the expected likelihood and their potential impact on the national financial system in the coming 12 months<sup>1</sup>.

### SURVEY RESULTS – SUMMARY

The Risk Survey, 2<sup>nd</sup> half of 2011 revealed that according to the assessment of financial market participants, the national financial system is assessed as stable. The strongest concern to Lithuania's financial institutions is raised by increasing imbalances of public finances and problems of the financial sector of other European countries. Two thirds of the respondents indicated that a probability of the occurrence in the nearest future of a high impact event in Lithuania's financial system increased in the previous half year. According to the assessment of financial institutions, unfavourable trends of the development of foreign economies may determine a slower recovery rate of Lithuania's economy as well. Funding issues of the financial institutions are managed successfully: deposit market has remained stable, while a small interbank market generates insignificant interlinks among banks for a possible contagion. The impact of problems confronted by AB Bank SNORAS on the financial market was insignificant and short-term – within November 2011, the volume of deposits (excluding AB Bank SNORAS) even increased by 0.3 per cent. The most important risks at the present time are macroeconomic, credit and market risks. Participants of the financial market state that lessons from mistakes made in 2006-2008 were learnt and before making decisions risks are assessed in a more cautious way. Markets are circumspect; the share of respondents expecting a decrease of their risk appetite has increased.

Chart 1. Lithuania's Financial System Risk Map



		Expected likelihood	Potential impact	Ability to mitigate the risk
<b>Systemic risks</b>				
1	Increasing public finance imbalances and financial sector problems of other European countries and a possible contagion effect on Lithuania's economy	5,7	5,8	6,9
2	Slow recovery of Lithuania's economy or economic downturn	5,0	6,0	5,8
3	Bank funding vulnerabilities in Lithuania and risks related to the volatility of funding costs	4,5	5,8	5,3
4	Increasing credit risk of corporates	4,5	5,4	5,4
5	Incapability of a systemically important financial institution to operate further (insolvency)	2,9	6,7	4,8
6	Increasing credit risk of households	4,4	4,7	5,4
7	Increasing inflation	4,6	4,4	5,8
8	Tensions related to international capital flows, asset growth in emerging countries and the risks associated with re-emergence of global imbalances	4,3	4,4	6,7
9	Declining real estate prices	4,1	4,0	5,6
10	The low level of interest rates	4,8	3,5	5,3
11	Government borrowing in Lithuania crowding out the lending to the private sector	3,6	3,6	3,7

Source: Risk Survey, 2nd half of 2011.

**Expected likelihood:** 1 – insignificant; 2 – very low; 3 – low; 4 – below medium; 5 – above medium; 6 – high; 7 – very high; 8 – certain.

**Potential impact:** 1 – insignificant; 2 – very low; 3 – low; 4 – below medium; 5 – above medium; 6 – high; 7 – very high; 8 – extremely high.

**Ability to mitigate the risk:** 1 – non problematic; 2 – very easy to mitigate; 3 – easy to mitigate; 4 – rather easy to mitigate; 5 – slightly difficult to mitigate; 6 – difficult to mitigate; 7 – very difficult to mitigate; 8 – cannot be mitigated.

<sup>1</sup> Note: Risk Survey reveals the situation in Lithuania's financial market until the limitation of the activities of AB Bank SNORAS on 16 November 2011.



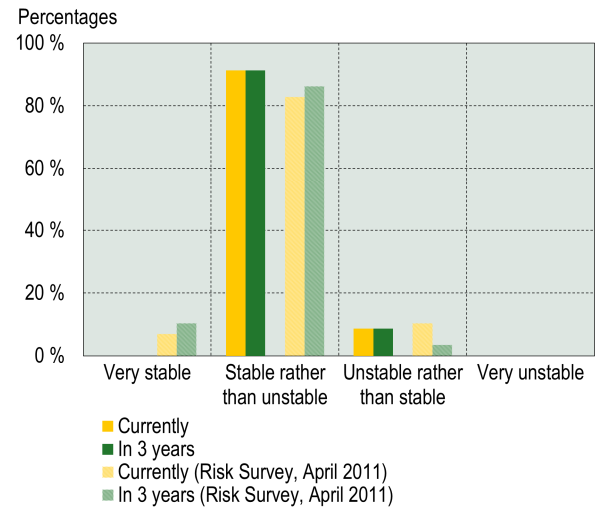
**According to the assessment of national financial institutions, Lithuania's financial system is stable.**

Based on the assessment of 65 per cent of the respondents, a probability of the occurrence in the nearest future of an event with a high impact in Lithuania's financial system increased in the course of the previous 6 months (to October 2011). To compare, 38 per cent of the respondents of the Risk Survey, April 2011 indicated that the probability of possible risks within a half-year period had been reducing.

According to the data of the Risk Survey, 2<sup>nd</sup> half of 2011, more than a half (57 %) of financial institutions are of the opinion that **in the nearest year the probability of high impact event on the stability of Lithuania's financial system is very small or small.** To compare with the survey of the previous half-year, the number of institutions perceiving a very small probability of the occurrence of an important event reduced in the second half of 2011 and the share of those distinguishing a medium- size probability expanded markedly. When asked to assess the probability of high-impact event in the country within the coming 3 years, the majority of respondents, similar to the previous survey, also chose a medium size probability of high-impact events.

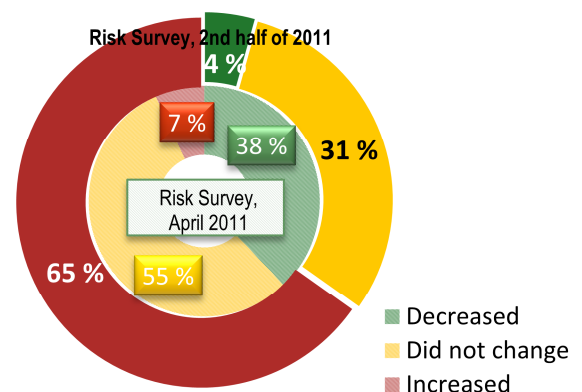
**The highest risk to the financial system participants operating in Lithuania is generated by public finance imbalances of other European countries.** As the surveyed financial institutions indicated, the highest threat to the development of the national economy is raised by increasing public finance imbalances and problems in the financial sector of other European countries, while possibilities to mitigate this risk are immensely complicated. Lithuania's financial institutions' direct losses incurred by a possible impairment of debt securities of certain European countries are insignificant. However, a pronounced threat is raised by deteriorating consumer expectations and a slower growth of foreign economies. Such a situation aggravates the financial position of Lithuania's enterprises oriented to both, domestic consumption and exports. Based on the

*Chart 2. Stability of Lithuania's financial system*



Source: Risk Survey, 2nd half of 2011.

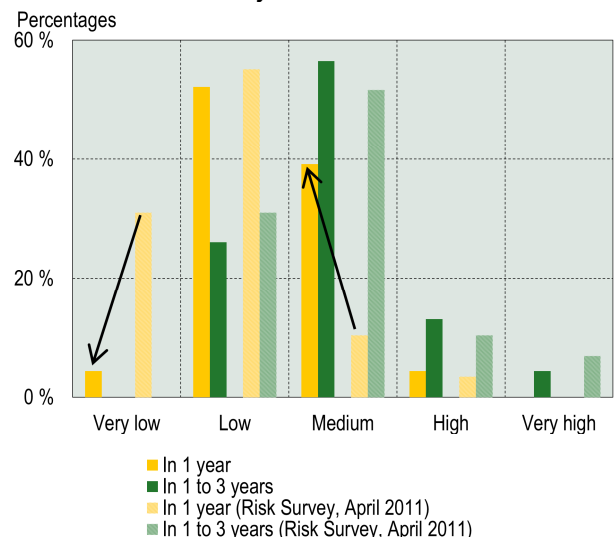
*Chart 3. Change of the probability of the occurrence of a high-impact event in Lithuania's financial system in the nearest future*



How did the probability **within previous 6 months** of the occurrence of a high-impact event in the Lithuania's financial system in the nearest future change?

Source: Risk Survey, 2nd half of 2011.

*Chart 4. Probability of a high-impact event in the Lithuania's financial system*



Source: Risk Survey, 2nd half of 2011.



assessment of financial institutions, the probability of a **slow recovery of Lithuania's economy** is larger than the medium one, and in spite of the complexity of taking appropriate measures, they are feasible to be taken.

**Funding of financial institutions remains to be stable.**

Respondents' assessment suggests that the probability of difficulties of financial institutions' funding within the nearest year is medium, and it is possible to take preventative measures though it is complicated. 80 per cent of banks operating in Lithuania belong to the foreign countries' large, soundly operating bank groups which also have few direct links with the countries suffering from the public debt crisis and the ones that have retained trust of international investors. The Bank of Lithuania data suggest that more than a half of the liabilities of banks in Lithuania are composed of deposits of residents and private enterprises and one third of funds has been obtained from parent banks. The amount of deposits in the financial system continues to be stable, and a small share of debts in Lithuania's inter-bank market determines insignificant interlinks among banks, therefore, makes no material threat to funding disruptions of the financial market participants.

**The financial markets' reaction to problems caused by AB Bank SNORAS was moderate.** A successful independent behaviour of banks in settling challenges raised by short-term market fluctuations and a moderate market reaction to the problems caused by AB Bank SNORAS proved that this problem was the problem of just one individual bank and its improper management and it was settled in no waste. Even before the suspension of the activities of AB Bank SNORAS, financial institutions were of the opinion that insolvency of one financial institution was a low probability event that might have a large impact on the financial system. However, feasibilities to mitigate this risk were assessed favourably. The experience of other countries gained in dealing with bank problems (cases of the Latvian *Parex banka*, French and Belgian *Dexia*, USA *MF Global* market group and other cases) demonstrated that given



proper and timely effective measures to retain and strengthen soundness of the banking system, the impact on the banking system would be short-term and not pronounced. This was also proved by the AB Bank SNORAS case – **the total amount of deposits (excluding AB Bank SNORAS) in November 2011 even increased by 0.3 per cent<sup>2</sup>.**

Recently **credit risk** of enterprises has been improving and is assessed as lower than medium. Credit risk of households reduced as well. Lower than the medium risk is caused by a possible real estate price drop scenario.

A high **inflationary threat** persisting in the first half of 2011 because of an anticipated slower than earlier projected development of international economy weakened.

Tensions related to international capital flows, asset growth in emerging countries and the risks associated with re-emergence of global imbalances is not pressing because of relatively small investments into the country and sound financing from parent banks. Possible imbalances will be also reduced by the Regulations on responsible lending that became valid from 1 November 2011. They will allow the Bank of Lithuania to perform a more active prevention of economic “bubbles” and manage an imbalanced growth of the economy better.

Risk and a possible negative impact of **long-term low interest rates** in financial markets in Lithuania, opposite to other European countries, is low. Insurance companies investing a large share of their assets to safe, long-term securities also do not treat low interest rates as a threat.

#### **Other external and internal risk sources**

When asked to indicate and assess more possible risk sources, the banks and insurance companies mentioned most frequently solvency difficulties of the European Union member states (65% of respondents) and perceived a public debt increase possibility. 40 per cent of the respondents were concerned about labour market

<sup>2</sup> The Bank of Lithuania took a decision to limit AB Bank SNORAS activities on 16 November 2011.



problems (structural imbalances and persisting emigration), 30 per cent of the representatives of the surveyed institutions mentioned various possible risks in the financial sector – information system malfunctions, possible intensification of electronic attacks against customers of electronic banking systems, debt refinancing risk. A significant concern is also raised by a political environment and possible decisions not in line with best economic practices: the issue of the continuation of the public finance consolidation, short-term benefit aiming (populistic) decisions when approving the country's budget, etc. The surveyed respondents also indicated problems of possible export growth decline and a large share of unaccounted economy.

#### **Market participants' assessments regarding expected risk likelihood**

The highest accord among market participants is reached in the assessment of enterprise and household credit risk likelihood – it is below medium. The largest difference is observed in the assessment of the probabilities generated by imbalances of international capital flows and possible public borrowing in Lithuania – insurance companies perceive a lower risk likelihood raised by public borrowing in the domestic market and by foreign capital flows compared to the probability perceived by banks.

#### **Market participants' assessments regarding potential impact of risks**

The surveyed financial institutions agree on a possible strong impact of a slower recovery of the national economy. Their perception differs most of all in assessing a possible impact of public borrowing in the domestic market. The banks see a somewhat stronger impact of a possible public borrowing in the domestic market on the national economy compared to other respondents.

#### **Market participants' assessments regarding possibilities of mitigating risks**

According to the respondents, it is very complicated to reduce the impact of problems born by other European



countries and of international capital flows, it is also not easy to accelerate the recovery of Lithuania's economy, to influence inflation or hedge against risk raised by real estate price changes. According to the surveyed institutions, the risk generated by public borrowing in the domestic market is settled in the most easiest way as it depends on decisions taken by market participants.

### PERSPECTIVES ON MAJOR RISK CATEGORIES

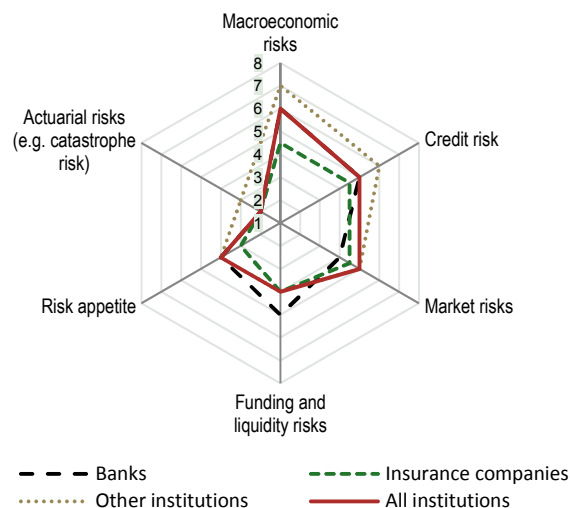
In this part of the questionnaire financial institutions assess the size of Lithuania's macroeconomic, credit, market, funding, liquidity and actuarial (insurance) risks (risk probability and a possible negative impact). The risks and conditions mentioned below are, by definition, always present in financial systems. Their severity, however, changes throughout time. To ensure the comparability of historical data, this part of questionnaire will not change and allow in the future to easily monitor the change of current risks.

According to the assessment of financial institutions, the main risk in Lithuania is **macroeconomic risks** (the assessment median – the score of 6 out of 8, i.e., high risk). This risk is more accented by bank representatives, while according to insurance companies this kind of risk is medium (median – the score of 4.5). The largest concern is caused by a slower growth of economies of the main Lithuania's export partners and problems provoked by some EU countries' public finance imbalances that may increase prices of borrowing in international markets for the Lithuanian institutions as well.

**Credit risk** is in the second place (median is the score of 5, i.e., medium risk). This risk is assessed by both, banks and insurance companies in a similar way. A larger credit risk means above medium business risk, while uncertainty still exists in relation to the pace of Lithuania's economic recovery, the loan portfolio quality deteriorated during the crisis, and the accumulation of overdue loans.

Differences in opinion become evident also in the assessment of **market** and **funding and liquidity risks** in the country. Banks are more moderate in the assessment of market risk, however they think that

Chart 5. Severity of major risks to Lithuania's financial system



Source: Risk Survey, 2nd half of 2011.

Risk: 1 – insignificant; 2 – very low; 3 – low; 4 – below medium; 5 – above medium; 6 – high; 7 – very high; 8 – extremely high.



funding risk in markets is currently above medium. Insurance companies pay attention to the fact that in the recurrence of tension observed in international financial markets in 2008, some financial institutions may be in a need of additional capital. However, the largest financial institutions of Lithuania belong to Scandinavian countries' financial groups which are substantially capitalised and, if appropriate, may provide assistance in liquidity or strengthen the capital.

The likelihood of other **possible high-impact** events is very low.

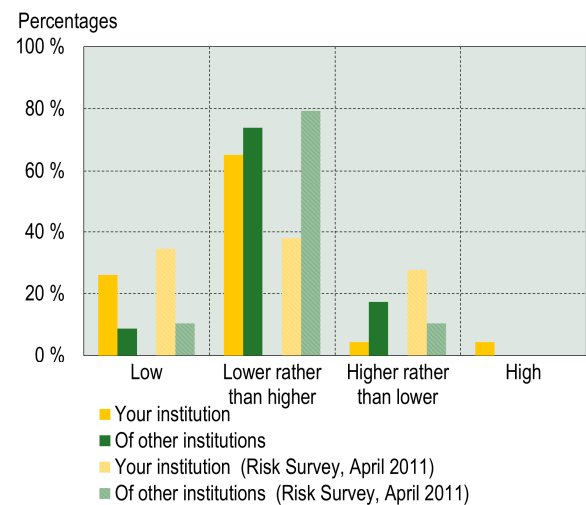
**ASSESSMENT OF RISK APPETITE**

When asked to assess their own risk appetite (intention to seek more profitable, but less certain projects) and that of other financial institutions in Lithuania, **respondents evaluated the risk appetite of their institution similarly to that of other financial institutions.** It has been observed that participants of the financial system are risk-averse. To compare with the survey conducted in the first half of 2011, the share of those thinking that **risk appetite currently being lower rather than higher will reduce in the coming six months.**

The respondents also pay attention to the trend in the market of a higher risk appetite of some financial institutions. They also state that lessons from mistakes made in 2006 – 2008 were learnt and before making decisions risks are assessed in a more conservative way. The impact of a too high **risk appetite** on the national economy is according to the respondents below medium (median – the score of 4).

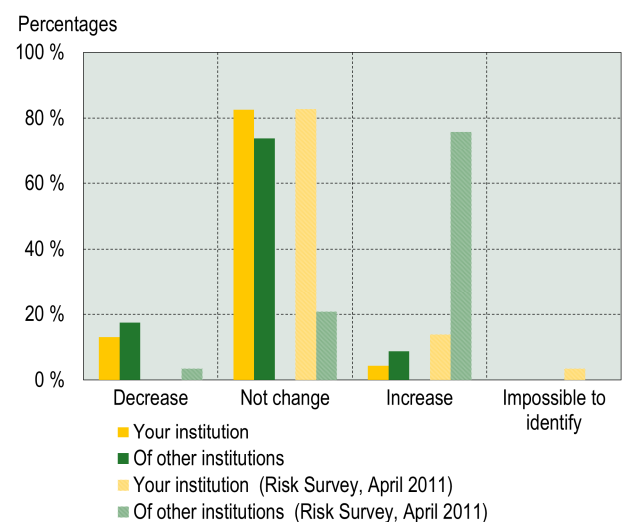
The Risk Survey has been prepared by the Financial Stability Division of the Economics Department of the Bank of Lithuania.

*Chart 6. Risk Appetite of Financial Institutions*



Source: Risk Survey, 2nd half of 2011.

*Chart 7. Risk appetite within the coming 6 months*



Source: Risk Survey, 2nd half of 2011.

*Number of respondents of Risk Survey, 2<sup>nd</sup> half of 2011.*

	Number
<b>Banks</b>	<b>12</b>
<b>Insurance companies</b>	<b>8</b>
<b>Other institutions</b>	<b>3</b>
Leasing companies	1
Management companies	1
Other	1
<b>Total</b>	<b>23</b>

Source: Risk Survey, 2<sup>nd</sup> half of 2011.