



LIETUVOS BANKAS

REVIEW

OF THE SURVEY OF RISKS TO
LITHUANIA'S FINANCIAL SYSTEM

2013
2



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The survey of risks to Lithuania's financial system is conducted in order to assess the views of Lithuania's financial institutions towards the domestic financial system and likely challenges to its sustainable future development.

In the preparation of the review of the survey of risks to Lithuania's financial system, the data of a survey conducted by the Bank of Lithuania was used.

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REVIEW OF THE SURVEY OF RISKS TO LITHUANIA'S FINANCIAL SYSTEM

In order to assess the views of Lithuania's financial institutions towards the domestic financial system and likely challenges to its sustainable future development, the Bank of Lithuania conducts a survey of risks to Lithuania's financial system. This Survey is conducted on a biannual basis. Banks, insurance and leasing companies, management companies and other financial institutions assess the sources of major risk to Lithuania's financial system, the probability of the occurrence of adverse events and their likely impact on the domestic financial system over the upcoming six months.

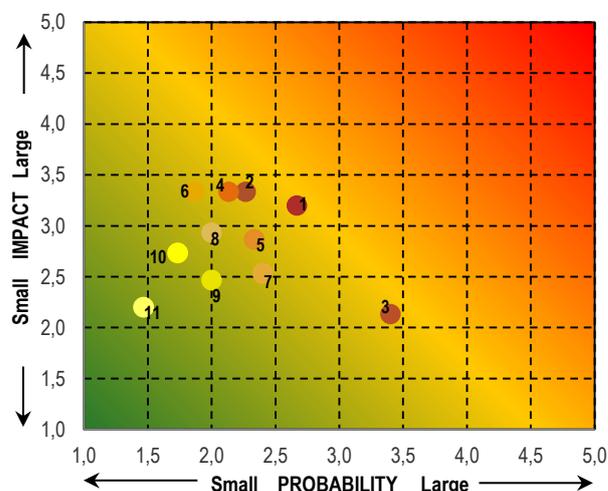
Fifteen respondents took part in the survey of risks to Lithuania's financial system, which included eight banks operating in Lithuania, four insurance undertakings, one leasing company and two other financial institutions. Representatives of the institutions in management positions were asked to describe the situation of the domestic financial system at the end of September 2013. In summarising the opinions and calculating the proportion of financial institutions that have chosen a particular answer, the responses of all institutions were given the same weight, regardless of their market share. This survey is voluntary; respondents can choose which questions to answer.

This survey of risks to Lithuania's financial system provides the summarized opinion of the respondents and does not reflect the official position and assessments of the Bank of Lithuania and its employees.

SUMMARY

- As compared to the similar survey conducted half a year ago, the probability of nearly all predefined risks and their consequences declined.
- Major concerns stem from the sovereign debt sustainability problems in the European countries and a possible decrease in Lithuania's exports due to weaker growth of the global economy. Lithuania's economy is open and dependent on global economic processes, thus the possibilities to reduce these risks remains limited.
- The risk of too-weak growth of the Lithuanian economy or of its downturn was perceived by the financial institutions as substantially decreased. The risk of the loss of Lithuania's competitiveness in foreign markets, in the perception of those surveyed, is low, but its relevance, relative to the other risks, has been increasing.
- Among the risks assessed, the probability of the risk of the environment of persistently low interest rates is the highest, although the impact of this risk is the lowest.
- The credit risk of corporations and households is perceived as lower rather than medium. Such a perception is affected by further improvement in loan portfolio quality and economic growth.
- The permanent risks to Lithuania's financial system such as macroeconomic, credit, market, liquidity and funding risk were perceived by those surveyed as lower than medium.
- The risk tolerance of most of the surveyed financial market participants remained unchanged: the risk appetite continues to be low and will not increase over the upcoming six months.

Chart 1. Map of risks to Lithuania's financial system



Sources: Survey of the Risks to Lithuania's Financial System and Bank of Lithuania calculations.

Note: the numerical values in the map of risks correspond with the sources of risk indicated in Table 1.

SUMMARY OF THE SURVEY RESULTS

Table 1. Sources of risk to Lithuania's financial system

Source of risk	Probability	Impact	Ability to mitigate the risk
1 countries, their interplay with the financial sector and potential for adverse contagion effects	2.7	3.2	3.1
2 Decline in Lithuania's exports due to the slow down of the global economy	2.3	3.3	2.9
3 Prolonged period of the low level of interest rates in the financial markets	3.4	2.1	3.1
4 Loss of competitiveness of Lithuania's economy in foreign markets	2.1	3.3	2.7
5 High credit risk of corporates in Lithuania	2.3	2.9	2.5
6 Too slow growth of Lithuania's economy or economic downturn	1.9	3.3	2.7
7 High credit risk of households in Lithuania	2.4	2.5	2.5
8 Limited possibilities of self-financing of financial institutions in Lithuania	2.0	2.9	2.7
9 Lack of funding of Lithuania's economy due to deleveraging	2.0	2.5	2.5
10 Incapability of financial institution to operate further (insolvency)	1.7	2.7	2.6
11 High funding costs of financial institutions in Lithuania	1.5	2.2	2.3

Source: Survey of Risks to Lithuania's Financial System.

Note: The relevance of the source of risk is defined in view of its probability and impact.

Probability: 1 – low; 2 – lower than medium; 3 – medium; 4 – higher than medium; 5 – high. Impact: 1 – low; 2 – lower than medium; 3 – medium; 4 – higher than medium; 5 – high. Ability to mitigate the risk: 1 – easy to take action; 2 – easy rather than difficult to take action; 3 – difficult to take action; 4 – impossible to take action.

1. Assessment of Sources of Risk

The surveyed domestic financial institutions reported their perception of the manifestation of likely sources of risk, their negative influence on Lithuania's financial system, and possibilities for reducing these sources of risk. The respondents expressed their opinion about the pre-defined sources of risk and specified relevant, in their opinion, other sources of risk, as well as reported their perception.

External sources of risk still remain the major threat to Lithuania's financial system. Participants of the financial system operating in Lithuania consider the likely contagion effects of sovereign debt sustainability problems in Europe on the Lithuanian economy and a decline in Lithuanian exports due to weaker growth of the global economy as the major sources of risk (see Table 1). In Lithuania the instruments that could reduce their manifestation or impact are scarce. According to the respondents, investment diversification and orientation towards "healthy" export destinations would mitigate the impact of the risks mentioned above.

As compared to the similar survey conducted half a year ago, the probability of manifestation of nearly all pre-defined risks and their consequences declined. Increased only the probability (despite its perception as lower than medium) that the possibilities for Lithuanian financial institutions to attract funding will become more difficult. According to the respondents, the probability that over the upcoming six months the financing costs of Lithuanian financial institutions will increase is lower than medium. Moreover, the risks of funding costs and of the attraction of funding would not have any greater impact on the financial system in Lithuania. The limited impact of these risks can be explained by low financial market interest rates and an increase in the volume of resident deposits with banks operating in Lithuania over the recent years.

A relatively high probability of the manifestation of risk was assigned to the prolonged period of low interest rate in the financial markets, although the impact of this risk is perceived as lower than medium. The realisation of this risk depends on the decisions that are adopted by major world central banks. The surveyed financial institutions think that mitigating this risk is a complicated task, moreover, it is believed that the impact of potential risk mitigation measures would be limited (e.g., bridging of the interest gap).

In the opinion of the respondents, the loss of the Lithuanian economy's competitiveness is hardly probable, but, as compared to the other risks, the relevance of this risk increased. Wage growth outpacing labour efficiency and a lack of adequately qualified staff may lead to the loss of the country's competitiveness in foreign markets. The difficulties faced in the export to Russia within certain sectors of the economy revealed the relevance of export diversification in order to ensure export stability. The surveyed financial institutions perceived the risk of the loss of competitiveness as fairly relevant; however the probability of its manifestation is not high.

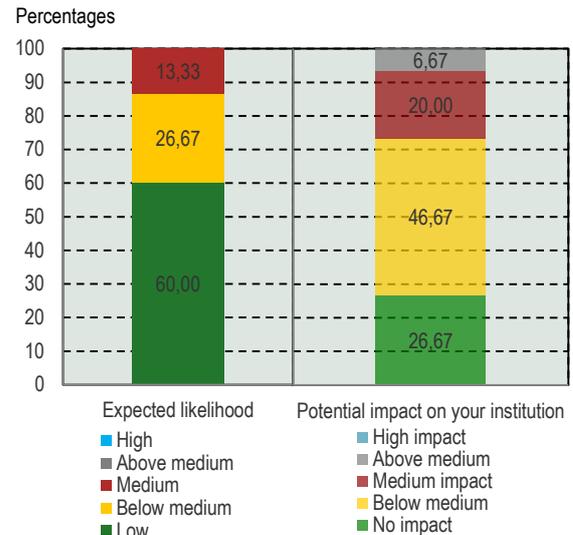
The credit risk of non-financial corporations and households is assessed as modest. This assessment is based on improvement in Lithuania's economic indicators and the financial condition of non-financial corporations and households. In the opinion of the surveyed, financial institutions are able to manage these risks by applying adequate lending requirements.

The probability of weak economic growth or a downturn diminished. Over the half-year, the probability of this risk diminished by almost one fifth owing to the contribution of the relatively strong economic growth rate, both current and projected. On the other hand, should this risk manifest itself, its impact on Lithuania's financial system would be substantial.

One fourth of the respondents see the increase of political risk as more relevant and likely to have quite many negative effects. Asked to indicate and assess more of the potential sources of risk, the surveyed financial institutions took note of the instability of the tax environment, lack of political will (uncertainty) in taking decisions of relevance to the economy and finances. Furthermore, the financial institutions indicated the current situation in Russia, Ukraine and Belarus as a source of increased risk.

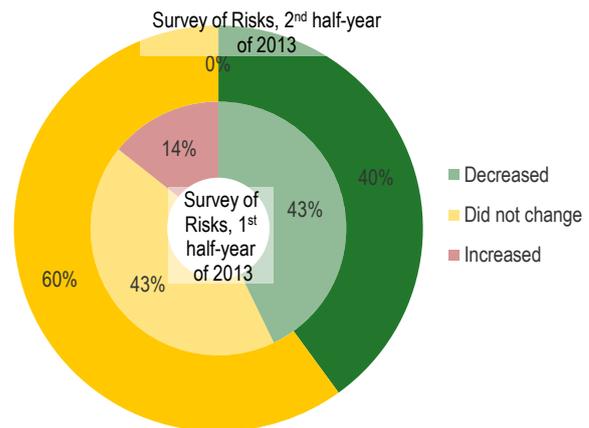
In the opinion of domestic financial institutions, the probability that a high-impact event in Lithuania's financial system will take place in the upcoming six months is low. Over four fifths of the respondents reported that the probability of such an event was lower than medium or low (see Chart 2). 40 per cent of the surveyed financial institutions believe that the probability of a high-impact event in Lithuania's financial system over the upcoming six months declined, whereas there were no surveyed financial institutions believing that such a probability increased (while half a year ago such respondents accounted for 14%; see Chart 3).

Chart 2. Probability of high-impact events in Lithuania's financial system and their impact on a financial institution



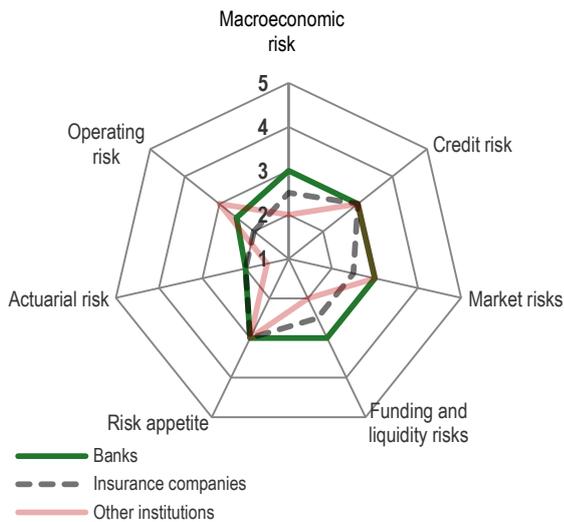
Source: Survey of Risks to Lithuania's Financial System.

Chart 3. Change in the probability of a high-impact event in Lithuania's financial system over the upcoming 6 months



Source: Surveys of Risks to Lithuania's Financial System.

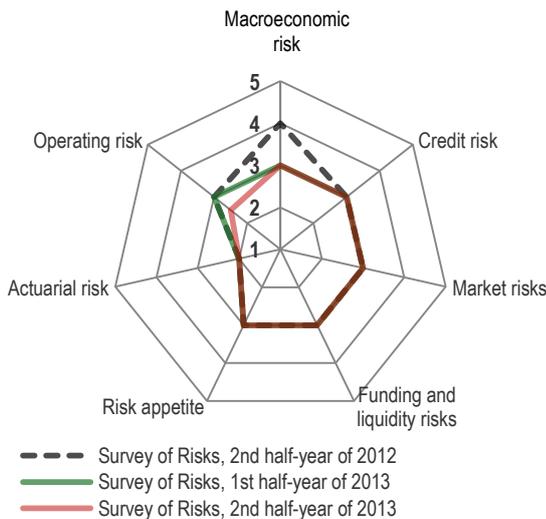
Chart 4. Level of permanent risks to Lithuania's financial system



Source: Survey of Risks to Lithuania's Financial System.

Risk: 1 – very low; 2 – low; 3 – lower than medium; 4 – higher than medium; 5 – high; 6 – very high.

Chart 5. Development of permanent risks to Lithuania's financial system



Sources: surveys of Risks to Lithuania's Financial System.

Risk: 1 – very low; 2 – low; 3 – lower than medium; 4 – higher than medium; 5 – high; 6 – very high.

2. Perception of Permanent Risks

The surveyed domestic financial institutions presented their perception of Lithuania's macroeconomic, credit, market, funding, liquidity, operating and actuarial (insurance) risk levels (risk probability and likely negative effects). These risks form an integral part of the financial system, and their levels are constantly changing. The respondents also presented their perception of the threats posed by the risk appetite of the financial institutions. To ensure the comparability of historical data, the "spider's web" of risks does not change and enables monitoring changes in the perception of existing risks.

In the perception of the financial institutions, permanent risks in Lithuania are low or lower than medium (the median of the assessment of many risks is 2 or 3; see Chart 4). The perception of the risks remained unchanged from the similar survey conducted half a year ago, except for the operating risk. This risk decreased. The respondents perceived their risk appetite and credit risk uniformly, while their opinions about the other risks diverged.

Macroeconomic risk has been perceived as lower than medium for a second half-year in a row, despite its perception in late 2012 as higher than medium (see Chart 5). Still, according to the respondents, this risk is relevant, because Lithuania's economy is open and dependent on global economic processes (especially those in the European Union). In the assessment of part of the surveyed financial institutions, a more favourable perception of the macroeconomic situation would be ensured by clear actions in reducing budget deficit and streamlining of the tax environment.

The banks' assessment of the credit risk of households and corporations was more favourable as compared to the similar survey conducted half a year ago (this assessment decreased from 4 to 3). This is driven by the improving financial situation of corporations and households; the risk of new clients is assessed more closely as well. Part of the respondents noted that the credit risk of small-sized enterprises continued to be relevant.

Credit, market funding and liquidity risks, as well as risk appetite are seen as lower than average (the median is 3; see Chart 5) and have remained unchanged for a second year in a row. For banks, as compared to insurance undertakings, market risk is of greater relevance. This risk is more relevant to banks, as banks are more sensitive to interest rate fluctuations due to the relatively shorter investment horizon of their securities portfolio. Owing to the environment of exclusively low interest rates, it is complicated to keep on cutting interest expenses, thus for banks, as compared to other financial institutions, funding and liquidity risks are more relevant as well. These risks depend on the European Central Bank's monetary policy. According to the surveyed financial institutions, they have accumulated a sufficient amount of liquid funds that would serve as a buffer should

liquidity and funding risk increase. Risk appetite is assessed as lower than average (see Chart 5), but the environment of exclusively low interest rates is increasingly prompting considering the possibilities of assuming higher risk.

While operating risk is perceived as lower than medium, according to the respondents, the on-going Basle III regulatory amendments in the banking sector may lead to the increase of this risk in the future. The risk arising from actuarial activities is perceived as hardly probable.

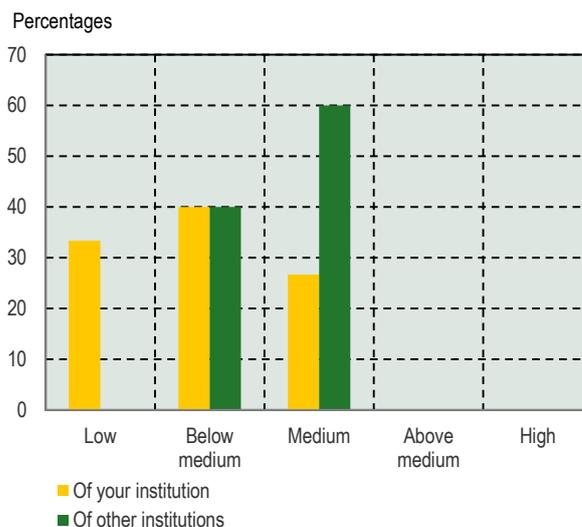
3. Perception of Risk Appetite

The surveyed domestic financial institutions reported their perception of risk appetite at their institution and at other institutions, and indicated its likely developments over the upcoming 6 months.

As half a year ago, in risk appetite of the financial institutions remains conservative. Asked to assess the risk appetite of their own institution and of other domestic financial institutions (to seek higher return in choosing more profitable, but at the same time riskier projects), the respondents reported that the risk appetite of the institutions they represent was low to medium (it was mostly claimed that the risk appetite was low rather than high (see Chart 6). The respondents reported that the risk appetite of the other institutions was similar; in their perception, the risk appetite was medium or low rather than high. Unlike half a year ago, it should be noted that there remained no respondents thinking that the risk appetite of the other financial institutions was low.

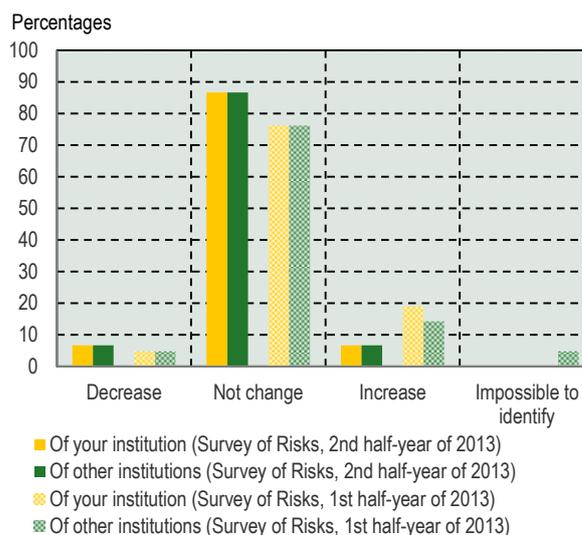
The risk appetite of financial institutions over the upcoming six months will remain basically unchanged. Nearly all of the surveyed financial institutions presume that, in the upcoming half-year, the risk assumed by them will remain unchanged (see Chart 7). Part of the respondents noted that the willingness of the banking sector to assume credit risk has been gradually increasing; however it may be adjusted by regulatory restrictions. Some of the respondents also noted that those in possession of capital increasingly more often seek higher returns beyond the European Union.

Chart 6. Risk appetite of financial institutions



Source: Survey of Risks to Lithuania's Financial System.

Chart 7. Risk appetite over the upcoming 6 months



Sources: surveys of Risks to Lithuania's Financial System.