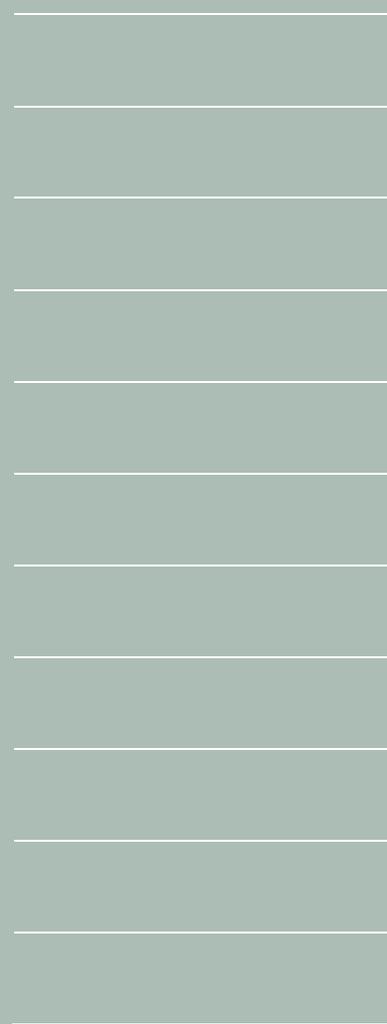




LIETUVOS BANKAS

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

2014



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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

The Bank of Lithuania conducts a biannual survey of risks to Lithuania's financial system to assess the views of Lithuania's financial institutions to the financial system of the country and potential challenges to its sustainable future development. Banks, insurance and leasing companies, management companies and other financial institutions assess the sources of major risks to Lithuania's financial system, the probability of the occurrence of adverse events and their likely impact on the financial system of the country over the next six months.

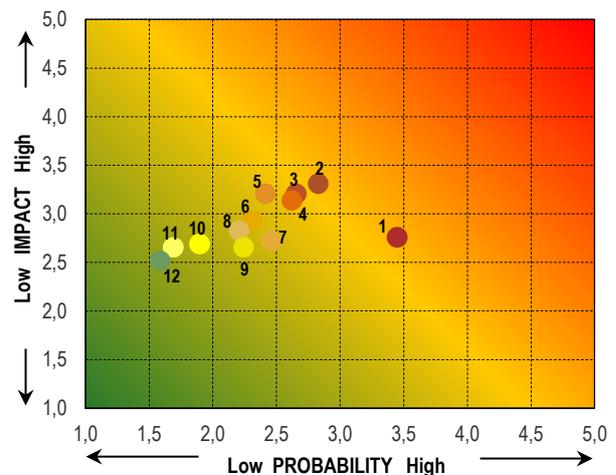
Thirty-six respondents took part in the survey of risks to Lithuania's financial system, including eleven banks operating in Lithuania, thirteen insurance undertakings, two leasing companies and ten other financial institutions. Executives representing the institutions were asked to describe the situation of the financial system of the country at the beginning of March 2014. In summarising the opinions and calculating the percentage of financial institutions that have chosen a particular answer, responses of all institutions were given equal 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 summarised opinion of the respondents and does not reflect the official position and views of the Bank of Lithuania or its employees.

SUMMARY

- Financial market participants covered by the survey expressed the greatest concerns about the prolonged low interest rate environment at the global level, sovereign debt sustainability problems in Europe and export decline driven by global economic slowdown. Lithuania's economy is open and depends on global economic processes, thus the space for minimising these risks is limited.
- The risk of a slowdown or downturn of the economy of Lithuania was perceived by financial institutions as having increased, but still lower than medium. This risk is viewed as having the greatest impact on Lithuania's financial system. The risk of loss of Lithuania's competitiveness in foreign markets also remains lower than medium, but, in the opinion of respondents, has been growing already for the second half-year in a row. Respondents suggest that the aforementioned risks can be minimised by simplifying the tax system and supporting the public sector enterprises of the country.
- The credit risk of corporations and households is perceived to be lower than medium. Such a view is stimulated by further improvement of the loan portfolio quality, growing profit of businesses in line with economy, increase of wages and reduction of unemployment level.
- Permanent risks to Lithuania's financial system, such as macroeconomic, credit, market, liquidity and self-financing risks, were rated by respondents as medium or lower than medium.
- The risk tolerance of the bigger part of surveyed financial market participants has remained unchanged, except for the risk appetite of the part of financial institutions, which, in contrast to the past six months, had grown. The risk appetite remains low and is not expected to grow over the next six months.

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



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

Note: Numerical values in the risk map coincide 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 risk
1 Prolonged low interest rate environment in financial markets	3.4	2.8	3.0
2 Regulatory environment	2.8	3.3	2.6
3 Sovereign debt sustainability problems in Europe, their correlations with the financial sector and possibility of their contagion effect to Lithuania's economy	2.7	3.2	3.1
4 Decline in Lithuania's exports due to the slowdown of the global economy	2.6	3.1	3.0
5 Too slow growth or downturn of Lithuania's economy	2.4	3.2	2.8
6 Loss of competitiveness of Lithuania's economy in foreign markets	2.3	2.9	2.8
7 High credit risk of households	2.5	2.7	2.5
8 High credit risk of corporations	2.2	2.8	2.7
9 Lack of funding of Lithuania's economy due to deleveraging	2.2	2.7	2.6
10 Limited self-financing possibilities of financial institutions of Lithuania	1.9	2.7	2.6
11 Incapability of financial institution to operate further (insolvency)	1.7	2.7	2.4
12 High funding costs of financial institutions in Lithuania	1.6	2.5	2.3

Source: Survey of risks to Lithuania's financial system

Note: The importance of the source of risk is determined by 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 mitigate; 2 – easy rather than difficult; 3 – difficult to mitigate; 4 – impossible to mitigate the risk.

Table 2. Changes in risk sources in the 2014 H1, compared with

	Probability	Impact	Ability to minimise risk
1	0	0.7	-0.1
2	-	-	-
3	0	0	0
4	0.3	-0.2	0.1
5	0.5	-0.1	0.1
6	0.2	-0.4	0.1
7	0.1	0.2	0
8	-0.1	-0.1	0.2
9	0.2	0.2	0.1
10	-0.1	-0.2	-0.1
11	0	0	-0.2
12	0.1	0.3	0

Source: Survey of risks to Lithuania's financial system
NB: risk numbering matches the numbering in Table 1

1. Assessment of Sources of Risk

The surveyed financial institutions of the country reported their views on the manifestation of potential sources of risks, their negative influence on the financial system of Lithuania, and possibilities to minimise these sources of risk. Respondents expressed their opinion about the predefined sources of risks and specified and rated other sources of risk relevant to them.

External sources of risk and the regulatory environment are still perceived as the key risks to Lithuania's financial system. Participants of the financial system operating in Lithuania consider the major sources of risk the likely prolonged low interest environment in financial markets and the spread of sovereign debt sustainability problems of Europe to the economy of Lithuania. The risk of changes in the regulatory environment is also cited among the key risks (see Table 1). According to respondents the simplification of tax system, reduction of tax burden and diversification of export markets would facilitate in minimising the impact of the aforementioned risks.

Compared to the survey conducted six months ago, the probability of occurrence of predefined risks and their consequences has increased rather than decreased (see Table 2). The probability of too slow growth (or downturn) of Lithuania's economy has increased mostly, but its likely impact is rated lower. In the opinion of respondents, probabilities of other events related to economic slowdown also kept growing: global economic slowdown driven export decline, loss of competitiveness of the country, insufficient funding of the national economy due to deleveraging of banks. Among these risks, the probability of the impact of insufficient funding of the national economy is higher than six months ago.

Perception of the probability of risk stemming from prolonged low interest environment in financial markets has not changed from the past half-year and remains higher than medium. Perception of the impact of this risk has changed mostly compared to all risks cited by respondents and is close to medium. Six months ago, the likely impact of low interest environment was reported to be lower than medium. The realisation of this risk for the most part depends on decisions adopted by major central banks of the world. Compared to the situation six months ago, it is clear now that the monetary policy in the USA will be gradually tightened. The surveyed financial institutions consider the reduction of this risk almost impossible.

The probability of the loss of competitiveness of Lithuania's economy in foreign markets is perceived by respondents as increasing for a second half-year in a row, but is still lower than medium. The bigger part of the surveyed financial institutions suggest that this risk could be minimised through the liberalisation and simplification of the tax system and more active support to the tradable sector.

Perceptions of the credit risk of non-financial corporations and households are moderate, but different. The credit risk of households is rated a bit higher. The risk of corporations has become a bit lower, and of households — has slightly increased.

The probability of economic slowdown or downturn has increased considerably. Over six months the probability of this risk went up almost by one-fourth, being influenced by geopolitical tension in Eastern Europe. Although perception of the impact of occurrence of this risk over six months has moderated to some extent, it still remains higher than medium.

Political and regulatory risks are cited among the key risks to Lithuania's financial system. Questions about these risks were included six months ago, after they had been cited by one-fourth of respondents. The probability of these risks is rated as close to medium, but the likely impact, in the opinion of respondents, is above medium. The surveyed financial institutions believe that these risks could be minimised by increasing the transparency of activities of public authorities and by pursuing consistent policies.

The surveyed financial institutions, being asked to identify and assess additional potential sources of risks, noted the unrest in Ukraine. Respondents of the survey are mostly concerned about potential implications of rising tensions in Ukraine. Furthermore, financial institutions cited higher operational risk related to the changeover to the euro as the national currency of Lithuania.

In the opinion of financial institutions of the country, the probability of a high-impact event in the financial system of Lithuania over the next six months is lower than medium. Such probability was cited by half of the surveyed financial institutions, one-third of respondents viewed the probability as low (see Chart 2), and 57% of respondents thought that the probability of a high-impact event in Lithuania's financial system has not changed over the half year. One-fifth of the surveyed financial institutions considered the probability of a high-impact event in Lithuania's financial to have increased over the half year (although six months ago there were no such respondents; see Chart 3).

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

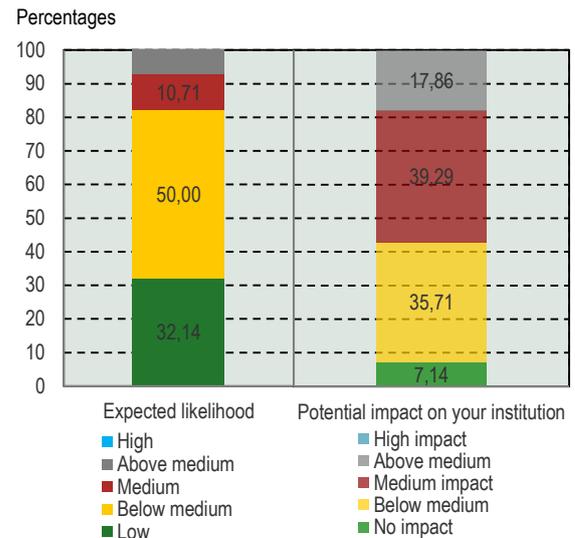


Chart 3. Change in probability of occurrence of a high-impact event in Lithuania's financial system over the next 6 months

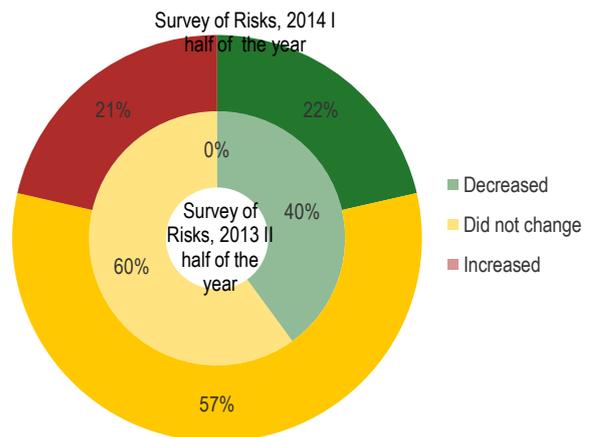
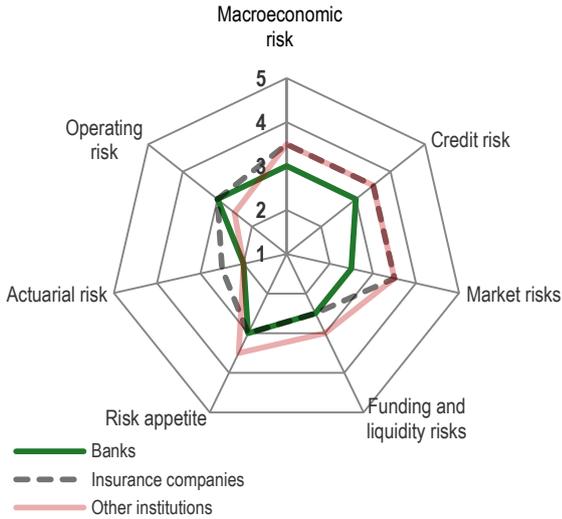


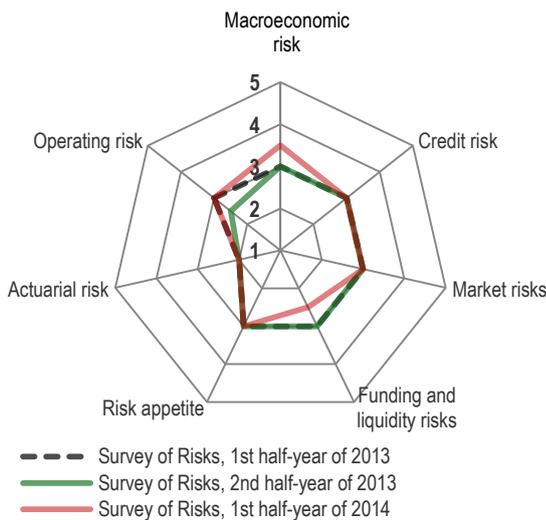
Chart 4. Level of permanent risks to Lithuania's financial system



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 – below medium, 4 – above medium, 5 – high, 6 – very high.

2. Perception of Permanent Risks

The surveyed financial institutions of the country presented their perception of Lithuania's macroeconomic, credit, market, self-financing, liquidity, operating and actuarial risk levels (risk probability and likely negative impact). These risks constitute an integral part of the financial system, but their level is constantly changing. Respondents also cited their views about threats stemming from risk appetite of financial institutions. To ensure the comparability of data, the "spider's web" of risks is not changed and allows monitoring the changing views on the existing risks.

The surveyed financial institutions rated permanent risks in Lithuania as lower than medium or medium (the mean of the assessment of many risks — 3 or 3.5; see Chart 4). Compared to the analogous rating of the previous survey, the level of macroeconomic risk was higher, but potential challenges related to self-financing and liquidity decreased over six months. Market, credit and macroeconomic risks were weighted equally by non-bank surveyed financial institutions, while their opinions about the other risks — diverged.

The macroeconomic risk perceived as medium is considered to be higher than six months ago (see Chart 5). To support their views the respondents indicated the vulnerability of Lithuania to the public debt tendencies of the EU Member States and still prevailing budget deficit. A certain part of respondents, in assessing this risk, noted potential negative economic implications of tensions in Ukraine.

The credit risk of banks rated lower six months ago did not change at the beginning of 2014. This risk is still perceived to be lower than medium and is mostly influenced by improving financial situation of the private sector and regulatory requirements tightened after financial crisis. In the light of intensified lending, a part of respondents indicate the emergence of threats for businesses and households to assume excessive obligations.

The operating risk, compared to its perception six months ago, is considered to have increased, but not above medium. In the opinion of respondents, this risk is considered to have increased because of more stringent supervisory requirements. It should be noted that respondents expect even tighter regulation in the future which they attribute, among other things, to the expected joining to Single Supervisory Mechanism.

The risk of self-financing and liquidity had reduced over six months (2.5 scores). That was mostly preconditioned by low interest rate environment. Furthermore, financial institutions covered by the survey often indicate the excess liquidity accumulated on the market.

The perception of market and actuarial risks and risk appetite had not changed over the past few years. These risks are still cited to be low or below medium. The majority of respondents note that risk appetite is not growing, the probability of catastrophic insured events is very low and market risk is mitigated by the possibility of Lithuania's joining the euro area.

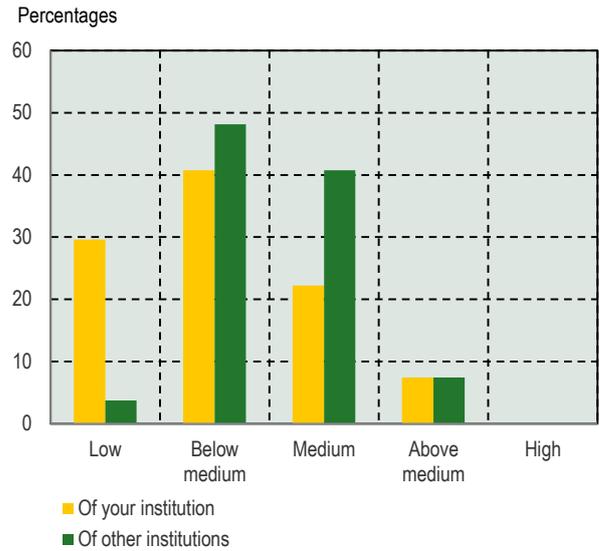
3. Perception of Risk Appetite

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 next 6 months.

The surveyed financial institutions perceive their risk appetite to be conservative. Traditionally, respondents consider the risk appetite of other financial institutions to be higher than their own risk appetite, but still conservative (see Chart 6). It should be noted that compared to the survey conducted six months ago, the risk appetite might be perceived as higher (see Chart 7). For instance, 7.4 per cent of respondents cited their own and other financial institutions' risk appetite to be high rather than low (six months ago such opinions had not been reported).

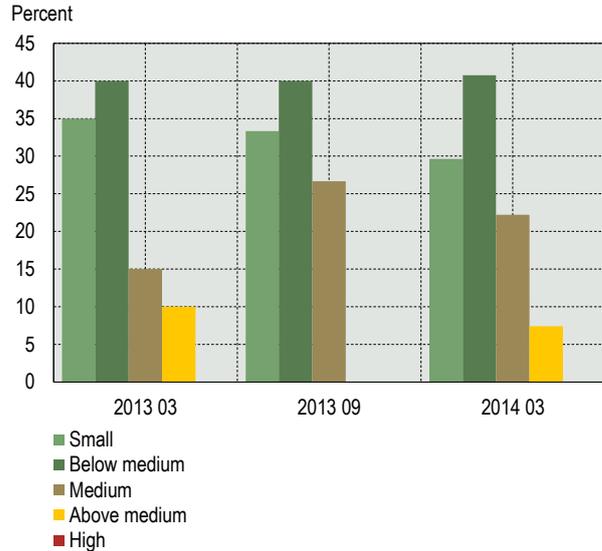
According to surveyed financial institutions, the risk appetite of financial institutions over the next six months will not change (Chart 8). Such a view about the forecasted future risk appetite of their financial institutions was expressed by almost 100 per cent of the surveyed respondents. The views of respondents on the risk appetite of competitors are slightly different: one-fifth of the respondents expect the risk appetite of other financial institutions to grow over the next 6 months.

Chart 6. Risk appetite of financial institutions



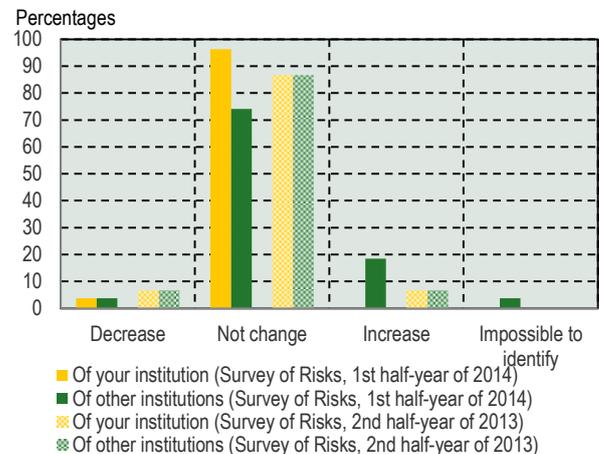
Source: Survey of Risks to Lithuania's Financial System.

Chart 7. Development of risk appetite of financial institutions



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

Chart 8. Risk appetite over the next 6 months



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