SURVEY OF RISKS TO LITHUANIA'S FINANCIAL SYSTEM, 2ND HALF OF 2012

To identify the view of Lithuania's financial institutions about the stability of the domestic financial system and likely challenges to its sustainable development in the future, the Bank of Lithuania conducts a periodical survey of risks to Lithuania's financial system biannually. Banks, insurance and leasing companies, management companies and other financial market institutions assess key sources of threats to Lithuania's financial system, the probability of the occurrence of adverse events and their likely impact on the domestic financial system in the next 12 months.

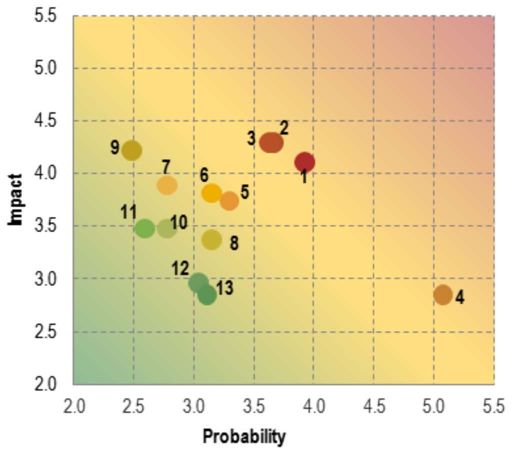
Twenty six respondents took part in the Survey of Risks to Lithuania's Financial System, 2nd Half of 2012, which included eleven banks operating in Lithuania, seven insurance companies, three leasing companies, two management companies and two other institutions. Highly experienced representatives of the institutions in management positions were asked to describe the domestic financial system situation as at the end of September 2012 This Survey of Risks to Lithuania's Financial System presents the summarised opinion of the respondents which does not necessarily reflect the official views and assessments of the Bank of Lithuania or its members of staff. While making a generalization of the views and calculating the share of financial institutions that chose one or another particular variant of the given answers, the responses of individual institutions were given the same weight regardless of their market share.

The data of the Survey of Risks to Lithuania's Financial System are posted on the Bank of Lithuania website.

SUMMARY

The surveyed participants found Lithuania's financial system to be stable. Sovereign debt problems in other European countries and likely contagion effects on Lithuania's economy have continued to be the major concern for Lithuania's financial institutions for a year already. The respondents acknowledge that Lithuania's economy is being influenced by the global situation, the situation in Europe in particular; therefore unfavourable economic trends in other countries may have significant negative effects on the recovery of the Lithuanian economy. It is namely the openness of the Lithuanian economy that determines constant perception of macroeconomic risk as higher than average. More than half of the respondents reported that the probability of a high-impact event in Lithuania's financial system in the next six months remained unchanged over the recent 6 months. The majority of the surveyed financial system participants reported their risk appetite as low and unlikely to increase during the coming 6 months.

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



Source: Survey of Risks to Lithuania's Financial System, 2nd Half of 2012.

Note: Numerical values in the risk map coincide with the sources of risk indicated in Table 1.

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

	Source of risk	Probability	Impact	Ability to mitigate the risk
1	Sovereign debt problems in other European countries and possible contagion effects on Lithuania's economy	3.9	4.1	4.6
2	An energy price shock	3.7	4.3	4.6
3	Too slow recovery of Lithuania's economy or an economic downturn	3.6	4.3	4.1
4	Low interest rate levels	5.1	2.9	4.4
5	High credit risk of corporates	3.3	3.7	3.6
6	A sharp decrease in global trade volumes	3.1	3.8	5.0
7	Vulnerabilities in bank funding and risk related to the volatility of funding costs	2.8	3.9	3.7
8	High credit risk of households	3.1	3.4	3.6
9	Incapability of a systemically important financial institution to operate further (insolvency)	2.5	4.2	3.6
10	Rapid contraction of banks' loan portfolios	2.8	3.5	3.6
11	High inflation in Lithuania	2.6	3.5	4.1
12	Banks' lending in foreign currency (including the euro)	3.0	3.0	3.2
13	Declining real estate prices	3.1	2.9	3.8

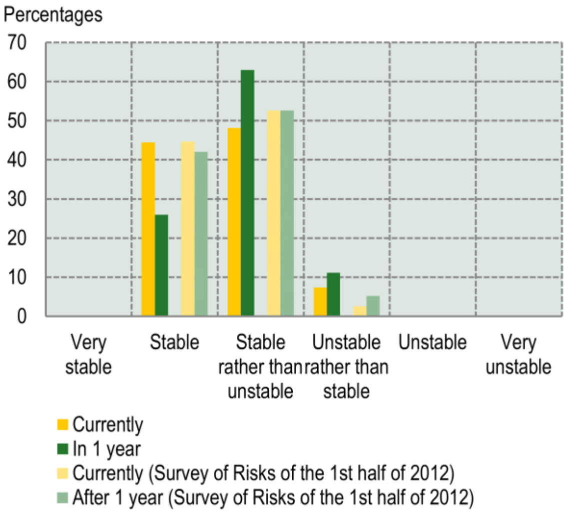
Source: Survey of Risks to Lithuania's Financial System, H2 of 2012.

Note: The importance of the source of risk is determined by its probability ant impact.

Probability: 1 – very low; 2 – low; 3 – lower than average; 4 – higher than avergae; 5 – high; 6 – very high. **Impact:** 1 – very low; 2 – low; 3 – lower than average; 4 – higher than average; 5 – high; 6 – very high. **Ability to mitigate the risk:** 1 – very easy to mitigate; 2 – easy to mitigate, 3 – easy rather than difficult, 4 – difficult to mitigate; 5 – very difficult to mitigate; 6 – impossible to mitigate.

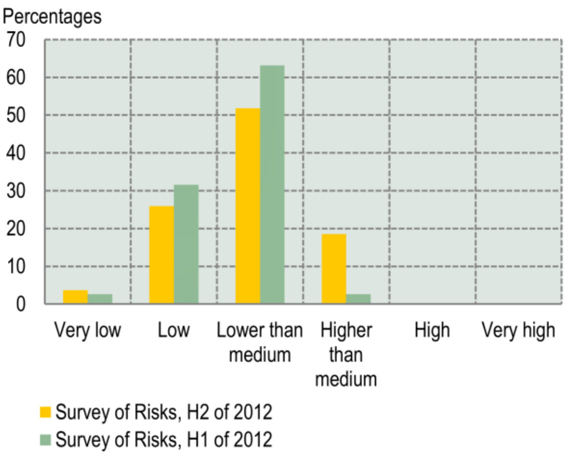
SURVEY RESULTS: SUMMARY

Chart 2. Stability of Lithuania's financial system



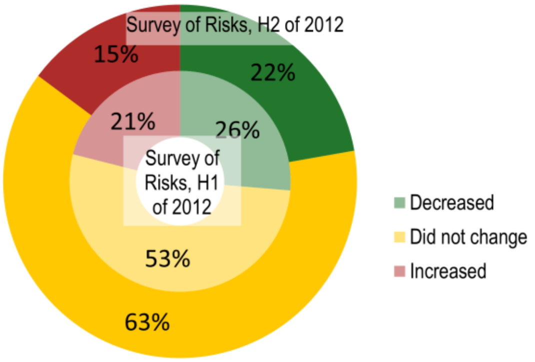
Source: Survey of Risks to Lithuania's Financial System, H1 and H2 of 2012.

Chart 3. Probability of a downturn in Lithuania's economy (in the next 12 months)



Source: Survey of Risks to Lithuania's Financial System, H1 and H2 of 2012.

Chart 4. Changes in the probability of a high-impact event in Lithuania's financial system in the next 6 months



Source: Survey of Risks to Lithuania's Financial System, H1 and H2 of 2012.

1. Assessment of the sources of risk

Domestic financial institutions assessed the probability of manifestation of risk sources, their potential negative impact on the stability of Lithuania's financial system, and their ability to mitigate risk. The respondents submitted their opinion on the sources of risk indicated in advance, which were the same as in the Survey of the 1st half of 2012, pointed out the risks of relevance in their opinion, and presented their assessments.

Domestic financial institutions find that Lithuania's financial system is stable and is expected to remain such in the next 12 month. Increasingly fewer respondents (6 p.p. fewer than six months ago) are of the opinion that the probability of a high-impact event in Lithuania's financial system in the next six months would have increased (see Chart 4.). The number of respondents indicating that the probability of high-impact events that can seriously affect the stability of Lithuania's financial system in the next 6 months is very low or low increased to 59 per cent. Assessing the probability of such an event during a somewhat longer period (in 1-2 months), most of the respondents (56%) indicated it was lower than medium, while the number of those believing it was high amounted to 7 per cent (see Chart 5).

The most relevant risk sources and those raising the highest concerns remained unchanged over six months. The highest risk to the participants in Lithuania's financial system stems from the problems associated with sovereign debt sustainability in other European countries, their relation with the financial sector and possible contagion effects on Lithuania's economy (see Table 1). The respondents found that the deteriorating situation in the euro area would affect Lithuania via the decreasing demand for domestic exports and the rising cost of funding for financial institutions. The importance of this source of risk is also enhanced by the limited possibilities for using risk mitigation measures in Lithuania, thus self-protection is complicated. But the respondents thought that proper joint decisions on a European level might mitigate the risk mentioned above.

Persisting turmoil in Europe resulted in a worsened assessment of the Lithuanian economy recovery as compated to six months ago. According to the respondents, the probability of a too slow recovery in the Lithuanian economy increased but no downturn is expected (81% of the respondents think that in the next 12 months the probability of a downturn in the Lithuanian economy is not higher than medium (see Chart 3). An energy price shock and low financial market interest rates have remained major sources of risk. The significance of the latter source was enhanced by the increased probability of the event itself, but its impact was assessed as lower than medium. Insurance companies investing in debt securities for a long term also stated they woud not face any negative impact of low interest rates. The credit risk of non-financial corporations and households continues to decrease and is perceived as lower than medium The surveyed participants believe that financial institutions are able to manage these risks through the application of tighter lending requirements.

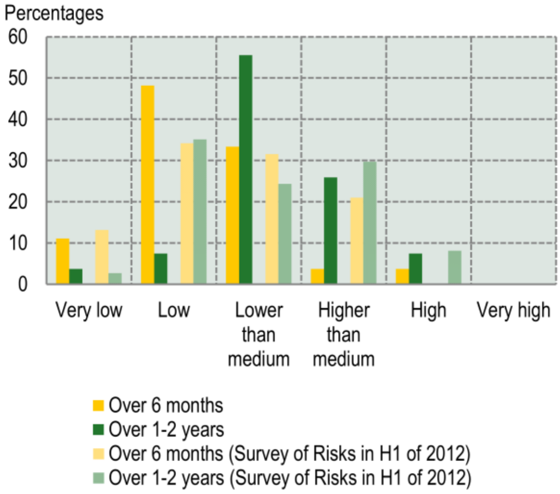
The funding of financial institutions has remained stable. Asked about the probability of funding difficulties in attracting financial resources in the next 12 months, the respondents perceived it as low or as lower than medium. In the assessment of the impact of this source of risk on Lithuania's financial system the respondents' opinions varied and the distribution of their assessments from impact low to very high was almost equal.

Rapid shrinkage of bank portfolios is an event with a probability lower than medium. This is the opinion of both banks and other domestic financial institutions. However, banks tended more often to assess the impact of this source of risk as higher than medium. Decreasing real estate prices would have an insignificant effect on the domestic financial system. Only 4 per cent of the respondents reported that a decrease of real estate prices would have a serious impact on financial stability in Lithuania.

Financial institutions are concerned about changes in the political environment. Asked to indicate and assess more sources of potential risk, financial institutions mentioned mainly changes in the political environment in Lithuania (26% of respondents). There are fears that when new political forces come to power after the Seimas elections, economic policy continuity problems may arise or populist decisions may be taken. Part of the respondents were concerned about possible labour market problems (high unemployment rate and related emigration of the population). Others indicated the risk of downgrading Lithuania's credit rating, expansion of government and SODRA debt, withdrawal of investment from the country.

It is most difficult to reduce the risks dependent on external factors. As a small and open economy, Lithuania is highly dependent on the processes taking place in the external environment in Europe and, more widely, in the world. According to the survey respondents, it would be difficult to avoid the negative impact of a sharp decrease in global trade volumes. Furthermore, it would hardly be possible to effectively limit the impact of an energy price shock and European sovereign debt sustainability problems. However, according to the respondents, the risk stemming from bank lending in foreign currency (including lending in euro) depends on decisions taken by market participants and it would be sufficiently easy for financial institutions to take measures for mitigating this risk.

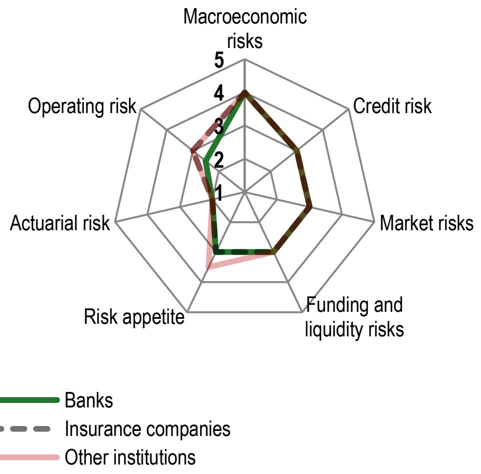
Chart 5. Probability of high-impact events in Lithuania's financial system



Source: Survey of Risks to Lithuania's Financial System, H1 and H2 of 2012.

2. PERCEPTION OF PERMANENT RISKS

Chart 6. Level of various risks to Lithuania's financial system



Source: Survey of Risks to Lithuania's Financial System, H2 of 2012.

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

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

According to financial institutions, macroeconomic risk has remained the major risk in Lithuania (the median is 4, i.e., there is a higher than medium risk, see Chart 6). In the opinion of the respondents, this risk will always be relevant due to the openness of the Lithuanian economy and its dependency on the global situation, particularly the European Union's situation. Referring to tighter lending standards, the surveyed financial institutions agree that credit risk has been decreasing and consider it as being lower than medium. The opinions of the respondents, which diverged in the assessment of market risk in the 1st half of 2012, this time coincide. Despite a conservative approach to financial institutions and their cautious perception of risk, market risk, according to the respondents, depends rather on external factors and is difficult to manage. According to the surveyed participants, overoptimistic business plans may lead to the emergence of operating risk (the median is 3, i.e., the risk is lower than medium). Banks alone tended more often to perceive this risk as low. Financial institutions had different perceptions of risk appetite. Some respondents believe they have learnt the lessons from the crisis and are much more cautious in perceiving assumed risk. Others point out that shrinking loan portfolios and increasing competition among banks exert pressure to assume higher risk. All the respondents perceive actuarial risk as low and expect it to remain low in the future.

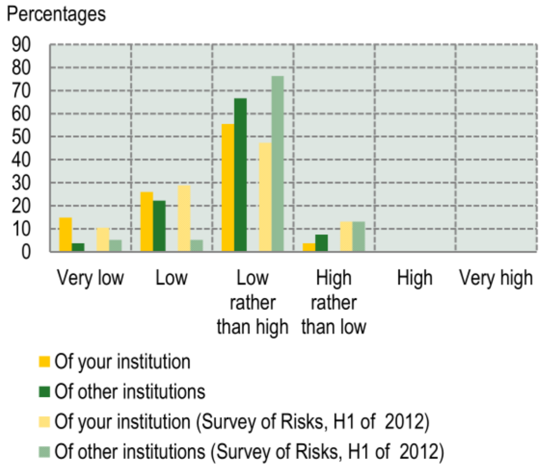
3. PERCEPTION OF RISK APPETITE

Domestic financial institutions reported the perception of risk appetite at their institution and at other institutions, and indicated its likely developments in the next 6 months.

The risk appetite of financial institutions is low. Requested to assess the risk apetite (to seek a higher return by selecting more profitable but riskier projects) of their own institution and of other domestic financial institutions, 56 per cent of the respondents reported that their risk appetite was low rather than high (see Chart 7). Very low or low risk appetite was more often attributed by the respondents to their own institution than to other institutions. On the other hand, compared to the results of the Survey of Risks to Lithuania's Financial System of the 1st half of 2012, the perception of own risk appetite and that of other institutions became similar.

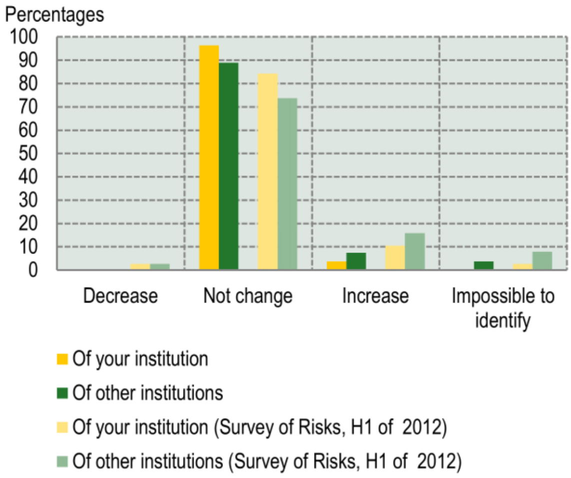
The risk appetite of financial institutions in the next 6 months will not change. Most of the respondents presume that in the next half-year their risk appetite will remain unchanged (see Chart 8). No one is of the opinion that the risk appetite of the financial institutions that they represent may decrease.

Chart 7. Risk appetite of financial institutions



Source: Survey of Risks to Lithuania's Financial System, H1 and H2 of 2012.

Chart 8. Risk appetite in the next 6 months



Source: Survey of Risks to Lithuania's Financial System, H1 and H2 of 2012.

The Survey was carried out by the Financial Stability Department of the Economics and Financial Stability Service of the Bank of Lithuania.