Totorių g. 4, Vilnius. Tel. (8 5) 268 0101; faks. (8 5) 212 4423; el. p. fsd@lb.lt; http://www.lb.lt

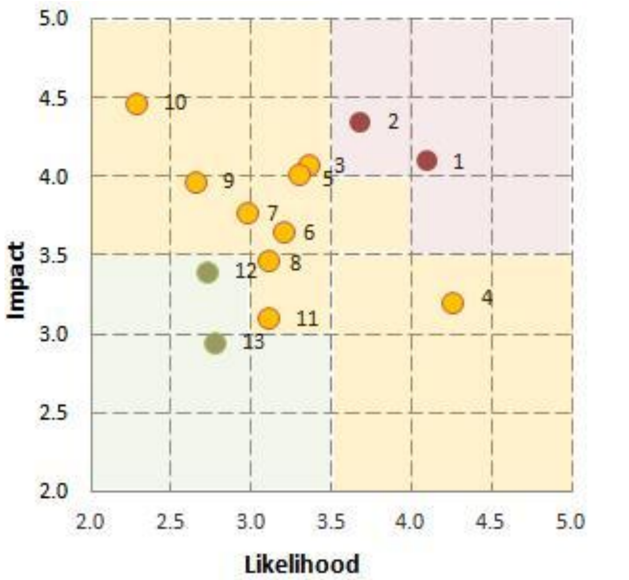
# Survey of Risks to Lithuania's Financial System, 1st Half of 2012

*To identify the view of Lithuania's financial institutions towards the domestic financial system stability and potential challenges to its sustainable development in the future, the Bank of Lithuania conducted the survey of risks to Lithuania's financial system in May 2012. Banks, insurance and leasing companies, financial brokerage companies and other financial market institutions reported their views on key sources of threats to Lithuania's financial system, the probability of the occurrence of adverse events and their potential impact on the domestic financial system in the coming 12 months. It is a periodical survey conducted biannually.*

## SURVEY RESULTS: SUMMARY

The surveyed financial institutions have found Lithuania's financial system to be stable. Sovereign debt problems in other European countries and possible contagion effects for Lithuania's economy have continued to be the largest concerns for Lithuania's financial institutions. Financial institutions acknowledge that Lithuania's economy has been influenced by the situation in global markets and Europe, and therefore unfavourable economic development trends in other countries may have negative effects on the recovery of economy in Lithuania. More than half of the respondents reported that the probability of a high-impact event in Lithuania's financial system in the nearest future remains unchanged. Macroeconomic, credit and market risks remain the most relevant. As indicated by the financial system participants, lessons from the crisis have been learned and a more conservative approach towards risk assessment has been adopted. Funding issues of the financial institutions have been successfully managed: the deposit market has remained stable, whereas a small share of inter-bank debts means weak links between banks for a potential spread of contagion risk. Most of respondents reported they would not expect any changes in their risk appetite in the nearest future.

*Chart 1. Risk map for the Lithuania's financial system*




| | Systemic risks | Likelihood | Impact | Ability to mitigate the risk |
|---|---|---|---|---|
| 1 | Sovereign debt problems in other European countries and possible contagion effects for | 4.1 | 4.1 | 4.4 |
| 2 | The energy price shock | 3.7 | 4.4 | 4.2 |
| 3 | Slow recovery of Lithuania's economy or economic downturn | 3.4 | 4.1 | 3.8 |
| 4 | The low level of interest rates | 4.3 | 3.2 | 4.0 |
| 5 | Big credit risk of corporates | 3.3 | 4.0 | 4.7 |
| 6 | Big credit risk of households | 3.2 | 3.7 | 3.6 |
| 7 | Bank funding vulnerabilities and risk related to the volatility of funding costs | 3.0 | 3.8 | 3.5 |
| 8 | Sharply decreasing loan portfolio of the banks | 3.1 | 3.5 | 3.8 |
| 9 | Sharp decrease in global trade volumes | 2.7 | 4.0 | 3.5 |
| 10 | Incapability of a systemically important financial institution to operate further (insolvency) | 2.3 | 4.5 | 3.7 |
| 11 | Banks' foreign currency (including euro) lending | 3.1 | 3.1 | 4.5 |
| 12 | High inflation in Lithuania | 2.7 | 3.4 | 3.6 |
| 13 | Declining real estate prices | 2.8 | 2.9 | 3.2 |

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

**Likelihood:** *1 – very low; 2 – low; 3 – lower than average; 4 – higher than avergae; 5 – high; 6 – very high.* **Impact:** *1 – 1 – very low; 2 – low; 3 – lower than average; 4 – higher than avergae; 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 mitigate; 5 –very difficult to mitigate; 6 – impossible to mitigate.*

Totorių g. 4, Vilnius. Tel. (8 5) 268 0101; faks. (8 5) 212 4423; el. p. fsd@lb.lt; http://www.lb.lt

## SURVEY RESULTS’ ANALYSIS

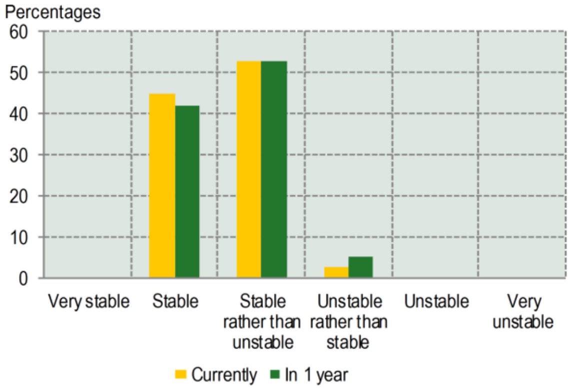
**Domestic financial institutions have found the Lithuania’s financial system to be stable** and expect it to remain stable in the nearest twelve-month period. More respondents (up to 79%) believe that the probability of a high-impact event in Lithuania’s financial system in the nearest future decreased slightly or remained at least unchanged during the last six months. By comparison, most of the H2 2011 survey respondents (65%) reported an increase in the probability of potential risks during a six-month period.

The H1 2012 survey results revealed 47 per cent of financial institutions were of the opinion that the probability of a high-impact **event that may threaten the stability of Lithuania’s financial system in the nearest six months was very low or low.** There were no respondents who reported high or very high probability of such event. When asked about the probability of occurrence of a high-impact event in the financial system in a slightly longer perspective (1 to 2 years), the majority (35 %) of respondents assessed it as low, whereas 8 per cent considered it to be high.

**Domestic financial institutions think that the threat posed by nearly all risk sources, which were also relevant in H2 2011, declined.** The highest risk to participants of Lithuania’s financial system is related to the problems associated with the sovereign **debt sustainability in other European countries**, their relation with the financial sector and potential contagion effects for Lithuania’s economy. Deteriorating situation in the euro area would mostly affect export volumes and boost self-financing costs for financial institutions. **A sharp decrease in global trade volumes** may also have a negative impact on Lithuania’s export demand. According to the surveyed respondents, reducing the aforementioned risks would be difficult, but possible (e.g. through responsible fiscal policy, investment diversification and new export destinations).

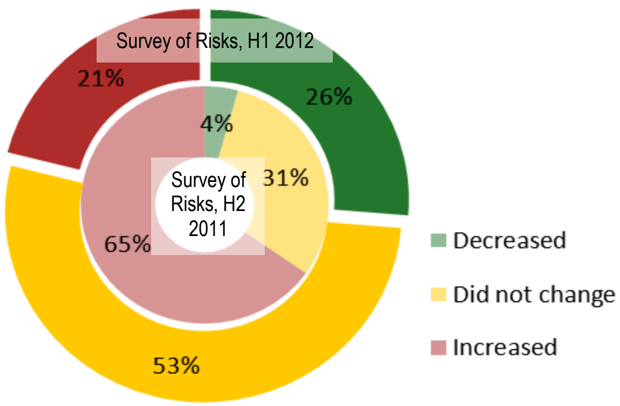
Rising energy prices usually cause inflation growth and a decline in consumption. According to financial institutions, the probability of an **energy price shock** in Lithuania was

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



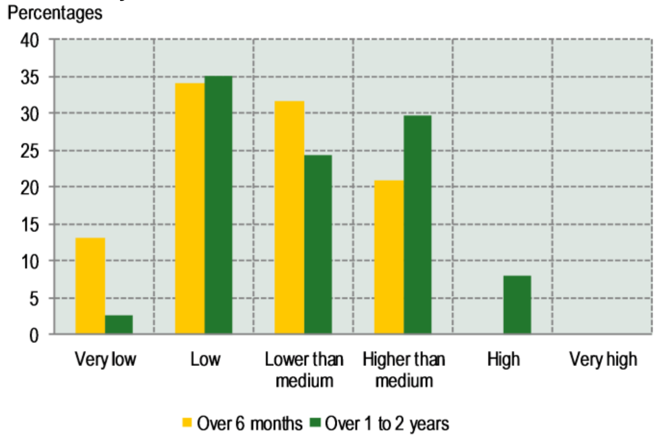

*Source: The Survey of Risks to Lithuania‘s Financial System, H1 2012.*

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




*Source: The Survey of Risks to Lithuania's Financial System, H1 2012.*

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




*Source: The Survey of Risks to Lithuania's Financial System, H1 2012.*

Totorių g. 4, Vilnius. Tel. (8 5) 268 0101; faks. (8 5) 212 4423; el. p. fsd@lb.lt; http://www.lb.lt

higher than medium; moreover, preventive measures require a lot of efforts.

In the opinion of the respondents, **a slow recovery of Lithuania's economy or an economic downturn is less likely than it was six months ago**, whereas its impact on the financial system stability would be less significant than earlier.

According to the domestic financial institutions, **the risks and potential negative effects associated with the low level of interest rates in financial markets increased during the last six months**. Tight credit standards should remain in place, in the opinion of the survey respondents, since low interest rates may distort the assessment of portfolio risk. Although the probability of a low interest rate risk is the highest among the risks specified above, its impact may be lower than medium.

The **probability of credit risk** both for corporates and households has continued to decrease and is assessed as being below medium. Most likely these positive changes have been prompted by the Provisions for Responsible Lending which came into effect on 1 November 2011. Some of the survey respondents believe that it would be useful to make legal entities subject to similar provisions too.

**Funding of financial institutions has remained stable.** When asked about the probability of funding difficulties related to the use of internal funds by financial institutions within a one-year period, the survey respondents were more optimistic than in H2 2011 and pointed out that the probability of this risk is lower than medium, although its impact on the financial system stability would remain above medium.

Domestic financial institutions believe that the **incapability of systemically important financial institutions to continue their activities** is the least probable out of all specified events. The survey respondents indicated that potential effects of insolvency of financial institutions would remain significant, but smaller than expected earlier. As the case of AB bankas SNORAS showed, domestic tensions caused by the bank collapse were short-lived and insignificant, and the financial markets' response to them was moderate.

**Other external and internal risk sources**

When asked to name and evaluate more potential risk sources, financial institutions often referred to changes in the political situation in Lithuania (28% of respondents). New political forces to come to power after the Seimas elections are feared to jeopardise the economic policy continuity and adopt populist decisions when approving the country's budget. Some respondents (10%) were worried over potential problems related to government debts and mentioned risks associated with the government debt refinancing and budget balancing. Other (7% of respondents) mentioned the risk of foreign investments withdrawal from Lithuania, insufficient regulation of market participants and labour market problems (emigration related with the high rate of unemployment). Several respondents also reported various other risks to the financial system, such as the bursting of the stock price bubble of technology corporations (e.g. *Facebook*) or the threat of cyber attacks against banks and government institutions.

**Perception of risk probabilities by market participants**

Market participants mainly agreed over the probability of a sharp decrease in global trade volumes and the corporate credit risk, which are lower than medium. The biggest differences could be observed in the perception of the risk of low interest rates in financial markets and the risk associated with bank lending in foreign currencies.

**Perception of a potential risk impact by market participants**

The surveyed financial institutions agree that the impact of an energy price shock on the stability of the domestic financial system may be larger than medium. The largest differences were observed in their perceptions of negative effects of financial institutions funding difficulties or volatility in funding costs on Lithuania's financial system stability.

Totorių g. 4, Vilnius. Tel. (8 5) 268 0101; faks. (8 5) 212 4423; el. p. fsd@lb.lt; http://www.lb.lt

**Perception of market participants associated with risk mitigation possibilities**

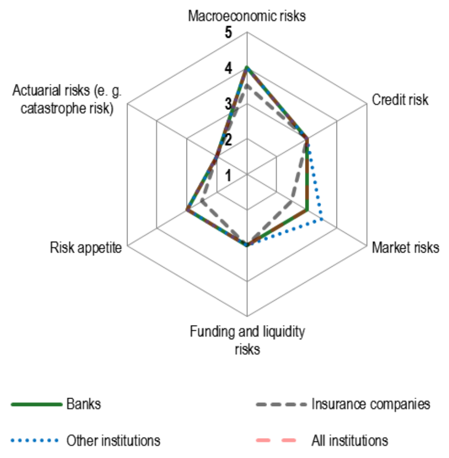
According to the survey respondents, it is actually impossible to avoid the threat posed by a sharp decrease in global trade volumes. Furthermore, it can be difficult to limit the risks caused by an energy price shock and the European sovereign debt problems. These two factors are related with the situation in global markets and Europe. Although Lithuania is highly dependent on them, the country cannot have a significant influence on the ongoing processes. According to the surveyed institutions, addressing the risk generated by bank lending in foreign currencies, which depends on decisions taken by market participants, is the least complicated issue.

## ASSESSMENT OF MAJOR RISK CATEGORIES

*In this part of the questionnaire, domestic financial institutions assess the size of Lithuania’s macroeconomic, credit, market, funding, liquidity and actuarial (insurance) risks (risk probability and possible negative effects). These risks make up an integral part of the existing financial system, although their severity is constantly changing. To ensure the comparability of historical data, the “spider’s web” of risks was left unchanged, allowing for facilitated monitoring of the changes in the existing risk perceptions.*

According to financial institutions, **macroeconomic risk** has remained the most important type of risk by now (the median is 4, i.e. it is higher than medium risk), though its assessment decreased, compared to H2 2011 survey, when it was assessed as high. In the opinion of the survey respondents, Lithuania is dependent on global economic processes; consequently, the economic situation in some EU Member States poses the highest risk, whereas its management and impact reduction tools are very limited in Lithuania. It also influences the assessment of **funding and liquidity risks**. Growing tensions in financial markets may have negative effects on the country’s lending facility and cause liquidity pressure on some market participants. However, the largest domestic financial institutions are owned by well-capitalised Scandinavian financial groups,

*Chart 5. Level of various risks to Lithuania's financial system*




*Source: The Survey of Risks to Lithuania‘s Financial System, H1 2012.*

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

Totorių g. 4, Vilnius. Tel. (8 5) 268 0101; faks. (8 5) 212 4423; el. p. fsd@lb.lt; http://www.lb.lt

which may, if appropriate, provide liquidity support or strengthen the capital base. Taking into account tighter lending standards, the surveyed financial institutions agree that the credit risk has been going down and consider it being lower than medium (in H2 2011, it was perceived as higher than medium). The opinions of respondents concerning the **market risk** perception diverged – insurance companies pointed out a low probability of a sharp change within the insurance market and tended to perceive this risk as low.

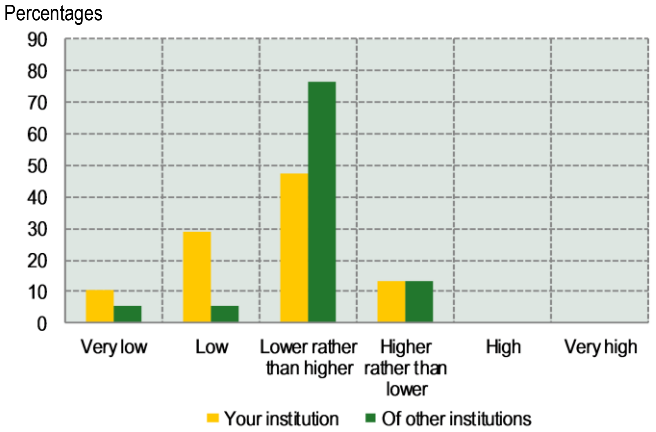
Financial institutions have contradictory perceptions of the **risk appetite**. Some respondents believe that market participants have learned the lessons from the crisis and are more conservative towards the assumed risk. Meanwhile, others indicated that relatively high funding costs of some financial institutions and shrinking loan portfolios lead to the assumption of higher risks.

All respondents agree that actuarial risk is low and expect it to remain low in the future.

## PERCEPTION OF RISK APPETITE

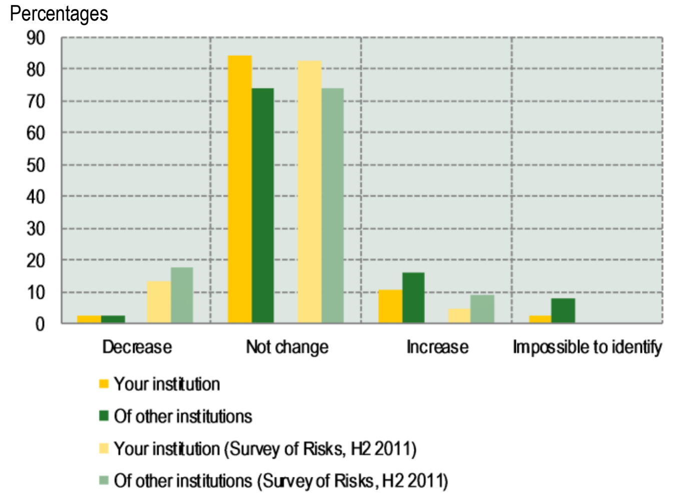
When assessing risk appetite (to go for higher return by selecting more profitable, but riskier projects) of their own institutions and other domestic financial institutions, respondents tended to attribute very low or low risk appetite to their own institution rather than other institutions. Financial market participants have remained reserved, as the majority of them reported **their risk appetite being low rather than high and unlikely to change in the coming six months**. Nonetheless, the percentage of respondents reporting a potential increase in risk appetite of their represented financial institutions grew by 7 percentage points (in H2 2011, 4% of respondents forecasted a potential increase), while 8% could not identify the developments in risk appetite in other institutions during the coming six-month period.

*Chart 6. Risk appetite of financial institutions*




*Source: The Survey of Risks to Lithuania's Financial System, H1 2012.*

*Chart 7. Risk appetite in the coming six months*




*Source: The Survey of Risks to Lithuania's Financial System, H1 2012.*

*Number of respondents in the Survey of Risks to Lithuania's Financial System, H1 2012.*

| | Number |
|---|---|
| **Banks** | **12** |
| **Insurance Companies** | **10** |
| **Other institutions** | **15** |
| Leasing companies | 4 |
| Management companies | 2 |
| Other | 9 |
| **Total** | **37** |

*Source: The Survey of Risks to Lithuania's Financial System, H1 2012.*

The survey was carried out by the Macroprudential Analysis Division
of the Financial Stability Department
of the Economics and Financial Stability Service
of the Bank of Lithuania