



LIETUVOS BANKAS

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

2014

2



ISSN 2335-8084 (ONLINE)

**REVIEW
OF THE SURVEY OF RISKS TO LITHUANIA'S FINANCIAL
SYSTEM
2014/2**

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.

Reproduction for educational and non-commercial purposes is permitted provided that the source is acknowledged.

© Bank of Lithuania, 2014

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.

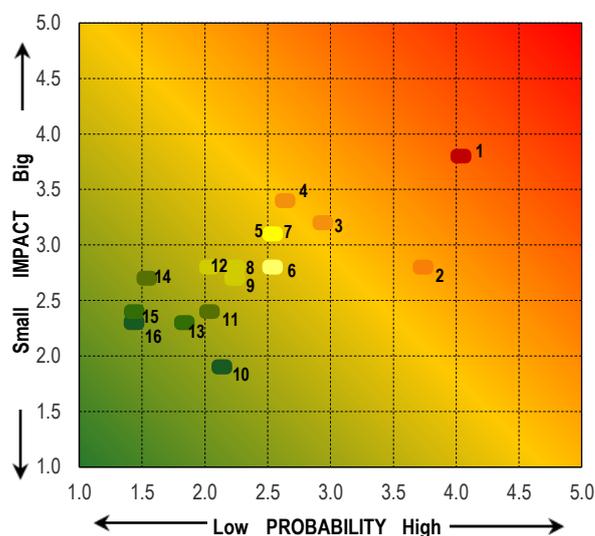
44 respondents took part in this survey, which included 13 banks operating in Lithuania, 15 insurance undertakings, 2 leasing companies and 14 other financial institutions. Representatives of the institutions in management positions were asked to describe the situation of the domestic financial system at the beginning of September 2014. 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.

The review provides the summarised opinion of the respondents and does not reflect the official position and assessments of the Bank of Lithuania and its employees.

SUMMARY

- Lithuania's surveyed financial institutions named the key risk to Lithuania's financial system — the conflict between Russia and Ukraine, as well as the consequences of the related economic sanctions. In addition, the tense geopolitical situation in Eastern Europe determined that the respondents now, more than half a year ago, are concerned about Lithuania's exports and economic growth. Risks related to a decrease in exports were among the most likely, while their potential impact on Lithuania's financial system was assessed as big. These risks are driven by external factors; therefore, in the assessment of the respondents, the possibility to reduce them is low.
- Low interest rate risk continues to be among the most likely, while the probability of the sovereign debt sustainability risk is assessed more moderately.
- The probability of domestic risks, such as the credit risk of corporates and households, decreased the most; they were assessed moderately.
- In the opinion of financial market participants, the probability that in the near future an important event will take place, which will negatively impact Lithuania's financial system, increased significantly. The share of those who believe so increased over the half-year by almost a third and amounted to more than half of those surveyed. Such a sharp change was mostly driven by the more complicated geopolitical situation in Eastern Europe. Nevertheless, most respondents claimed that the impact of such an event would not be very significant.
- Out of the permanent risks arising to the financial system, the surveyed financial institutions listed macroeconomic and market risks as being the greatest. The assessment indicators of such risks slightly increased over the half-year.
- The inclination of financial institutions to take risk has remained almost unchanged over the half-year and is distributed from low to medium. As usual, financial institutions assessed their inclination to take risk more moderately than their competitors, but the share of those who believe that they will assume more risk over the coming 6 months, decreased by a third.

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



Sources: The survey of risks to Lithuania's financial system and Bank of Lithuania calculations

Note: numerical values in the risk map correspond to the risk sources listed in table 1

SUMMARY OF THE SURVEY RESULTS

1. Assessment of Risk Sources

Table 1. Source of risks to Lithuania's financial system

Risk source	Probability	Potential impact	Ability to mitigate the risk
1 Risk, related to the conflict between Russia and Ukraine as well as the application of economic sanctions	4	3.8	3.2
2 Prolonged period of low interest rates in the financial markets	3.7	2.8	2.8
3 Drop in Lithuania's export in regards to the global economic slowdown	2.9	3.2	3.0
4 Too slow Lithuanian economic growth or economic recession	2.6	3.4	2.8
5 Loss of economic competitiveness in foreign markets	2.5	3.1	2.7
6 Risk, related to legislative changes or lack of necessary changes	2.5	2.8	2.4
7 European sovereign debt sustainability issues, their relations with the financial sector and possible contagion effect on the Lithuanian economy	2.5	3.1	3.1
8 Non-financial companies credit risk	2.2	2.8	2.4
9 Unsustainable rise in real estate prices	2.2	2.7	2.5
10 Operational risk due to the euro adoption	2.1	1.9	1.8
11 Household credit risk	2	2.4	2.3
12 Lack of funding for the country's economy due to banks' deleveraging	2	2.8	2.4
13 Risk arising due to the concentration of large exposures in the loan portfolio	1.8	2.3	2
14 Inability of financial institutions to continue their operation (insolvency)	1.5	2.7	2.3
15 Limited financing possibilities for financial institutions	1.4	2.4	2.3
16 High price of funding for Lithuania's financial institutions	1.4	2.3	2.3

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

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.

Table 2. Change in importance of risk sources over the half-year

Risk source	2013 I	2013 II	2014 I	2014 II
1 Risk, related to the conflict between Russia and Ukraine as well as the application of economic sanctions				
2 Prolonged period of low interest rates in the financial markets				
3 Drop in Lithuania's export in regards to the global economic slowdown				
4 Too slow Lithuanian economic growth or economic recession				
5 Loss of economic competitiveness in foreign markets				
6 Risk, related to legislative changes or lack of necessary changes				
7 European sovereign debt sustainability issues, their relations with the financial sector and possible contagion effect on the Lithuanian economy				
8 Non-financial companies credit risk				
9 Unsustainable rise in real estate prices				
10 Operational risk due to the euro adoption				
11 Household credit risk				
12 Lack of funding for the country's economy due to banks' deleveraging				
13 Risk arising due to the concentration of large exposures in the loan portfolio				
14 Inability of financial institutions to continue their operation (insolvency)				
15 Limited financing possibilities for financial institutions				
16 High price of funding for Lithuania's financial institutions				

low importance medium importance high importance

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

Notes: 1) risk importance is expressed as the product of such risk possibilities, possible impact and possibilities to decrease risk; 2) risk, related to legislative changes or lack of necessary changes, in the 2014 Q1 survey was treated as political and regulatory risk.

The surveyed domestic financial institutions reported their assessment of likely risk sources, negative influence of them on Lithuania's financial system as well as possibility to mitigate them. The respondents expressed their opinion about the pre-defined sources of risk and specified relevant, in their opinion, other risk sources, as well as reported their assessment.

In the opinion of Lithuania's surveyed financial institutions, the major risk to Lithuania's financial system — the conflict between Russia and Ukraine, as well as the consequences of the related economic sanctions. This risk distinguished in all the aspects of the assessment: the greatest possibility of confirmation, greatest possible impact and least possibilities to mitigate the risk (see Table 1). According to the respondents, although it is particularly difficult to decrease such risk, it can be mitigated by active participation in the EU institutions that deal with issues of the conflict, by supporting enterprises directly hit by the economic sanctions and with the Government taking measures to promote the expansion of new export markets.

Risk due to the prolonged period of low interest rates continued to be among the greatest, while risk regarding European sovereign debt sustainability decreased. Compared to the survey conducted half a year ago, the possibility of the low interest rate risk increased significantly (see Table 2) and came closer to higher than average. As the European Central Bank continues to conduct expansionary monetary policy, it is expected that the relatively high probability of such risk will prevail also in the coming 6 months. The possible impact of such risk was considered by respondents as unchanged and assessed as moderate. On the other hand, European sovereign debt sustainability risk, which had been among the three most likely risks for a rather long time, was assessed as less likely; the probability indicator came closer to below average.

The probability of risk, related to the slowdown of Lithuania's exports and the decrease in economic growth, grew and was one of the highest. Risks related to the drop in Lithuania's exports, due to the global economic slowdown, too-slow growth (or downturn) of Lithuania's economy and loss of competitiveness in foreign markets, compared to the survey performed half a year ago, became more likely. In addition, in the assessment of the respondents, the impact of the possible materialisation of these risks grew and came closer to higher than average. Such changes in assessment could in part be due to the significantly deteriorated, since the previous survey period, geopolitical situation in Eastern Europe and the trade restrictions that Russia brought into effect. According to respondents, these risks could be reduced by decreasing the tax burden and promoting investment programmes intended for increasing the efficiency of export and production.

The probability of risks stemming from Lithuania and their potential impact decreased. Compared to the survey that took place half a year ago the credit assessment of households significantly improved. The likelihood of such

risk and its potential impact were assessed as below average. The most likely risk arising in the country, as considered by the respondents, was the risk due to legislative changes or lack of necessary changes; however its probability was assessed as below average. According to the respondents, household credit risk could be decreased by applying responsible lending requirements, while risk related to legislative changes would decrease with the Government implementing consistent policy and removing administrative obstacles to business.

Lithuania's financial market participants do not perceive risk related to the unsustainable growth of real estate prices. The risk probability is assessed as below average, while its potential impact — as moderate. According to the respondents, possibilities to mitigate this risk exist (e.g. with banks lending responsibly or increasing housing supply by liberalising conditions for construction and managing of land plots).

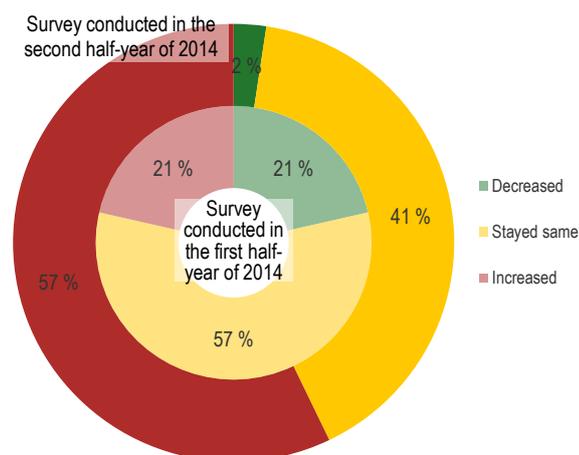
Risks related to the financing of Lithuania's financial institutions were among the least likely. According to the respondents, the probability of risks related to the limited funding opportunities of Lithuania's financial institutions and the high price of financing, is low. In addition, compared to the earlier survey it decreased.

When asked to indicate and assess more sources of likely risk, financial institutions drew attention to the danger of deflation and the slowdown in the economic growth of the EU countries. In Lithuania and Europe inflation continues to be exceptionally low, and with the economy of the EU states basically stagnant, such sources of risk are likely to remain important to financial institutions in the future as well.

In the opinion of the respondents, the probability of an event that would have a high impact on the country's financial system significantly increased over the last half-year. Most of Lithuania's financial institutions (57%) indicated that over the past 6 months such a possibility increased; 41 per cent of those surveyed assessed the possibility as being unchanged and only one institution indicated that the possibility had decreased (see Chart 2). Compared to the survey performed in the previous half-year the share of those believing that the probability of a high-impact event on the country's financial system had increased grew by almost three times, while those claiming that it had decreased dropped by 10 times. Such changes were driven by the escalated geopolitical situation in Eastern Europe. According to the surveyed financial institutions, the probability of a high-impact event on the country's financial system continued to be mostly assessed as below average (see Chart 3).

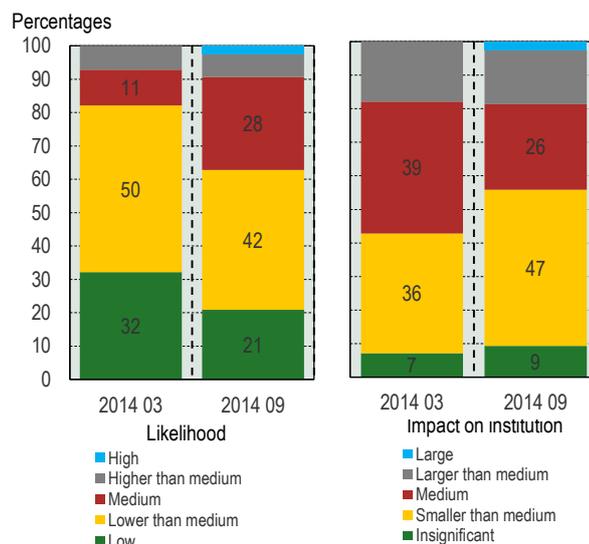
The potential impact of a big event on the financial institutions was assessed as being lower after a half-year. The surveyed financial institutions were more likely to consider the impact of such events on themselves as more moderate, compared to half a year ago. The share of institutions that would not be impacted or impacted less than average by big events increased, while those that would be impacted moderately or severely — decreased. However, the impact is assessed differently by various participants of the financial sector. 38 per cent of surveyed banks claimed that a big event would impact them moderately or severely, while not one insurance undertaking indicated such a strong impact.

Chart 2. Change in the probability of a high-impact event in Lithuania's financial system over the upcoming 6 months



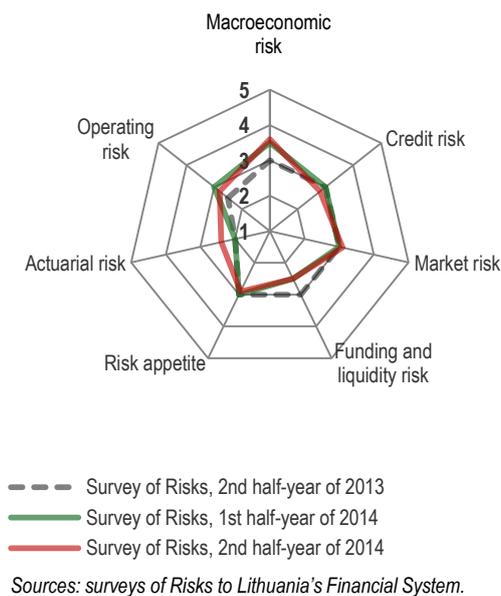
Sources: Surveys of Risks to Lithuania's Financial System.

Chart 3. Probability of high-impact events in Lithuania's financial system and their impact on a financial institution within the upcoming 6 months



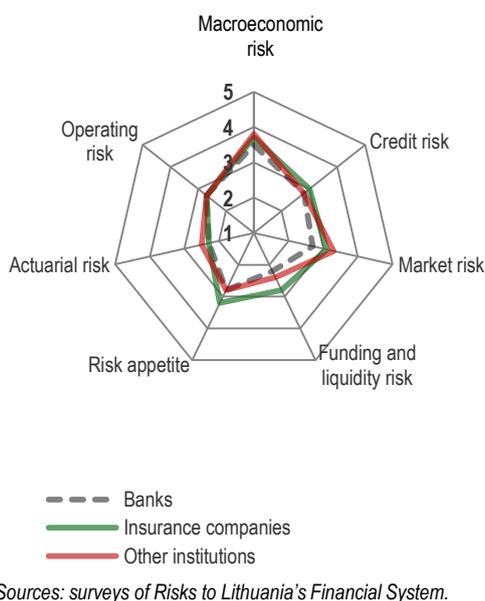
Source: Survey of Risks to Lithuania's Financial System.

Chart 4. Development of structural 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. Level of structural 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. Assessment of Structural 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's operations, while their levels are constantly changing. The respondents also presented their perception of the risk appetite of the financial institutions. Seeking to ensure the comparability of data, this risk "spider's web" is presented as being the same as in previous surveys, allowing to monitor the risk assessment changes.

Structural risks, which impact Lithuania's financial system, are assessed as below average or average. In the opinion of the surveyed financial institutions, the most important are macroeconomic and market risks; after half a year they are assessed as being even greater (see Chart 4). In addition, actuary risk became more important, although it is still assessed as low. On the other hand, credit and operational risk decreased from the previous survey; they were assessed as lower than average.

Macroeconomic risk increased for the second half year in a row and was assessed as the most important of the permanent risks. This risk was considered as the highest by all market participants, while its assessment came closer to above average. Such risk assessment was based by the respondents on the deterioration of the geopolitical situation in Eastern Europe, imposition of economic sanctions and slowdown of the economic growth of the EU countries.

Credit risk assessment decreased over the half-year. According to the respondents, such a change was due to both the better financial situation of debtors and that the lenders ensure better quality of the loan portfolio. Although there is risk related to losses experienced by non-financial companies due to the conflict between Russia and Ukraine, the ability of these companies to diversify income decreases the credit risk. Also, in the opinion of those surveyed, banks have sufficient reserves to cover potential losses.

The market risk assessment slightly increased, but was still lower than average. True, different participants of the financial sector assessed such risk differently. According to banks, market risk increased over the half-year, while in the opinion of insurance undertakings and other financial institutions, it decreased (see Chart 5). On the other hand, insurance undertakings and other financial institutions still consider this risk as being greater than banks do. Respondents associated this with low interest rate environment, search for yield and possible risk premium increase.

The funding and liquidity risk assessment remained unchanged, it is assessed as low. However, insurance undertakings assessed this risk as having slightly increased, while banks — as having decreased. In the opinion of the latter, funding and liquidity risk has been decreasing for the second consecutive half-year. The main reasons for such a change are considered to be liquid fund reserves in banks, low interest rate environment and expanding local funding sources.

The risk appetite of Lithuania's financial institutions remained essentially unchanged. In the assessment of all of the financial institutions, it remained lower than average, and this was mainly driven by the tendency of banks to maintain stable capital indicators and external sources of risk (i.e. the conflict between Russia and Ukraine). On the other hand, the risk appetite of other financial institutions (not banks and insurance undertakings) de-

creased over the half year.

Actuarial risk over the half year slightly increased, while operational risk decreased. According to the respondents, the probability of catastrophic events during this time is low; it is decreased even more by reinsurance. At the same time, operational risk is still mostly assessed as lower than average, and such an assessment is usually based by respondents on strict control of the supervision of financial market participants.

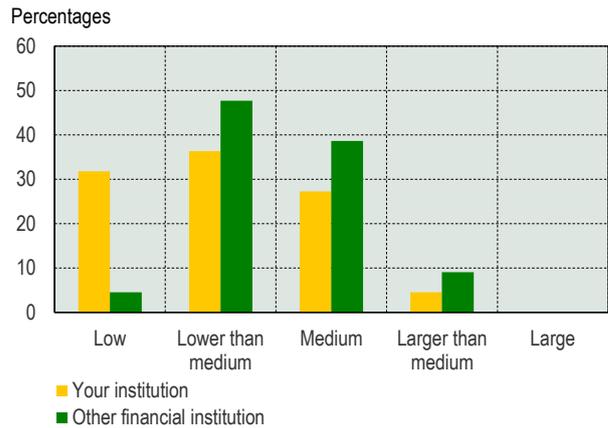
3. Perception of Risk Appetite

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.

The surveyed financial institutions still assess their risk appetite as cautious. As usually, the risk appetite of other financial institutions was assessed by respondents as being greater than their own, however, it still remains conservative (see Chart 6). Compared to the survey performed half a year ago, the risk appetite of financial institutions barely changed. The risk appetite assessment weighted average decreased, but not enough for it to be considered a major change in attitude towards risk (see Chart 7). The share of the financial institutions assessing their risk appetite as moderate increased the most — by 5.1 p.p.

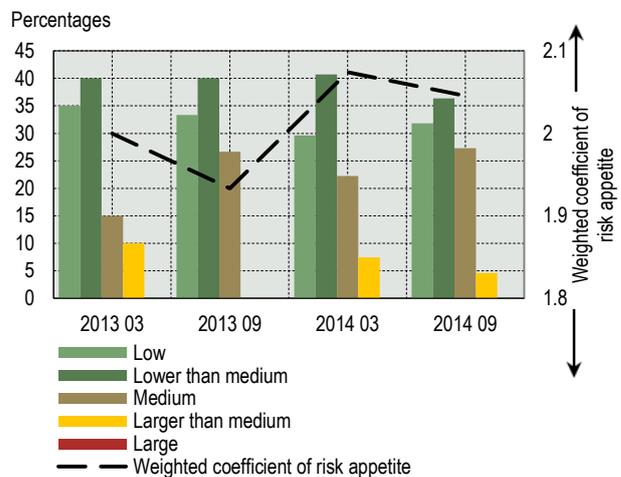
The risk appetite of most financial institutions over the upcoming 6 months will remain unchanged (see Chart 8). The percentage of respondents with such claims was the greatest — 84.1 per cent. On the other hand, their share, compared to the survey performed in the previous half-year, decreased (12.2%). In addition, there appeared financial institutions (4.5%) claiming that their risk appetite will increase over the coming 6 months. In assessing the behaviour of market participants, those surveyed were more conservative than half a year ago. Although the greatest share of respondents claimed that the risk appetite of other financial institutions will not change, it still decreased, compared to last half-year's survey. The share of those who answered that such a tendency of financial participants will decrease was larger, while of those who believe that it would increase — lower.

Chart 6. Risk appetite of financial institutions



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

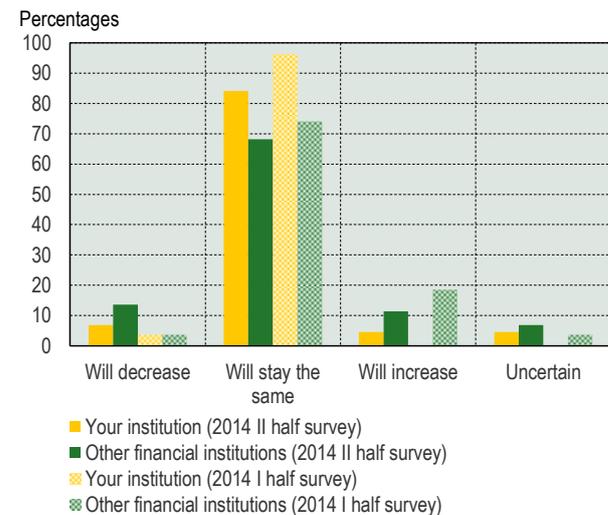
Chart 7. Risk appetite of financial institutions dynamics



Source: Survey of Risks to Lithuania's Financial System

Note: weighted coefficient is calculated appointing numerical values to the risk appetite levels from 1 to 5 (where 1 corresponds to low and 5 -high risk appetite) and adding weights to them according the share of responses.

Chart 8. Risk appetite over upcoming 6 months



Source: Survey of Risks to Lithuania's Financial System

The Review was prepared by the Financial Stability Department of the Economic and Financial Stability Service of the Bank of Lithuania