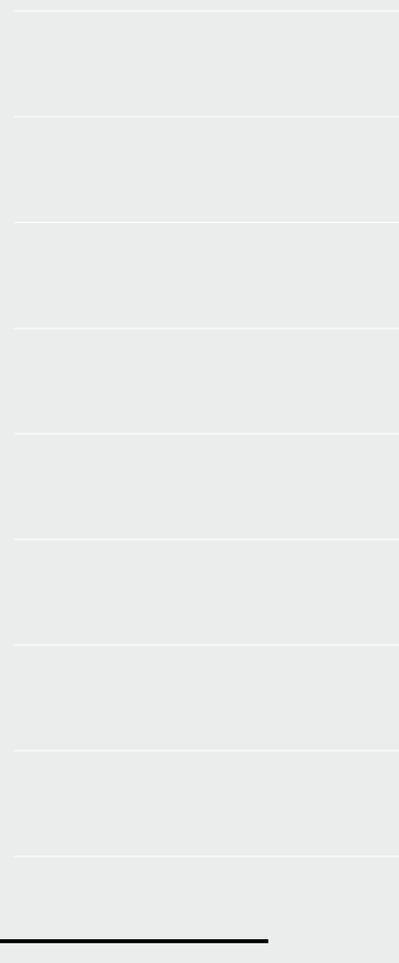


REVIEW OF THE SURVEY OF RISKS TO LITHUANIA'S FINANCIAL SYSTEM

2013-I



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To identify the view of Lithuania's financial institutions regarding the domestic financial system and likely challenges to its sustainable development in the future, the Bank of Lithuania conducts biannually a periodical survey of risks to Lithuania's financial system. Banks, insurance and leasing companies, management companies and other financial institutions assess key sources of risk 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 6 months.

Twenty three respondents took part in the survey of risks to Lithuania's financial system, which included eight banks operating in Lithuania, seven insurance companies, two leasing companies, three management companies, two financial brokerage firms, and others. Highly experienced representatives of institutions in management positions were asked to describe the situation in the domestic financial system at the end of February 2013. In summarizing the opinions and calculating the share of financial institutions that chose one or other particular variant of the given answers, the responses of individual institutions were given the same weight, regardless of their held market share. This survey is voluntary; respondents can choose which questions to answer.

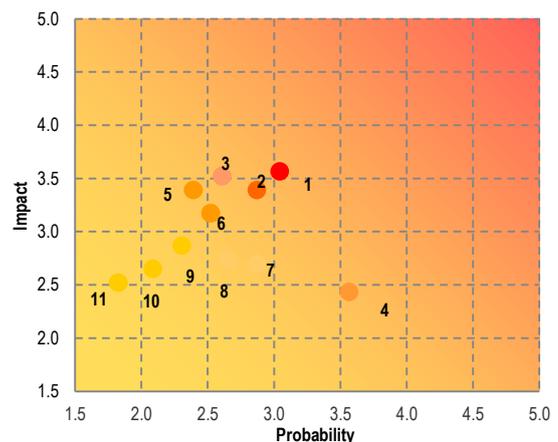
This survey of risks to Lithuania's financial system provides the summarized opinion of the respondents and does not reflect the official position and assessments of the Bank of Lithuania and its employees.

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

SUMMARY

Financial institutions are mainly concerned about external sources of risk. Major concerns stem from European sovereign debt sustainability problems and a decrease in exports due to weaker growth in the global economy. Unfavourable trends in the economic development of foreign countries may have significant negative effects on the financial system. The instruments that can reduce them or their impact are scarce in Lithuania. The country's economy is open and dependent on global economic processes, thus macroeconomic risk, despite its abatement, still remains relevant. Credit risk is assessed as higher than average. Such assessment is influenced by the quality of the loan portfolio, which has been improving, albeit slowly. Most of the surveyed financial system participants claim that their risk appetite is low and will not increase in the next 6 months.

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



Source: Survey of Risks to Lithuania's Financial System, 2013-I.

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

SUMMARY OF THE RESULTS OF THE SURVEY

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

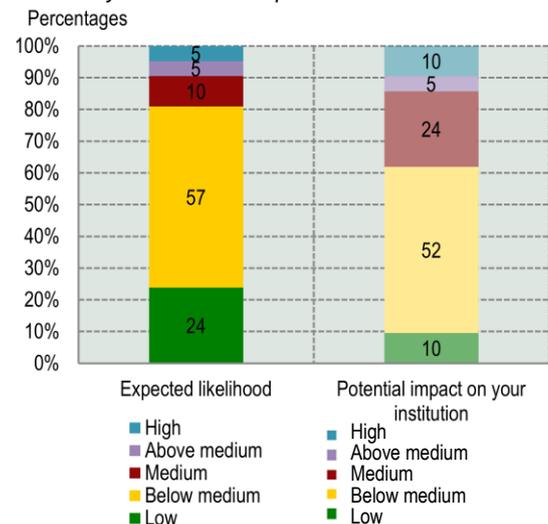
Source of risk	Probability	Impact	Ability to mitigate the risk
1 The problems of debt stability in the European countries, their interplay with the financial sector and potential for adverse contagion effects	3.0	3.6	3.5
2 Decline in Lithuania's exports due to the slow down of the global economy	2.9	3.4	3.1
3 Too slow growth of Lithuania's economy or economic downturn	2.6	3.5	3.0
4 Prolonged period of the low level of interest rates in the financial markets	3.6	2.4	2.8
5 Loss of competitiveness of Lithuania's economy in foreign markets	2.4	3.4	2.8
6 High credit risk of corporates in Lithuania	2.5	3.2	2.8
7 Lack of funding of Lithuania's economy due to deleveraging	2.9	2.7	2.5
8 High credit risk of households in Lithuania	2.7	2.7	2.5
9 Incapability of financial institution to operate further (insolvency)	2.3	2.9	2.4
10 High funding costs of financial institutions in Lithuania	2.1	2.7	2.5
11 Limited possibilities of self-financing of financial institutions in Lithuania	1.8	2.5	2.3

Source: Survey of Risks to Lithuania's Financial System, 2013-I.

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.

Chart 2. Probability of high-impact event in Lithuania's financial system and the impact on financial institution



Source: Survey of Risks to Lithuania's Financial System, 2013-I.

1. Assessment of Sources of Risk

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

Lithuanian financial institutions are mainly concerned about external sources of risk. Participants of the financial system operating in Lithuania consider the likely contagion effects of European sovereign debt sustainability problems on the Lithuanian economy and a decline in Lithuanian exports due to weaker growth in the global economy as major sources of risk (see Table 1). The instruments that can reduce their manifestation or impact are scarce in Lithuania. According to the respondents, prudent management of investment and orientation towards new export destinations could mitigate the impact of the risk sources mentioned above.

The recovery of the Lithuanian economy is assessed more favourably. Lithuania's strong economic performance last year and the forecasted one of the highest growth rates in the European Union in the future determined a more restrained perception of the too slow recovery in Lithuania's economy or the probability of economic downturn. The prolonged period of low interest rates in financial markets remains the most likely source of risk; however, its impact would be lower than medium. Insurance companies investing in debt securities for a long term also reported that they would not face any negative impact of low interest rates.

Financial institutions do not see solid reasons why Lithuania's economy could lose competitiveness in foreign markets. Wage growth outpacing labour productivity growth raises problems of the country's competitiveness. The financial institutions surveyed believe that this is a sufficiently significant source of risk, assessing the probability of its manifestation as low, however.

According to the respondents, bank loan portfolio changes are in line with today's economic situation. It is observed that financial institutions are concerned with complicated and long judicial proceedings in solving recovery cases. Certainty regarding the tax environment would also contribute to the mitigation of this source of risk.

The credit risk of non-financial enterprises and households is perceived as lower than medium. The Survey participants report that financial institutions are able to manage these risks by applying tighter lending requirements.

The funding of financial institutions is stable. According to the respondents, both the high funding costs of Lithuania's financial institutions and limited possibilities of self-financing are the events with a probability lower than average, which will not have any greater impact on Lithuania's financial system.

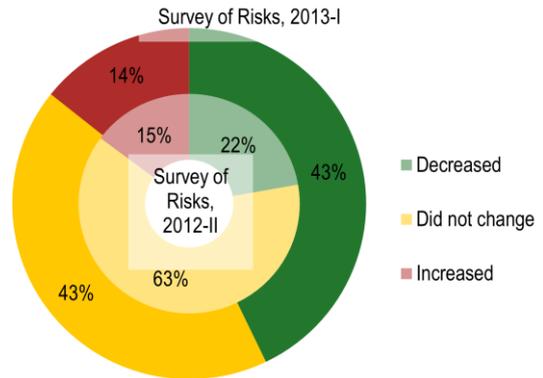
Financial institutions have been observing the situation both in Europe and globally. Asked to indicate and assess more of the potential sources of risk, financial institutions took note of likely political and economic difficulties in other countries of the world (e.g., USA and Russia). Furthermore, there still is some uncertainty that, after the coming into power of new political forces after the Republic of Lithuania Seimas elections, the continuity of economic policies may be hindered. As the likely sources of risk, financial institutions pointed out the downgrading of Lithuania's borrowing ratings,

increasing labour costs, a currency crisis.

It is most difficult to reduce the sources of risk dependent on external factors. As a small and open economy, Lithuania is highly dependent on events in Europe and the world. 57 per cent of respondents claim that it is impossible to mitigate the effects of European sovereign debt sustainability problems on Lithuania's financial system. It would be complicated to avoid the negative effects of the slowdown in global economic growth.

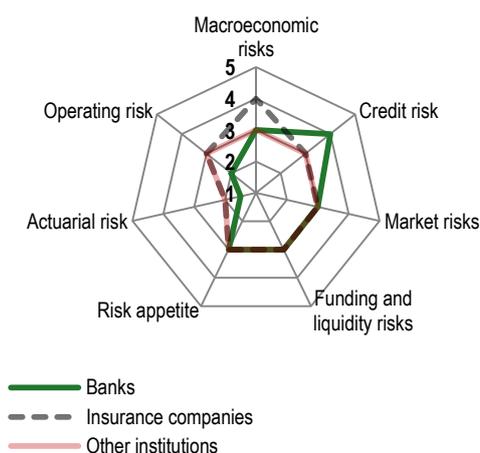
In the assessment of domestic financial institutions, there is little probability that a high-impact event in Lithuania's financial system will take place in the next 6 months. The bulk of the respondents reported that the probability of such an event is lower than medium or low (see Chart 2). Correlation between the assessment of the probability and the impact of events that may have a high-impact on the financial system is observed, i.e. the respondents reporting a lower probability of an event mentioned above are inclined to believe that such an event would not have a high impact on the financial institution they represent. Increasingly more financial institutions believe that the probability of the occurrence of a high-impact event in Lithuania's financial system in the next 6 months has decreased (see Chart 3).

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



Sources: Survey of Risks to Lithuania's Financial System, 2012-II and 2013-I.

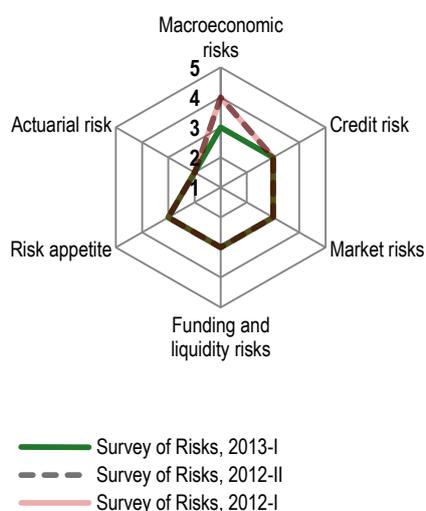
Chart 4. Level of risks to Lithuania's financial system



Source: Survey of Risks to Lithuania's Financial System, 2013-I.

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

Chart 5. Changes in the perception of risks to Lithuania's financial system



Sources: Survey of Risks to Lithuania's Financial System, 2012-I, 2012-II and 2013-I.

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

2. Perception of Permanent Risks

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

According to financial institutions, constant risks in Lithuania are lower than medium (the median of the assessment of many risks is 3; see Chart 4).

Macroeconomic risk, which in 2011 was assessed as high, in the present survey (see Chart 5) is assessed **as lower than medium**. In the respondents' perception, this risk still remains sufficiently relevant, as Lithuania's economy is open and dependent on global economic processes, while the perception of risk as lower by part of financial institutions is related to a more stable economic situation in the European Union.

More often than the other respondents, banks tended **to assess credit risk as higher than medium**. In their view, this risk is still sufficiently important due to psychological factors and the problem assets that emerged during the crisis and form part of the loan portfolio. In the perception of non-banking institutions, the largest domestic credit institutions belong to the financial groups of Scandinavian countries, which perceive and forecast credit risk closely enough.

The surveyed financial institutions agree **on the perception of market, funding and liquidity risks, and risk appetite. As compared to the results of the 2012 surveys, the perception did not change** (the median is 3, i.e. the risk is lower than medium). As in 2012, financial institutions closely assess market risk, which, according to the respondents, is rather dependant on external factors and is difficult to manage. Funding and liquidity risks, in the opinion of the surveyed, depends mainly on the European Central Bank's policies. Furthermore, according to financial institutions, they have accumulated a sufficient amount of liquid funds that are to serve as a buffer, should this risk increase. The surveyed financial institutions claim in concert that risk appetite is assessed responsibly and cautiously, banks aim not to increase the amount of risky assets. While operating risk is perceived as lower than medium, according to the respondents, it may increase in the future if strategic plans are underestimated or unfavourable changes in business regulation occur. Actuarial risk is perceived as hardly probable.

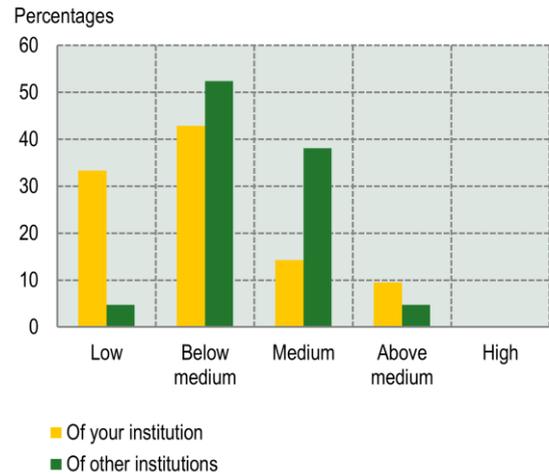
3. Perception of Risk Appetite

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

Financial institutions remain conservative further. When requested 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 below medium, or low (over 76% of the surveyed) (see Chart 6). It should be noted that the respondents often tend to believe that the risk appetite of their institutions is lower than that of other institutions. This notwithstanding, none of the respondents indicated that financial institutions tended to assume high risk.

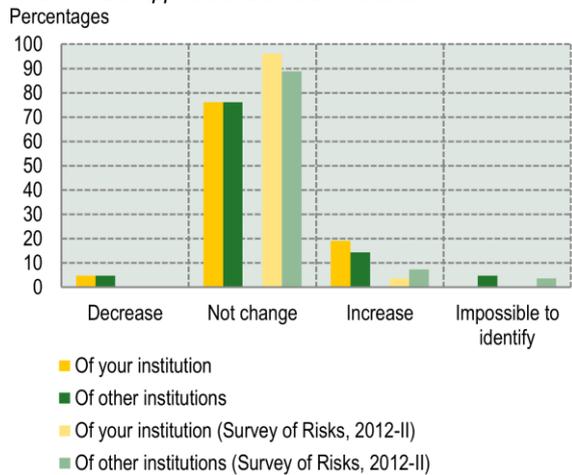
The risk appetite of financial institutions will not change significantly during the next 6 months. Most of those surveyed presume that in the next half-year the level of their risk assumed will remain unchanged (see Chart 7). Financial institutions attribute this to the prolonged stagnation in financial markets and moderate forecasts for GDP growth. Increasingly more respondents, however, believe that, in the future, the risk assumed by the financial institutions they represent and by other financial institutions is likely to increase.

Chart 6. Risk appetite of financial institutions



Source: Survey of Risks to Lithuania's Financial System, 2013-I.

Chart 7. Risk appetite in the next 6 months



Sources: Survey of Risks to Lithuania's Financial System, 2012-II and 2013-I.

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