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# REVIEW

## OF THE SURVEY OF RISKS TO LITHUANIA'S FINACIAL SYSTEM

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The Review was prepared by the Economics and Financial Stability Service of the Bank of Lithuania.

## AIMS, METHODS AND PRINCIPLES OF THE SURVEY

*In order to assess the views of Lithuania's financial institutions towards potential challenges to sustainable development of the financial system, the Bank of Lithuania conducts a Survey of Risks to Lithuania's Financial System. The Survey is conducted on a biannual basis (in May and November). Banks, insurance undertakings, leasing companies, investment management companies and other financial institutions evaluate the sources of major risks to Lithuania's financial system, the probability of adverse events and their potential impact on the domestic financial system over the upcoming 6 months.*

*32 respondents, i.e. 8 banks operating in Lithuania, 11 insurance undertakings, and 13 other financial institutions (leasing companies, financial brokerage firms, management companies, credit unions and payday loan companies), took part in this Survey. Questions were presented to the executives of the financial institutions surveyed. 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. Participation in the Survey is voluntary – respondents may choose which questions to answer.*

# REVIEW OF THE SURVEY RESULTS

**The surveyed financial institutions believe that cyber attacks is the greatest and most likely risk to the domestic financial system (see Table 1).** According to the respondents, both the probability and potential impact of this risk followed an upward path. Overall, financial institutions of all types (banks, insurance undertakings and other financial institutions) saw this risk as the most likely. Over the half-year, insurance undertakings' assessment of the risk turned the most stringent: in their opinion, it should exert a powerful impact on the financial system. On the other hand, the respondents evaluated their possibilities of mitigating cybercrimes as fairly strong, emphasising the impact of enhancing investment in IT security.

**The significance of the risk posed by potential imbalances in Lithuania's real estate market was seen as one of the most profound in terms of the domestic financial system, with other internal risks viewed as rather unlikely.** The importance of imbalances in the domestic real estate market has been picking up for a third consecutive half-year (see Table 2). The respondents (especially banks) viewed the risk as potentially having the most considerable impact on the financial system, with its probability indicator also elevating over the half-year. On the other hand, the importance of other internal risks was assessed more moderately. Risks related to unsustainable credit developments and deterioration in corporate and household financial health were considered to be the least likely, their probability scaling down even more over the half-year. According to the respondents, possibilities of mitigating the risk related to imbalances in the credit or real estate market are overall the highest.

**Risks related to a snapback in risk premia and a drop in profitability during a prolonged period of low interest rates remain among the key risks.** Other financial institutions and insurance undertakings attached most importance to the snapback in risk premia (see Chart 1). The latter saw this risk as potentially having the strongest impact on the financial system compared to all other risks. Banks and insurance undertakings considered the drop in profitability during a prolonged period of low interest rates to be highly important. The largest share of respondents saw this risk as the major risk not only to the financial system as a whole, but also to financial institutions that they represent (see Chart 2). Possibilities of mitigating both risks were seen as lower than medium, with diversification of the investment portfolio and sources of income being indicated most often.

**According to the surveyed, importance of geopolitical risk diminished, other external risks also became less likely.** Having been waning since the start of 2015, the importance of geopolitical risk diminished the most in the last half-year compared to all other risks; it was assessed as lower than medium. To insurance undertakings, this risk was somewhat more important compared to other financial institutions surveyed. Over the half-year, probability of other external risks, such as those related to European sovereign debt sustainability, problems within the European banking sector and imbalances in Scandinavian countries, also moderated. Financial institutions of all types, however, saw the potential impact of imbalances in Scandinavia as one of the most substantial risks. Possibilities of minimising the abovenamed risks were considered to be the lowest.

**Probability of a high-negative-impact event was assessed more moderately.** The majority of the surveyed (71%) stated that the probability of such an event remained unchanged over the half-year, yet there were significantly less of those believing that it had increased (see Chart 3). In the opinion of the surveyed, geopolitical tensions, which are heightening on a global scale, potential shifts in political decision-making in EU countries and the downturn in financial markets, as well as imbalance corrections in Scandinavia continued to be the most likely high-impact events.

**Over the half-year, the risk appetite of financial institutions followed a moderate upward trend.** The majority of financial institutions surveyed (45.2%) stated that they assume low rather than high risk. Slightly less respondents (38.7%) assume medium risk (see Chart 4). Compared to the survey conducted half a year ago, the share of financial institutions assuming high rather than low risk expanded, while that of financial institutions assuming low risk reduced. Thus the overall risk appetite of the surveyed has increased for the third consecutive half-year. Financial institutions of all types assessed their own risk appetite more moderately than that of other financial market participants (see Chart 5).

**The majority of the surveyed believed that worsening demographic trends in Lithuania will weigh on their activities in the next 5 years.** The bulk of the respondents (55%) stated that such trends will have have a somewhat negative impact on their activities, 19 per cent – a negative impact, 3 per cent – a strong negative impact. Only less than a quarter of the respondents indicated that demographic trends in Lithuania will have no effect whatsoever on their operations.

# KEY CHARTS AND TABLES

**Table 1. Cyber attacks is the greatest and most likely risk to the financial system**

*Assessment of risks to Lithuania's financial system*

| Risks | Im-portance | Probabil-ity | Potential impact | Possibili-ties of mitigating risk |
|---|---|---|---|---|
| I. Cybercrime risk | 3.0 | 3.2 | 2.9 | 2.7 |
| II. Snapback in risk premia in financial markets | 2.8 | 2.5 | 3.1 | 3.8 |
| III. Unsustainable development in real estate prices or imbalances in the real estate market | 2.8 | 2.5 | 3.1 | 3.0 |
| IV. Drop in profitability of Lithuania's financial institutions during a prolonged period of low | 2.6 | 2.7 | 2.6 | 3.6 |
| V. Imbalances in Scandinavian countries and potential contagion effects on Lithuania | 2.5 | 2.2 | 2.9 | 4.0 |
| VI. Problems in the European banking sector and potential contagion effects on Lithuania | 2.4 | 2.1 | 2.7 | 4.2 |
| VII. Weakening European sovereign debt sustainability and potential contagion effect on | 2.4 | 2.0 | 2.8 | 3.9 |
| VIII. Geopolitical tensions and their implications for Lithuania's financial system | 2.3 | 2.2 | 2.5 | 4.1 |
| IX. Deceleration in Lithuania's exports due to the slowdown in main trading partners | 2.3 | 1.9 | 2.8 | 3.8 |
| X. Deterioration in corporate financial health | 2.2 | 1.8 | 2.8 | 3.5 |
| XI. Deterioration in household financial health | 2.2 | 1.9 | 2.6 | 3.4 |
| XII. Unsustainable credit dynamics or imbalances | 2.1 | 1.6 | 2.8 | 2.7 |

Notes: Risk importance is calculated as a geometric mean of estimates for its probability and potential impact. **Probability**: 1 – low; 2 – lower than medium; 3 – medium; 4 – higher than medium; 5 – high. **Potential impact:** 1 – low; 2 – lower than medium; 3 – medium; 4 – higher than medium; 5 – high. **Possibilities of mitigating risk:** 1 – high; 2 – higher than medium; 3 – medium; 4 – lower than medium; 5 – low. Risks were grouped according to importance.

**Table 2. Risk related to the domestic real estate market is gaining influence**

*Risks to financial system importance dynamics*

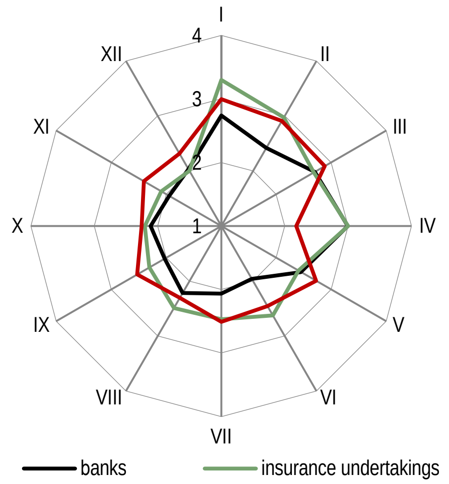
| Risks | H1 2015 | H2 2015 | H1 2016 | H2 2016 | H1 2017 |
|---|---|---|---|---|---|
| I | | | | | |
| II | | | | | |
| III | | | | | |
| IV | | | | | |
| V | | | | | |
| VI | | | | | |
| VII | | | | | |
| VIII | | | | | |
| IX | | | | | |
| X | | | | | |
| XI | | | | | |
| XII | | | | | |

Notes: Risk importance is calculated as a geometric mean of estimates for its probability and potential impact. Risks are enumerated in line with risk sources in Table 1. The level of risk importance is marked in the following way:

low importance — medium importance — high importance

**Chart 1. Banks assessed risks more moderately than other respondents, viewing the drop in profitability during a prolonged period of low interest rates as the key risk to the financial system**

*Importance of risks by financial institution sector*




*Notes: Risks are enumerated in line with risk sources in Table 1; risk importance is calculated as a geometric mean of estimates for its probability and potential impact.*

**Chart 2. Majority of institutions indicated the drop in profitability during a prolonged period of low interest rates as the key risk to their activities**

*Assessment of the key risk*

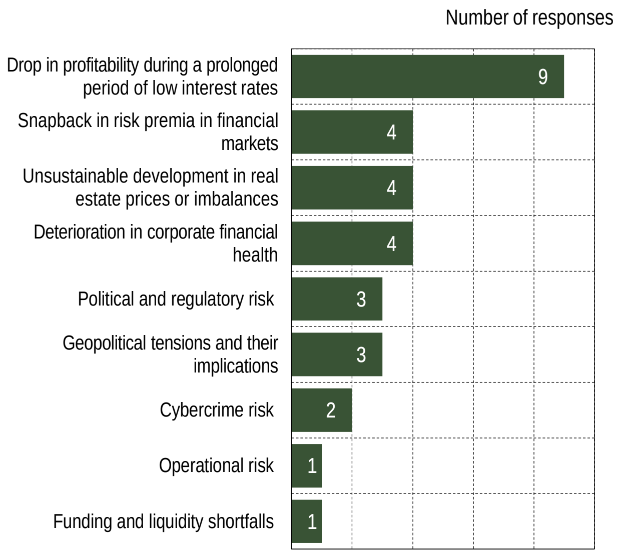


**Chart 3. Most respondents believed that the probability of a high-negative-impact event remained unchanged over the half-year**

*Change in the probability of a high-impact event in Lithuania's financial system in the next 6 months*

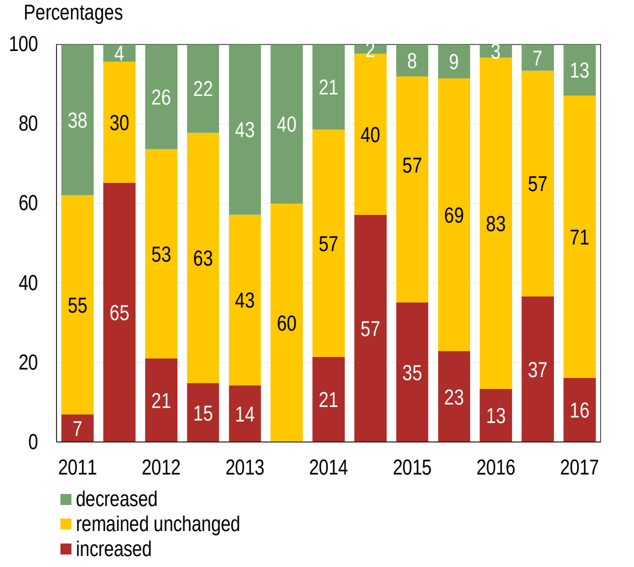
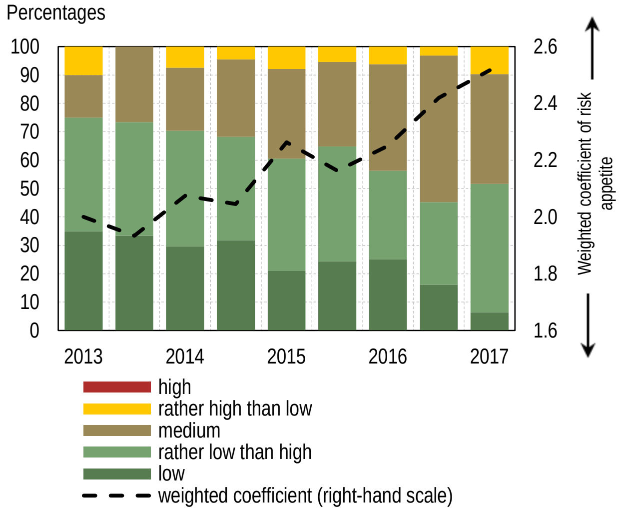



**Chart 4. Risk appetite of financial institutions increased moderately**

*Level of own risk appetite (during the survey)*




*Note: The weighted coefficient is calculated by giving numerical values to risk appetite levels from 1 to 5 (where 1 is low and 5 – high risk appetite) and adding weights to them against the share of each selected answer.*

**Chart 5. Financial institutions of all types assessed the risk appetite of others higher than their own**

*Level of own and other financial institutions' risk appetite (during the survey)*

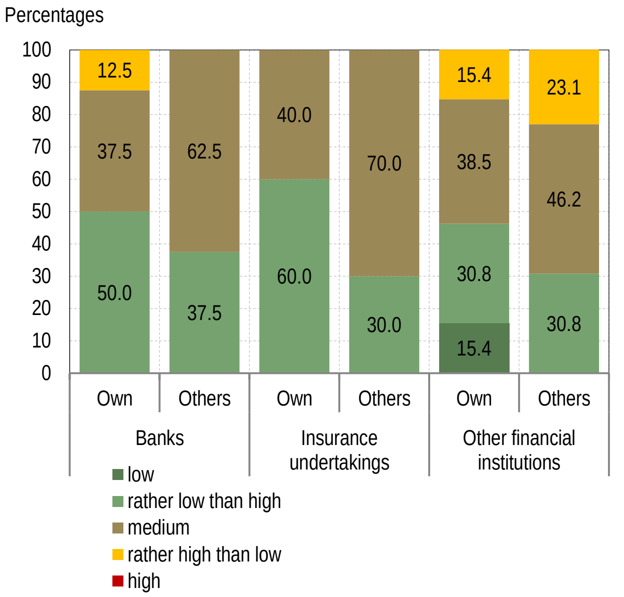



**Chart 6. Worsening demographic trends in Lithuania will exert a negative impact on most of financial institutions**

*Impact of negative demographic trends in Lithuania (i.e. depopulation and population ageing) on the respondent in the next 5 years*