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

2015

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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.

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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 undertakings, leasing companies, investment 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 potential impact on the domestic financial system over the upcoming six months.

37 respondents took part in this survey, which included 11 banks operating in Lithuania, 11 insurance undertakings, and 15 other financial institutions. Executives of the surveyed institutions were asked to describe the situation of the domestic financial system in September 2015. Summary statistics were calculated, giving the same weight to each survey response, regardless of the market share of the respondent. 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

The surveyed financial institutions assessed risk sources more moderately than half a year ago. Risk related to geopolitical tensions was still viewed as the most prominent (see Chart 1); however, in comparison to previous assessment, both its probability and potential impact reduced significantly. Risk related to a drop in export volumes in regards to the slowdown in growth of the economy of main trading partners became less likely as well.

Sources of risks related to protracted low interest rate period and reduced risk premia in the financial market were seen as one of the most prominent. The surveyed banks and insurance undertakings viewed the challenge to financial institution profitability in an environment of persistent low interest rates as more prominent. Other financial institutions viewed the risk related to an abrupt rise in risk premia in financial markets as one of the most important.

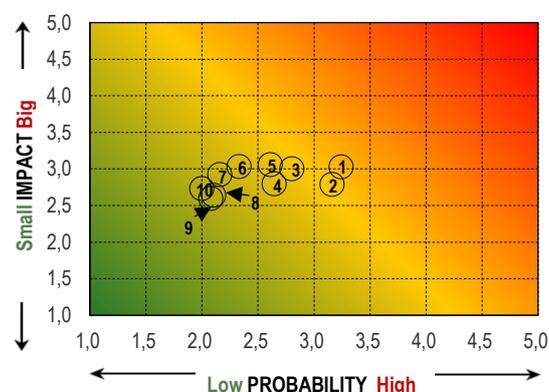
Cybercrime risk was also seen as one of the most prominent risk sources; other risks arising in Lithuania were considered to be less important. Out of all surveyed institutions banks saw cybercrime risk as more prominent. However, the surveyed financial institutions did not expect deterioration in the financial standing of non-financial undertakings and households. The respondents also viewed risks related to unsustainable lending growth and unsustainable development in real estate prices as less likely.

Financial institutions viewed the aggravation of the refugee crisis in Europe as most likely to negatively impact the domestic financial system. Events related to the increase of geopolitical tensions in the East and the slowdown in the economic growth of China were mentioned slightly less frequently. A fourth of the respondents believed that the probability of an event that could have a negative impact on the financial system increased. However, there were less of those sharing this view than half a year ago.

When assessing permanent risks, respondents viewed macroeconomic and market risks as the most important. The importance of the latter risk over the half-year increased the most. Banks assessed permanent risks more moderately than half a year ago, insurance undertakings and other financial institutions viewed them as slightly higher than half a year ago.

The surveyed financial institutions mostly viewed the risk appetite as medium or lower. Risk appetite decreased over the half-year. However, there were more respondents stating that the risk appetite will increase in the near future than those believing that it will reduce.

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



Sources: The Survey of Risks to Lithuania's Financial System and the Bank of Lithuania calculations.

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

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

	Risk source	Probability	Potential impact	Ability to mitigate the risk
1	Geopolitical tensions in the East and imposition of economic sanctions related to them.	3.2	3.0	4.1
2	Challenge to financial institution profitability in an environment of persistent low interest rates	3.2	2.8	3.7
3	Abrupt rise in risk premia in financial markets	2.8	3.0	3.4
4	Cyber-crime risk	2.6	2.8	3.1
5	Drop in Lithuania's export in regards to the slowdown in growth of the economy of main trading partners	2.6	3.1	3.6
6	Deterioration in European sovereign debt sustainability and possible contagion effect on the Lithuanian economy	2.3	3.0	4.1
7	Deterioration in financial standing of enterprises	2.2	2.9	2.9
8	Unsustainable credit developments or imbalances in the credit market	2.1	2.6	3.2
9	Unsustainable development in real estate prices	2.1	2.6	3.3
10	Deterioration in the financial standing of households	2.0	2.7	3.5

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

Notes: 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. Ability to mitigate the risk: 1 — high; 2 — higher than medium; 3 — medium; 4 — lower than medium; 5 — low.

Table 2. Most likely sources of risks according to the type of financial system participants

Financial institution	Sequence of probability	Risk source
Banks	1	Geopolitical tensions in the East and imposition of economic sanctions related to them (3.5)
	2	Challenge to financial institution profitability in an environment of persistent low interest rates (3.5)
	3	Cybercrime risk (3.1)
Insurance undertakings	1	Challenge to financial institution profitability in an environment of persistent low interest rates (3.4)
	2	Geopolitical tensions in the East and imposition of economic sanctions related to them (3.1)
	3	Drop in Lithuania's export in regards to the slowdown in the economy of main trading partners (2.6)
Other institutions	1	Geopolitical tensions in the East and imposition of economic sanctions related to them (3.1)
	2	Abrupt rise in risk premia in financial markets (3.1)
	3	Challenge to financial institution profitability in an environment of persistent low interest rates (2.8)

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

Notes: probability 1 — low; 2 — lower than medium; 3 — medium; 4 — higher than medium; 5 — high. Arithmetic averages of the indicated probabilities of respective financial system participants are provided in the brackets.

Table 3. Change in importance of risk sources

	Risk source	H1 2014	H2 2014	H1 2015	H2 2015
1	Geopolitical tensions in the East and imposition of economic sanctions related to them				
2	Challenge to financial institution profitability in an environment of persistent low interest rates				
3	Abrupt rise in risk premia in financial markets				
4	Cybercrime risk				
5	Drop in Lithuania's export in regards to the slowdown in growth of the economy of main trading partners				
6	Deterioration in European sovereign debt sustainability and possible contagion effect on the Lithuanian economy				
7	Deterioration in financial standing of enterprises				
8	Unsustainable credit developments or imbalances in the credit market				
9	Unsustainable development in real estate prices				
10	Deterioration in the financial standing of households				

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

Note: risk importance is expressed as the product of such risk probability and potential impact.

SUMMARY OF THE SURVEY RESULTS

1. Perception of Risk Sources

Domestic financial institutions that participated in the survey reported their views regarding the pre-defined set of risk sources and the probability for them to materialise, as well as their negative impact on Lithuania's financial system, and possibilities for mitigating the risks. Respondents also identified and assessed other relevant (in their opinion) sources of risk.

The surveyed financial institutions continue to view the risk related to geopolitical tensions in the East as the most prominent risk source (see Table 1); however it is less likely than half a year ago. Assessment of probability of such risk and of potential impact, which had been higher than medium (4.1 and 3.7 respectively), approached medium in this survey (3.2 and 3.0 respectively). This risk was viewed as the most likely by banks and as slightly less likely — by other surveyed financial institutions (see Table 2). Respondents considered the possibility for mitigating risk to be lower than medium and indicated the search for new export markets and more active state involvement in developing trade in other regions as potential risk mitigation measures.

The challenge to profitability in an environment of persistent low interest rates is still viewed as one of the most important risks (see Table 3). Even though probability of risk reduced slightly, this risk was still seen as one of two most likely. Banks gave its probability the highest mark, while insurance undertakings identified it as the most likely out of all predefined risks. The surveyed financial institutions viewed the potential impact of risk as medium; banks assessed it somewhat more strictly than other institutions. Even though, according to the respondents, possibilities for mitigating risk are lower than medium, the risk would be mitigated by the increase of non-interest income from such assets and higher risk-taking.

According to the respondents, the probability of an abrupt rise in risk premia in financial markets increased over the half-year. Having assessed such risk as lower than medium half a year ago, financial institutions viewed it as medium in this survey. Other financial institutions, i.e. non-banks and non-insurance undertakings, stood out: they saw both the probability of risk and potential impact as somewhat higher than medium. Diversification of the investment portfolio, ongoing monitoring and the use of hedging transactions were the most mentioned risk mitigation measures.

Cybercrime risk was also seen as one of the most important among risk sources. Over the half-year, the assessment of this risk remained essentially unchanged. In comparison to other surveyed enterprises, banks viewed it as more important — they indicated that it is one of the most likely (see Table 2). Respondents viewed possibilities for mitigating risk as medium, i.e. as relatively good in comparison to other risks. The surveyed enterprises identified greater investment in computer system security and more active state involvement in developing cyber security system as risk mitigation measures.

Probability that Lithuania's export will drop in regards to the slowdown in the economy of main trading partners reduced over the half-year. On average, such probability in this survey was seen as slightly lower than medium. However, respondents viewed the potential impact as relatively the largest out of all predefined risks, i.e. somewhat higher than medium. Possibilities for mitigating risk were seen as lower than medium and often included export diversification and the search for new markets.

The importance of risk related to the deterioration in European sovereign debt sustainability was seen as relatively low. Such probability of risk decreased somewhat and was lower than medium. However, the surveyed essentially did not see any possibilities for mitigating the risk, while the risk mitigating measures indicated most often included the diversification of the investment portfolio and the limitation of investments in debt securities of greater credit risk euro area governments.

The deterioration in the financial standing of the private sector was seen as relatively unlikely. The probability of the deterioration in the financial standing of both enterprises and households reduced over the half-year and was viewed as lower than medium. The potential impact of such risk was also seen as relatively small, i.e. as somewhat lower than medium. In comparison to other financial institutions, banks viewed this risk as the least likely and having the smallest potential impact. According to the surveyed institutions, the possibility for mitigating the credit risk of enterprises is slightly better than that of households; usually respondents indicated that strict credit assessment is the mitigating measure for both risks.

Risks related to the unsustainable credit development and the unsustainable development in real estate (RE) prices were viewed as the least important risk sources. Both of these risks were perceived similarly: their probability — lower than medium, whereas the potential impact — the smallest out of all predetermined risks, i.e. somewhat lower than medium. Possibilities of mitigating risks were also viewed as relative good, i.e. as slightly lower than medium. According to the respondents, risks related to the unsustainable credit development and the unsustainable development in RE prices are mitigated by the regulation of the central bank.

When asked to indicate additional risk sources, financial institutions usually mentioned possible changes in the regulatory environment and the slowdown in the economy of China (see Table 4). These two risk sources were mentioned four times. Two financial institutions viewed the refugee crisis in Europe as a risk source.

Almost a fourth of the respondents believed that the probability of an event that could have a high impact on the domestic financial system increased (see Chart 2). There were more of those believing that such risk increased for the third consecutive half-year than those believing that it decreased. Thus the cumulative high-impact change coefficient increased over the half-year. However, the majority of the surveyed (69.0%) believed that the probability of a high-impact event remained unchanged, whereas in this survey there were less of those believing that the probability increased (less by 12 percentage points).

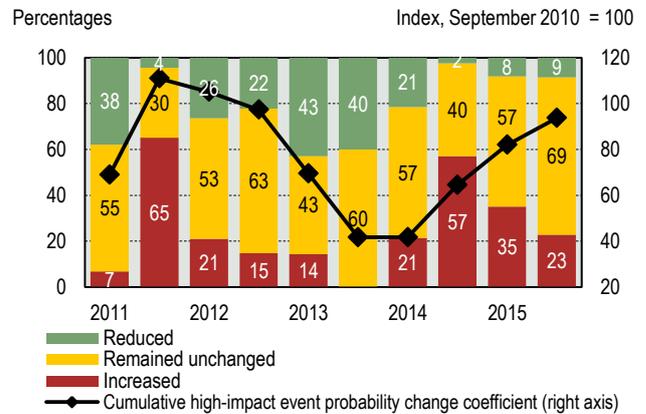
Most often the surveyed financial institutions indicated three events that could have a significant impact on the financial system (see Chart 3). Financial institutions mostly indicated events related to the tension which is rising in Europe at the moment due to the increased refugee flow (26%). Having been mentioned the most half a year ago (71%), events related to the Russian-Ukrainian conflict this half-year were mentioned much less frequently (22%). Events related to the slowdown in the economy of China and the possible contagion effect on the global financial markets also stood out (17%).

Table 4. Additional risk sources indicated by financial institutions

Risk sources	Frequency of response
Possible changes in the regulatory environment	4
Slowdown in the economic growth of China	4
Refugee crisis in Europe	2
Slow recovery of the EU economy	1
Strong competition among financial institutions	1
Administrative budget issues in the US	1
Too large a share of investments by pension funds in Lithuania	1
Corruption	1
Rise of inflation	1
Economic downturn in Russia	1

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

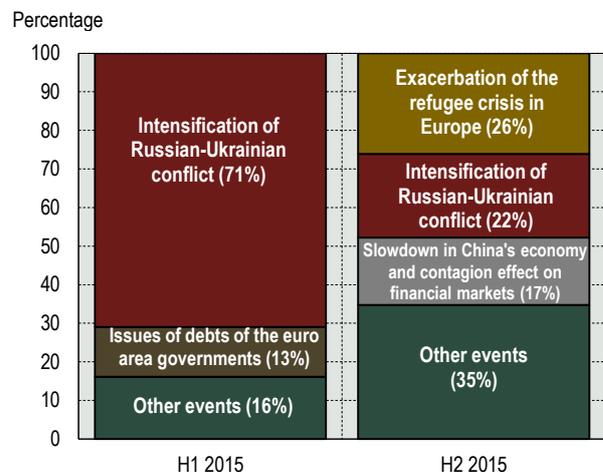
Chart 2. Change in the probability of a high-impact event in Lithuania's financial system over the upcoming 6 months



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

Note: cumulative high-impact probability change coefficient is calculated by adding the net probability change of a high-impact event to the index value, equal to 100 at the beginning of the base period. For example, an increase in the coefficient indicates a rise of the probability of a high-impact event over the half-year.

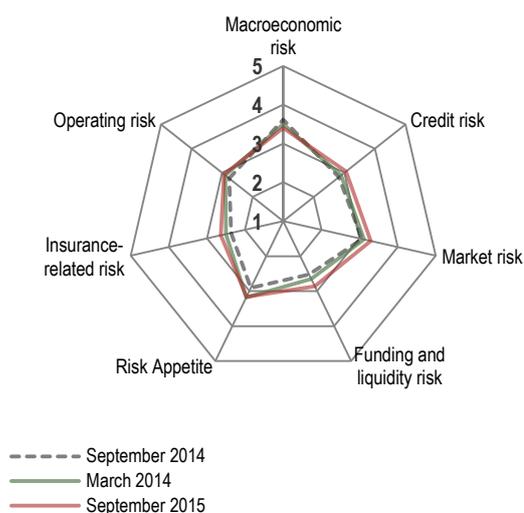
Chart 3. Most likely high-impact events in Lithuania's financial system in the near future that are most often indicated by financial institutions



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

Note: the chart presents the ratios of the frequency of events indicated by financial institutions to the total number of responses. Events mentioned less than three times are included into the category of other events.

Chart 4. Development of the importance of permanent risks to Lithuania's financial system

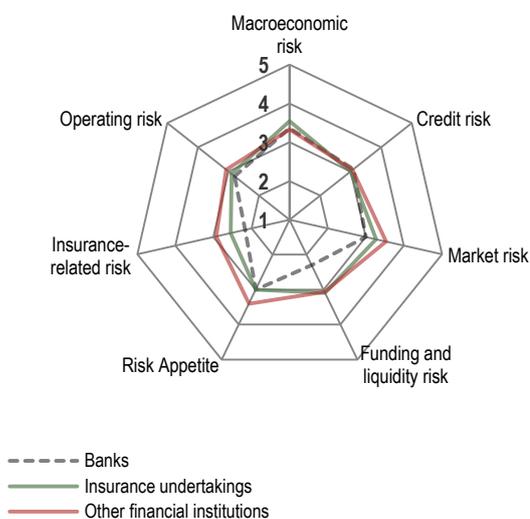


Sources: surveys of Risks to Lithuania's Financial System.

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

Chart 5. Assessment of the importance of structural risks to Lithuania's financial system according to the type of a financial institution



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

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

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

2. Assessment of Permanent Risks

The surveyed domestic financial institutions presented their perception of the importance of the permanent risks — macroeconomic, credit, financial market, funding and liquidity, operating, insurance (actuarial) risks — and the risk appetite as well.

The assessment of the permanent risks to the Lithuania's financial system remained medium or somewhat lower than medium (see Chart 4). Over the half-year the assessment of risk did not change much; however, it was different among financial institutions. Banks considered almost all risks to be decreased, whereas insurance undertakings and other financial institutions believed them to be slightly more important than the previous half-year.

The importance of the macroeconomic risk dropped slightly; however, it remained the highest. The surveyed financial institutions viewed the importance of such risk as medium. In comparison to banks and other financial institutions, insurance undertakings saw it as somewhat more important (see Chart 5). According to them, the importance of the risk increased even more over the half-year. Respondents based the relatively high importance of the macroeconomic risk on the slowdown in the economic growth in Lithuania, the geopolitical tensions in the East and the slowdown in the economy of China.

The importance of the financial market risk was one of the greatest among permanent risks. The assessment of importance of this risk came close to medium over the half-year. Other financial institutions (non-banks and non-insurance undertakings) viewed the financial market risk as the most important among permanent risks. Insurance undertakings saw it as somewhat less important, banks — as even less important. According to the surveyed, the relatively high risk importance is based on the slowdown in the economic growth in China, still relevant issues of the debt of Eastern Europe and the increased volatility in the financial markets.

The assessment of the risk appetite remained unchanged and was lower than medium. In comparison to other financial institutions, banks and insurance undertakings viewed the risk appetite as somewhat less important. Comments provided by respondents on the assessment of this risk were different as well. Some stated that the risk appetite in the financial sector is growing, while others considered the financial sector to be conservative. Nonetheless, the majority of the surveyed indicated that the risk appetite is limited by the regulatory environment.

The importance of funding and liquidity and credit risks increased somewhat. Respondents viewed the importance of the credit risk as somewhat greater than that of funding and liquidity risks; however, the assessment of the importance of both risks was close to being lower than medium. All surveyed financial institutions perceived the importance of credit risk almost in the same way. In comparison to other surveyed institutions, banks considered the importance of funding and liquidity risks to be lower. According to the respondents, both credit and funding and liquidity risks are reduced by low interest rates.

Operational risk and risk related to the insurance sector were still viewed as the least important among permanent risks. Respondents viewed operational risk as slightly more important, i.e. as being of lower than medium importance. In addition, other financial institutions (non-banks and non-insurance undertakings) also saw it as somewhat more important. The importance of risks related to the insurance sector was still seen as low. According to the respondents, the operational risk is increased by hacker activity. However, many insurance undertakings indicated the requirements of the Solvency II Directive, which will enter into force, as a measure mitigating operational risk and risk in the insurance sector.

3. Assessment of Risk Appetite

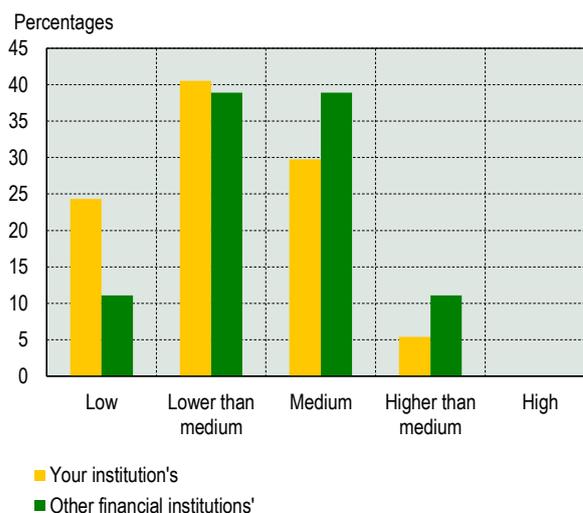
The surveyed financial institutions reported their perception of risk appetite at their institution and at other institutions, and indicated its likely developments over the upcoming 6 months.

The assessment of the risk appetite, provided by the surveyed financial institutions, remains rather conservative. Most financial institutions viewed their risk appetite as low rather than high (see Chart 6). Respondents viewed the level of the risk appetite of other financial institutions in Lithuania as being higher than their own, i.e. as largely medium. Insurance undertakings assessed their risk appetite somewhat more conservatively than other surveyed institutions — they viewed it as low or as lower than medium. Out of all respondents, the number of those viewing their risk appetite as low increased over the half-year, whereas the number of those viewing their risk appetite as high rather than low decreased. As a result, the overall risk appetite decreased somewhat; this is also seen from the decreased weighted coefficient of such risk (see Chart 7).

The majority of surveyed financial institutions will not change their risk appetite over the next half-year (see Chart 8). This was stated by 73.0 per cent of all respondents, i.e. slightly less than a half-year ago (79.0%). There were more financial institutions stating that their risk appetite will decrease (10.8%) over the next half-year, whereas the number of those stating that it will increase generally remained unchanged (16.2%). Assessing the risk appetite of other financial institutions, the surveyed institutions also mostly stated (69.4%) that it will remain unchanged. However, not one respondent believed that the risk appetite of other financial institutions will decrease; 19.4 per cent believed that it will grow over the next 6 months.

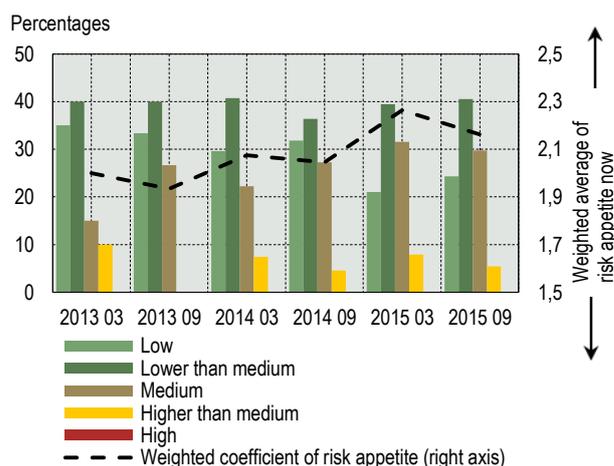
The Review was prepared by the Financial Stability Department of the Economics and Financial Stability Service of the Bank of Lithuania

Chart 6. Comparison of the assessment of the risk appetite of financial institutions (during the carrying out of the survey) to the assessment of the risk appetite of other financial institutions



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

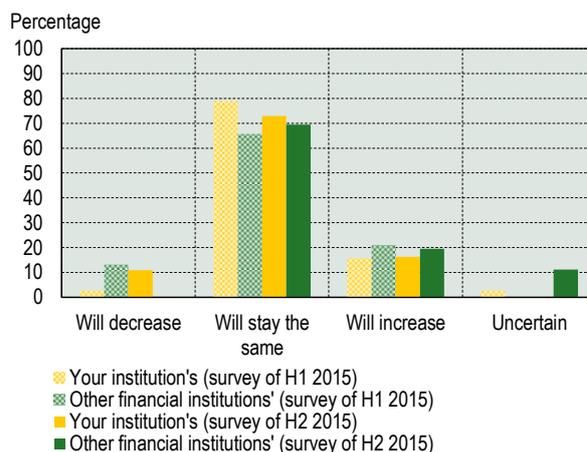
Chart 7. Development of the assessment of the risk appetite of financial institutions (during the carrying out of the survey)



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

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

Chart 8. Projection of risk appetite over the upcoming 6 months



Source: Survey of Risks to Lithuania's Financial System