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REVIEW

OF THE SURVEY OF RISKS TO LITHUANIA'S FINANCIAL SYSTEM

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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, which aims at assessing the views of Lithuania's financial institutions towards the risks to the domestic financial system and challenges to its sustainable future development, was used.

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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. The Survey is conducted twice a year (in April and October). Banks, insurance corporations, leasing companies, investment management companies and other financial institutions assess the major risks 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.

34 respondents, i.e. 9 banks operating in Lithuania, 12 insurance undertakings, and 13 other financial institutions, took part in this Survey. Executives of the surveyed institutions were asked to describe the situation of the domestic financial system in April 2016. 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 saw the challenge to profitability in a persistently low interest rate environment as the major risk (see Chart 1). Over the half-year, the assessment of both the probability of this risk and its potential impact increased. In addition, the surveyed financial institutions of all types (banks, insurance corporations and other financial institutions) considered this risk to be the most likely (compared to all pre-defined risks).

The risk related to geopolitical tensions in the East remained important, even though the surveyed believed that the probability of the risk related to a drop in exports reduced. Geopolitical tensions in Eastern Europe and the imposition of related economic sanctions were the second most important risk. Nevertheless, the surveyed (especially banks) considered the drop in Lithuania's exports due to the downturn in the economies of main trading partners to be less likely than half a year ago.

Cybercrime risk — among the key risks. Even though the assessment of this risk remained basically unchanged over the half-year, the surveyed financial institutions of all types viewed it as one of three most likely risks. The surveyed banks saw it as somewhat more important.

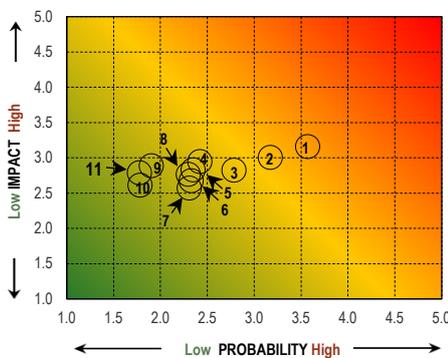
Respondents attached the least importance to internal (domestic) risks. Most often, the probability of deterioration in the financial situation of both non-financial corporations and households was seen as relatively low. Respondents also viewed risks related to unsustainable lending growth and unsustainable real estate price dynamics as rather unlikely.

When asked to indicate the most likely event that could have a high negative impact on Lithuania's financial system, the surveyed usually indicated the mounting geopolitical tensions in Europe. A fourth of the respondents stated this directly; however, other frequent answers could also be linked to geopolitical factors. For example, the possibility of the UK leaving the EU and the aggravation of the refugee crisis in Europe were often indicated as events that could have a negative impact on the financial system.

Permanent risks were assessed more moderately than half a year ago, whereas the macroeconomic risk remained to be seen as the key risk. However, the importance of this risk reduced over the half-year; other surveyed financial institutions (as opposed to banks and insurance corporations) believed it to be the most important.

Risk appetite of the surveyed financial institutions increased somewhat. The respondents mostly viewed their risk appetite as medium, yet the overall level of risk appetite changed somewhat. Nevertheless, the majority of the respondents (87%) stated that risk appetite will remain unchanged in the near future.

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



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

Table 1. Risks to Lithuania's financial system

	Risk	Probability	Potential impact	Possibilities of mitigating the risk
1	Challenge to financial institution profitability in a low interest rate environment	3.6	3.2	3.6
2	Geopolitical tensions in Eastern Europe and the imposition of related economic sanctions	3.2	3.0	4.5
3	Cybercrime risk	2.8	2.8	3.2
4	Drop in Lithuania's exports due to the downturn in the economies of main trading partners	2.4	2.9	3.9
5	Abrupt rise in risk premia in financial markets	2.4	2.8	3.8
6	Deterioration in European sovereign debt sustainability and possible contagion effect on the Lithuanian financial system	2.3	2.7	4.3
7	Imbalances in Scandinavian countries	2.3	2.6	4.4
8	Unsustainable real estate price dynamics	2.3	2.8	3.3
9	Deterioration in enterprise financial situation	1.9	2.9	3.6
10	Deterioration in household financial situation	1.8	2.6	3.8
11	Unsustainable credit dynamics or imbalances in the credit market	1.8	2.8	3.2

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. Possibilities of mitigating the risk: 1 — high; 2 — higher than medium; 3 — medium; 4 — lower than medium; 5 — low.

SUMMARY OF THE SURVEY RESULTS

1. Assessment of pre-defined risks

Financial institutions that participated in the Survey reported their views on the probability of materialisation of pre-defined risks, their negative impact on Lithuania's financial system, and possibilities of mitigating these risks. Respondents also identified and assessed other relevant (in their opinion) risks.

Respondents saw the challenge to financial institutions profitability in an environment of persistently low interest rates as the most likely risk (see Table 1). Over the half-year, the probability of such risk increased the most compared to all pre-defined risks. Financial institutions of all types considered it to be the most likely risk (see Table 2). According to the surveyed, the potential impact of the risk also enhanced significantly over the half-year and was the highest among all pre-defined risks. In the opinion of the respondents, possibilities of mitigating the risk were seen as lower than medium, whereas the impact of the risk was usually weakened by searching for higher-profitability investments, reducing costs and selling more products related to services.

The risk related to geopolitical tensions in the East was the second in terms of importance (see Table 3). According to the surveyed, the probability of this risk and its potential impact remained basically unchanged over the half-year. They continued to view the risk as potentially having a medium impact on the domestic financial system, while the probability of the risk — as somewhat higher than medium. The surveyed financial institutions of all types assessed the risk similarly, even though insurance corporations viewed it as somewhat more likely. Respondents considered the possibilities of mitigating this risk to be the lowest compared to all pre-defined risks. Nonetheless, in their opinion, the direction of exports to Western country markets, higher export diversification, promotion of domestic consumption and strengthening of national defence forces would mitigate the risk.

According to the surveyed, cybercrime risk was one of three major pre-defined risks. Respondents saw the probability of the risk as somewhat lower than medium. It should be noted that the surveyed financial institutions of all types believed the cybercrime risk to be one of three most likely risks. As stated by the surveyed, the potential impact of the risk remained unchanged in the half-year and was slightly lower than medium. Respondents considered the possibilities of mitigating this risk to be somewhat lower than medium, yet relatively good compared to other risks. Investment in IT security on both enterprise and national levels was seen as a factor that could potentially mitigate the risk.

The importance of the drop in Lithuania's exports due to the downturn in the economies of main trading partners continued to reduce. The probability of this risk had been reducing for the three consecutive half-years and in this Survey was seen as lower than medium. According to the respondents, the overall potential impact of the risk weakened as well. As opposed to other surveyed institutions, banks were the ones that stood out — they considered the probability of the risk to be lower, while the potential impact — higher. Possibilities of mitigating the risk were seen as lower than medium and often encompassed higher export diversification and the search for new markets.

The importance of the abrupt rise in risk premia in financial markets diminished. Compared to the Survey conducted in the previous half-year, when the probability of the risk increased significantly, the risk was seen as less likely in the present Survey. Its potential impact reduced somewhat as well. Banks assessed the risk more moderately than insurance corporations and other financial institutions. The surveyed financial institutions viewed the possibilities of mitigating the risk as lower than medium and often indicated higher investment portfolio diversification and the reduction of riskier security positions as risk mitigating factors.

Table 2. Most likely pre-defined risks according to the type of financial system participants

Financial institution	Sequence of probability	Risk
Banks	1	Challenge to financial institution profitability in a low interest rate environment (3.8)
	2	Geopolitical tensions in Eastern Europe and the imposition of related economic sanctions (3.1)
	3	Cybercrime risk (2.9)
Insurance corporations	1	Challenge to financial institution profitability in a low interest rate environment (3.8)
	2	Geopolitical tensions in Eastern Europe and the imposition of related economic sanctions (3.3)
	3	Cybercrime risk (2.7)
Other institutions	1	Challenge to financial institution profitability in a low interest rate environment (3.2)
	2	Geopolitical tensions in Eastern Europe and the imposition of related economic sanctions (3.2)
	3	Cybercrime risk (2.8)

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

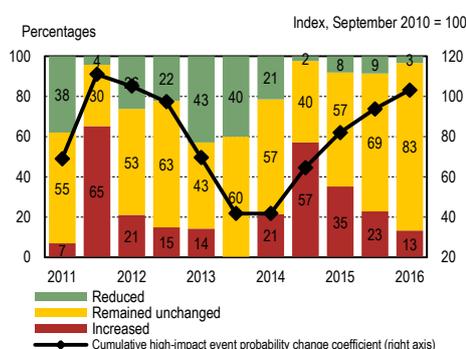
Table 3. Pre-defined risk importance dynamics

	Risk	2014 II	2015 I	2015 II	2016 I
1	Challenge to financial institution profitability in a low interest rate environment	Orange	Orange	Orange	Orange
2	Geopolitical tensions in Eastern Europe and the imposition of related economic sanctions	Red	Red	Orange	Orange
3	Cybercrime risk	White	Yellow	Yellow	Yellow
4	Drop in Lithuania's exports due to the downturn in the economies of main trading partners	Orange	Orange	Yellow	Yellow
5	Abrupt rise in risk premia in financial markets	White	Light Green	Light Green	Light Green
6	Deterioration in European sovereign debt sustainability and possible contagion effect on the Lithuanian financial system	Yellow	Yellow	Light Green	Light Green
7	Imbalances in Scandinavian countries	White	White	Light Green	Light Green
8	Unsustainable real estate price dynamics	Light Green	Light Green	Light Green	Light Green
9	Deterioration in enterprise financial situation	Light Green	Light Green	Light Green	Light Green
10	Deterioration in household financial situation	Light Green	Light Green	Light Green	Light Green
11	Unsustainable credit dynamics or imbalances in the credit market	White	White	Light Green	Light Green



Note: risk importance is expressed as the multiplication of the probability of such risk and its potential impact; the white boxes represent periods when respective risks were not included in the Survey.

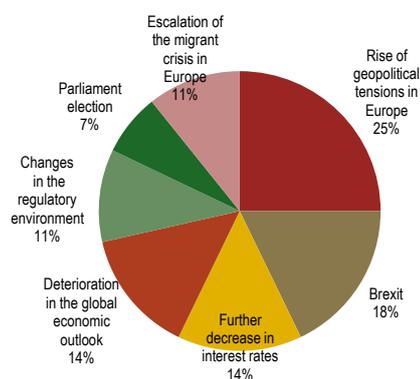
Chart 2. Change in the probability of a high-impact event in Lithuania's financial system over last six months and cumulative change coefficient



Sources: Surveys 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 an increase in 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



Note: respondents presented high-impact events in answering an open question; the classification was done by expertly attributing the respondents' answers to respective answer groups.

The importance of the risk related to the deterioration in European sovereign debt sustainability was seen as relatively low. The probability of this risk remained basically unchanged over the half-year and was still seen as lower than medium. As stated by the surveyed, the potential impact of the risk reduced over the half-year and became slightly lower than medium. Possibilities of mitigating the risk were assessed as relatively low and usually encompassed the reduction of investment in government (experiencing debt sustainability problems) security positions.

The surveyed financial institutions considered the risk related to imbalances in Scandinavian countries to be relatively unlikely. Banks assessed the probability of the risk as lower than medium, insurance corporations and other financial institutions — as slightly higher. The potential impact of the risk, according to respondents, was one of the lowest among the pre-defined risks. However, the surveyed institutions also viewed the possibilities of mitigating the risk as one of the lowest compared to other pre-defined risks.

The surveyed financial institutions did not expect deterioration in the financial situation of the private sector. The probability of the deterioration in the financial situation of both enterprises and households reduced over the half-year and was seen as one of the lowest compared to other pre-defined risks. Banks considered these risk to be less likely than other surveyed financial institutions. The potential impacts of such risks were also seen as relatively small, i.e. as somewhat lower than medium. Possibilities of mitigating the risk were also believed to be somewhat lower than medium, whereas more careful credit assessment, accumulation of reserves for offsetting potential losses, compliance with the provisions of the Responsible Lending Regulations and education of the public were mentioned as risk mitigants.

Risks related to unsustainable credit and real estate (RE) market dynamics were viewed as having minor importance. The probability of both risks was seen as lower than medium. However, the probability of the risk related to unsustainable RE price dynamics increased somewhat over the half-year. Potential impacts of both risks were viewed as somewhat lower than medium — one of the lowest among all pre-defined risks. Compared to all pre-defined risks, possibilities of mitigating the risk were seen as being relatively the best. According to the respondents, this risk is mitigated by the Responsible Lending Regulations, monitoring of the RE market and regulatory measures applied by the Bank of Lithuania.

When asked to indicate additional risks, financial institutions usually mentioned the upcoming Seimas elections and potential changes in the regulatory environment. Each of these risks was mentioned three times. It should be noted that a substantial share of other risks that were mentioned were related to geopolitical factors.

In the opinion of the majority of respondents, the probability of a high-impact event in the Lithuania's financial system remained unchanged over the last half-year (see Chart 2). In this Survey, those that shared this view accounted for 83.3 per cent — the largest share of respondents since the start of survey compilation in 2010. It should be noted that the share of respondent stating that such probability increased had been decreasing for the third consecutive half-year. Nonetheless, there were more of those which believed that the probability of such an event increased than those stating otherwise. Thus, over the half-year, the cumulative high-impact change coefficient increased somewhat.

The surveyed financial institutions usually linked high-impact events to geopolitical tensions (see Chart 3). Events that were directly related to the mounting geopolitical tensions in Europe were mentioned by a fourth of the surveyed financial institutions. However, events often mentioned by other respondents could also be linked to geopolitical factors. For example, the possibility of the UK leaving the EU and the aggravation of the refugee crisis in Europe were mentioned in 18 and 11 per cent of the cases respectively. A substantial share of the answers were linked to macroeconomic factors: a drop in interest rates (14%) and slower global economic growth (14%). Slightly less answers were related to changes in the regulatory environment (11%) and the upcoming Seimas elections (7%).

2. Assessment of permanent risks

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

The importance of permanent risks to Lithuania's financial system diminished somewhat over the half-year (see Chart 4). Respondents attached less importance to almost all pre-defined risks, while banks minimised the importance of the risks the most. The latter assessed most of permanent risks most moderately compared to all surveyed financial institutions (see Chart 5).

The importance of the macroeconomic risk reduced, however, it remained relatively the highest. The surveyed financial institutions viewed the importance of this risk as lower than medium. Compared to banks and insurance corporations, other financial institutions saw it as slightly more important. According to them, the risk importance increased somewhat and was the highest among permanent risks. Respondents based the relatively high importance of macroeconomic risk on the still-weak global economy growth.

The importance of the developments in the financial market reduced somewhat; however, it remained one of the highest among permanent risks. This risk was seen as having lower than medium importance. The surveyed insurance corporations viewed it as more important than banks and other financial institutions — for them, this risk was the most important out of all permanent risks. According to the surveyed, the relatively-high risk importance was based on the slowdown in China's economic growth and debt sustainability problems in South Europe.

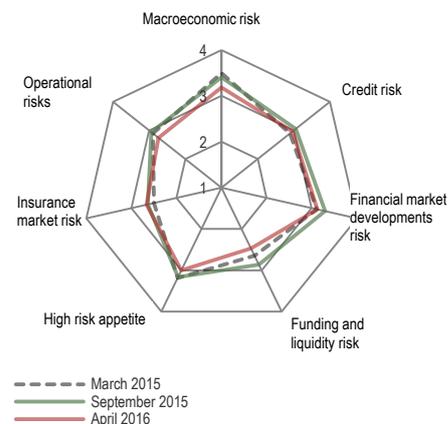
The importance of the risk related to the too-high risk appetite of financial institutions diminished somewhat and was lower than medium. The surveyed banks assessed the risk appetite somewhat more moderately than insurance corporations and other financial institutions. Comments on the assessment of this risk provided by respondents differed as well. For example, some stated that the risk appetite of financial institutions is higher due to the low interest rate environment, yet the majority of the respondents indicated that the too-high risk appetite is limited by the regulatory environment.

Credit risk importance remained lower than medium. Over the half-year, the importance of this risk remained essentially unchanged. Banks and insurance corporations assessed this risk somewhat more moderately, while the assessment of other financial institutions was stricter. According to the respondents, credit risk is mitigated by the low interest rate environment and sufficiently-strict lending standards.

Funding and liquidity risk declined the least in terms of importance. The importance of this risk was seen as being higher than low but lower than medium. Banks stood out as they assessed the importance of the risk more moderately, i.e. as low. According to the respondents, financial institutions have large reserves of liquid funds, and, currently, the funding cost is also especially low.

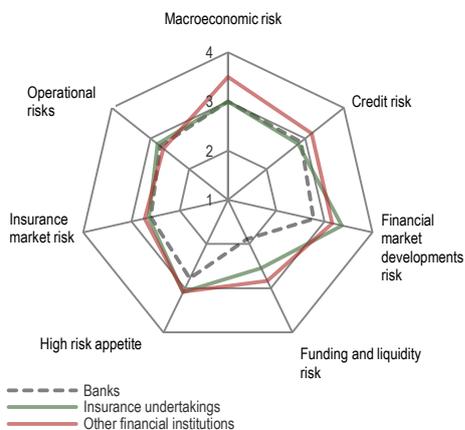
The importance of the operational risk and the risk related to the insurance sector was still seen as relatively low. Both risks were assessed similarly, i.e. their importance was seen as being higher than low but lower than medium. Insurance corporations assessed the operational risk somewhat stricter, while the risk related to the insurance market was assessed stricter by other financial institutions. In the opinion of the surveyed, the operational risk is increased by hacker activity, while the low interest rate environment and the rapidly-growing life assurance market contribute to the insurance market risk. However, many surveyed insurance corporations indicated the requirements of the Solvency II Directive, which are in force, as a factor mitigating operational and insurance sector risks.

Chart 4. Development of the importance of permanent 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.

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



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

3. Assessment of risk appetite

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

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

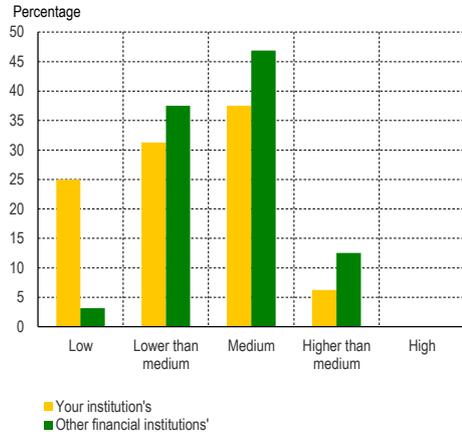
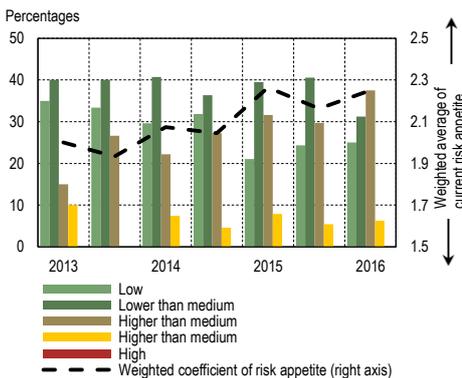


Chart 7. Development of the assessment of risk appetite of financial institutions (during the carrying out of the survey)

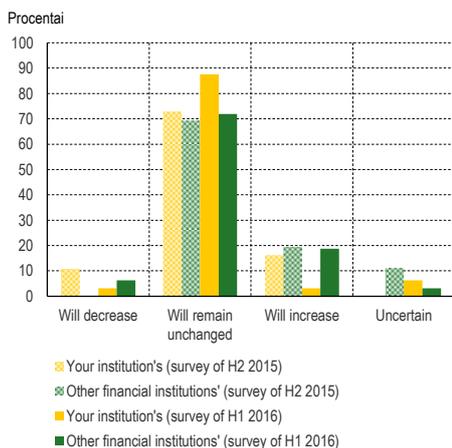


Note: the weighted indicator is calculated by giving numerical values to the risk appetite (from 1 to 5, where 1 corresponds to low risk appetite and 5 — high risk appetite) and weighing them according to the share of each selected answer.

The risk appetite of the majority of the surveyed financial institutions continued to be medium or lower than medium; however, overall risk appetite increased somewhat over the half-year. As usual, respondents viewed the level of the risk appetite of other financial institutions in Lithuania as being somewhat higher than their own (see Chart 6). Most surveyed financial institutions considered their risk appetite (37.5%) to be medium. There were still significantly more respondents stating that their risk appetite was low or low rather than high than those indicating that it was high or high rather than low. Thus it might be stated that the level of financial institutions' risk appetite remained quite conservative. On the other hand, the share of respondents indicating that their risk appetite is low rather than high (-9.3 p.p.) reduced significantly; however, the share of respondents that assessed their risk appetite as medium (7.8 p.p.) increased. As a result, the overall assessment of the risk appetite increased somewhat over the half-year; this was also seen from the higher weighted coefficient of such risk (see Chart 7).

The majority of the surveyed financial institutions will not change their risk appetite over the next half-year (see Chart 8). This was stated by 87.5 per cent of all respondents, i.e. significantly more than half a year ago (73.0%). An equal share (3.2%) of the surveyed financial institutions indicated that their risk appetite will reduce or increase. In assessing the risk appetite of other financial institutions, the surveyed also usually (69.4%) stated that it will remain unchanged in the near future. However, the share of those believing that the risk appetite of other financial institutions (not theirs) will decrease was smaller (6.3%) than those stating that it will increase in the upcoming six months (18.8%).

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



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