



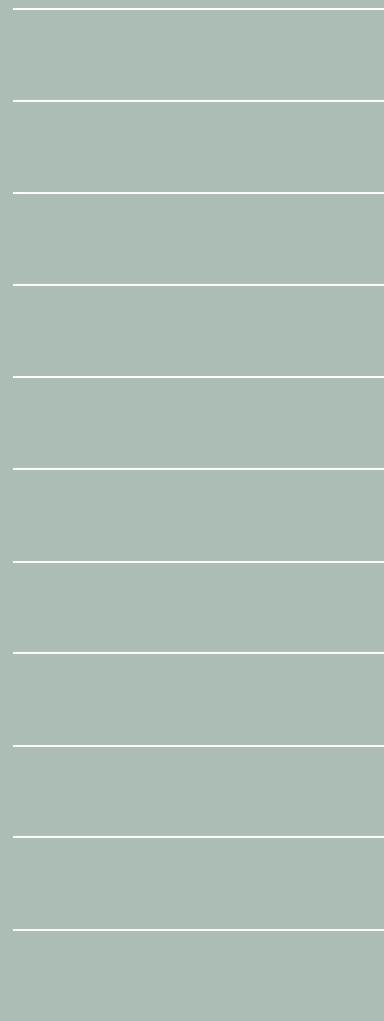
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REVIEW

OF THE SURVEY OF RISKS TO
LITHUANIA'S FINANCIAL SYSTEM

2016

2



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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 domestic 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 April 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 six 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 this Survey is voluntary – respondents may choose which questions to answer.

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

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REVIEW OF THE SURVEY RESULTS

The surveyed assessed that the most likely and one of the greatest risks to the domestic financial system continues to be the drop in profitability of domestic financial institutions in a low interest rate environment (see Table 1). However, respondent answers show that both the probability of this risk and its potential impact diminished over the half-year, leading to its less pronounced importance to the domestic financial system (see Table 2). Compared to banks or other financial institutions, insurance undertakings saw this risk as being more important (see Chart 1). Possibilities of mitigating the risk were assessed as being lower than medium, while the most frequently cited risk-mitigating measures were the adaptation of business models to the changed environment, search for alternative investment opportunities and cuts in operational costs. The majority of respondents judged this risk as being of the utmost importance not only to the financial system in general, but also to financial institutions that they represent (see Chart 2).

The significance of a snapback in risk premia boosted over the half-year, attributing to it becoming one of the major perceived risks. The surveyed saw increases in both the probability of the risk and its potential impact. Other financial institutions (leasing companies, financial brokerage firms, management companies, credit unions and payday loan companies) indicated this risk as the most significant, while banks, conversely, attached the least importance to it. Respondents did not recognise many opportunities to safeguard against a snapback in risk premia in financial markets, yet they usually cited greater diversification of the investment portfolio as a potential risk-mitigating measure.

Geopolitical tensions and their implications for Lithuania's financial system is the third most severe risk, whereas cybercrime – the third most likely risk to the domestic financial system. Even though, according to respondents, the probability and potential impact of geopolitical risk scaled down over the half-year, it remained a major perceived risk. Compared to all risks, possibilities to mitigate this risk were seen as the faintest, and greater diversification of corporate exports was by far the only factor that could potentially mitigate it. As before, insurance undertakings stood out from the rest of financial institutions surveyed: they found this risk to be the most important risk. The risk of cyber attacks was among the most likely risks, even though over the half-year its overall probability remained basically unchanged. Although seeing it as having lower impact, banks and other financial institutions saw this risk as most probable out of all risks listed.

Importance of the risk related to imbalances in the real estate market elevated, yet, overall, the probability of internal risks in Lithuania remained the lowest. According to respondents, the probability of imbalances in the real estate market is one of the lowest; however, its impact is the highest. Its potential impact continued on an upward trajectory for a third consecutive half-year, whereas, in terms of all financial institutions surveyed, the highest level was cited by banks. In the opinion of the respondents, deterioration in corporate financial health could also weigh on the financial system. The probability of this and other internal risks (deterioration in household financial state and unsustainable credit dynamics), however, was indicated as the lowest. Regarding possibilities to mitigate internal risks, financial institutions surveyed are rather positive.

More than a third of the surveyed believed that the probability of a high-impact event in the financial system increased over the half-year. The share of respondents who provided such an answer was almost three times bigger than in the previous half-year (37%), while those believing that the probability of such an event has moderated accounted for 7 per cent (see Chart 3). When asked to indicate the most likely high-impact event, financial institutions mainly cited the change in political trends after the US presidential election, more pronounced global geopolitical tensions, a deceleration in Lithuania's economic growth and reforms in Lithuania, should they be implemented improperly.

Over the half-year, risk appetite of financial institutions followed a moderate upward trend and should remain largely unchanged in the near future. As usual, respondents assessed their risk appetite more moderately compared to other financial market participants. The majority of financial institutions surveyed (51.6%) stated that they assume medium risk (see Chart 4). Almost all other respondents indicated their risk appetite as being lower than medium. Compared to the results of the previous survey, the share of financial institutions assuming low risk shrunk by 8.9 p.p., while the number of institutions that assume medium risk grew significantly (by 14.1 p.p.), hence the overall level of risk

appetite of financial institutions surveyed continued on its upward trajectory for the second consecutive half-year. However, the majority of respondents (77.4%) indicated that they do not plan to alter their risk appetite in the upcoming half-year; another 16.1 per cent stated that they will assume less risks in the near future, while 6.5 per cent will boost their risk appetite.

KEY CHARTS AND TABLES

Table 1. Most likely risk to the financial system – drop in profitability of domestic financial institutions in a low interest rate environment

Assessment of risks to the domestic financial system

Risks	Importance	Probability	Potential impact	Possibilities to mitigate
I. Drop in profitability of Lithuania's financial institutions in a low interest rate environment	2.8	2.9	2.7	3.6
II. Snapback in risk premia in financial markets	2.8	2.6	3	3.9
III. Geopolitical tensions and their implications for Lithuania's financial system	2.7	2.8	2.7	4.4
IV. Unsustainable real estate price dynamics or imbalances in the real estate market	2.7	2.3	3.2	2.8
V. Imbalances in Scandinavian countries and potential contagion effects on Lithuania	2.7	2.4	3	4
VI. Cybercrime risk	2.6	2.8	2.5	2.7
VII. Slump in Lithuania's export volumes due to economic slowdown of main trading partners	2.6	2.4	2.9	3.9
VIII. Deterioration in corporate financial health	2.6	2.2	3.1	3.5
IX. Weakening European sovereign debt sustainability and potential contagion effect on Lithuania	2.6	2.3	2.9	4.2
X. Difficulties in the European banking sector and potential contagion effect on Lithuania	2.5	2.4	2.6	3.9
XI. Deterioration in household financial state	2.4	2.2	2.7	3.5
XII. Unsustainable credit dynamics or imbalances	2.2	1.8	2.6	2.6

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 to mitigate the risk:** 1 – high; 2 – higher than medium; 3 – medium; 4 – lower than medium; 5 – low. Risks were grouped according to their importance.

Table 2. Importance of imbalances in the real estate market continues to rise for several consecutive half-years

Development of the importance of risks to the financial system

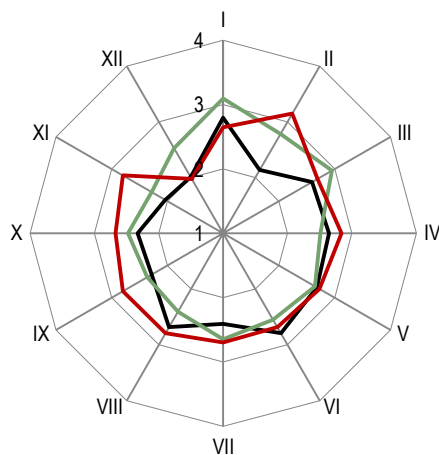
Risks indicated	H1 2015	H2 2015	H1 2016	H2 2016
I	Medium	Medium	High	High
II	Low	Low	Low	Low
III	High	Medium	Medium	Medium
IV	Low	Low	Low	Low
V	Medium	Medium	Medium	Medium
VI	Medium	Medium	Medium	Medium
VII	Medium	Medium	Medium	Medium
VIII	Medium	Medium	Medium	Medium
IX	Medium	Medium	Medium	Medium
X	Medium	Medium	Medium	Medium
XI	Low	Low	Low	Low
XII	Medium	Medium	Medium	Medium

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. Level of risk importance is marked in the following way:

■ low importance
 ■ medium importance
 ■ high importance

Chart 1. Banks assessed risks more moderately than insurance undertakings and other financial institutions

Risk importance by financial institution sectors



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 cited a drop in profitability in a low interest rate environment as the major risk to them

Assessment of major risk to the financial institution surveyed

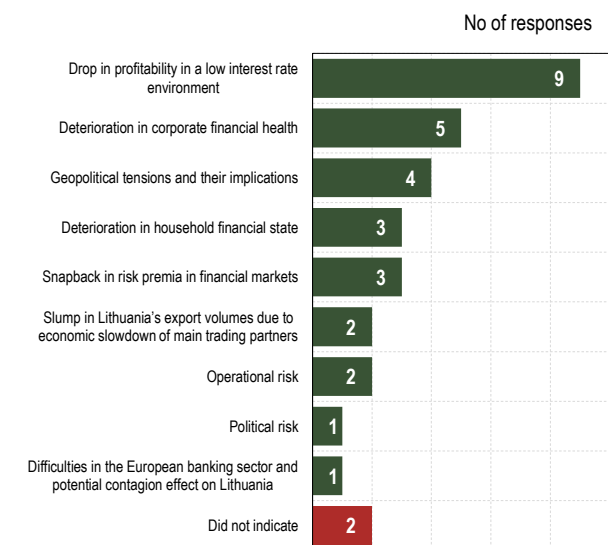


Chart 3. More than a third of respondents believed that the probability of a high-impact event peaked over the half-year

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

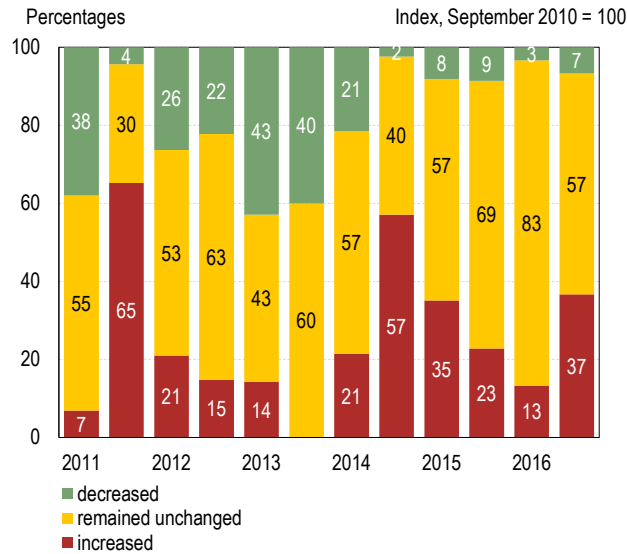
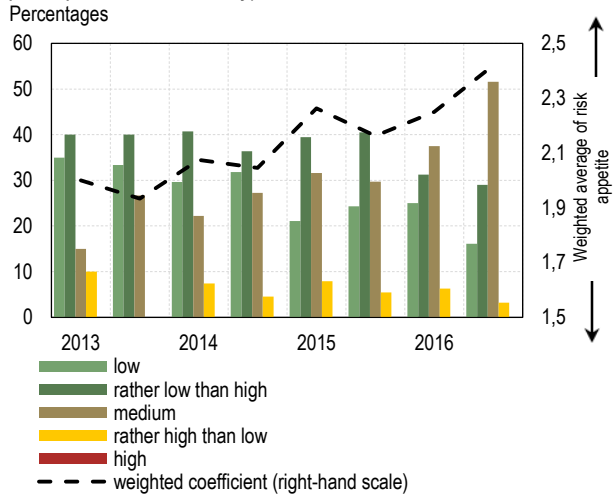


Chart 4. Risk appetite of financial institutions followed a moderate upward trend over the half-year

Assessment of the risk appetite of financial institutions (during participation in 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.

ANNEX. RESULTS OF ANSWERS TO THE MAIN QUESTIONS

Table 1. Respondent sample and its dynamics

Respondent	H1 2012	H2 2012	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015	H1 2016	H2 2016
Bank	15	12	8	8	10	13	10	11	9	8
Leasing company	6	3	2	1	2	2	3	3	1	2
Insurance undertaking	10	7	7	4	10	15	12	11	12	11
Financial brokerage firm	5	0	2	1	1	1	3	3	4	3
Management company	2	2	3	0	2	8	6	5	6	5
Other	5	3	1	2	7	5	4	4	2	3
Total	43	27	23	16	32	44	38	37	34	32

Table 2. Assessment of the probability of sources of risk to the financial system (no of respondents)

Risk source	Banks					Insurance undertakings					Other financial institutions					All financial institutions				
	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low
Geopolitical tensions and their implications for Lithuania's financial system	0	1	2	4	1	0	3	4	4	0	0	4	4	3	1	0	8	10	11	2
Waning profitability of Lithuanian financial institutions in a persistently low interest rate environment	0	1	3	3	0	1	4	4	1	1	0	4	3	3	2	1	9	10	7	3
Snapback in risk premia in global financial markets	0	0	1	4	2	0	1	3	7	0	0	4	5	3	0	0	5	9	14	2
Weakening European sovereign debt sustainability and potential contagion effect on Lithuania's financial system	0	0	1	5	1	0	0	1	6	3	1	2	4	4	1	1	2	6	15	5
Slump in Lithuania's export volumes due to economic slowdown of main trading partners	0	0	0	7	0	0	1	5	2	2	0	2	4	4	2	0	3	9	13	4

Deterioration in household financial state	0	0	0	5	3	0	0	2	6	2	0	3	4	4	1	0	3	6	15	6
Deterioration in corporate financial health	0	0	2	3	2	0	0	2	7	2	0	3	1	8	0	0	3	5	18	4
Cybercrime risk	0	2	3	2	0	0	1	5	4	1	0	4	5	2	1	0	7	13	8	2
Unsustainable real estate price dynamics or imbalances in the real estate market	0	0	2	4	2	0	0	2	8	1	0	3	3	4	2	0	3	7	16	5
Unsustainable credit dynamics or imbalances in the credit market	0	0	1	2	5	0	1	2	6	2	0	0	2	4	5	0	1	5	12	12
Imbalances in Scandinavian countries and potential contagion effects on Lithuania's financial system	0	0	4	2	1	0	1	4	5	1	0	2	4	3	3	0	3	12	10	5
Difficulties in the European banking sector and potential contagion effect on Lithuania's financial system	0	0	1	5	1	0	1	5	3	2	1	1	3	6	1	1	2	9	14	4

Table 3. Assessment of potential impact of perceived risks to the financial system (no of respondents)

Risk source	Banks					Insurance undertakings					Other financial institutions					All financial institutions				
	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low
Geopolitical tensions and their implications for Lithuania's financial system	1	1	3	1	2	1	3	4	1	2	0	1	6	3	2	2	5	13	5	6
Waning profitability of Lithuanian financial institutions in a persistently low interest rate environment	0	2	2	3	0	0	2	7	1	1	0	3	2	5	2	0	7	11	9	3
Snapback in risk premia in global financial markets	0	0	3	4	0	0	4	4	3	0	0	4	6	2	0	0	8	13	9	0
Weakening European sovereign debt sustainability and potential contagion effect on Lithuania's financial system	0	1	3	2	1	0	3	5	2	0	1	2	5	2	2	1	6	13	6	3
Slump in Lithuania's export volumes due to economic slowdown of main trading partners	0	1	4	2	0	0	1	7	1	1	1	3	3	4	1	1	5	14	7	2
Deterioration in household financial state	1	0	2	5	0	0	1	5	3	1	0	4	3	4	1	1	5	10	12	2
Deterioration in corporate financial health	2	1	3	1	0	0	2	7	1	1	1	2	5	4	0	3	5	15	6	1
Cybercrime risk	1	0	2	3	1	0	2	4	4	1	0	2	3	5	2	1	4	9	12	4
Unsustainable real estate price dynamics or imbalances in the real estate market	2	1	4	1	0	0	3	5	3	0	1	3	4	4	0	3	7	13	8	0
Unsustainable credit dynamics or imbalances in the credit market	0	1	4	1	1	0	2	7	1	1	0	0	5	4	2	0	3	16	6	4
Imbalances in Scandinavian countries and potential contagion effects on Lithuania's financial system	1	2	1	2	1	0	3	3	5	0	1	4	3	3	1	2	9	7	10	2
Difficulties in the European banking sector and potential contagion effect on Lithuania's financial system	0	0	5	2	0	0	1	4	5	1	0	5	0	6	1	0	6	9	13	2

Table 4. Assessment of possibilities to mitigate risks (no of respondents)

Risk source	Banks					Insurance undertakings					Other financial institutions					All financial institutions				
	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low	high	higher than medium	medium	lower than medium	low
Geopolitical tensions and their implications for Lithuania's financial system	0	0	0	0	8	0	0	1	5	5	0	0	5	3	4	0	0	6	8	17
Waning profitability of Lithuanian financial institutions in a persistently low interest rate environment	0	2	0	3	2	0	0	3	6	2	0	3	5	3	1	0	5	8	12	5
Snapback in risk premia in global financial markets	0	1	0	3	3	0	0	4	3	4	0	1	5	3	3	0	2	9	9	10
Weakening European sovereign	0	0	1	1	5	0	0	1	7	2	0	0	3	5	4	0	0	5	13	11

debt sustainability and potential contagion effect on Lithuania's financial system																				
Slump in Lithuania's export volumes due to economic slowdown of main trading partners	0	0	1	3	3	0	0	2	5	3	0	1	4	6	1	0	1	7	14	7
Deterioration in household financial state	0	3	1	2	2	0	0	4	3	3	0	3	3	6	0	0	6	8	11	5
Deterioration in corporate financial health	0	1	3	2	1	0	0	3	6	2	0	2	5	5	0	0	3	11	13	3
Cybercrime risk	1	2	4	0	0	0	4	5	2	0	2	4	2	3	1	3	10	11	5	1
Unsustainable real estate price dynamics or imbalances in the real estate market	1	1	4	1	1	0	4	4	2	1	1	4	6	1	0	2	9	14	4	2
Unsustainable credit dynamics or imbalances in the credit market	1	2	4	0	0	0	4	5	2	0	2	3	6	0	0	3	9	15	2	0
Imbalances in Scandinavian countries and potential contagion effects on Lithuania's financial system	0	0	1	2	4	0	1	2	5	3	0	0	5	4	3	0	1	8	11	10
Difficulties in the European banking sector and potential contagion effect on Lithuania's financial system	0	0	0	4	3	0	1	3	4	3	0	1	3	6	2	0	2	6	14	8

Table 5. Assessment of the major risk to a financial institution surveyed (no of respondents)

Risk	Bank	Insurance undertaking	Other financial institutions	All financial institutions
Geopolitical tensions and their implications for Lithuania's financial system	2	1	0	3
Waning profitability of Lithuanian financial institutions in a persistently low interest rate environment	4	3	2	9
Snapback in risk premia in global financial markets	0	1	1	2
Weakening European sovereign debt sustainability and potential contagion effect on Lithuania's financial system	0	0	0	0
Slump in Lithuania's export volumes due to economic slowdown of main trading partners	0	1	1	2
Deterioration in household financial state	1	1	1	3
Deterioration in corporate financial health	0	2	2	4
Cybercrime risk	0	0	0	0
Unsustainable real estate price dynamics or imbalances in the real estate market	0	0	0	0
Unsustainable credit dynamics or imbalances in the credit market	0	0	0	0
Imbalances in Scandinavian countries and potential contagion effects on Lithuania's financial system	0	0	0	0
Difficulties in the European banking sector and potential contagion effect on Lithuania's financial system	0	1	0	1
Operational risk	0	0	2	2
Political risk	0	1	0	1
Total	7	11	9	27

Table 6. Assessment of the change in probability of an event with a high negative impact on the stability of the domestic financial system over the last 6 months (no of respondents)

Probability	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015	H1 2016	H2 2016
Decreased	9	6	6	1	3	3	1	2
Remained unchanged	9	9	16	17	21	24	25	17
Increased	3	0	6	24	13	8	4	11

Table 7. Present level of risk appetite of a financial institution surveyed (no of respondents)

Level of risk appetite	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015	H1 2016	H2 2016
Low	7	5	8	14	8	9	8	5
Rather low than high	8	6	11	16	15	15	10	9
Medium	3	4	6	12	12	11	12	16
Rather high than low	2	0	2	2	3	2	2	1
High	0	0	0	0	0	0	0	0

Table 8. Present level of risk appetite of other financial institutions surveyed, opinion of a respondent (no of respondents)

Level of risk appetite	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015	H1 2016	H2 2016
Low	1	0	1	2	1	4	1	0

Rather low than high	11	6	13	21	18	14	12	2
Medium	7	9	11	17	16	14	15	21
Rather high than low	1	0	2	4	3	4	4	8
High	0	0	0	0	0	0	0	0

Table 9. Level of risk appetite of a financial institution surveyed in the upcoming 6 months (no of respondents)

Change in the level of risk appetite in the upcoming 6 months	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015	H1 2016	H2 2016
Will decrease	1	1	1	3	1	4	1	5
Will remain unchanged	16	13	26	37	30	27	28	24
Will increase	4	1	0	2	6	6	1	2
Impossible to indicate	0	0	0	2	1	0	2	0

Table 10. Level of risk appetite of other financial institutions surveyed in the upcoming 6 months, opinion of a respondent (no of respondents)

Change in the level of risk appetite in the upcoming 6 months	H1 2013	H2 2013	H1 2014	H2 2014	H1 2015	H2 2015	H1 2016	H2 2016
Will decrease	1	1	1	6	5	0	2	2
Will remain unchanged	16	13	20	30	25	25	23	25
Will increase	3	1	5	5	8	7	6	3
Impossible to indicate	1	0	1	3	0	4	1	1