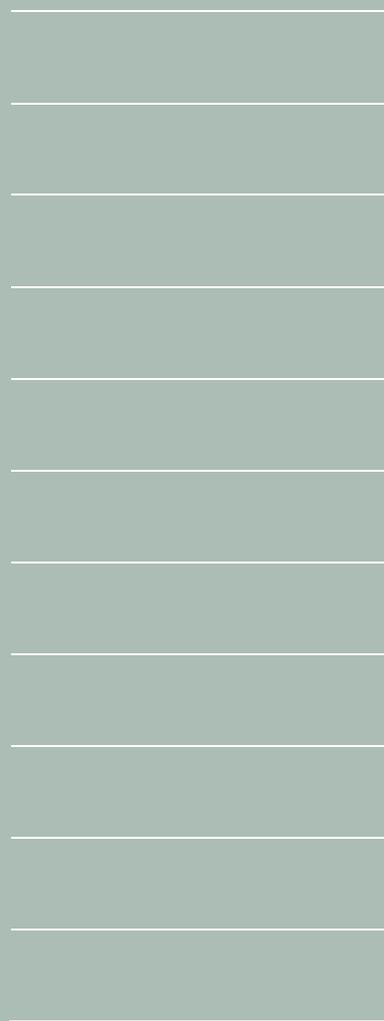




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REVIEW OF THE SURVEY OF RISKS TO LITHUANIA'S FINANCIAL SYSTEM

2015



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**REVIEW
OF THE SURVEY OF RISKS TO LITHUANIA'S FINANCIAL
SYSTEM
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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 were 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 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.

38 respondents took part in this survey, which included 10 banks operating in Lithuania, 12 insurance undertakings, 3 leasing companies, and 13 other financial institutions. Executives of the surveyed institutions were asked to describe the situation of the domestic financial system at the beginning of March 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

Surveyed financial institutions continue to view the Russian-Ukrainian conflict, its intensification, and related economic sanctions as the main risk to the country's financial system. Moreover, as the geopolitical tensions in the East continue, respondents still find important the risks linked to shrinking Lithuanian exports. On the other hand, alternative export markets discovered by national companies slightly reduced the probability for the latter risks to materialise during the last six months.

The prolonged low interest rate period is gradually growing into a top risk for financial institutions in Lithuania. In addition, given the uncertainty regarding Greece's solvency, the risk linked to the European sovereign debt problems remains among the most important. However, respondents do not expect an abrupt rise in the risk premia in the financial markets.

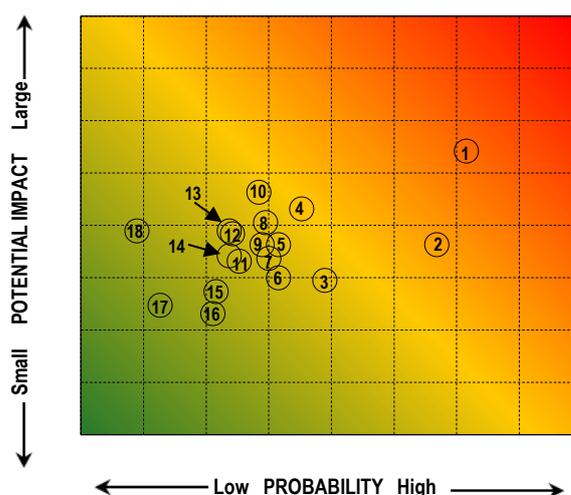
The cybercrime risk is cited by financial institutions as one of the most plausible and the one that may have a negative effect on the domestic financial system.

Financial market participants believe that the possibility of a high-impact event in the nearest future, which may have a negative impact on the country's financial system, continued to grow for the second consecutive six-month period. One third of respondents support this opinion. Similar to the past half-year period, the intensification of geopolitical tensions in the East was widely reported as a potential high-impact event.

Regarding macro-economic risk, the survey respondents continued to see it as the most prominent among permanent risks. The assessment by banks has become stricter, i.e. all the existing risks were viewed by them as more significant than six months ago.

A slight increase was observed in the risk appetite of financial institutions. Although the majority of financial institutions claimed their risk appetite would remain unchanged in the nearest future, there was an increase in the number of respondents who spoke of more risk to be assumed by them in the coming half-year period.

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



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

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

SUMMARY OF THE SURVEY RESULTS

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

	Risk source	Probability	Potential impact	Ability to mitigate the risk
1	Risk, related to the escalation of the conflict between Russia and Ukraine as well as the imposition of the economic sanctions	4.1	3.7	3.3
2	Prolonged period of low interest rates in the financial markets	3.8	2.8	2.8
3	Uncertainty regarding oil price volatility	2.9	2.5	3.0
4	Drop in Lithuania's export in regards to the global economic slowdown	2.8	3.2	2.8
5	Risk, related to low inflation or deflation	2.6	2.5	2.7
6	Cyber crime risk	2.6	2.8	2.4
7	Risk, related to legislative changes or lack of necessary changes	2.5	2.7	2.4
8	European sovereign debt sustainability issues, their relations with the financial sector and possible contagion effect on the Lithuanian economy	2.5	3.0	3.0
9	Non-financial companies credit risk	2.4	2.8	2.4
10	Too slow Lithuanian economic growth or economic recession	2.4	3.3	2.8
11	Unsustainable development in real estate prices	2.3	2.7	2.4
12	Abrupt rise in risk premia in financial markets	2.2	2.9	2.8
13	Lack of funding for the country's economy due to banks' deleveraging	2.2	2.7	2.3
14	Loss of economic competitiveness in foreign markets	2.2	2.9	2.6
15	Risk arising due to the concentration of large exposures in the loan portfolio	2.1	2.4	1.9
16	Household credit risk	2.1	2.2	2.2
17	Limited funding possibilities for financial institutions	1.6	2.2	2.1
18	Insolvency of a systemically important financial institution	1.4	2.9	2.3

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

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. Ability to mitigate the risk: 1 — easy to take action; 2 — easy rather than difficult to take action; 3 — difficult to take action; 4 — impossible to take action.

Table 2. Change in importance of risk sources over the half year.

	Risk source	2013 II	2014 I	2014 II	2015 I
1	Risk, related to the escalation of the conflict between Russia and Ukraine as well as the imposition of the economic sanctions				
2	Prolonged period of low interest rates in the financial markets				
3	Drop in Lithuania's export in regards to the global economic slowdown				
4	European sovereign debt sustainability issues, their relations with the financial sector and possible contagion effect on the Lithuanian economy				
5	Too slow Lithuanian economic growth or economic recession				
6	Uncertainty regarding oil price volatility				
7	Abrupt rise in risk premia in financial markets				
8	Cyber crime risk				
9	Rizika, kylanti dėl mažos infliacijos ar defliacijos				
10	Loss of economic competitiveness in foreign markets				
11	Non-financial companies credit risk				
12	Risk, related to legislative changes or lack of necessary changes				
13	Unsustainable development in real estate prices				
14	Lack of funding for the country's economy due to banks' deleveraging				
15	Insolvency of a systemically important financial institution				
16	Household credit risk				
17	Risk arising due to the concentration of large exposures in the loan portfolio				
18	Limited funding possibilities for financial institutions				

Low importance Medium importance High importance

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

Notes: 1) risk importance is expressed as the product of such risk possibilities, possible impact and possibilities to decrease risk; 2) risk, related to legislative changes or lack of necessary changes, in the Q1 2014 survey was treated as political and regulatory risk.

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 to mitigate the risks. Respondents also identified and expressed their opinion regarding relevant, in their opinion, other sources of risk.

The intensification of the Russian-Ukrainian conflict and related economic sanctions continue to be cited as the top risk sources (see Table 1). The average score of the views regarding risk probability, its potential impact, and risk mitigation possibilities basically did not change over the last six months, and the views of individual respondents became more homogenous. As most respondents claimed, the probability of such risk and its potential impact are higher than medium, while possibilities to use risk mitigation measures are scarce. The search for new export destinations and their diversification were major potential risk mitigation factors mentioned by the surveyed financial institutions.

The protracted low interest rate period continued to be considered as a highly-important risk (see Table 2), while the likelihood of an abrupt rise of risk premia was seen by respondents as low. In six months, the probability of low interest rate risk grew slightly and was perceived as higher than medium. This type of risk was seen slightly more likely by banks rather than by other financial institutions. According to respondents, the risk is difficult to mitigate, while the most frequently reported risk-mitigating factors include investment diversification, increasing of non-interest income, and narrowing the duration gap between liabilities and investment. However, the probability of risk related to an abrupt rise in risk premia is considered lower than medium, and its effect is seen as medium. Such probability assessment is based on expectations that the ECB will continue its accommodative monetary policy; moreover, the risk can be mitigated by thorough monitoring of investment portfolio.

Risks from a slowdown of export and economic growth continued to be important, although their probability decreased slightly over a half-year period. The export contraction due to a slowdown of the global economy growth was less likely; the view of risks arising from too slow growth of Lithuania's economy was less strict. However, the potential impact of the latter risk is still seen as one of the biggest. In addition, respondents were more reserved when presenting their view of risks related to the loss of competitiveness of Lithuania's economy. In the opinion of surveyed financial institutions, export diversification and increasing domestic consumption could reduce the risk of Lithuania's export slowdown, while a simplified tax system, targeted accommodative policy, and productivity-enhancing investments could promote economic growth.

The perception of risks of the European sovereign debt sustainability did not change over six months and remained relatively important. Regarding challenges related to probable insolvency of Greece, surveyed financial institutions did not think there were changes in such risk and its impact on Lithuania over the last six months. However, this risk continued to be viewed as one of the top risks, and its potential impact — as relatively high. In the opinion of respondents, it would be difficult to reduce the risk, although curtailing investments into higher-risk government securities could have a mitigating effect on them.

The probabilities of risks arising from low inflation or deflation and uncertainties regarding oil price fluctuations remain relatively high. With decreasing price level in Lithuania and a dramatic drop in oil

prices in 2014, respondents view the probability of both risks as relatively high. However, respondents perceive the potential impact of such risks as lower than medium, and their importance therefore is relatively low compared to other risks. Insurance undertakings viewed these risks as the least important, while banks and other financial institutions considered them a little bit more important. Respondents claimed that growing consumption and continued accommodative monetary policy of the ECB could support inflation growth, while long-term contracts and the use of financial derivatives could help companies avoid risks arising from fluctuations in oil prices.

The surveyed financial institutions perceive cybercrime risk as being of medium importance, but their views diverge. Among respondents, the highest probability of this risk is cited by banks, while insurance undertakings assess it as being lower. Respondents view both risk probability and its potential impact as being above medium, and believe the risk can be mitigated by investing in IT security and more active state involvement.

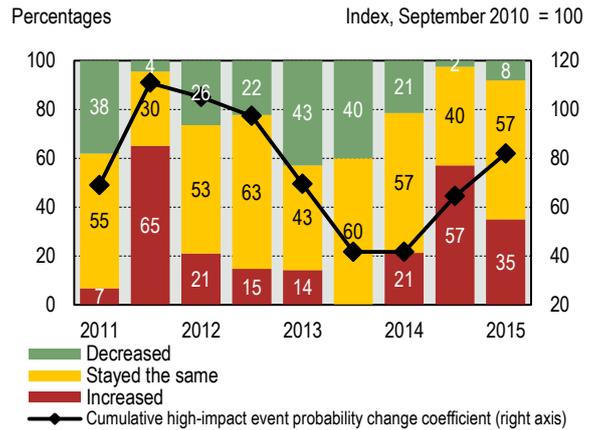
Domestic risks in Lithuania, in the opinion of respondents, remained of low importance. The credit risk of Lithuania's non-financial sector was cited as being still low, although banks stood out by viewing the corporate credit risk as of medium importance. In the opinion of respondents, the importance of the unsustainable rise of real estate prices did not change over the last half-year and remained relatively low, while risk probability continued to be viewed as low. No changes were observed in the perception of risks linked to legislative changes or their absence — it remained slightly lower than medium.

Risks arising directly from the country's financial system were viewed as the least important. The potential impact of the risk of scarce financing of the country's economy was cited to be somewhat more important, i.e. medium; however, the probability for the risk to materialise was seen as low. Respondents perceived risks linked to the concentration of large exposure in the loan portfolio and limited financing possibilities as low or extremely low. Moreover, no respondent cited the probability of insolvency of a systemically important financial institution being higher than medium.

One third of surveyed financial institutions claimed that the probability of an event that may have high impact on the financial system increased in the last half year (see Chart 2). Although such increase in the previous survey was cited by more than half of the respondents, only 8 per cent of the current survey participants claimed that such probability decreased. The above suggests that the probability of a high-impact event has been growing for the second consecutive half-year. When asked what sort of event it could be, almost all the financial institutions mentioned further escalation of the Russian-Ukrainian conflict, while problems within the euro area were cited less frequently.

Respondents forecasted the probability and potential impact of a major event that may have an effect on the entire financial system in the nearest six month-period to be medium or lower than medium (see Chart 3). Although 46 per cent of surveyed financial institutions view the probability as low or lower than medium, their percentage declined significantly, by 18 p.p., over the half year, while the percentage of those who view the probability as medium grew by 15 p.p. The proportion of respondents claiming that such an event would have a higher than medium impact on them remained unchanged at 16 per cent, and there were no respondents viewing the probability as high. However, a significant decrease was observed in the number of respondents saying that the impact of such an event on them would be lower than medium, while the proportion of those speaking about medium-size impact grew by 15 p.p. to 41 per cent.

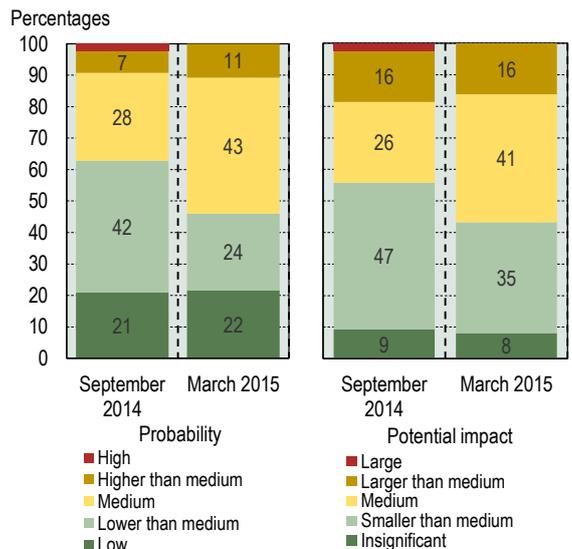
Chart 2. Change in the probability of a high-impact event in Lithuania's



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

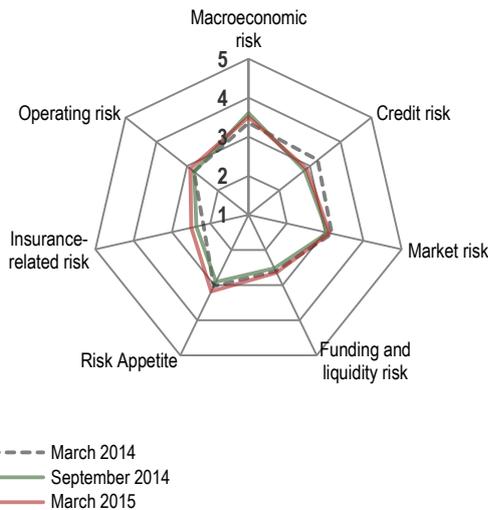
Note: cumulative high-impact probability change coefficient is calculated by adding the net probability change of a high-impact event to the index value, equal to 100 at the beginning of the base period. E.g., an increase in the coefficient indicates a rise of the probability of a high-impact event over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

Chart 3. Probability of high-impact events in Lithuania's financial system and their impact on a financial institution within the upcoming 6 months..



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

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



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

Note: risk importance 1 — very low, 2 — low, 3 — below medium, 4 — above medium, 5 — high, 6 — very high.

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



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

Note: risk importance 1 — very low, 2 — low, 3 — below medium, 4 — above medium, 5 — high, 6 — very high.

2. Assessment of Permanent Risks

Financial institutions that took part in the survey provided their views on the probability, size, and potential impact of permanent risks such as macroeconomic, credit, market, financing, liquidity, operational, insurance sector (actuarial), as well as their risk appetite.

Permanent risks impacting Lithuania's financial system are still widely viewed as being lower than medium (see Chart 4). In the opinion of surveyed financial institutions, most important are macroeconomic and market risks, as well as risk appetite. The importance of the latter increased the most, while the assessment of other risks remained basically unchanged. The assessment of the respondents diverged depending on their institution's type: banks perceived the importance of all the risks as increased, while insurance undertakings reported that it had decreased.

Macroeconomic risks are further cited as the most important among the permanent risks. Generally, financial institutions viewed this type of risk as practically unchanged, i.e. medium; however, responses of different financial system participants varied. Banks cited macroeconomic risk as more important compared to the past half-year, and insurance undertakings viewed it as less prominent (see Chart 5). Uncertainties regarding the geopolitical situation in the East were cited as the main reason behind the relatively high risk importance, while the slow recovery of the EU economy and the political situation in Greece were mentioned less frequently.

The risk appetite grew over six months to come close to medium. Financial institutions other than banks and insurance undertakings viewed this type of risk as close to medium, although banks also perceived it as increased over the past half-year period. In the opinion of respondents, risk appetite, despite conservative policy toward it, depends mainly on the prolonged low interest rate period and growing competition.

Market risk remained relatively important. Surveyed financial institutions viewed the importance of this risk as being lower than medium. Insurance undertakings and other financial institutions perceived market risk as slightly decreased, although in the opinion of banks, it has grown most out of all the permanent risks. Such perception is based mainly on the search for yield behaviour in a low-interest rate environment.

The assessment of credit risk remained unchanged over six months. Many of the surveyed financial institutions viewed this risk as being lower than medium; banks perceived it as slightly higher. Respondents cited the unstable geopolitical situation in the East and growing competition as factors behind the growth of credit risk. However, the financial standing of borrowers, which has improved, driven by low interest rates, as well as strict assessment of borrowers' risks reduced credit risk.

Operational, funding and liquidity as well as insurance-related risks were the least important among permanent risks. The importance of such risks is viewed as low. Respondents cited low interest rates, strong support from the Scandinavian-based banks, and accommodative monetary policy of the ECB as key factors behind the reduction of funding risk. Actuarial risk is reduced due to reinsurance arrangements and strict supervision.

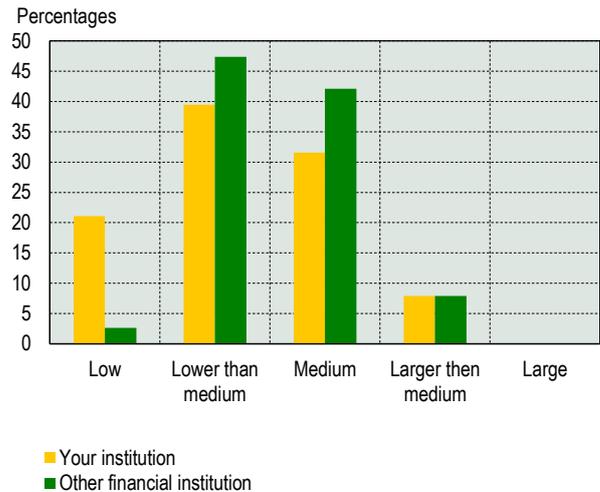
3. Assessment of Risk Appetite

Surveyed domestic financial institutions presented responses about risk appetite of their own and other institutions as well as, indicated how it may change in the upcoming six months.

Although the assessment of the risk appetite of surveyed financial institutions grew, it remains relatively low. As a rule, respondents viewed the appetite for risk of other financial institutions as being higher than their own, and conservative nevertheless (see Chart 6). Banks' perceptions of their risk appetite were stricter. The percentage of financial institutions viewing their risk appetite as low has decreased compared to the results of the survey half a year ago, while the portion of those who perceived it as larger than medium has increased. This led to an increase in overall risk appetite, as indicated also by an increase in the weighted coefficient of risk appetite (see Chart 7).

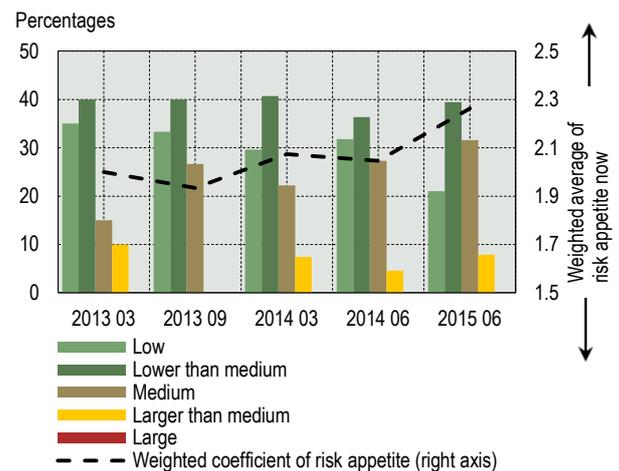
The share of financial institutions expecting higher risk-taking in the nearest six-month period increased (see Chart 8). Although a majority of respondents, i.e. 79.0 per cent, continued to claim their risk appetite to not change over the upcoming half-year period, the number of those claiming the opposite grew to 15.8 per cent from previous 4.6 per cent. Respondents' predictions regarding the behaviour of other financial institutions were similar: 21.0 per cent of respondents expect the risk appetite of other market participants to grow in the future, i. e. 9.7 p.p. more than half a year ago.

Chart 6. Comparison of the assessment of the risk appetite of financial institutions to the assessment of the risk appetite of other financial institutions.



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

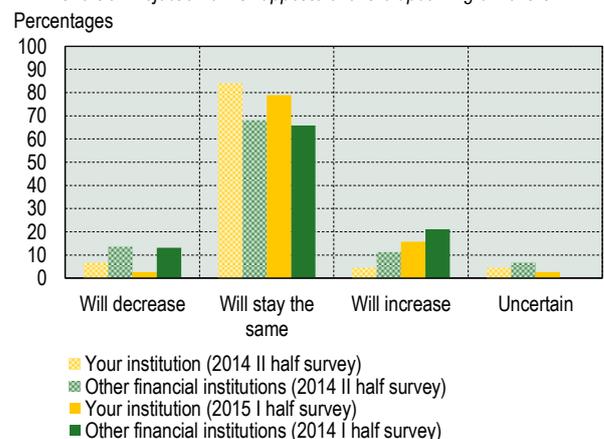
Chart 7. Development of the risk appetite of financial institutions.



Source: Survey of Risks to Lithuania's Financial System

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

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



Source: Survey of Risks to Lithuania's Financial System

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