



1. Systemic risk indicators and financial market conditions

Market based measures of systemic stress in the European Union (EU) have remained at low levels. Despite existing uncertainties in the policy area and high geopolitical tensions, both the composite indicator of systemic risk (indicator 1.1) and the equity market implied volatility index (VIX) ([indicator 5.1b](#)) are close to historical low levels. However, these low levels of volatility, in particular those of implied volatility, do not necessarily imply an absence of risk in financial markets. Indeed, it has been documented that periods of low implied volatility coincide with continuous price increases in financial markets.¹ In a situation with high political uncertainty and stretched valuations in several market segments, volatility in the financial markets could rise rapidly and significantly.

2. Macro risk

Economic recovery in the EU has continued in the second quarter of 2017. GDP rose by 2.4% in the EU ([indicator 2.1](#)) compared with the same quarter of 2016. The majority of the EU countries have now experienced faster economic growth than they had, on average, in the last three years. According to its spring forecast, the European Commission expects the GDP growth rate in the EU, as a whole, to be 1.7% for 2017 and 1.8% for 2018.

Unemployment remains high in some EU countries, but continues its downward trend. In five countries, the unemployment rate is still over 10%. However, in almost all EU countries, the current unemployment rate is lower than the three-year average ([indicator 2.4](#)).

Although most countries have deleveraged in the past years following the global financial crisis, debt levels remain elevated across countries and sectors in the EU ([indicators 2.5a and 2.5b](#)). Compared with their peak levels until 2012, debt-to-GDP ratios have decreased in the household sector in 20 EU countries and in the non-financial corporate (NFC) sector in 23 EU countries. However, these reductions have generally been less intense than the increases in indebtedness in the years before the global financial crisis. The high debt levels leave these economies vulnerable to shocks, such as changes to the growth outlook or to the effects of a rise in interest rates. With regard to government debt, levels remain above the 60% threshold of GDP, as laid down in the Maastricht Treaty, in the majority of the EU countries ([indicator 2.6](#)).

¹ For further details on the relation between implied volatility and market prices, see, among others, “Stock Market Volatility and Economic Factors”, J. Binder and M. Merges ([link](#)), and “Volatility concepts and the risk premium”, M.J. Lombardi and A. Schrimpf ([link](#)). For a detailed discussion on the current low volatility levels and implications for financial stability, please refer to “The volatility paradox: tranquil markets may harbor hidden risks”, OFR Market Monitor Second Quarter 2017 ([link](#)).

3. Credit risk

Bank lending both to households and to NFCs in the EU continued to increase. The majority of EU countries saw a positive annual growth rate in MFI loans to households and to NFCs ([indicators 3.1 and 3.2](#)) in July 2017. In addition, these growth rates are now higher in the majority of the EU countries compared with the same period last year, and are increasing rapidly in some of these countries. By contrast, some countries are still experiencing a contraction in loans. Yet, the contraction in loans to households is less than it was in July 2016.

The cost of borrowing for both households and NFCs remains low, reflecting the low interest rate environment. Debt servicing cost was, in most countries, lower in July 2017 than the previous year. This holds particularly true for NFCs, while in some countries the debt servicing cost increased for households ([indicators 3.3 and 3.4](#)). The lower debt servicing cost is partly due to lower lending margins of banks ([indicators 3.5 and 3.6](#)).

Lending standards have eased slightly over the quarter. This is the case for loans both to households and NFCs for the euro area as a whole ([indicators 3.7 and 3.8](#)).

Residential real estate prices continue to grow strongly in the EU. Almost all EU countries observed increasing residential real estate prices between the first quarter of 2016 and the first quarter of 2017, as well as between the first quarter of 2014 and the first quarter of 2017 ([indicator 3.13](#)). Residential real estate prices in several EU countries also appear to be overvalued owing to different valuation methods ([indicator 3.12](#)).

4. Banks

Banks' profitability in the EU improved in the second quarter of 2017, but remains, on average, low. Median return on equity (8%) and return on assets (0.6%) were higher in the second quarter of 2017 than they have been for the past two years. The situation for banks with the lowest returns has also improved ([indicators 6.1a and 6.1b](#)). Other indicators, such as cost-to-income and net interest income compared with operating income, have remained more or less unchanged over the past year ([indicators 6.1c and 6.1d](#)).

The median capitalisation of EU banks increased in the second quarter of 2017. The median CET 1 to- risk-weighted-assets ratio increased from the first to the second quarter of 2017, as was the case for the past four quarters ([indicator 6.2 a](#)). Over the past year, the median increased by almost 1 percentage point. By contrast, the median ratio of non-performing loans (NPLs) to total gross loans and advances was almost unchanged from the first to the second quarter of 2017, at around 4%. However, the banks with the highest share of NPLs reported improving asset quality ([indicator 6.2 b](#)).

5. Investment funds and other financial institutions

The size of the non-banking part of the EU financial sector increased over the past year relative to the total assets of credit institutions, but was stable in the first quarter of 2017. The total assets of investment funds and other financial institutions (OFIs) compared to the total assets of credit institutions was stable for the EU but increased for the euro area in the first quarter of 2017 ([indicator 7.4](#)). The indicators are now at a historically high level. Both the total assets of credit institutions, investment funds and OFIs, as well as insurance corporations and pension funds increased in absolute terms over the first quarter of 2017 ([indicator 7.3](#)).