1. Systemic risk indicators and financial market conditions

Geopolitical and political uncertainties pushed up market-based indicators of systemic stress in the European Union (EU) over the past quarter. Both the composite indicator of systemic stress (CISS – indicator 1.1) and the indicator for probability of simultaneous default by large and complex banking groups and EU sovereigns (indicator 1.2) increased, although they remain low in historical terms. In addition, the implied volatility of short-term euro interest rates rose from very low levels (indicator 5.4). EU equity indices were relatively stable, reflecting lower levels of volatility (indicator 5.1a). However, the equity index for EU banks has been falling since the beginning of 2018, leading to a continued correction in price/earnings ratios for bank equities (indicator 5.2).

2. Macro risk

Economic growth in the EU moderated from the high levels seen in 2017. EU GDP rose by 2.4% year on year in the first quarter of 2018, down from 2.7% in the fourth quarter of 2017 (indicator 2.1). Overall, EU GDP is estimated to have expanded by 2.4% last year, its highest rate since 2007, which marked the start of the global financial crisis. In its spring forecast, the European Commission projected EU GDP growth of 2.3% in 2018 and 2.0% in 2019, unchanged from its winter forecast. However, there has recently been mounting uncertainty over that growth outlook, with the downside risks stemming mainly from three sources: (1) the threat of increased global protectionism; (2) rising oil prices owing to geopolitical risks; and (3) the possibility of persistently high financial market volatility.

Although most countries deleveraged in the years following the global financial crisis, debt levels remain elevated across countries and sectors in the EU (indicators 2.5a and 2.5b). The debt reductions in recent years have generally been smaller in scope than the debt increases in the run-up to the global financial crisis. High debt levels mean that economies are vulnerable to shocks, such as changes in the growth outlook or interest rate hikes. In terms of government debt, the level in most EU Member States exceeds the 60% debt-to-GDP ratio established under the Maastricht Treaty (indicator 2.6), while the government deficit-to-GDP ratio was below 3% for almost all Member States in 2017 (indicator 2.7).

3. Credit risk

Credit to households and non-financial corporations (NFCs) continued to grow robustly in many EU Member States, with most witnessing positive annual growth in MFI (monetary financial institution) loans to households and NFCs in April 2018 and some experiencing a rapid rise in loans to the private sector on the back of strong economic growth. By contrast, a few Member States are still seeing a contraction in lending in the aftermath of earlier financial crises (indicators 3.1 and 3.2).
The cost of borrowing for both households and NFCs remains low, reflecting the low interest rate environment. The majority of Member States saw lower year-on-year debt servicing costs in April 2018, both for households and NFCs (indicators 3.3 and 3.4), with some experiencing more significant decreases, owing partly to lower bank lending margins (indicators 3.5 and 3.6).

Lending standards for loans to households eased over the quarter. This was the case for loans to both households and NFCs in the euro area as a whole (indicators 3.7 and 3.8). In particular, lending standards for loans to households eased in every quarter over the last year.

Residential real estate prices continue to rise sharply in several EU Member States. From the fourth quarter of 2016 to the fourth quarter of 2017, residential real estate prices rose by more than 5% in almost half of the Member States. Most of them have also experienced significant hikes in prices over the past three years (indicator 3.13). Although there is some degree of heterogeneity, residential real estate prices in several EU Member States appear to be inflated based on various valuation methods (indicator 3.12).

4. Banks

Bank profitability in the EU continued to improve in the first quarter of 2018. Both median return on equity (6.9%) and return on assets (0.47%) increased compared with the first quarter of 2017 (by 0.4 and 0.07 percentage points respectively). The situation for banks with the lowest returns also improved somewhat (indicators 6.1a and 6.1b). However, the cost-to-income ratio rose in the first quarter of 2018, while net interest income-to-total operating income ratio remained relatively unchanged (indicators 6.1c and 6.1d).

Banking sector resilience continued to strengthen in the first quarter of 2018. The median CET1 to risk-weighted assets ratio increased to 15.8% in the first quarter of 2018, up from 14.7% in the first quarter of 2017 (indicator 6.2a). Moreover, the median ratio of non-performing loans to total gross loans and advances continued its downward trend, reaching 3.1% in the first quarter of 2018 (indicator 6.2b). Ongoing supervisory and regulatory work, as well as the improved economic environment, contributed to easing the severity of vulnerabilities in the European banking sector.

5. Insurance

Solvency and profitability indicators suggest that the EU insurance sector is performing well overall. The median Solvency Capital Requirement ratio rose to over 200% in the fourth quarter of 2017, continuing the gradual upward trend from below 190% in the fourth quarter of 2016 (indicator 6.4a). This slight improvement was driven partly by the moderate increase in the risk-free rates, with the 10-year EIOPA risk-free rate, for example, rising from 0.571% in the fourth quarter of 2016 to 0.802% in the fourth quarter of 2017. As the majority of EEA insurance companies have a combined ratio below 100% (indicator 6.3b), this would also suggest that underwriting performance for non-life insurance portfolios has, on average, been healthy.

No big shifts have been observed in insurers’ overall asset allocation over the last four quarters (indicator 1.10). In terms of liquidity and credit quality characteristics, the investment exposures of EU insurers are, on average, considered to be highly liquid (indicator 4.10) and the majority of the bond portfolio is still of investment-grade qualityts (indicator 6.7).

6. Investment funds and other financial institutions

Total assets of EU investment funds and other financial institutions (OFIs) changed little in 2017, although the euro area saw slightly stronger growth (indicator 7.4). This contrasts with the period 2012-15, during which assets of EU investment funds and OFIs increased more rapidly. The size of the EU shadow banking
system can be measured using a broad approach that covers all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs). Within this measure, investment funds account for around one-third of assets and OFIs, including securitisation vehicles, account for the remainder. In terms of total assets, the EU shadow banking system accounted for approximately 40% of the EU financial system. This measure has remained stable over the past few years.

7. CCPs

In recent quarters, CCPs’ resources have remained broadly stable. Indicator 8.1 presents the share of CCPs’ own contributions to the default funds in relation to the clearing members’ contributions. It indicates that, over time, CCPs have held a stable level of own capital that could be used to absorb potential losses resulting from a clearing member’s default and to prevent default contagion. The overall collateral policies in indicator 8.3 indicate that the amounts of collateral being posted to the CCPs are sufficient to withstand immediate potential margin calls. This is in line with the indicators on liquidity policies, where all CCPs hold more than enough qualifying liquid resources to withstand the default of at least the two clearing members to which CCPs have the largest exposures (indicator 8.4). This, in conjunction with indicator 8.5, shows ample liquidity in the initial margin posted.

The contributions of larger clearing members are relatively high. Despite the comfortable positions of European CCPs, it is the largest clearing members making high contributions to the CCPs’ total initial margin. That being said, the figures have remained stable with no major fluctuations. The wind-down ratio, in spite of the heterogeneity across CCPs, indicates that all CCPs are complying with PFMI Principle 15 under which CCPs’ capital needs have to be small enough for an orderly wind-down within six months. For the five current interoperability arrangements of European CCPs, the initial margins provided vary significantly, but remain relatively stable.