



### 1. Systemic risk indicators and financial market conditions

**Risks to financial stability in the European Union (EU) remain a concern, as reflected by market-based indicators of systemic stress in the EU over the past quarter.** The composite indicator of systemic stress (CISS – [indicator 1.1](#)) increased somewhat during the third quarter of 2018 as a result of market tensions in some emerging market and sovereign segments, also related to broader political uncertainties. The indicator for the probability of simultaneous default by large and complex banking groups and EU sovereigns ([indicator 1.2](#)) remained at slightly elevated levels compared with the beginning of 2018, although it was still relatively low in historical terms. In addition, the implied volatility of short-term euro interest rates rose slightly from very low levels ([indicator 5.4](#)). The overall EU equity index was relatively stable, but the equity index for EU banks has been falling since the beginning of 2018 ([indicator 5.1a](#)), 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 levels observed in 2017.** EU GDP rose by slightly more than 2% year on year in the second quarter of 2018, down from 2.5% in the second quarter of 2017 ([indicator 2.1](#)). Overall, EU GDP is estimated to have expanded by 2.6% last year, its highest growth rate since 2007, which marked the start of the global financial crisis. In its summer forecast, the European Commission lowered its estimation of EU GDP growth to 2.1% in 2018 (from the 2.3% forecast in spring) and kept the 2.0% growth forecast for 2019. The downside risks stem mainly from three sources: (1) the threat of increased global protectionism and its impact on international trade; (2) rising oil prices owing to geopolitical risks; and (3) the possibility of repricing in financial markets and increasing volatility.

**Although most countries have deleveraged somewhat in recent years, 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. Regarding sovereign debt, the level in half of the EU Member States, as well as at the aggregate euro area and EU levels, 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 the first quarter of 2018 ([indicator 2.7](#)).

### 3. Credit risk

**Credit to the private sector continued to grow robustly in many EU Member States.** In July 2018 in most Member States positive annual growth in monetary financial institution (MFI) loans to households and non-financial corporations (NFCs) was observed, in some countries reaching relatively elevated levels. At the same time, in a few Member States very low lending activity was still being observed, in the aftermath of the earlier financial crisis ([indicators 3.1 and 3.2](#)).

**The cost of borrowing for the private sector remains low, reflecting the low interest rate environment.** In most Member States the cost of borrowing was lower in July 2018 than in July 2017, both for households and NFCs ([indicators 3.3 and 3.4](#)). At the same time, lending margins of MFIs also decreased during the past year in many Member States ([indicators 3.5 and 3.6](#)).

**Credit standards continued to ease over the last quarter.** This was the case for both loans to households (for house purchase) and loans to NFCs ([indicators 3.7 and 3.8](#)).

**Residential real estate prices continued to rise considerably in most EU Member States.** In the first quarter of 2018 year-on-year growth in residential real estate prices exceeded 5% in most EU Member States, following significant cumulative price increases over the past three years ([indicator 3.13](#)). Although there is some degree of heterogeneity, residential real estate in several EU Member States appears to be overvalued based on various valuation methods ([indicator 3.12](#)).

#### 4. Banks

**Bank profitability in the EU showed a slight deterioration in the second quarter of 2018.** The median return on equity decreased by 75 basis points to 6.7% on a year-on-year basis and the return on assets declined by 2 basis points to 0.45% ([indicators 6.1a and 6.1b](#)). At the same time, the cost-to-income ratio remained relatively high, registering increases in 2018 compared with previous years ([indicator 6.1c](#)). On the income side, banks seem to have further increased their dependence on net interest income ([indicator 6.1d](#)).

**Banking sector resilience continued to strengthen in the second quarter of 2018.** The median ratio of Common Equity Tier 1 to risk-weighted assets increased to 15.8% in the second quarter of 2018, up from 14.8% in the second 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 3.0% in the second quarter of 2018 ([indicator 6.2b](#)). Overall, ongoing supervisory and regulatory work, as well as the improved economic environment, continued to support the reduction 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 ratio rose to over 210% in the first quarter of 2018, continuing the gradual upward trend from around 180% in the third quarter of 2016 ([indicator 6.4a](#)). This slight improvement was driven partly by the moderate increase in risk-free rates, with the ten-year Solvency II risk-free rate, for example, rising from 0.19% in the third quarter of 2016 to 0.88% in the first quarter of 2018. With regard to non-life insurance, the majority of insurers in the European Economic Area have had a combined ratio below 100% since the third quarter of 2017, indicating that the premiums written over these quarters were sufficient to cover both the insurance claims and other related costs ([indicator 6.3b](#)). This would suggest that the underwriting performance of non-life insurance portfolios has, on average, been good.

**No big shifts have recently been observed in insurers' overall asset allocation** ([indicator 1.10](#)). In terms of liquidity and credit quality characteristics, the investment exposures of EU insurers are, on average, considered to be liquid ([indicator 4.10](#)) and most of the bond portfolio, although slightly decreasing in size, is still of investment-grade quality, i.e. credit quality steps 0 to 3 ([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** ([indicator 7.4](#)). This contrasts with the period 2012-15, during which assets of EU investment funds and OFIs increased 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).<sup>1</sup> 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. Within this measure, investment funds account for around one-third of total assets of the EU shadow banking system, and OFIs, including securitisation vehicles, account for the remainder. At the end of 2017 the EU OFI residual<sup>2</sup> amounted to €20 trillion<sup>3</sup>, which means that for around 47% of the EU shadow banking system a more detailed statistical breakdown is not available ([indicator 7.5](#)).

## 7. CCPs

**In recent quarters CCPs' collateral has remained broadly stable.** The amount of collateral posted to CCPs exceeded the amount of collateral required by them, indicating a situation of over-collateralisation ([indicator 8.3](#)). The indicators on liquidity policies show that all CCPs hold sufficient qualifying liquid resources to withstand the default of at least the two clearing members to which CCPs have the largest exposures ([indicator 8.4](#)). For the five current interoperability arrangements of European CCPs, the initial margins provided vary significantly, but have remained relatively stable over time ([indicator 8.8](#)).

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<sup>1</sup> See [EU Shadow Banking Monitor](#), No 3, ESRB, September 2018, Chart 2.

<sup>2</sup> The OFI residual is defined as the difference between the total financial sector according to the financial accounts and the known sub-sectors for which primary statistics are available. The residual arises because assets are not broken down in sufficient detail in the financial accounts data to reflect their ownership.

<sup>3</sup> See [EU Shadow Banking Monitor](#), No 3, ESRB, September 2018, Chart 4.