



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

**Risks to EU financial stability remained a concern as reflected by the market-based indicators of systemic stress in the European Union (EU) over the past quarter.** The indicators of systemic stress ([indicator 1.1](#)) increased somewhat during the past quarter at the back of tensions in some market segments and political uncertainties internationally and within Europe. In addition, the indicators for probability of simultaneous default by large and complex banking groups and EU sovereigns ([indicator 1.2](#)) remained at slightly elevated levels, as compared to the beginning of 2018, although still relatively low in historical terms. EU equity indices declined for all sectors ([indicator 5.1a](#)) leading to a continued correction in price/earnings ratios ([indicator 5.2](#)). At the same time, financial market uncertainty, as measured by implied volatility, increased somewhat ([indicator 5.1b](#)).

### 2. Macro risk

**Economic growth in the EU moderated from the levels observed in 2017.** EU GDP rose by slightly less than 2% year on year in the third quarter of 2018, down from 2.8% in the third quarter of 2017 ([indicator 2.1](#)). Overall, EU GDP is estimated to have expanded by 2.6% last year, its highest rate since 2007, which marked the start of the global financial crisis. In its autumn forecast, the European Commission kept the 2.1% growth forecast for 2018 EU GDP growth, but lowered its estimation for 2019 to 1.9% (from 2% forecast earlier this year). The downside risks stem mainly from the threat of increased global protectionism and its impact on international trade, as well as the possibility of re-pricing in financial markets and increasing volatility.

**Debt levels remain elevated across countries and sectors in the EU, although most countries deleveraged somewhat in the recent years** ([indicators 2.5a and 2.5b](#)). The debt reductions in recent years have been generally 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, exceeded 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 all Member States in Q2 2018 ([indicator 2.7](#)).

### 3. Credit risk

**Credit to the private sector continued to grow robustly in many EU Member States.** In September 2018 most Member States registered positive annual growth rates of loans granted by monetary financial institutions (MFI) to households and NFCs ([indicators 3.1 and 3.2](#)). Compared to the year before, growth rates of both, loans to households and loans to NFCs, remained elevated or further increased in many

countries. At the same time, in a few Member States very low lending activity is still observed, in the aftermath of the financial crisis.

**The cost of borrowing for the private sector remains low, reflecting the low interest rate environment.** In most Member States, the cost of borrowing recorded in September 2018 was broadly similar to or lower than the levels observed one year ago, both for households and NFCs ([indicators 3.3 and 3.4](#)). The same applies to the dynamics of the lending margins of MFIs ([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 continue to rise considerably in most EU Member States.** In the second quarter of 2018 year-on-year growth rates of the residential real estate prices slowed down slightly in some countries. However, in many EU Member States residential real estate price growth still exceeded 5%, following also significant cumulative price increases 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 overvalued, as 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.** Median return on equity decreased by 75 basis points to 6.7% on a year-on-year basis and the return on assets decreased by 10 basis points to 0.45% ROE ([indicators 6.1a and 6.1b](#)). At the same time, the cost-to-income ratio remained relatively high, denoting increases in 2018, as compared to previous years ([indicator 6.1c](#)). On the income side, banks seem to have further increased their dependence on the net interest income ([indicator 6.1d](#)).

**Banking sector resilience continued to strengthen in the second quarter of 2018.** The median CET1 to risk-weighted assets ratio increased to 15.8% in the second quarter of 2018, up from 14.9% 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, continue 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.** Despite a slight drop compared to the previous quarter, the median solvency ratio remained well above 200% in the second quarter of 2018 ([indicator 6.4a](#)). For non-life insurance companies, the majority of EEA insurers 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 to be paid ([indicator 6.3b](#)). This would suggest that underwriting performance for non-life insurance portfolios has, on average, been healthy. For life insurance, annual growth rates of gross premiums written have been positive, with median at close to 5% ([indicator 6.3c](#)).

**No big shifts have 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 the majority of the bond portfolio, although slightly decreasing, 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 2018** ([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).<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 assets and OFIs, including securitisation vehicles, account for the remainder.

**Investment funds represent about one-third of the EU shadow banking system, and other financial institutions (OFIs), including securitisation vehicles, account for the remainder.** 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. At the end of 2017 the EU OFI residual amounted to €20 trillion,<sup>2</sup> which means that for around 47% of the EU shadow banking system a more detailed statistical breakdown is not available ([indicator 7.5](#)). Specifically, the residual arises because assets are not broken down in further detail to reflect their ownership in the financial accounts data.

## 7. CCPs

**In recent quarters, CCPs' collateral has remained broadly stable.** With one exception, the amounts of collateral posted to the CCPs exceed the level of collateral required by the CCPs, indicating overcollateralisation on the level of the CCPs ([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 remain relatively stable over time ([indicator 8.8](#)).

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<sup>1</sup> See [ESRB Shadow Banking Monitor 2018](#), Chart 2.

<sup>2</sup> See [ESRB Shadow Banking Monitor 2018](#), Chart 4.