



1. Systemic risk indicators and financial market conditions

Market-based indicators of systemic stress in the European Union (EU) remained relatively benign despite significant geopolitical and policy uncertainties, highlighting the potential for re-pricing of risks by markets. The indicators of systemic stress (indicator 1.1) moderated during the fourth quarter of 2019, despite prevailing geopolitical and policy uncertainties internationally and within Europe, as well as the weakening economic outlook. Similarly, the equity market uncertainty, as measured by implied volatility remained relatively contained (indicator 5.1b), while the probability of simultaneous default by large and complex banking groups and EU sovereigns (indicator 1.2) steadied in the fourth quarter of 2019, with some bouts of volatility during the review period. EU equity indices remained broadly stable, except for EU industrials, which experienced a slight recovery recently, after a drop in the previous quarter (indicator 5.1a). Further, price/earnings ratios for the EU banking and insurance sectors recovered somewhat in line with developments for the non-financial corporations (indicator 5.2).

Moderate economic growth prevailed in the EU over the last year, while economic activity in the EU is expected to remain subdued over the medium term. In the third quarter of 2019, EU GDP rose by approximately 1.3% year on year (indicator 2.1). The European Commission maintained the GDP growth forecast for the EU for 2019 at 1.4% in its autumn forecast from November 2019, while the outlook for 2020 was slightly lowered to 1.4% (from 1.5% published in July 2019).¹ This reflects downside risks stemming mainly from the threat of increased global protectionism and its impact on international trade and output.

Debt levels remain elevated across countries and sectors in the EU, although over the past years most countries have deleveraged somewhat (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. For most countries, the aggregate debt-to-GDP ratio in Q2 2019 was somewhat lower than the three years average, suggesting that the deleveraging process in the European Union continued. Still, most countries have not reduced their indebtedness levels significantly. Generally, high debt levels mean that economies are vulnerable to shocks, such as changes in the growth outlook. Regarding sovereign debt, the level in around 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 but three Member States in Q2 2019 (indicator 2.7).

¹ See European Commission Economic Forecast, Autumn 2019, November 2019, available at https://ec.europa.eu/info/sites/info/files/economy-finance/ip115_en_0.pdf.

2. Credit risk

Credit to the private sector continued to grow robustly in many EU Member States. In October 2019, 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](#)). In many countries, growth rates of both loans to households and loans to NFCs continued to be quite significant, also as compared to the year before. At the same time, in a few Member States very low lending activity is still observed.

The cost of borrowing for the private sector remains low, reflecting the low refinancing costs for banks and the low risk pricing. In most Member States, the cost of borrowing recorded in October 2019 somewhat declined for the households and NFCs in most countries in year-on-year comparison ([indicators 3.3 and 3.4](#)). Lending margins of MFIs also declined or remained broadly stable in most EU countries for loans to households for house purchase, with increases registered in some countries for loans to NFCs ([indicators 3.5 and 3.6](#)).

While credit standards remained relatively stable with some bouts of volatility in 2019, a minor easing of credit standards was registered over the last quarter, both for loans to households for house purchases and for loans to non-financial corporations ([indicators 3.7 and 3.8](#)).

Residential real estate prices continued to rise considerably in all but one EU Member States. In the second quarter of 2019 year-on-year growth of residential real estate prices continued to exceed 5% in most EU Member States, following also significant price increases over the past three years ([indicator 3.13](#)). Reflecting these dynamics, the residential real estate prices appear to be overvalued in several EU Member States, as based on various valuation methods ([indicator 3.12](#)).

3. Banks

Bank profitability in the EU remained broadly stable in the third quarter of 2019. Median return on equity stood at 6.4%, while return on assets was 0.44% ([indicators 6.1a and 6.1b](#)). At the same time, the median cost-to-income ratio slightly decreased compared to the previous quarter ([indicator 6.1c](#)). On the income side, the share of net interest income to total operating income has not changed markedly over the last quarters ([indicator 6.1d](#)).

Banking sector capitalisation stood broadly unchanged, whilst the reduction of non-performing loans halted. The median CET1 to risk-weighted assets ratio remained broadly stable 15.5% in the third quarter of 2019 ([indicator 6.2a](#)). At the same time, the decline of the median ratio of non-performing loans to total gross loans and advances halted at around 2.8% in the third quarter of 2019 ([indicator 6.2b](#)).

4. Insurance

After a decrease during the previous quarter, the median solvency ratio of the EU insurance sector stabilised at around 195%. While the lowest quartile of solvency ratios increased moderately to roughly 165%, the highest quartile dropped by 11 percentage points to slightly above 247% ([indicator 6.4a](#)). Although the median combined ratio for non-life insurance barely moved, standing at just above 95%, both the lowest and highest quartiles respectively increased/decreased by a few percentage points. As a result, there were fewer combined ratios over 100% in the second quarter ([indicator 6.3b](#)). The annual growth rates of gross written premiums for both life and non-life insurance remained broadly stable, with the median

growth rate standing at 1.4% for life insurance ([indicator 7.7a](#)) and at 3.3% for non-life insurance ([indicator 7.7b](#)). In terms of profitability, the median return on equity during the first half of 2019 decreased from 4.9% to 3.4% ([indicator 6.3a](#)).

Regarding the EU insurers' asset allocation, there were no significant changes neither in the credit quality characteristics of EU insurers' bond portfolio, nor in the liquidity profile of their assets. The EU insurers' holdings of government or corporate bonds remained fairly unchanged, at around 50% of total investments ([indicator 1.10](#)). Roughly 80% of these investments have a credit quality below or equal to credit quality step 3 (equivalent to BBB; [indicator 3.14](#)). The EU insurers' assets liquidity did not move significantly in this quarter, with the median liquid asset ratio remaining at around 63% ([indicator 4.9](#)).

5. Investment funds and other financial institutions

Total assets under management in the EU investment funds continued to grow in the second quarter of 2019, although at a slower pace. The assets under consideration include all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs).² Both investment funds and OFIs had an increase in total assets over this quarter. However, the OFIs' assets were still below their level from one year ago ([indicator 7.5b](#)). Euro area investment funds saw continued inflows in the second quarter, which were supported by increases in asset values. In terms of total assets, investment funds and OFIs account for 38% of the EU financial system. This measure has remained stable over the past few years and did not change significantly in the second quarter of 2019. Within this measure, investment funds account for 36% of assets and OFIs, including securitisation vehicles, account for the remainder.

While all investment fund types benefited from increases in asset valuations, equity funds and hedge funds saw investor outflows in the second quarter of 2019. Investor inflows continued into bond funds, mixed funds and real estate funds, with inflows particularly high for bond funds. While real estate funds saw lower increases in assets under management, this follows a long period of continued asset growth over the past decade. At the same time, equity funds and hedge funds experienced an outflow of investments in the second quarter. For hedge funds, these outflows were sufficiently high to offset increases in asset valuations. As a result, total assets in hedge funds decreased in the second quarter.

6. CCPs

The overall picture drawn from the CCP indicators has remained broadly stable, notwithstanding the differences between the CCPs. Overcollateralisation appears to be widely practiced, to different degrees by the CCPs ([indicator 8.3](#)). Liquidity resources available to the CCPs, which include a significant percentage of margins posted in the form of cash, seem adequate with no sign of meaningful deterioration ([indicators 8.4 and 8.5](#)). Moreover, CCPs' investment policies do not seem to suggest meaningful increase in their risk taking ([indicator 8.10](#)). However, central clearing in general and client clearing in particular still appear to be highly concentrated activities ([indicator 8.6 and 8.9](#)). For the five current interoperability arrangements of

² See EU Non-Bank Financial Intermediation Risk Monitor 2019, ESRB Jul 2019. Assets under management by CCPs are partially included in the monitoring universe as so-called 'other financial institutions' unless the CCPs have a banking license in which case they are included within monetary financial institutions (MFI) statistics.

European CCPs, the initial margins provided vary significantly, but have remained relatively stable over time (indicator 8.8).