1. Systemic risk indicators and financial market conditions

Market-based indicators of systemic stress in the European Union (EU) have increased sharply after the outbreak of the coronavirus (COVID-19). The indicators of systemic stress (indicator 1.1) have increased abruptly following the outbreak of the coronavirus pandemic. Accordingly, uncertainty, as measured by implied volatility, increased notably across various market segments (indicator 5.1b, 5.3-5.5), while the probability of the simultaneous default of large and complex banking groups and EU sovereigns (indicator 1.2) soared. Similarly, EU equity indices declined sharply, also impacting the equity prices of financials, particularly banks and insurance companies (indicator 5.1a). Furthermore, price/earnings ratios for the EU banking and insurance sectors also fell, in line with developments in non-financial corporations (indicator 5.2).

Regarding macro-economic developments prior to the coronavirus crisis, euro area monetary financial institution (MFI) credits and deposits contracted slightly in the last quarter of 2019. The total amount of four-quarter cumulated credit flows declined by around €300 billion (indicator 1.4.a) owing mainly to a small decrease in general government credit and a somewhat larger one for MFIs (excluding the Eurosystem) and, more especially, non-euro area residents. Total deposits fell by approximately the same amount as credits (indicator 1.5.a) because of the negative contribution of the non-euro area resident share and the MFI’s (excluding the Eurosystem) share. There were no significant changes in the domestic credit-to-GDP gap (indicator 2.2) in the third quarter of 2019.

Moderate economic growth prevailed in the European Union throughout 2019. The coronavirus pandemic has created significant uncertainty regarding economic outlook. In the fourth quarter of 2019, EU GDP grew by approximately 1.2% year on year (indicator 2.1). The outlook for the EU economy is surrounded by a significant level of uncertainty regarding the depth and length of the coronavirus pandemic and its ultimate economic effects.

There were no significant changes either in the current account balances in the third quarter of 2019 or in the unemployment rate, until February. The current account balance-to-GDP ratio did not show any significant movement either within individual countries or in terms of location of the horizontal distribution in the third quarter of 2019 (indicator 2.3). Moreover, the unemployment rate remained broadly stable throughout the euro area from October 2019 to the end of February 2020, with the only exception being

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1 Most of the charts in this Risk Dashboard edition do not show the developments relating to the coronavirus outbreak since the latest observations do not overlap with this event. The high-frequency financial indicators are an exception in this respect.
Greece, where there was a decline of around 2 percentage points. Due to the economic crisis related to coronavirus outbreak, sizeable rise in the level of unemployment can be expected.

**Debt levels remained elevated across countries and sectors in the European Union, although over the last few years most countries have deleveraged somewhat (indicators 2.5a and 2.5b).** 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 the third quarter of 2019 was somewhat lower than the three-year average, suggesting that the deleveraging process in the European Union had continued. Nevertheless, most countries have still not reduced their levels of indebtedness significantly, with the exceptions of Cyprus and Luxembourg. Generally, high debt levels mean that economies are vulnerable to shocks, such as changes in the growth outlook as is currently occurring due to the coronavirus crisis. Regarding sovereign debt, levels 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 two Member States in the third quarter of 2019\(^2\) (indicator 2.7). Following the outbreak of the coronavirus crisis, rising sovereign risk concerns by market participants were reflected in the sharp increases in the sovereign CDS premia, particularly on countries with weaker fiscal fundamentals (indicator 2.8).

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### 2. Credit risk

**Credit to the private sector continued to grow robustly in many EU Member States until the outbreak of the coronavirus crisis.** In January 2020, most Member States registered positive annual growth rates of loans granted by MFIs to households and non-financial corporations (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. At the same time, very low lending activity was still observed in a few Member States.

The cost of borrowing for the private sector remained also low before the coronavirus outbreak, reflecting low refinancing costs for banks and low risk pricing. In most Member States, a year-on-year comparison shows the cost of borrowing declined slightly or remained stable for households and NFCs in January 2020 (indicators 3.3 and 3.4). MFI lending margins also declined or remained broadly stable in most EU countries for loans to households for house purchase, with some countries registering increases for loans to NFCs (indicators 3.5 and 3.6).

**The option-adjusted spreads on euro area corporate bonds have been strongly affected by the economic crisis triggered by the COVID-19 pandemic.** As a result, between the end of February and the beginning of March the high-yield bond spread widened significantly, gaining around 500 basis points in half a month, while the other two spreads grew by about 100 points (indicator 3.9).

While credit standards remained relatively stable in 2019, albeit with some bouts of volatility, a minor improvement in credit standards was registered in the survey conducted in January 2020, before the coronavirus crisis, both for loans to households for house purchase and for loans to NFCs (indicators 3.7 and 3.8).

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\(^2\) In the previous quarter, Cyprus was the EU country with the highest deficit-to-GDP ratio (around 3.5%), whereas just one quarter later its value is the lowest among the countries (around -3.5%).
Residential real estate prices continued to rise considerably in all but one EU Member State. In the third quarter of 2019 year-on-year growth in residential real estate prices continued to exceed 5% in the majority of EU Member States, following significant price increases over the previous three years (indicator 3.13). Reflecting these dynamics, based on various valuation methods, residential real estate prices appear to be overvalued in several EU Member States (indicator 3.12).

3. Banks

Banks’ profitability in the European Union decreased in the fourth quarter of 2019. The median return on equity decreased by approximately 60 basis points compared with the third quarter of 2019, to stand at 5.8%, while return on assets decreased by 4 basis points to 0.4% (indicators 6.1a and 6.1b). At the same time, the median cost-to-income ratio increased slightly over its third-quarter 2019 value, to stand at 63.2% for the fourth quarter of 2019 (indicator 6.1c). On the income side, the share of net interest income to total operating income decreased by 20 basis points to 63.9% (indicator 6.1d).

Banking sector capitalisation stood broadly unchanged and the reduction of non-performing loans improved slightly. The median ratio of Common Equity Tier 1 (CET1) to risk-weighted assets remained broadly stable at 15.6% in the fourth quarter of 2019 (indicator 6.2a). At the same time, the median ratio of non-performing loans to total gross loans and advances was around 2.6% in the fourth quarter of 2019, falling by 10 basis points compared with the previous quarter (indicator 6.2b).

As mentioned earlier, EU banks’ equity prices and other instruments have declined sharply after the coronavirus outbreak (indicator 5.1a).

4. Insurance

The median solvency ratio of the EU insurance sector deteriorated by around 10 percentage points to roughly 185%. Both the lowest and the highest quartiles of the ratio also dropped, from 165% to around 160% and from 245% to around 230% respectively (indicator 6.4a). The median combined ratio for non-life insurance remained stable, standing at just above 95% (indicator 6.3b). The median annual growth rates of gross written premiums increased slightly for both life and non-life insurance, to 1.9% and 3.9% respectively. The lowest quartile of growth rates increased from around -5% to just above -2% for life insurance, while it remained stable for non-life insurance. The highest quartile increased by a few percentage points for both life insurance (indicator 7.7a) and non-life insurance (indicator 7.7b).

Regarding the EU insurers’ asset allocation, there were no significant changes in the credit quality characteristics of EU insurers’ bond portfolio, but the liquidity profile of assets deteriorated slightly for some insurers. The EU insurers’ holdings of government or corporate bonds remained relatively unchanged, at around 50% of total investments. However, the share of investments made via funds has been increasing slowly (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 median value of EU insurers’ asset liquidity remained at around 63%, but the lowest quartile dropped from 53% to roughly 51% (indicator 4.9).

Similarly to the other financial stocks, equity prices of EU insurers have declined sharply after the coronavirus outbreak (indicator 5.1a).
5. **Investment funds and other financial institutions**

Total assets held in the EU investment funds and other financial institutions (OFIs) continued to grow in the third quarter of 2019. The assets under consideration include all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs).\(^3\) Both investment funds and OFIs recorded an increase in total assets over this quarter. The strong negative outflow from OFIs shown by indicator 7.5b continues to reflect the decrease in assets at the end of 2018. Euro area investment funds saw continued inflows in the third quarter of 2019, which were supported by increases in asset values. In terms of total assets, investment funds and OFIs hold approximately the same amount of assets as credit institutions in the European Union (Indicator 7.4) and account for 39% of the EU financial system. This measure has remained stable over the past few years and did not change significantly in the third quarter of 2019. Within this measure, investment funds account for 36% of assets while OFIs, including securitisation vehicles, account for the remainder.

**Continued increases in asset valuations in the third quarter of 2019 resulted in an increase in assets under management across fund types.** Besides higher asset valuations, investor inflows also continued across most fund types, including bond funds, mixed funds and real estate funds. The higher asset valuations in equity funds and hedge funds were partially offset by investor outflows as some investors re-allocated their investment portfolios.

6. **CCPs**

The overall picture drawn from the CCP indicators until the third quarter of 2019 remained broadly stable, notwithstanding the differences between the CCPs. Haircuts on non-cash initial margins reflect a period of low market volatility (indicator 8.2). CCPs’ prefunded default resources have also tracked historical levels (indicator 8.1). Overcollateralisation continued to be widely, though variably, practiced (indicator 8.3). Moreover, liquidity resources available to the CCPs, which include a significant percentage of margins posted in the form of cash, did not show a sign of meaningful deterioration (indicators 8.4 and 8.5). In line with these trends, CCPs’ investment policies did not suggest a meaningful increase in their risk taking until the third quarter of 2019 (indicator 8.10).

**Systemic dynamics, like interoperability and concertation of clearing activity, remained meaningful but stable.** 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 European CCPs, the initial margins provided vary significantly but have remained relatively stable over time (indicator 8.8).

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\(^3\) 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.