ESRB
European Systemic Risk Board
European System of Financial Supervision

The ESRB risk dashboard: an overview

1 October 2020

Issue 33

1. Systemic risk indicators and financial market conditions

Market-based indicators of systemic stress in the European Union (EU) mostly maintained positive signs of recovery from the economic shock caused by the outbreak of the coronavirus (COVID-19). The indicators of systemic stress (indicator 1.1) decreased further during the third quarter of 2020, following the trend from the previous three-month period. The probability of the simultaneous default of large and complex banking groups and EU sovereigns (indicator 1.2) also fell. Other indicators of implied volatility, which measure market uncertainty across several segments, followed different patterns. The stock market and particularly the foreign exchange market indicators (indicators 5.1b and 5.3) increased in May and fell back in June, ultimately stabilising at higher levels. The implied volatility of long-term interest rates (indicator 5.5) denominated in pounds sterling increased further and only fell back in August. The implied volatility of short-term interest rates (indicator 5.4) also denominated in pounds sterling hit record levels in July before returning in August to their previous upward trend. EU equity indices and price/earnings ratios either recovered most of their losses or even improved (indicators 5.1a and 5.2).

Regarding macroeconomic developments, euro area monetary financial institution (MFI) credits and deposits rose significantly in the second quarter of 2020. The total amount of four-quarter cumulated credit flows increased by around €800 billion (indicator 1.4a) owing mainly to a large increase in credit to MFIs. Total deposits soared by roughly the same amount (indicator 1.5a) thanks to the positive contribution of the deposits of Eurosystem MFIs and non-financial corporations (NFCs). There were no significant changes in the domestic credit-to-GDP gap in the first quarter of 2020 (indicator 2.2), except for the substantial decreases in Luxembourg, Hungary and Malta with respect to their three-year average; Ireland experienced a noticeable increase of the negative gap in absolute terms.

The EU suffered a deep economic contraction throughout the second quarter of 2020 as a result of the stringent lockdown measures implemented in most Member States, a collapse in global trade and the confidence shock affecting the economy. EU GDP and euro area GDP plummeted by 14% and 14.7% year on year respectively in the second quarter of 2020 (indicator 2.1). All EU Member States suffered an economic slump, with Spain, France and Italy being the most severely hit countries (recording falls in GDP of 22.1%, 18.9% and 17.7% respectively in the second quarter of 2020) and Luxembourg the least affected (-0.2%). The impact on production and unemployment was visibly larger in the second quarter of 2020 than in the first quarter with the European Commission and ECB forecasts not anticipating a sustained recovery before 2021. The outlook for the EU economy is still surrounded by considerable uncertainty with regard to the extent and duration of the coronavirus pandemic and its ultimate economic consequences.

In the first quarter of 2020 current account balances started to worsen and rising unemployment accelerated in several countries in July. There were no large movements in the current account balance-to-

GDP ratio across the EU in terms of location of the horizontal distribution (indicator 2.3), although some countries performed worse than others (Ireland and Cyprus). Unemployment (indicator 2.4) increased in all countries, especially Greece, Spain and Italy (17.8%, 15.8% and 9.7% respectively), while euro area and EU rates reached 7.9% and 7.2%, respectively. Owing to a somewhat sluggish effect on unemployment, sizeable increases can still be expected in the coming quarters.

Debt levels across countries and sectors in the EU started to be influenced by the COVID-19 pandemic in the first quarter of 2020 (indicators 2.5a and 2.5b). Overall, debt reductions in recent years have been smaller in scope than the increases in debt in the run-up to the global financial crisis. This trend is expected to be reversed as the ongoing COVID-19 pandemic will lead to significant increase in indebtedness owing to the significant private and public debt borrowing. Generally speaking, high levels of debt mean that economies are vulnerable to shocks, such as changes in the growth outlook, which are currently occurring because of the coronavirus crisis. Regarding sovereign debt, in the first quarter of 2020 around half of the EU Member States, as well as countries at the aggregate euro area and EU levels, exceeded the 60% debt-to-GDP ratio (indicator 2.6) established under the Maastricht Treaty, while the government deficit-to-GDP ratio (indicator 2.7) was below 3% for all Member States except Romania, France and Spain.[1] The EC 2020 projections show that all countries will suffer from an increase in both the indicators, while all the Member States apart from one are expected to exceed the 3% threshold at the end of the year. After a peak caused by the onset of the coronavirus crisis, market participants' sovereign risk concerns eased around March 2020 and then stabilised until September at a higher level than before the crisis (indicator 2.8).

2. Credit risk

The growth of MFI loan extension to households remained broadly steady, while a sharp increase in the growth rate of loans to NFCs was observed in many Member States, following the peak of the coronavirus crisis. The year-on-year growth in the amount of loans supplied to households has generally remained at par with the levels seen earlier in the year and also close to the three year average for most EU Member States (indicator 3.1). In contrast, the annual growth rate of loans to NFCs (indicator 3.2) saw an overall increase compared to July 2019. However, low growth in lending activity to NFCs was observed in some Member States (Cyprus, Latvia, Lithuania, Malta and Poland).

The cost of borrowing remained low for the private sector in July, despite a slight increase in NFC borrowing, reflecting low funding costs for banks and low risk pricing. In most Member States, a year-on-year comparison shows that the cost of borrowing from MFIs declined slightly or remained stable for households in July 2020 (indicator 3.3), but rose somewhat for NFCs in a few countries (indicator 3.4). A driver of this indicator is likely to be the support measures (e.g. public guarantee schemes) mitigating the Covid-19 impact. Overall, MFI lending margins also remained broadly stable for loans to households for house purchase in most EU countries (indicators 3.5 and 3.6).

After being pushed upwards by the economic turmoil, the option-adjusted spreads on euro area corporate bonds (indicator 3.9) **decreased further during the third quarter of 2020.** In line with this, the high-yield

[1] The onset of the coronavirus crisis in 2020 recently pushed France and Spain beyond the 3% threshold as the pandemic emergency eroded public finances. Even bigger consequences are expected in the later quarters of 2020, as is more fiscal leeway.

bond spread fell slowly between the beginning of March and the beginning of September, losing around 40 basis points, to return to pre-crisis values for AA-rated and BBB-rated bonds.

Notwithstanding the COVID-19 crisis, credit standards for loans to households for house purchase tightened somewhat across EU Member States in the third quarter of 2020, while standards for loans to NFCs were eased in some countries (indicators 3.7 and 3.8). Only France reported a visible move towards easing of credit standards for loans granted to households for house purchase (-30% of banks).

In the first quarter of 2020 residential real estate prices continued to rise considerably in all but one EU Member State despite the sharp impact of the coronavirus crisis. 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). Based on various valuation methods at the same time, residential real estate prices appeared to be overvalued in several EU Member States at the beginning of 2020 (indicator 3.12).

3. Banks

Bank profitability in the EU decreased sharply in the first quarter of 2020. The median returns on equity and assets stood at 1.35% and 0.1% respectively for the first quarter of 2020, compared to 5.8% and 0.4% in the previous quarter (indicators 6.1a and 6.1b). On the income side, due to fall in income, the median cost-to-income ratio (indicator 6.1c) increased by 460 basis points to 67.8%, and the net interest income-to-total operating income ratio (indicator 6.1d) increased by approximately 360 basis points to 67.5%.

The levels of both banking sector capitalisation and non-performing loans remained broadly unchanged. The median ratio of Common Equity Tier 1 (CET1) capital to risk-weighted assets (indicator 6.2a) remained broadly stable at 15.6% in the first quarter of 2020. At the same time, the median ratio of non-performing loans to total gross loans and advances (indicator 6.2b) was around 2.6% in the first quarter of 2020.

While the long-term effects of the coronavirus crisis on the EU banking sector are still uncertain in terms of their magnitude, its impact on the sector's profitability, as seen above, and funding profile is already evident. Banks' funding by central banks (indicator 4.3) sharply increased in almost all EU countries (23 out of 24 for which data are available), indicating volatility in the interbank funding market. Average banks' funding by central banks as a share of total liabilities increased from 1.5%, before the onset of the coronavirus crisis, to 4.2% as of the end of July 2020.

As mentioned earlier, the equity indices for EU banks and other instruments declined sharply following the start of the coronavirus outbreak (indicator 5.1a). Price-to-earnings ratios for banking stock, after declining in the first quarter of 2020, recovered in the third quarter of 2020, as they surpassed the level prior to the coronavirus emergency (indicator 5.3a).

4. Insurance

The median solvency ratio (indicator 6.4a) of the EU insurance sector decreased by 7 percentage points to roughly 210% in the first quarter of 2020. Both the lowest and the highest quartiles of the ratio also declined, from around 180% to approximately 170% and from just above 260% to just below 250% respectively. This decrease can be explained partly by the fall in financial markets in the first quarter of

2020. This can also be seen in the significant reduction in total assets, which went from around €9 trillion to slightly more than €7 trillion (indicator 1.10). The median combined ratio for non-life insurance diminished slightly, from 96% to 93% (indicator 6.3b). The median annual growth rates of gross written premiums remained stable for both life and non-life insurance, standing at 4.0% and 4.9% respectively (indicators 7.7a and 7.7b). The first quartile of growth rates decreased for life insurance from -0.8% to -3.2%, reflecting a noticeable decrease in premiums.

The EU insurers' bond portfolio remained largely at investment-grade quality in the first quarter of 2020, while there seems to have been a move towards more liquid assets. EU insurers increased their holdings of government or corporate bonds from just above 45% to just below 52% 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 liquidity of assets held by EU insurers increased slightly in the first quarter of 2020, with the median liquid asset ratio now standing at around 65% (indicator 4.9).

5. Investment funds and other financial institutions

Total assets held in EU investment funds and other financial institutions (OFIs) decreased in the first quarter of 2020 following the onset of the COVID-19 pandemic. The assets under consideration include all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs).[2] The aggregate total assets held by investment funds and OFIs is approximately the same as for credit institutions in the EU (indicator 7.4), making up around 39% of the EU financial system. Investment funds account for almost 35% of assets while OFIs, decreasing slightly from 37% in the previous quarter including securitisation vehicles, account for the remainder.

Most investment fund types and OFIs saw a decrease in assets under management in the first quarter as asset values fell. While making up a small percentage of total assets under management (indicator 7.5), money market funds (MMFs) play a key role in providing short-term funding to financial institutions and NFCs. Euro area variable and low volatility net asset value MMFs faced substantial outflows at the peak of the market turmoil in mid-March, reaching 8% of their assets. By contrast, constant net asset value MMFs, which invest in government assets, experienced net inflows during the same period, which may partially reflect a flight-to-safety reaction by investors.

6. CCPs

The impact of the COVID-19 pandemic shock on CCPs is not yet visible in the first quarter data. There is no statistically relevant difference between these data and those of the previous quarters, which in turn painted a picture of sound risk management, healthy collateral levels and composition and stable trends throughout the periods considered. In particular, the trends in CCP investment policies do not suggest a meaningful increase in their risk-taking (indicator 8.10).

Systemic dynamics, like interoperability and concentration of clearing activity, remained meaningful but stable. Central clearing in general and client clearing in particular still appear to be highly concentrated

[2] See EU Non-Bank Financial Intermediation Risk Monitor 2019, ESRB, July 2019. Assets under management by CCPs are partially included in the monitoring universe under "other financial institutions" unless the CCPs have a banking licence, in which case they are included within MFI statistics.

activities (indicators 8.6 and 8.9). For the five current interoperability arrangements of European CCPs, the initial margins provided vary significantly despite remaining relatively stable over time (indicator 8.8).