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The ESRB risk dashboard: an overview

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1. Systemic risk indicators and financial market conditions

Market-based indicators of systemic stress in the European Union (EU) showed signs of continued recovery following the initial shock due to the coronavirus (COVID-19) pandemic earlier in the year. The indicator of systemic stress (indicator 1.1) continued to fall, although it remained slightly above pre-pandemic levels. The probability of a simultaneous default of large and complex banking groups and EU sovereigns (indicator 1.2) also declined and is now reaching levels seen in the fourth quarter of 2019. However, some measures of implied volatility seemed to react quite strongly to the onset of the second wave of infections which swept across Europe from October 2020. The stock market indicator and, in particular, the foreign exchange market indicator (indicators 5.1b and 5.3 respectively) peaked around the middle of the fourth quarter of 2020, but subsequently resumed the steady decrease exhibited since the start of the second quarter. While a number of EU equity indices fully recovered following the pandemic shock in the spring, bank and insurance equity indices are still somewhat below their pre-pandemic levels (indicator 5.1a). Price/earnings ratios, on the other hand, all recovered and are now well above the levels at which they started the year (indicator 5.2).

Loans and deposits of euro area monetary financial institution (MFI) continued to rise in the second quarter of 2020. The total amount of four-quarter cumulated credit flows continued to increase into the fourth quarter (indicator 1.4a), albeit at a slower rate. Total deposits increased by a similar amount (indicator 1.5a) thanks to a positive contribution from the Eurosystem deposits and non-financial corporations (NFCs). A number of significant changes were observed in the domestic credit-to-GDP gap in the second quarter of 2020 (indicator 2.2), with most countries starting to move away from their three-year average. A majority of countries experienced a closing of their domestic credit-to-GDP gap, while it significantly increased for France and Ireland, compared to data for Q1 2020.

Following a strong economic recovery in Q3, the second wave of COVID-19 infections and concomitant containment measures have increased uncertainty and downside risks to the growth outlook in the near term. Real GDP in the EU fell by 11.3% q-o-q in Q2 2020. The recovery was somewhat stronger than expected in Q3 2020, with EU GDP rising by 11.5% q-o-q. For the year 2020 the European Commission Autumn Forecast projects EU GDP growth of -7.4%, but the outlook is subject to considerable downside risks with regard to the extent and the duration of the pandemic and its long-term economic consequences.

Results were mixed for the current account balance within Member States, while the rise in unemployment was slightly more pronounced than expected. Some significant movements in the current account balance were noted during the second quarter (indicator 2.3), with some countries performing worse (Ireland and Cyprus) and others better (Estonia, Lithuania and Austria) than they did on average over the past three years. Unemployment (indicator 2.4) increased in a number of countries compared to the previous year. Euro area and EU unemployment rates reached 8.3% and 7.5%, respectively. Owing to the lagged impact on unemployment—not least on account of part-time working schemes—, further increases may still be expected in the forthcoming quarters.

While NFC debt perceptibly increased in the second quarter of 2020, largely on account of policy support measures, household debt hardly rose (indicator 2.5). Between end-2019 and end-June 2020 NFC sector debt rose by 4.5% in the EU and by 7.4% in the euro area.[1] Compared to the three-year average, EU NFC sector debt at end-June 2020 was 0.9% higher. Debt of the EU household sector increased by 3.6% between end-2019 and end-June 2020. Compared to the three-year average, EU household sector debt at end-June 2020 was 2.25% higher.

Sovereign debt surged in all EU Member States on the back of swift and large-scale fiscal support measures. According to the European Commission's Autumn Forecast, the government deficit-to-GDP ratio in the EU (indicator 2.7) is expected to reach 6% in 2020. For individual EU Member States the ratio is expected to reach between 1-11% of GDP in 2021, exceeding the 3% threshold in 21 out of the 27 Member States. Accordingly, the debt-to-GDP ratio in EU Member States increased for all EU member states, with increases perceptibly differing between countries. The ratio varied between 20-190% of GDP at the end of March 2020. Following the peak caused by the onset of the coronavirus crisis leading to a drastic increase in CDS premia on sovereign debt, the premia eased since March 2020 and subsequently stabilised until September, although at a slightly higher level than before the crisis (indicator2.8). As of November 2020, sovereign risk premia began to further decline on the back of the prospect of a vaccine.

[1] As NFCs partially used additional loans to increase their precautionary cash holdings, the increase in net debt is somewhat smaller than the increase in gross debt.

2. Credit risk

In the third quarter of 2020 there were significant differences between countries regarding growth in MFI loans. Annual growth of MFIs loans to households dropped significantly in a majority of countries (indicator 3.1). Growth rates of loans to NFCs in the third quarter declined in most countries, while increasing in a few others (indicator 3.2). Low or even negative growth rates were observed in the Czech Republic, Latvia, Lithuania, Poland and Slovenia.

The cost of borrowing remained low for the private sector in September 2020, despite an 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 September 2020 (indicator 3.3), with the exceptions of Cyprus and France. A similar decline is found for NFCs (indicator 3.4), the exceptions being Germany, Belgium, Austria and the Netherlands, where the cost of borrowing marginally increased. Significant shifts in MFI lending margins were revealed in a number of countries, both for lending to households (indicator 3.5) and for lending to NFCs (indicator 3.6).

After being pushed upwards by the heightened market tensions earlier in the year, the option-adjusted spreads on euro area corporate bonds (indicator 3.9) **decreased further during the fourth quarter of 2020.** In line with this, the high-yield bond spread fell quite rapidly during this quarter, losing well over 100 basis points, and returning to pre-crisis values in the case of AA-rated and BBB-rated bonds.

Against the backdrop of the COVID-19 crisis, credit standards for loans to households for house purchases tightened to some extent across EU Member States in the fourth quarter of 2020, as were standards for loans to NFCs for a majority of countries (indicators 3.7 and 3.8). Most notably, France drastically increased its credit standards for loans to households, while also increasing its standards for loans to NFCs.

In the first quarter of 2020 residential real estate prices continued to rise considerably in all but one EU Member State, despite the coronavirus crisis. Year-on-year growth in residential real estate prices continued to exceed 5% in the majority of EU Member States, following the significant price increases seen over the previous three years (indicator 3.13). Based on various valuation methods, 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 recovered partially in the second quarter of 2020. The median returns on equity and assets stood at 2.49% and 0.16% respectively in the second quarter of 2020, compared with 1.25% and 0.09% in the previous quarter (indicators 6.1a and 6.1b). The median cost-to-income ratio (indicator 6.1c) decreased by 241 basis points to 65.7%, while the net interest income-to-total operating income ratio (indicator 6.1d) dropped by approximately 125 basis points to 65.9%.

Banking sector capitalisation improved marginally, while non-performing loans remained broadly unchanged. The median ratio of Common Equity Tier 1 (CET1) capital to risk-weighted assets (indicator 6.2a) increased slightly to 16.3% in the second 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 2.5% in the second quarter of 2020.

Previous trends in the liquidity profile of banks consolidated in the third quarter of 2020. Banks' funding by central banks (indicator 4.3) continued to rise in almost all EU countries (19 out of the 24 for which data are available). The average for banks' funding by central banks as a share of total liabilities maintained its upward trend, having increased from 1.5% before the onset of the coronavirus crisis to 6.1% at the end of October 2020.

Following a brief rebound in the second quarter of 2020, equity indices for EU banks and other instruments once again declined in the third quarter of 2020 (indicator 5.1a). Price-to-earnings ratios for banking stock continued to bounce back from their earlier decline in the first quarter of 2020, reaching in Q3 their highest value in the year 2020 so far (indicator 5.2).

4. Insurance

The median solvency ratio (indicator 6.4a) of the EU insurance sector continued to decrease, falling by 6% to around 200% in the second quarter of 2020. One of the main reasons for this might be lower risk-free interest rates. Following the severe decline in the value of assets held by insurers in the first quarter of 2020, total assets recovered partially to approximately €7.8 trillion (indicator 1.10), still below their level in the fourth quarter of 2019 (€9.1 trillion). The median return on equity for the first semester of 2020 was below 2%, reflecting the market turmoil at the beginning of 2020 (indicator 6.3a). The median combined ratio for non-life insurance diminished further, from 93% to 91% (indicator 6.3b), as there were fewer claims (as shown by the decrease in the loss ratio). Median annual growth rates for gross written premiums decreased for both life and non-life insurance (indicators 7.7a and 7.7b). More specifically, the median annual growth rate for life insurance decreased sharply from 4% to -2.7%, while the median annual growth rate for non-life insurance decreased from 4.9% to 3%. Moreover, the interquartile range spread for life insurance increased drastically, with the lowest quartile declining from -3% to about -20%. This sharp decrease gives an indication that the pandemic has had a greater impact on life insurance than on non-life insurance in terms of gross written premiums.

The EU insurers' bond portfolio is stable, remaining largely at investment-grade quality. EU insurers' holdings of government and corporate bonds are stable at around 50% of total investments (indicator 1.10). Roughly 80% of these investments have a credit quality that is below or equal to credit quality step 3 (equivalent to BBB; indicator 3.14). The liquidity of assets held by EU insurers remained stable in the second quarter of 2020, with the median liquid asset ratio 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) increased in the second quarter of 2020, although they have not yet returned to pre-pandemic levels. The assets under consideration include all financial sector assets except for those of banks, insurance corporations, pension funds and central counterparties (CCPs).[2] Within this group, investment funds account for almost 40% of assets, while the share of OFIs, which include securitisation vehicles, decreased slightly in the second

[2] See "EU Non-Bank Financial Intermediation Risk Monitor 2020", ESRB, October 2020. 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.

quarter, and accounts for the remainder. The aggregate value of total assets held by investment funds and OFIs is approximately the same as that for credit institutions in the EU (indicator 7.4), representing around 40% of the EU financial system.

All types of investment funds saw an increase in their assets under management in the second quarter of 2020, while assets in OFIs fell for the second consecutive quarter. The decrease in OFIs' assets is partially due to reclassifications of financial vehicle corporations and special purpose entities that have amended their activities and are no longer classified as financial institutions. The increase in assets under management in investment funds was driven by higher asset values, while most fund types also saw investor inflows. Apart from assets in real estate funds, which remained stable in the first half of 2020, investment funds showed a pattern of sharp falls in assets under management in the first quarter followed by increases in the second quarter. This dynamic was primarily driven by changing asset valuations. Bond and hedge funds also experienced substantial outflows in the first quarter which, in the case of bond funds, were compensated by net inflows of a similar magnitude in the second quarter of 2020.

6. CCPs

The overall picture drawn from the indicators until the second quarter of 2020 suggests that CCPs have, thus far, been resilient to the effects of the COVID-19 pandemic. While variation between individual CCPs is clearly visible, the data continue to show stable trends. Overcollateralisation remains a notable feature of the industry and is present in all European CCPs (indicator 8.3). CCPs' prefunded default resources also continued to track historical levels (indicator 8.1). The liquidity resources are, overall, sufficient to absorb any potential defaults of the largest clearing members (indicator 8.4) and to cover operating costs for extended periods of time (indicator 8.7), albeit the former indicator shows signs of deterioration amongst selected CCPs. In line with these trends, CCPs' investment policies do not point towards a pronounced increase in their risk-taking (indicator 8.10).

Systemic dynamics, such as interoperability and concentration of clearing activity, remained important but stable. Central clearing in general and customer clearing in particular, still appear to be highly concentrated activities. All indicators related to concentration increased in the second quarter of 2020 and remain close to or slightly below their average for the previous two years (indicators 8.6 and 8.9). The majority of the five current interoperability arrangements of European CCPs show signs of some slowdown in activity, with EuroCCP reporting a particularly sharp fall in the initial margin provided across links (indicator 8.8). More data are needed to confirm whether this is a significant development or a statistical anomaly.