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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) have mostly recovered following an increase in stress levels in 2020 due to the COVID-19 pandemic. The composite indicator of systemic stress (indicator 1.1) continued to decline through end-February, falling slightly below its pre-pandemic levels in some markets. 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 similar to those of January 2020. Implied volatility has slightly declined in foreign exchange markets since end-2020 (indicator 5.3). However, the Euro Stoxx 50 index remained as volatile as during the latter half of the fourth quarter of 2020 (indicator 5.1b), with a peak in volatility occurring around end-January. This means volatility is still above the levels seen in the fourth quarter of 2019 on the back of new COVID-19 mutations and slower-than-expected vaccination campaigns. EU industrial and building materials/fixtures equity indices continued to increase in value, in line with developments in the second half of 2020. These are still the sectors which appear to be recovering the quickest. Moreover, other equity indices, such as EU banks and insurers, seemed to regain value more rapidly as well since November 2020 (indicator 5.1a). Price/earnings ratios kept on climbing up to the end of the sample period in the first quarter of 2021 (indicator 5.2).

Following a strong economic recovery in the third quarter, the renewed surge in COVID-19 infections and concomitant containment measures are weighing on the growth outlook. Following a stronger-than-expected recovery in the third quarter (11.6% q-o-q), real GDP in the EU decreased by 0.5% q-o-q in the fourth quarter of 2020. For 2021, the European Commission's Autumn 2020 Economic Forecast projects EU GDP growth of 4.1% (following -7.4% in 2020), but the outlook is still subject to considerable downside risks with regard to the extent and duration of the pandemic and its long-term economic consequences (indicator 2.1)[1].

[1] The more recent Winter 2021 Economic Forecast by the European Commission projects EU GDP growth of 3.7% in 2021, compared to a decrease of 6.3% in 2020.

Loans and deposits of euro area monetary financial institutions (MFIs) have continued to rise. The total amount of four-quarter cumulated credit flows continued to increase in the fourth quarter of 2020 (indicator 1.4a), mostly due to credit supplied to non-euro area residents and reserves held at the Eurosystem (which are classified as MFI loans to the Eurosystem). Excluding lending to non-residents and the Eurosystem, lending was virtually unchanged. Total deposits increased by a similar amount in Q4 2020 (indicator 1.5a) thanks to positive contributions from Eurosystem refinancing (which is classified as deposits, deposits of non-financial corporations (NFCs) and of non-euro area residents. The domestic credit-to-GDP gap has become more positive across all Member States, except for Luxembourg, as a result of expanding credit to the non-financial sector (indicator 2.2) and the GDP developments, with most countries continuing to move away from their three-year average. These developments suggest an increase of credit-to-GDP ratios for most Member States. While GDP growth in 2020 as a whole was negative, the European Commission forecasts positive y-o-y growth rates for all Member State in 2021.

Strong movements were observed in the current account balances of the EU Member States, while unemployment rates rose almost in all EU countries. Some significant movements in the current account balance occurred during the third quarter of 2020 (indicator 2.3). While most Member States saw positive growth to their current account surplus or a decrease to their current account deficit, a few countries saw their current account balance worsen in the third quarter of 2020 compared to the previous quarter. The unemployment rate (indicator 2.4) increased y-o-y in all countries apart from Greece and Italy. Euro area and EU unemployment rates reached 8.1% and 7.3% respectively in December 2020. Further increases may still materialise in the coming quarters owing to the lagged impact on unemployment—particularly after the expiration of short-time work arrangements.

While NFC debt increased perceptibly in the third quarter of 2020, supported by public loan guarantees, household debt rose only moderately (indicator 2.5). NFC sector debt increased by 3.2% in the euro area between end-2019 and end-September 2020,[2] at which point it was 4.3% above the three-year average. The debt of the euro area household sector increased by 1.9% between end-2019 and end-September 2020, putting it 4.2% above the three-year average.

Sovereign debt surged in all EU Member States on the back of large-scale fiscal support measures. Accordingly, the government debt-to-GDP ratio increased in all Member States, with increases perceptibly differing between countries (indicator 2.6). The ratio varied between 18.5% and 199% of GDP at end-September 2020. According to the European Commission's Autumn 2020 Forecast, the government deficit-to-GDP ratio in the EU (indicator 2.7) is expected to decline from 8.4% in 2020 to 6.1% in 2021. For individual Member States, the ratio is forecast to amount to between 1.3% and 11.3% of GDP in 2021, exceeding the 3% threshold in 21 out of the 27 Member States. Following the peak caused by the onset of the coronavirus pandemic, CDS premia on sovereign debt started to ease in March 2020 and subsequently saw a smooth downward trend moving into 2021; all CDS premia on sovereign debt have now returned to their February 2020 levels (indicator 2.8).

[2] The increase in net debt is somewhat smaller than the increase in gross debt as some NFCs used additional loans to increase their precautionary cash holdings.

2. Credit risk

Substantial differences in the growth rates of MFI loans remain present across Member States as of December 2020, although the variances have shrunk compared to December 2019 for household loans. The annual y-o-y growth of MFIs loans to households declined in the majority of Member States (indicator 3.1). Instead, annual growth rates of loans to NFCs increased in most countries in the fourth quarter of 2020 compared to the previous quarter and are still well above the levels seen in January 2020 in the majority of Member States (indicator 3.2). However, negative growth rates were observed in the Czech Republic, Lithuania, Luxembourg, Poland and Slovenia in the fourth quarter.

The cost of borrowing remained low for the private sector in January 2020, despite an increase in NFC borrowing, reflecting low funding costs for banks and low risk pricing. A year-on-year comparison shows that the cost of borrowing from MFIs declined slightly for households in all Member States except Cyprus and France in January 2021 (indicator 3.3). More mixed results are found for NFCs' cost of borrowing (indicator 3.4), which has increased marginally in several countries.

After being pushed upwards by the heightened market tensions in the previous year, the option-adjusted spreads on euro area corporate bonds (indicator 3.9) declined further during the first quarter of 2021. Option-adjusted spreads on AA- and BBB-rated corporate bonds reached levels last seen in February 2020, while spreads on high-yield corporate bonds are also approaching the lows seen in February 2020. Short-term increases in the option-adjusted spreads on BBB-rated and high yield corporate bonds occurred during the first quarter of 2021, which were recovered quickly and did not affect the longer-term downward trend which started in the second quarter of 2020.

Against the backdrop of the coronavirus pandemic, credit standards for loans to households for house purchases tightened to some extent across EU Member States in the first quarter of 2021, as did standards for loans to NFCs in a majority of countries (indicators 3.7 and 3.8). Most notably, French banks tightened their credit standards for loans to households and NFCs.

Residential property prices continued to rise considerably in all but one EU Member State in the third quarter of 2020. Year-on-year growth in residential real estate prices continued to exceed 5% in the majority of EU Member States, continuing the trend of significant price increases during the previous three years (indicator 3.13). Based on various valuation methods, residential property prices appeared to be overvalued in several EU Member States as of the third quarter of 2020 (indicator 3.12).

3. Banks

The recovery of bank profitability in the EU continued in the fourth quarter of 2020. The median returns on equity and assets stood at 3.78% and 0.27% respectively in the fourth quarter of 2020, after 3.57% and 0.27% in the previous quarter (indicators 6.1a and 6.1b). Likewise, the median cost-to-income ratio (indicator 6.1c) decreased by 23 basis points to 64.7%, while the net interest income-to-total operating income ratio (indicator 6.1d) dropped by around 213 basis points to 62.5%.

Banking sector capitalisation and the non-performing loans ratio improved marginally. The median ratio of Common Equity Tier 1 (CET1) capital to risk-weighted assets (indicator 6.2a) increased slightly to 16.9% in the fourth quarter of 2020 from 16.7% in the third quarter. At the same time, the median ratio of non-performing loans to total gross loans and advances (indicator 6.2b) declined slightly to 2.3%.

Banks' dependence on central bank funding continued to increase in the fourth quarter of 2020. Banks' funding by central banks (indicator 4.3) continued to rise in 14 out of the 26 Member States for which data are available. However, the upward trend in the average of banks' central bank funding as a share of total liabilities lost momentum to stand at 4.6% in December 2020, although this still represents a strong increase from the average of 1.5% registered before the pandemic.

After a steep decline following the onset of the pandemic, equity indices for EU banks and other instruments showed the first signs of recovery in the fourth quarter of 2020, increasing 35.6% over the previous quarter (indicator 5.1a). The price/earnings ratio for banking stocks rose significantly, to 17.5, thus surpassing the levels around 10 observed just prior to the pandemic (indicator 5.2).

4. Insurance

The median solvency ratio (indicator 6.4a) of the EU insurance sector rebounded in the third quarter of 2020, increasing by 7 percentage points to around 208% despite risk-free interest rates remaining at very low levels. Following the severe decline in the value of assets held by insurers in the first quarter of 2020, total assets recovered further to around €7.9 trillion (indicator 1.10), albeit this is still below the level recorded in the fourth quarter of 2019 (€9.1 trillion). The median combined ratio for non-life insurance increased slightly, from 91% to 92% (indicator 6.3b), as claims picked up again. The decline in median annual growth rates for gross premiums written by life insurers reached a floor at -2%, whereas gross premiums written by non-life insurers continued to grow by 3% (indicators 7.7a and 7.7b). The interquartile range spread for life insurance stabilised, while the lowest quartile continued to see very large annual declines, of 18%, in gross premiums written. 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 premiums written. By contrast, the lowest quartile in non-life gross premiums written experienced broadly flat median annual growth of -1%.

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 grade 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 declined slightly in the third quarter of 2020, with the median liquid asset ratio standing at around 64% (indicator 4.9).

5. Investment funds and other financial institutions

Total assets held in EU investment funds and other financial institutions (OFIs) continued to increase in the third quarter of 2020, despite a small decrease in the euro area figures. The assets under consideration include all financial sector assets except for those of banks, insurance corporations, pension funds and central counterparties (CCPs).[3] Investment funds and money market funds (MMFs) account for around 41% of assets, while the share of OFIs, which include financial vehicle corporations amongst others, decreased slightly in the third quarter, and accounts for the remainder. The aggregate value of total assets held by investment funds and OFIs continues to be close to, but slightly larger than, that for credit institutions in the EU (indicator 7.4), representing around 40% of the EU financial system.

Investment funds and MMFs saw an increase in assets under management in the third quarter of 2020, while assets in OFIs fell for the third consecutive quarter. The decrease in OFIs' assets is driven by valuation losses and negative cumulated flows for OFIs other than financial vehicle corporations, as the assets of the latter remained stable in the third quarter of 2020 (indicator 7.5b). The increase in assets under management in investment funds was driven by higher asset values while, with the exception of hedge funds, most fund types also saw investor inflows. Taken together, these two factors resulted in the assets under management of EU investment funds reaching pre-pandemic levels in the third quarter of 2020.

6. CCPs

The overall picture drawn from the indicators up to the third quarter of 2020 suggests that CCPs have been resilient to the effects of the COVID-19 pandemic. While variation between individual CCPs is visible, the data continues to show stable trends. Overcollateralisation remains a notable feature but seems to vary depending on the size of the CCP. Fluctuations in this amount could be an indicator of procyclicality, but this also depends on the size of the CCP concerned (indicator 8.3). CCPs' prefunded default resources are mostly stable, although in some CCPs there is an increase in capital and/or skin in the game[4] (indicator 8.1). Although the liquidity resources vary between CCPs, they seem to be overall sufficient to absorb potential defaults by the largest clearing members (indicator 8.4). In terms of the liquidity available for wind-down and to cover operating costs for extended periods of time, some CCPs hover around the minimum ratio required (0.5) whereas most are well above this level (indicator 8.7). This indicator does not yet reflect the requirements of the new CCP Recovery and Resolution Regulation. CCP investment policies do not point towards a pronounced increase in their risk-taking, although some CCPs have decreased the share of cash they hold at central banks (indicator 8.10).

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[3] 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.

[4] Where the "skin in the game" is the mandatory contribution of the CCP in the default waterfall and the capital is the capital of the CCP that remains after the whole default waterfall has been used.

Systemic dynamics, such as interoperability and concentration of clearing activity, remained stable. Central clearing in general, and customer clearing in particular, still appear to be highly concentrated activities. The indicators related to concentration remained more or less stable in the third quarter of 2020, although two CCPs showed a significant decrease in initial margin concentration and a few other CCPs significant decreases in default fund concentration (indicators 8.6 and 8.9). Whereas in the previous quarter the majority of the current interoperability arrangements of European CCPs showed signs of some slowdown in activity - with EuroCCP reporting a particularly sharp fall in the initial margin provided across links - this trend reversed during the third quarter of 2020 (indicator 8.8).