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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 slightly and is at roughly the same level as in December 2019. The probability of a simultaneous default of large and complex banking groups or EU sovereigns (indicator 1.2) was unchanged, at approximately 2.2% and 1.1%, respectively. Following a short peak during the first quarter of 2021, implied volatility in foreign exchange markets declined slightly in April and May 2021 (indicator 5.3). The Euro Stoxx 50 index was, however, slightly more volatile in April and May 2021 than during previous months (indicator 5.1b). Equity indices for EU industrial and building materials/fixtures continued to rise quickly during the second quarter of 2021, extending their trend from the second half of 2020. Other equity indices also continued to regain value during the second quarter of 2021, albeit at a slower rate than the industrial and building materials/fixtures indices (indicator 5.1a). However, price/earnings ratios started to decline towards the end of April 2021 (indicator 5.2), as a result of increased 12-month trailing earnings.

Following a decline in EU GDP in Q4 2020 and Q1 2021, the recovery is expected to gain momentum in the second half of 2021 on the back of the roll-out of vaccinations. Real GDP in the EU declined by 0.5% quarter-on-quarter during the fourth quarter of 2020, and 0.4% quarter-on-quarter during the first quarter of 2021. For 2021 as a whole, the European Commission's 2021 Spring Forecast projects EU GDP growth of 4.2% (following -6.1% in 2020). However, the recovery continues to rely on comprehensive policy support and is subject to downside risks with regard to the extent and duration of the pandemic and its long-term economic consequences (indicator 2.1). Moreover, significant cross-country heterogeneity prevails regarding the economic recovery prospects. While according to the European Commission 2021 Spring Forecast the EU as a whole will reach the pre-crisis GDP level already at end-2021, some countries will reach this point only towards the end of 2022.

The debt-to-GDP ratios of non-financial corporations (NFCs) and households has increased in most EU Member States during 2020 (indicator 2.5). The debt-to-GDP ratios of the NFC sector in the euro area increased by 7.2 percentage points between end-2019 and end-2020, in part supported by public loan guarantees.[1] The debt-to-GDP ratio of the household sector rose in all but one Member State (the exception being Ireland), but at a slower pace (4.8 percentage points) than the ratio for the NFC sector (indicator 2.5b). Significant cross-country heterogeneity in households' debt-to-GDP ratios persisted. Moreover, increased government spending over the course of 2020 has led to a pronounced increase in the general government debt-to-GDP ratios in all Member States. In the euro area, this ratio increased by 14.1 percentage point to 98.1% of GDP between end-2019 and end-2020. The domestic credit-to-GDP gap turned more positive in the majority of Member States during 2020 (indicator 2.2). This reflected the decline in GDP as well as the increase in loans and debt securities of the private non-financial sector.

Sovereign debt surged in all EU Member States on the back of large-scale fiscal support measures. Between end-2019 and end-2020 the government debt-to-GDP ratio increased in the majority of Member States, with the size of increases perceptibly differing between countries (indicator 2.6). The smallest increase occurred in Ireland (2.2 pp) and the largest in Greece (25.1 pp). The public debt-to-DP ratio at end-2020 varied between 18.2% in Estonia and 205.7% in Greece. According to the European Commission's 2021 Spring Forecast, the government deficit-to-GDP ratio in the EU (indicator 2.7) is expected to increase from 6.9% in 2020 to 7.5% in 2021. For individual Member States, the 2021 deficit-to-GDP ratio is forecast to amount to between 0.3% in Luxembourg and 11.8% in Malta in 2021. Credit default swap (CDS) premia on sovereign debt have been slowly returning to normal since March 2020 (indicator 2.8).

Recent trends in current account balances[2] of Member States were mixed (indicator 2.3). In the fourth quarter of 2020 just over half of the Member States experienced declining current account balances, while an improvement was recorded in others (most notably Ireland, Latvia and Slovakia). Some countries with improving current account balances benefited from robust export growth on account of their industrial specialisation. On the other hand, deteriorating current account balances in several other countries reflected declining service exports as a result of travel restrictions that severely affected the tourism sector.

The unemployment rate (indicator 2.4) in all EU countries rose in March 2021 compared to the same month in the previous year.[3] Euro area and EU unemployment rates reached 8.1% and 7.3%, respectively, in March 2021. The European Commission 2021 Spring Forecast projects the EU and euro area unemployment rates to rise to 7.6% and 8.4%, respectively, in 2021 on account of the lagged impact of the COVID-19 crisis on unemployment and an expected gradual phasing-out of job retention schemes.

[1] 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] Based on a 12-month rolling sum to account for seasonality. This applies to both the current account as well as GDP.

[3] Data for March 2021 was not yet available for Greece.

2. Credit risk

MFI credit in the euro area grew by 4.1% between end-2020 and end-March 2021, mostly reflecting increased lending to NFCs and the Eurosystem (indicator 1.4). NFCs in the euro area further increased their lending and issued debt securities during the first quarter, in part on account of the expected recovery. Loans to households also rose steadily during the first quarter of 2021, continuing their previous trend. The main driving force continued to be mortgage lending.

The cost of borrowing remained low for the private sector in March 2021, reflecting low funding costs for banks and low risk pricing. The cost of borrowing by households from MFIs continued to decline in March 21 in most Member States (indicator 3.3), extending a long-run trend that was interrupted in H1 2020. In contrast, borrowing costs for NFCs (indicator 3.4) increased in several Member States, albeit only marginally.

Option-adjusted spreads on euro area corporate bonds (indicator 3.9) continued to decline during the second quarter of 2021. Option-adjusted spreads on AA-rated and high-yield corporate bonds reached levels last seen in February 2020 during the second quarter of 2021. BBB-rated corporate bonds even reached levels below those seen prior to the pandemic. Meanwhile, expected default frequencies in the financial sector have started to rise again in the second quarter of 2021 (indicator 3.10) according to Moody's Analytics, and are now above February 2020 levels again.

Credit standards for NFCs continued to tighten during the second quarter of 2021, while standards household loans for house purchases somewhat eased (indicators 3.7 and 3.8). Notably, French banks started to ease their standards on loans for house purchases in the second quarter of 2021. In contrast, credit standards in Spain for this type of loans started to tighten again. NFC loan standards tightened across the countries in the sample during the second quarter of 2021, with the exception of France where credit standards for NFC loans remained unchanged.

Residential property prices continued to rise considerably in all EU Member States in the fourth quarter of 2020. Year-on-year growth in residential real estate prices continued to exceed 5% in the weighted EU average, 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 fourth quarter of 2020 (indicator 3.12).

3. Banks

Profitability in the EU banking sector further improved in the first quarter of 2021. The median returns on equity and assets stood at 5.97% and 0.41%, respectively, in the first quarter of 2021, up from 3.65% and 0.26% in the previous quarter (indicators 6.1a and 6.1b). The median cost-to-income ratio (indicator 6.1c) increased by 30 basis points to 64.9%, while the net interest income-to-total operating income ratio (indicator 6.1d) dropped by around 202 basis points to 60.5%.

Banking sector capitalisation and the non-performing loans ratio remained broadly stable. After a slight increase in the previous quarter, the median ratio of Common Equity Tier 1 (CET1) capital to risk-weighted assets (indicator 6.2a) declined to 16.6% in the first quarter of 2021, from 17.2% in the fourth quarter of 2020. At the same time, the median ratio of non-performing loans to total gross loans and advances (indicator 6.2b) decreased to 2.2%.

Banks' dependence on central bank funding surged in the first quarter of 2021. Bank funding from central banks (indicator 4.3) rose in 15 out of the 24 Member States for which data are available. Banks' central bank funding as a share of total liabilities averaged 5.5% in March 2021, a value that is 2.4 times larger than that observed in March 2020.

The recovery of equity indices for EU banks, as well as other instruments, continued in the first quarter of 2021, with an increase by 13.6% compared to the previous quarter (indicator 5.1a). The price/earnings ratio for banking stocks rose significantly to 19, well above the levels observed immediately before the onset of the pandemic (indicator 5.2).

4. Insurance

The median solvency ratio (indicator 6.4a) of large EU insurance companies and groups with more than €12 billion in total assets further increased in the fourth quarter of 2020, by 4 percentage points to around 212%, 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 during the remainder of the year and amounted to around €7.5 trillion at the end of 2020 (indicator 1.10), still below the level recorded in the fourth quarter of 2019 (€9.1 trillion). The median combined ratio for non-life insurance remained broadly unchanged compared to the third quarter of 2020, at 92% (indicator 6.3b). The decline in the median annual growth rate for gross premiums written by life insurers, however, accelerated to -4%, its lowest level since 2012. Gross premiums written by non-life insurers continued to grow, increasing by 3% (indicators 7.7a and 7.7b). Whereas the interquartile range spread for the annual growth of life insurance gross written premiums decreased, the lowest quartile continued to see very large annual declines in gross premiums written, with a fall of 14%. This sharp decrease indicates 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 annual growth of -1%.

The bond portfolio of large EU insurers remained stable during the fourth quarter of 2020, remaining largely at investment-grade. Holdings of government and corporate bonds are stable, at around 50% of total investments (indicator 1.10). Roughly 80% of these investments have investment-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 large EU insurers also remained broadly stable in the fourth 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 OFIs continued to recover in the fourth quarter of 2020 and exceeded pre-crisis levels for the first time. This also applies to euro area figures. The assets under consideration include all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs).[4] Investment funds and money market funds (MMFs) account for more than 42% of assets, while the share of OFIs, which include financial vehicle corporations, decreased by 1 percentage point in the fourth 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 fourth quarter of 2020, while assets in OFIs fell for the fifth consecutive quarter. The decline in OFI assets was driven by negative cumulative flows of captives and "residual OFI"[5], while assets of financial corporations engaged in lending and financial vehicle corporations remained stable in the fourth quarter of 2020 (indicator 7.5b). The increase in assets under management in investment funds was driven by higher asset values and by investor inflows for all but hedge funds. Taken together, these two factors resulted in the assets under management of EU investment funds exceeding pre-pandemic levels in the fourth quarter of 2020.

6. CCPs

Indicators up to the fourth 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 are signs of a decrease in capital and/or skin in the game following the peaks in the third quarter of 2020[6] (indicator 8.1). While the liquidity resources vary between CCPs, they seem to be sufficient overall to absorb potential defaults by the largest clearing members and appear to be improving compared with the beginning of the pandemic (indicator 8.4). In terms of the liquidity available for wind-down and to cover operating costs for extended periods of time, some CCPs are hovering around the minimum ratio required (0.5), although most are well above this level (indicator 8.7). This indicator does not yet reflect the

[4] See ESRB (2020), *EU Non-bank Financial Intermediation Risk Monitor 2020*, October. 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.

[5] Captives (ESA 2010, S.127) are financial or non-financial holding companies, which hold the assets of a group of subsidiary corporations). The term "residual OFIs" refers to financial auxiliaries (financial corporations whose activities are closely related to financial intermediation but who are not classified as financial intermediaries (ESA 2010, S.126), security and derivative dealers (SDDs) and specialised financial corporations (e.g. venture capital, export/import financing, central counterparties).

[6] 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.

requirements of the new CCP Recovery and Resolution Regulation. CCP investment policies do not point to a pronounced increase in their risk-taking, with central bank deposits and cash deposits at commercial banks continuing to be the most important strategies for the majority of institutions (indicator 8.10).

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 do not reveal an overarching trend affecting all CCPs in the fourth quarter of 2020, but they do show large volatility among certain institutions. Three CCPs showed a significant decrease in the share of initial margin and client clearing contributed by the five largest clearing members. On the other hand, CCG reported a large hike in initial margin and client clearing concentration from less than 10% to 70%, effectively nullifying the movement in the third quarter of 2020 (indicators 8.6 and 8.9). By contrast, the current interoperability arrangements of European CCPs remained stable during the fourth quarter of 2020 (indicator 8.8).