



1. Systemic risk indicators and financial market conditions

Risks to EU financial stability remain a concern, as reflected by the market-based indicators of systemic stress in the European Union (EU) over the past quarter. The indicators of systemic stress ([indicator 1.1](#)), increased during the second quarter of 2019, reflecting geopolitical and policy uncertainties internationally and within Europe, as well as the weakening economic outlook. Accordingly, the financial market uncertainty, as measured by implied volatility, increased in the beginning of the second quarter of 2019 and recovered back towards the end of the review period ([indicator 5.1b](#)). At the same time, the probability of simultaneous default by large and complex banking groups and EU sovereigns ([indicator 1.2](#)) decreased in the second quarter of 2019, with some bouts of volatility during the review period. EU equity indices remained broadly stable, with some downward corrections throughout the quarter ([indicator 5.1a](#)). Correspondingly, price/earnings ratios decreased somewhat ([indicator 5.2](#)), in particular for the EU banking sector.

The outlook for the economic growth in the EU moderated further. EU GDP rose by approximately 1.8% year on year in the first quarter of 2019 ([indicator 2.1](#)). In its spring forecast from May 2019, the European Commission cut the GDP growth forecast for the EU for 2019 to 1.4% and for 2020 to 1.6% (from 1.5% and 1.7% published in February 2019).¹ The downside risks stem mainly from the threat of increased global protectionism and its impact on international trade and output.

Debt levels remain elevated across countries and sectors in the EU, although most countries deleveraged somewhat in the recent years ([indicators 2.5a and 2.5b](#)). The 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 Q4-2018 was somewhat lower than the three years average, suggesting that the deleveraging process in the European Union continued in the recent years. Still, some countries have not reduced their indebtedness levels significantly. Generally, high debt levels mean that economies are vulnerable to shocks, such as changes in the growth outlook or interest rate hikes. Regarding sovereign debt, the level in 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 almost all Member States in Q4 2018 ([indicator 2.7](#)).

¹ See European Commission Economic Forecast, Spring 2019, May 2019, available at https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts_en.

2. Credit risk

Credit to the private sector continued to grow robustly in many EU Member States. In April 2019, most Member States registered positive annual growth rates of loans granted by monetary financial institutions (MFI) to households and 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, also as compared to the year before. At the same time, in a few Member States very low lending activity is still observed.

The cost of borrowing for the private sector remains low, reflecting the low refinancing costs for banks and the low risk pricing. In most Member States, the cost of borrowing recorded in April 2019 did not change significantly for households and NFCs in year-on-year comparison, slightly declining in most EU countries ([indicators 3.3 and 3.4](#)). Lending margins of MFIs also declined or remained broadly stable in most EU countries ([indicators 3.5 and 3.6](#)).

Following a period of relative easing, credit standards slightly tightened over the last quarter for loans to households for house purchases and remained broadly unchanged for loans to non-financial corporations ([indicators 3.7 and 3.8](#)).

Residential real estate prices continued to rise considerably in most EU Member States. In the fourth quarter of 2018 year-on-year growth of residential real estate prices continued to exceed 5% in most EU Member States, following also significant price increases over the past three years ([indicator 3.13](#)). Reflecting this dynamics, the residential real estate prices appear to be overvalued in several EU Member States, as based on various valuation methods ([indicator 3.12](#)).

3. Banks

Bank profitability in the EU slightly deteriorated in the first quarter of 2019. Median return on equity year-to-year percentage change decreased by 8 basis points to 6.2% on a year-on-year basis, while return on assets remained broadly stable at 0.45% ([indicators 6.1a and 6.1b](#)). At the same time, the cost-to-income ratio increased to the levels highest since 2014 ([indicator 6.1c](#)). On the income side, banks' dependence on the net interest income has not changed markedly over the last quarters ([indicator 6.1d](#)).

Banking sector resilience remained broadly stable while the pace of the reduction of non-performing loans slightly lost momentum. The median CET1 to risk-weighted assets ratio remained stable at 15.5% in the first quarter of 2019, with the highest-capitalised banks reducing their capitalisation ([indicator 6.2a](#)). Moreover, the median ratio of non-performing loans to total gross loans and advances slightly increased, reaching 3.2% at the beginning of 2019, up from 2.9% at the end of 2018 ([indicator 6.2b](#)). Overall, ongoing supervisory and regulatory work needs to support the reduction of vulnerabilities in the European banking sector, in view of weakening economic environment.

4. Insurance

Despite a lower profitability due to reduced investment returns, the median solvency ratio of the EU insurance sector is stable above 200%. The lowest quartile of solvency ratios was slightly above 180% in the fourth quarter of 2018 ([indicator 6.4a](#)). The median return on equity has increased since the first half of 2018, from around 2.5% to around 5.0% ([indicator 6.3a](#)). For non-life insurers, the median combined ratio is relatively stable over the past 5 quarters, below 100% ([indicator 6.3b](#)). One can still note the combined ratio over 100%, showing that for a quartile of the insurance sector, the written premiums are not sufficient to cover the insurance claims and costs of the period. The annual growth rates of gross premiums written have

been mostly positive for both life and non-life insurance, both with a median at around 4% ([indicators 7.7a and 7.7b](#)).

The EU insurers' asset allocation remained stable. In terms of credit quality characteristics, the EU insurers' bond portfolio remained largely at investment-grade quality, while the liquidity available varied importantly from one insurer to another. Around 50% of the EU insurers' investments are in government or corporate bonds ([indicator 1.10](#)). 80% of these investments have a credit quality below or equal to credit quality step 3 (equivalent to BBB; [indicator 3.14](#)). The liquid asset ratio indicator shows a quartile of the insurance sector holding more than 70% of liquid assets, while another quartile holds less than 55% liquid assets ([indicator 4.9](#)).

5. Investment funds and other financial institutions

Total assets under management in EU investment funds and other financial institutions (OFIs) declined at the end of 2018 while assets in the banking sector increased slightly over the year ([indicator 7.3](#)). The assets under consideration include all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs).² The decline in assets under management in the final quarter of 2018 was driven by falls in asset valuations. Investor inflows into investment funds continued and valuation effects largely reversed in early-2019. In terms of total assets, investment funds and OFIs accounted for approximately 40% of the EU financial system. This measure has remained stable over the past few years. Within this measure, investment funds account for around one-third of assets and OFIs, including securitisation vehicles, account for the remainder.

New data sources allowed for a reduction in the OFI residual in 2018. The OFI residual is defined as the difference between the total financial sector according to the financial accounts, and the known sub-sectors for which primary statistics are available. The analysis of the OFI residual has been enhanced by the inclusion of Eurostat data, which help to identify total assets related to captive financial institutions. Given the large number of captive firms domiciled in Luxembourg, the inclusion of the Eurostat data helps to describe half of the OFI residual, reducing it from around 47% in 2017 to approximately 24% in 2018 of total assets held in investment funds and OFIs.

6. CCPs

The overall picture drawn by the CCP indicators has remained broadly stable, notwithstanding differences between CCPs. Overcollateralisation appears to be widely practiced, to different degrees ([indicator 8.3](#)); liquidity resources available to CCPs, which include a significant percentage of margins posted in the form of cash, seem adequate with no sign of meaningful deterioration ([indicators 8.4 and 8.5](#)); investment policies do not seem to suggest meaningful increase in risk taking ([indicator 8.10](#)). However, central clearing in general and client clearing in particular still appear to be a highly concentrated activity ([indicator 8.6 and 8.9](#)). For the five current interoperability arrangements of European CCPs, the initial margins provided vary significantly, but remain relatively stable over time ([indicator 8.8](#)).

² See EU Non-Bank Financial Intermediation Risk Monitor 2019 (forthcoming). 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.