



1. Systemic risk indicators and financial market conditions

Market-based indicators of systemic stress in the European Union (EU) remained relatively benign despite significant geopolitical and policy uncertainties, highlighting the potential for re-pricing of risks by markets. The indicators of systemic stress ([indicator 1.1](#)) increased slightly during the third quarter of 2019, despite prevailing geopolitical and policy uncertainties internationally and within Europe, as well as the weakening economic outlook. Similarly, the equity market uncertainty, as measured by implied volatility remained relatively contained ([indicator 5.1b](#)), while the probability of simultaneous default by large and complex banking groups and EU sovereigns ([indicator 1.2](#)) decreased in the third quarter of 2019, with some bouts of volatility during the review period. Also EU equity indices remained broadly stable, except for EU industrials, which experienced a more pronounced drop, somewhat recovering towards the end of the review period ([indicator 5.1a](#)). Price/earnings ratios decreased somewhat ([indicator 5.2](#)), in particular for the EU banking and insurance sectors.

Economic growth in the EU remained moderate with downside risks to the outlook. EU GDP rose by approximately 1.4% year on year in the second quarter of 2019 ([indicator 2.1](#)). In its summer forecast from July 2019, the European Commission maintained the GDP growth forecast for the EU for 2019 at 1.4% and for 2020 at 1.6%, while the euro area outlook for 2020 was slightly lowered to 1.4% (from 1.5% published in May 2019).¹ This reflects that downside risks stemming mainly from the threat of increased global protectionism and its impact on international trade and output remain.

Debt levels remain elevated across countries and sectors in the EU, although over the medium-term most countries have deleveraged somewhat ([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 Q1 2019 was somewhat lower than the three years average, suggesting that the deleveraging process in the European Union continued in the recent years. Still, most 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. Regarding sovereign debt, the level in around 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 all but three Member States in Q1 2019 ([indicator 2.7](#)).

¹ See European Commission Economic Forecast, Summer 2019, July 2019, available at https://ec.europa.eu/info/publications/european-economic-forecast-summer-2019_en.

2. Credit risk

Credit to the private sector continued to grow robustly in many EU Member States. In July 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 July 2019 somewhat declined for households and NFCs in most countries in year-on-year comparison ([indicators 3.3 and 3.4](#)). Lending margins of MFIs also declined or remained broadly stable in most EU countries for loans to households for house purchase, with increases registered in some countries for loans to NFCs ([indicators 3.5 and 3.6](#)).

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

Residential real estate prices continued to rise considerably in all but one EU Member States. In the first quarter of 2019 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 these 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 remained broadly stable in the second quarter of 2019. Median return on equity stood at 6.3%, while return on assets was 0.46% ([indicators 6.1a and 6.1b](#)). At the same time, the median cost-to-income ratio continued to drift upwards ([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 reduction of non-performing loans continued. The median CET1 to risk-weighted assets ratio has declined slightly over the last four quarters to stand at 15.6% in the second quarter of 2019 ([indicator 6.2a](#)). The median ratio of non-performing loans to total gross loans and advances continued to decline to 2.7% in the second quarter of 2019 ([indicator 6.2b](#)).

4. Insurance

The median solvency ratio of the EU insurance sector decreased by around 15 percentage points to 193%. The lowest quartile of solvency ratios also fell in the first quarter of 2019, from 180% to roughly 160% ([indicator 6.4a](#)). Although for non-life insurance, the median combined ratio has been relatively stable over the past two years and below 100%, the volatility has increased in this quarter, with a higher number of combined ratios over 100% ([indicator 6.3b](#)). The annual growth rates of gross written premiums have been slowly decreasing over the past three quarters for life insurance. Moreover, the lowest quartile fell to -5% in the first quarter of 2019, indicating that fewer premiums have been collected ([indicator 7.7a](#)). For non-life insurance there has been a stable evolution, with a median at around 3.5% ([indicator 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 there seems to have been a move towards less liquid assets. Around 50% of the EU insurers' investments are in government or corporate bonds ([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 EU insurers' assets liquidity slightly decreased in the first quarter of 2019, with the median liquid asset ratio now at around 63% ([indicator 4.9](#)).

5. Investment funds and other financial institutions

Total assets under management in the EU investment funds and other financial institutions (OFIs) increased in the first quarter of 2019, reflecting a rise in asset valuations following strong declines in the final quarter of 2018. The assets under consideration include all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs).² Investor inflows into investment funds continued and valuation effects reversed in early-2019. In terms of total assets, investment funds and OFIs account 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 2018.³ 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 final quarter of 2018 saw significant outflows from OFIs ([indicator 7.5b](#)) which started to reverse during the first quarter of 2019. Over the past year, 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 26% in 2018 of total assets held in investment funds and OFIs.

6. CCPs

The overall picture drawn from the CCP indicators has remained broadly stable, notwithstanding differences between CCPs. Overcollateralisation appears to be widely practiced, to different degrees by CCPs ([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 highly concentrated activities ([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, ESRB Jul 2019. 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.

³ See EU Non-Bank Financial Intermediation Risk Monitor 2019, ESRB Jul 2019.