



## 1. Systemic risk indicators and financial market conditions

**Market-based indicators of systemic stress in the European Union (EU) showed positive signs of recovery from the economic shock caused by the outbreak of the coronavirus (COVID-19).** During the second quarter of 2020 the indicators of systemic stress ([indicator 1.1](#)) gradually decreased and stabilised at a lower level. Similarly, indicators of implied volatility, which measure market uncertainty, decreased notably across various market segments ([indicators 5.1b, 5.3 and 5.5](#)) and the probability of the simultaneous default of large and complex banking groups and EU sovereigns ([indicator 1.2](#)) also fell. Instead, there was some variation in the implied volatility of short-term interest rates ([indicator 5.4](#)), as the level of volatility of interest rates denominated in pound sterling continued to rise while the volatility for US dollar interest rate decreased, with large fluctuations. EU equity indices and price/earnings ratios recovered most of their losses ([indicators 5.1a and 5.2](#)). However, equity prices of financials, particularly banks and insurance companies, recovered only moderately and did not return to their pre-COVID-19 levels.

**Regarding macroeconomic developments, euro area monetary financial institution (MFI) credits and deposits rose significantly in the first quarter of 2020.** The total amount of four-quarter cumulated credit flows increased by around €600 billion ([indicator 1.4.a](#)) owing mainly to a large increase in credit to non-euro area residents and somewhat smaller increases in credit to non-financial corporations (NFCs) and to the general government. Total deposits soared by approximately the same amount as credits ([indicator 1.5.a](#)) because of the positive contribution of the deposits of the Eurosystem, NFCs, and other financial institutions. There were no significant changes in the domestic credit-to-GDP gap ([indicator 2.2](#)) in the fourth quarter of 2019.

**A deep economic contraction prevailed in the EU and the euro area throughout the first quarter of 2020 as a result of the stringent lockdown measures implemented in most the Member States, a collapse of global trade and the confidence shock affecting the economy.** In the first quarter of 2020, EU GDP and euro area GDP plummeted by 2.6% and 3.1% year on year respectively ([indicator 2.1](#)). More than half of EU Member States suffered an economic slump, with Italy, France and Spain being the most severely hit countries (recording falls in GDP of 5.4%, 5.1%, and 4.1% respectively in the first quarter of 2020). The outlook for the EU economy is surrounded by considerable uncertainty with regard to the depth and length of the coronavirus pandemic and its ultimate economic implications. Even larger impacts on production and unemployment are expected in the second quarter of 2020, while the European Commission and the ECB forecasts do not anticipate a sustained recovery before 2021.

**There were no significant changes in the current account balances in the fourth quarter of 2019. However, unemployment started to increase in several countries in April.** In the fourth quarter of 2019 the current account balance-to-GDP ratio did not show any significant movement either within individual countries or in

terms of location of the horizontal distribution ([indicator 2.3](#)). However, the unemployment rate started to increase in several countries ([indicator 2.4](#)). Inactivity rates probably increased more significantly, hiding the full impact of the pandemic on the labour market so far. Owing to a somewhat sluggish effect on unemployment, sizeable increases can be expected in the coming quarters.

**In the fourth quarter of 2019 debt levels remained elevated across countries and sectors in the EU, although over the last few years most countries have deleveraged somewhat** ([indicators 2.5a and 2.5b](#)). 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 the fourth quarter of 2019 was somewhat lower than the three-year average, suggesting that the deleveraging process in the EU had continued. Nevertheless, most countries have still not reduced their levels of indebtedness significantly, with the exceptions of Cyprus, Luxembourg (especially NFC debt), and the Netherlands. Generally, high debt levels mean that economies are vulnerable to shocks, such as changes in the growth outlook, which is currently occurring owing to the coronavirus crisis. Regarding sovereign debt, levels 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 Member States in the fourth quarter of 2019 ([indicator 2.7](#)), except for Romania<sup>1</sup>. After the peak caused by the outbreak of the coronavirus crisis, market participants' sovereign risk concerns eased around the end of March 2020 and, after some fluctuations, continued decreasing steadily ([indicator 2.8](#)).

## 2. Credit risk

**Credit to the private sector grew robustly in many EU Member States during the first months of the coronavirus crisis; in particular, loans to NFCs increased.** In April 2020 almost all Member States registered positive annual growth rates of loans granted by MFIs to households ([indicator 3.1](#)) and most of them reported a slight increase in this rate since January. The rise in loans to NFCs within the same time period was significantly larger ([indicator 3.2](#)), with Luxembourg, Spain and Ireland witnessing record changes compared with January. Very low lending activity was still observed in a few Member States (Cyprus, Latvia, Lithuania and Malta).

**The cost of borrowing for the private sector remained low in April, reflecting low refinancing costs for banks and low risk pricing.** In most Member States, a year-on-year comparison shows the cost of borrowing recorded in April 2020 declined slightly or remained stable for households and NFCs ([indicators 3.3 and 3.4](#)), although some countries showed some changes since January. Overall, MFI lending margins also remained broadly stable in most EU countries for loans to households for house purchase, with some countries registering increases for loans to NFCs ([indicators 3.5 and 3.6](#)).

**After being pushed upwards by the economic turmoil, the option-adjusted spreads on euro area corporate bonds began to decrease at the start of the second quarter of 2020.** As a result, between the end of March and the beginning of June the high-yield bond spread narrowed significantly, losing almost 400 basis points,

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<sup>1</sup> In the previous quarter, both France and Romania exceeded the threshold, with France subsequently improving its performance in the last quarter of 2019. However, as [indicator 2.7](#) clearly shows, government deficits will increase rapidly as a result of the economic recession caused by the coronavirus pandemic.

although it did not return to pre-crisis values. Similarly, the spreads for higher credit quality bonds fell significantly ([indicator 3.9](#)).

**Notwithstanding the COVID-19 crisis, credit standards remained relatively stable across EU Member States in the survey conducted in April 2020, both for loans to households for house purchase and for loans to NFCs ([indicators 3.7 and 3.8](#)).** Only France reported a notable tightening of credit standards for loans granted to households for house purchases (+40% of banks).

**Residential real estate prices continued to rise considerably in all but one EU Member State.** In the fourth quarter of 2019 year-on-year growth in residential real estate prices continued to exceed 5% in the majority of EU Member States, following significant price increases 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 end of 2019 ([indicator 3.12](#)).

### 3. Banks

**Banks' profitability in the EU remained steadily low in the fourth quarter of 2019.** The median return on equity stood at 5.8%, while the return on assets was 0.4% for the fourth quarter of 2019 ([indicators 6.1a and 6.1b](#)). On the income side, the median cost-to-income ratio stood at 63.2% for the fourth quarter of 2019 ([indicator 6.1c](#)), while the share of net interest income to total operating income was 63.9% ([indicator 6.1d](#)).

**Banking sector capitalisation stood broadly unchanged and the reduction of non-performing loans improved slightly.** The median ratio of Common Equity Tier 1 (CET1) to risk-weighted assets remained broadly stable at 15.6% in the fourth quarter of 2019 ([indicator 6.2a](#)). At the same time, the median ratio of non-performing loans to total gross loans and advances was around 2.6% in the fourth quarter of 2019 ([indicator 6.2b](#)). Thus, overall the EU banking sector capitalisation was robust before the onset of the Coronavirus crisis, but it suffered challenges related to profitability, and in some cases, to asset quality due to legacy assets.

**While the magnitude of the long-term effects of the coronavirus crisis on the EU banking sector are still uncertain, some impact on the sector's liquidity and funding profile is already evident.** Interbank interest rate spreads for liquidity denominated in euro, pound sterling and US dollars ([indicator 4.1](#)) peaked in April 2020 before almost fully reverting by the beginning of May. These spreads reached highs not seen since the global financial crisis of 2007-08 (pound sterling and US dollars) and the euro area crisis (euro), implying heightened interbank credit risk. The CDS spread between senior and subordinated bank debt ([indicator 4.8](#)) more than doubled in mid-end March, highlighting an increased perceived risk of default, and now stands at around 100 basis points, slightly higher than before the coronavirus outbreak. In addition, banks' funding by central banks ([indicator 4.3](#)) increased in most EU countries (17 out of 24 for which data are available), reflecting additional monetary policy measures.

As mentioned earlier, EU banks' equity prices and other instruments declined sharply following the coronavirus outbreak ([indicator 5.1a](#)).

#### 4. Insurance

**The median solvency ratio of the EU insurance sector increased by around 30 percentage points to roughly 215% in the fourth quarter of 2019.** Both the lowest and the highest quartiles of the ratio also rose, from around 160% to 180% and from around 230% to just above 260% respectively ([indicator 6.4a](#)). This increase can be explained partly by the increase in the risk-free rate term structure in the fourth quarter of 2019 compared with the previous quarters, but also by more idiosyncratic changes in the legal framework of some countries (see the EIOPA risk dashboard). The median combined ratio for non-life insurance remained stable, standing at just above 95% ([indicator 6.3b](#)). The median annual growth rates of gross written premiums increased for both life and non-life insurance, to 4.0% and 4.9% respectively. The lowest quartile of growth rates increased from -1.8% to -0.8% for life insurance and from just above 1% to 2.4% for non-life insurance. The highest quartile decreased from close to 11% to around 8.5% for life insurance ([indicator 7.7a](#)) and increased slightly for non-life insurance, to just above 10% ([indicator 7.7b](#)).

**Regarding the EU insurers' asset allocation, in the fourth quarter of 2019 there were no significant changes in the liquidity profile of assets or in the credit quality characteristics of EU insurers' bond portfolio.** The EU insurers' holdings of government or corporate bonds remained relatively unchanged, at just above 45% of total investments ([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 median value of EU insurers' asset liquidity remained at around 63% ([indicator 4.9](#)).

#### 5. Investment funds and other financial institutions

**Total assets held in EU investment funds and other financial institutions (OFIs) decreased in the fourth quarter of 2019.** The assets under consideration include all financial sector assets except those of banks, insurance corporations, pension funds and central counterparties (CCPs).<sup>2</sup> While assets in investment funds continued to grow, recording inflows in every quarter of 2019, this was offset by a decrease in assets held by OFIs ([indicator 7.5b](#)). In terms of total assets, investment funds and OFIs hold approximately the same amount of assets as credit institutions in the EU ([indicator 7.4](#)) and account for roughly 38% of the EU financial system. This measure has remained stable over the past few years, with investment funds accounting for almost 38% of assets while OFIs, including securitisation vehicles, account for the remainder.

**Assets under management increased for most fund types in the fourth quarter of 2019, supported by investor inflows, but decreased in bond funds and hedge funds.** Inflows into bond funds continued in every quarter of 2019, although in the final quarter this was offset by falls in asset valuations. Assets in hedge funds also decreased in the final quarter, driven by investor withdrawals. Equity funds, on the other hand, experienced a substantial increase in assets under management which was driven mainly by rising asset values.

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<sup>2</sup> See EU Non-Bank Financial Intermediation Risk Monitor 2019, ESRB, July 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.

## 6. CCPs

**The overall picture drawn from the CCP indicators until the fourth quarter of 2019 remained stable, with expected variation remaining between the CCPs.** Haircuts on non-cash initial margins continued to reflect low market volatility (indicator 8.2). CCPs' prefunded default resources also continued to track historical levels (indicator 8.1). High levels of overcollateralisation remained a meaningful, if varied, feature of the industry (indicator 8.3). Moreover, liquidity resources available to CCPs, which include a significant percentage of margins posted in the form of cash, did not show signs of meaningful deterioration (indicators 8.4 and 8.5). In line with these trends, CCPs' investment policies did not suggest a meaningful increase in their risk taking in the fourth quarter of 2019 (indicator 8.10).

**Systemic dynamics, like interoperability and concertation of clearing activity, remained meaningful but stable.** 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 have remained relatively stable over time (indicator 8.8).