

# Joint Committee Update on Risks and Vulnerabilities in the EU Financial System – Spring 2024

EFC-FST meeting, 29 April 2024

Verena Ross, Chair of ESMA and of the Joint Committee of the ESAs

JC 2024 22

# Background and contents

## Joint Committee ESAs Update on Risks and Vulnerabilities

The Joint Committee is a forum with the objective of strengthening cooperation between the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), collectively known as the three European Supervisory Authorities (ESAs).

Under the Joint Committee, the ESAs prepare a cross-sectoral risk assessment to the Economic and Financial Committee- Financial Stability Table (EFC-FST) which is summarised in this presentation.

## Spring 2024 ESAs Update on Risks and Vulnerabilities

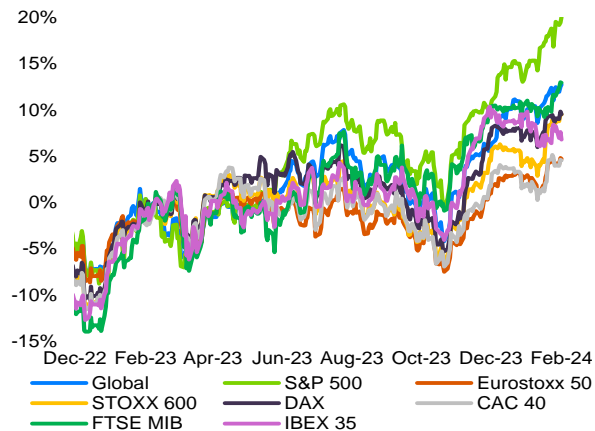
- Summary of outlook and risks
  - Outlook, market developments and risks
  - Financial sectors trends
  - Innovation and digitalisation risks
- Annex: outlook and risks in detail

# Summary of outlook and risks

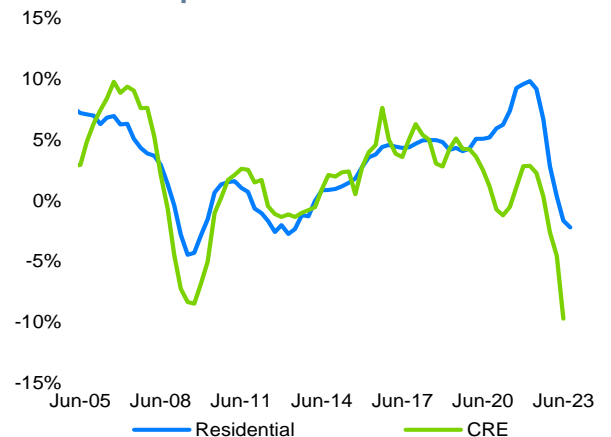
# Outlook, market developments and risks

## Expectations of rate cuts grow in uncertain environment, credit risks increased

### Equities strong growth since late 2023



### Real estate prices continue to fall



### High uncertainty with risk of market corrections

- **Inflation and growth** slowed further, rate cuts are now increasingly expected in 2024, fuelling asset price growth.
- **Uncertainty** on pace/depth of rate cuts and on geopolitics (wars, 2024 elections) remains.
- **Equities:** global equity indices boosted by anticipated rate cuts, but with risks of corrections on unexpected events.
- **Bonds:** EU sovereign yields fell end 2023, as did corporate yields for both investment grade and high-yield, yields more stable in 2024
- **Fund performance and flows were volatile** with environment changes in 2H23. Reduced investor appetite seen for ESG investments.

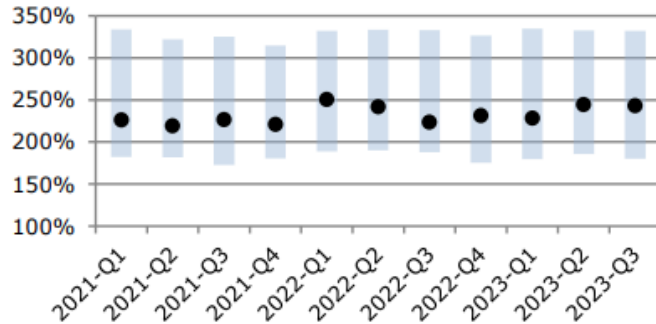
### Increased credit risk, deteriorating asset quality expected

- **Economic development:** growth slowing further.
- **Credit risk:** Credit quality of HY non-financials and real estate continued to fall, with default rates trending upwards, though these remain moderate by historical standards.
- **Real estate:** Slowdown could drive impairments at banks and liquidity risks in real estate funds which could have wider impacts.
- **Asset quality** in banking sector remained robust, but deterioration is expected across lending portfolios. Revaluation of level 3 assets potentially happening also in the insurance sector.

# Prudential and liquidity risks

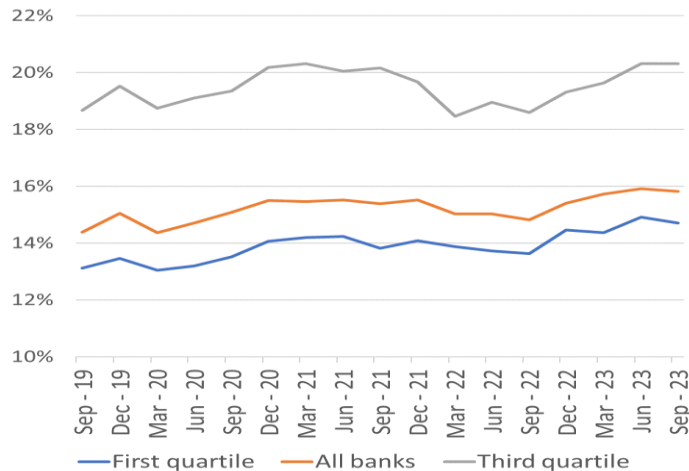
## Insurer and bank positions robust, though outlook becoming more challenging

SCR ratio > 200% for EEA Insurance groups shows a resilient industry



Source: EIOPA Insurance risk dashboard- Feb 2024.

Evolution of banks CET1 ratio and interquartile CET1 ratio (Q3 2019 – Q3 2023)



### Prudential and liquidity positions remained solid in 2023

- **Insurance** solvency ratios are well above 200%. Non-life undertakings report increasing solvency ratios while life ones show stability.
- **Defined benefit occupational pension schemes (IORPs)** improved their financial position.
- **Insurers have ample availability of highly liquid assets**, but liquidity positions slightly diminished.
- **In the banking sector capital and liquidity positions are solid** with high profitability in 2023. These supported resilience of EU banks through US regional bank crisis and beyond.
- **Bank capital ratios remained rather strong**, with a 15.8% CET1 ratio in Q3 2023 (14.8% in Q3 2022), while liquidity positions remained solid.

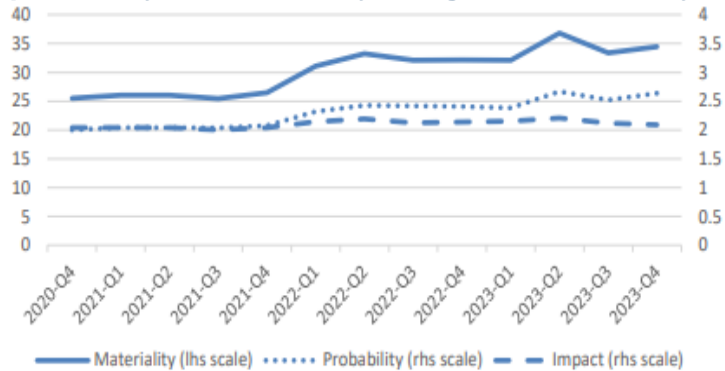
### But outlook more challenging in 2024

- **For banks**, challenges driven by repricing of liabilities vs assets with prospects of lower interest income, slower loan growth, high costs and a challenging macro environment.
- **For insurers**, challenges come for potential repricing of risk premia and subdued growth combined with potential second round effect of inflation.

# Innovation and digitalisation risks

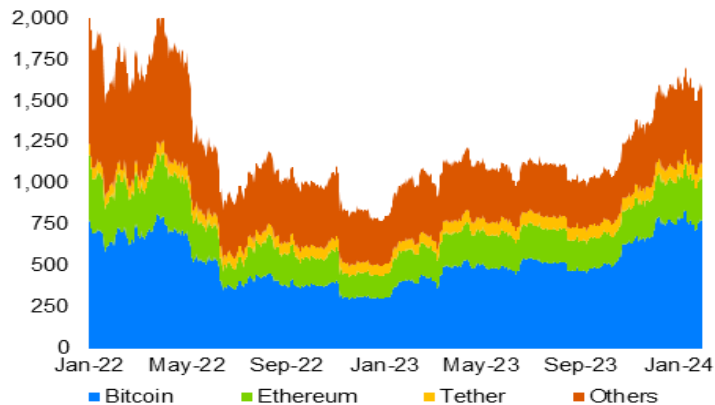
## Cyber risks are growing

EIOPA's supervisory assessment shows increase in probability and materiality of digitalization and cyber



Source: EIOPA Insurance risk dashboard – Feb. 2024

Crypto market capitalisation markedly up but still below 2021 historical peak



Note: Market capitalisation of Bitcoin, Ethereum, Tether and other crypto-assets, in EUR bn.  
Sources: CoinMarketCap, ESMA.

## Cyber threats have become more aggressive

- **Increasing number of attacks** attempting to disrupt services or attain access to data and services, including ransomware.
- **But impact of attacks** so far has been limited.
- **Cyber-related insurance claims keep increasing.** The frequency and severity of attacks has led the (re)insurance industry to further strengthen pricing techniques and risk transfer mechanisms.
- In the **banking sector**, it will be important to reflect on findings from the cyber resilience testing currently underway.
- **Heightened geopolitical instability and increased reliance on digital solutions** are also increasing cyber insecurity.

## Importance of DORA

- **Developments show importance of ESAs** jointly addressing risks to cyber resilience, and have reinforced expectations on the application of the Digital Operational Resilience Act (DORA).

## Crypto rally following spot Bitcoin ETF approval in US

- **Crypto-assets:** total market cap more than doubled year-over-year largely driven by spot Bitcoin ETFs approval in the US. Crypto risk levels remain very high.

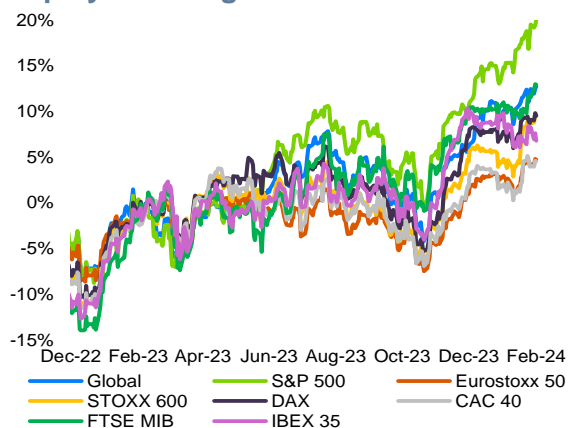
# Annex

## Outlook and risks in detail

# Macro-outlook and securities markets

## Growing expectations of rate cuts, but with significant uncertainty

### Equity indices growth since late 2023



### Recent surge in bond prices



### Growth and inflation fall further, market expects rate cuts

- **GDP and inflation:** Downward revisions to EU growth (0.5% in 2023) and to inflation forecasts (6.3% in 2023, 3.0% in 2024).
- **Rates:** Market expectations of cuts in 2024 in EU and US growing.
- **Uncertain environment continues** with geopolitical risks high.

### Equity and bond performance affected by macro-outlook

- **Equities:** Increase in global equity indices, boosted by anticipated rate cuts, lower volatility in 2024, but risks of corrections.
- **Listed EU banks** have underperformed so far in 2024.
- **Sovereign bonds:** EU yields fall in late 2023, but demand for new issuance rose in early 2024 as investors locked in high-yields.
- **Corporate bonds:** Fall in yields for IG and HY in 4Q23, with falls varying by bond rating (credit risk), liquidity improved in H2 2023.
- **Commodities:** price trending up in 2024 after 2023 falls.

### Credit quality falls especially in high-yield and real estate

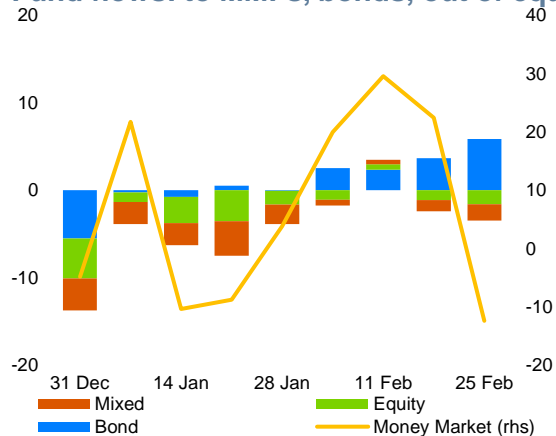
- **Credit risk and real estate:** Credit quality of HY non-financials and real estate continued to fall, with default rates trending upwards, though these remain moderate by historical standards.



# Asset management

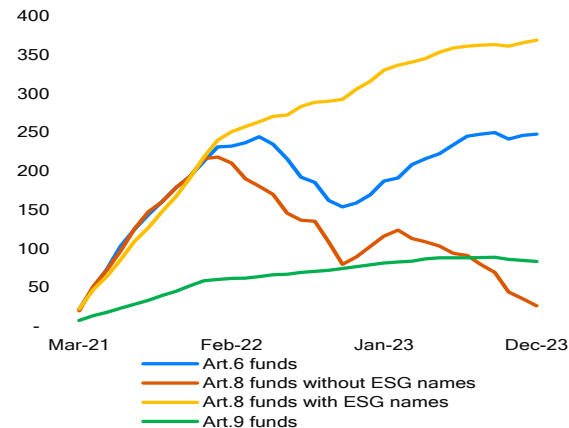
## Fund performance and flows were volatile as environment changed

Fund flows: to MMFs, bonds, out of equity, mixed



Note: Weekly flows in EEA-domiciled investment funds, in EUR bn.  
Source: Refinitiv Eikon, ESMA.

### ESG: outflows from Art.8 funds



Note: Cumulative net flows into EU-domiciled funds (excluding MMFs) by SFDR fund type since SFDR started to apply, EUR bn. Article 8 funds split between funds using ESG-related terms in their names and funds not using such terms.  
Sources: Morningstar, ESMA.

### Volatile performance and fund flows in H2 2023

- **Slow volatile recovery in performance** across types.
- **Bond funds preferred over equity** on rate expectations; inflows for BFs, inverted yield curve especially benefited MMFs.
- **Outflows** from real estate, mixed and equity funds.

### Adaptation to the macro environment

- **MMFs:** after historical low of 2022, weighted average life increased, with more maturity transformation.
- **Bond funds:** decrease in maturity transformation / portfolio duration as rates were rising.
- **Credit risk:** remains increased for high-yield bond funds.

### Reduced investor appetite for ESG investments

- **ESG fund outflows in SFDR Art. 9 and Art. 8 funds** in 4Q23, but Art 8 funds with ESG in name had inflows; new disclosures under SFDR increased transparency, despite data quality issues.
- **Green bond issuance slowed in H2 2023** with a 34 % decline in 2H23 compared to 2H22, slowing growth in the ESG debt market
- **Banks' ESG bond issuance volume increased** in 2023 compared to 2022, driven by higher green senior non-preferred bond and issuance from holding companies.

# Real estate downturn

## Commercial real estate downturn a driver of risks

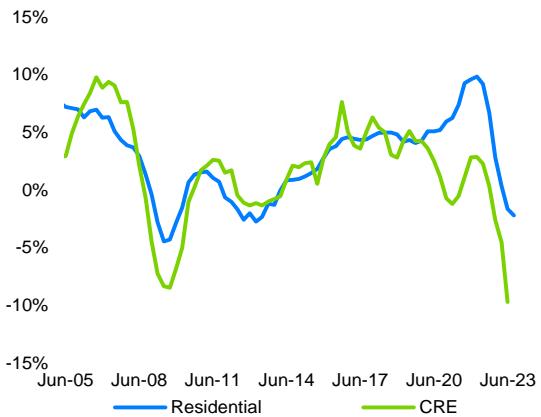
### Continuing stress in the real estate, particularly commercial

- **EU is experiencing a real estate (RE) downturn**, especially in commercial real estate. (CRE). CRE was down 10% in 12 months to June 2023, down 2% in residential real estate (Euro area).
- **Real estate is a source of credit risk:** EEA real estate corporate ratings drift strongly negative over 2023, more than in other sectors.

### Vulnerabilities related to real estate exposure

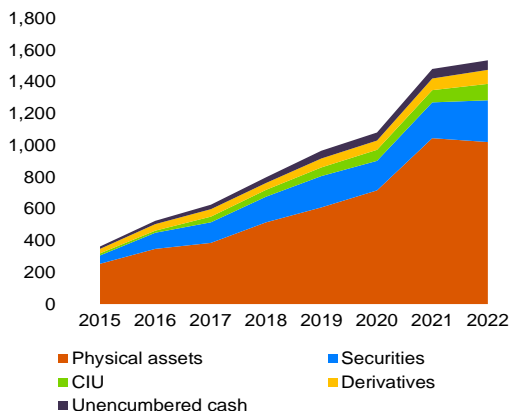
- **EU banks reported ca. EUR 1.4tn of loans collateralised by CRE in Q3 2023**, same level as Q3 2022, of which EUR 210bn towards non-EU counterparties, with potential contagion risk from the US.
- **Asset quality deterioration for RE exposure of banks is not yet fully evident.** But overall slowdown in real estate markets could lead to additional impairments. 16.7% of EU banks' CRE exposure are in IFRS stage 2; 3.8% are NPLs, both broadly stable over the last year. 0.25% of CRE loans are past due between 30 and 90 days.
- **Banks have tightened their lending standards** while demand for loans, including real estate loans, remains weak. EBA surveys show a lower share of banks planning to increase their real estate lending looking forward.
- **Real estate funds quadrupled in size from 2015 to 2022** (to EUR 1.5tn). About two thirds invested in physical assets (share is falling). A main investor is insurers and pension funds, whereas small share of investment for banks.
- **Liquidity mismatches a key vulnerability at open-ended RE funds**
- **EU insurers reported around EUR 746 bn investments in RE** as of Q3-2023, out of which 30% are via funds and 23% are loans and mortgages. **IORPs exposure to RE was EUR 252 bn as of Q3-2023**, of which 58% is in funds and 9% in loans and mortgages.
- **EU insurance and IORPs sectors** are relatively less exposed to RE and asset quality deterioration was not visible in 2022. The latter could be related to a lag in valuation as well as data availability.

### RE prices continue to fall



Note: Residential and commercial real estate prices for Euro area year-on-year change in prices in %.  
Sources ECB ESMA:

### Funds RE investment growth in AuM

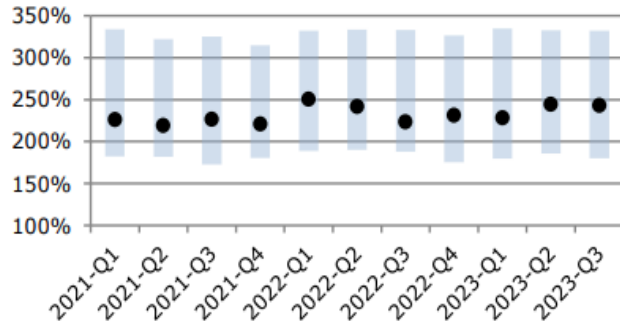


Note: AuM by type of RE managed and/or marketed by authorised AIFMs and sub-threshold managers registered only in national jurisdictions, in EUR bn. Data for the EEA30.  
Sources: AIFMD database, national Competent Authorities, ESMA.

# Insurance and IORP sector

## Resilience of Insurers and IORPS, despite high inflation and low growth in 2023

Solvency Ratio > 200% for EEA Insurance groups proves a resilient Insurance Industry



Source: EIOPA Insurance risk dashboard- Feb 2024.

Funding Ratios (DB schemes) for EEA have slightly increased due to effects from increasing interest rates



Source: EIOPA IORPs risk dashboard – Feb. 2024. Note: Interquartile range and median are unweighted, while the back dot is a weighted average by technical provision.

### Insurers and IORPs balance sheet positions remain robust in 2023

- **Insurers** : Insurers SCR ratios remain well above 200% on average in Q3-2023, life undertakings median SCR ratio increased (243% in Q3-2023 from 229% in Q4-2022), non-life median SCR is at lower level but also improved (219% in Q3-2023 from 210% in Q4-2022).
- **IORPs**: DB IORPs funding ratios improved from 119.2% to 120.6% in Q3-2023, due to a slight decrease in technical provisions following increasing interest rates. Simultaneously, asset values slightly increased.
- For both sectors, there is heterogeneity across EEA member states.

### Persistence of high inflation and low growth pose challenges

- **In the short term, the negative effects of inflation have been counterbalanced by strong market performance and high interest rates.** For life and composite especially, the increase interest rates contributes to support capital position of insurers given their long-term liabilities and material negative duration gap, compensating for the negative effects of inflation. Non-life insurers positions also remained resilient, despite being more exposed to inflation via claims.
- **In the medium- long- term, persistent inflationary environment coupled with low growth present challenges for both life and non-life business**

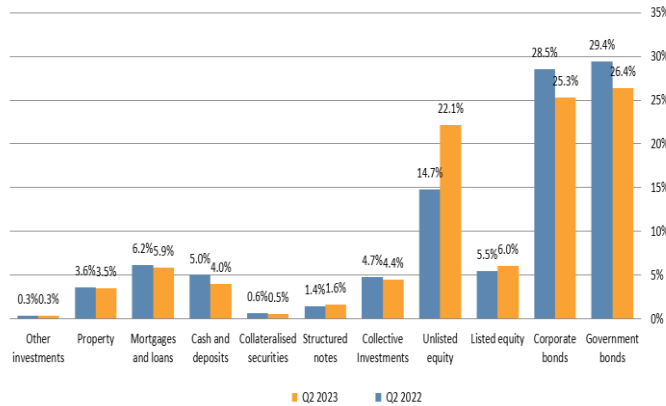
### And market risks remain key concern for the sectors.

- Increased concerns for risk premia repricing in particular for private debt and other illiquid assets.

# Insurance and IORP sector

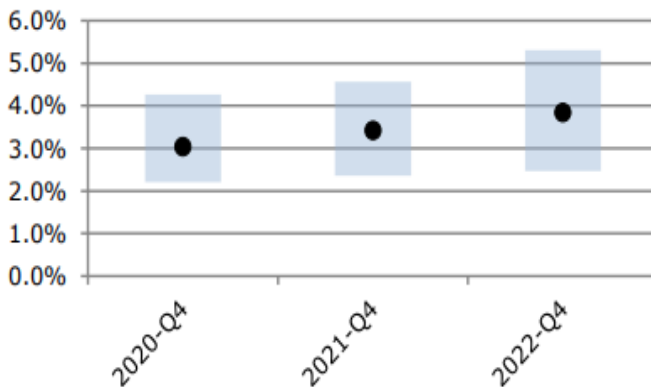
## Asset quality and liquidity positions satisfactory but headwinds surfacing

### Insurers asset allocation



Source: EIOPA Financial Stability Report Dec. 2023

### Slight increasing trend in lapses by Life Insurers



Source: EIOPA Insurance risk dashboard – Feb. 2024

### Asset quality robust but there are signs of negative credit outlook

- **Asset quality of insurers' and IORPs' investments remain robust** with weighted average credit quality of direct investments corresponding to AAA-AA S&P rating in Q3-2023.
- **EU Insurers and IORPs have low exposure to high yield bonds but the exposure is increasing in 2023.** Both sectors reported a slight but steady increase in investments in bonds with low credit ratings in 2023 in their direct investment. Moreover, the share of investments in funds, whose credit quality is less transparent, has also been steadily increasing.
- **Valuation of alternative assets could be subject to corrections,** as tightening financing conditions tests resilience of firms and households.

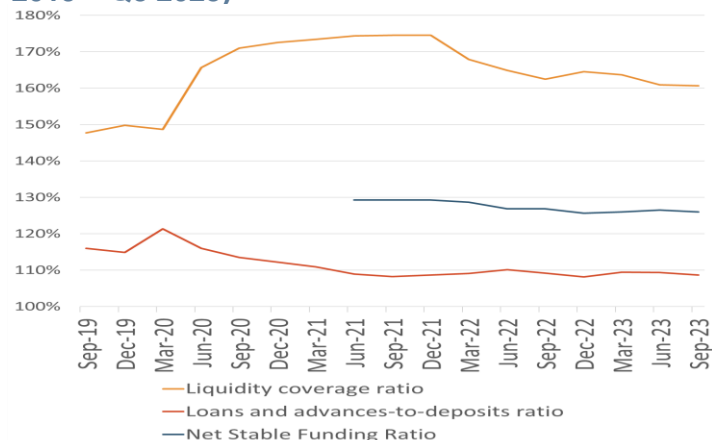
### Liquidity position of both sectors satisfactory but with a declining trend until Q3 2023

- **Insurers have ample availability of highly liquid assets, yet liquidity position slightly diminished** as indicated by lower cash holdings and liquid asset ratio, due to increase in margin calls and fall of bond prices in Q3-2023.
- **Increase in lapses remains a concern for insurers.** Higher short-term interest rates (e.g., than the guarantees offered) could motivate surrendering the insurance savings contracts, that can be non-optimal from a savings perspective. These lapses can be more pronounced, depending on distribution channels as well as penalties or loss of tax benefits when lapsing.
- **IORPs' market value of derivative positions decreased** due to increasing interest rates, resulting in losses and in some cases to strained liq. ratios.

# Banking sector

## Higher interest rates support a resilient banking sector

Evolution of liquidity coverage ratio, net stable funding ratio and loans and advances to deposits ratio, (Q3 2019 – Q3 2023)



Evolution of net interest margins of EU banks (Q1 2015 – Q3 2023)



### EU banks demonstrated their resilience in 2023

- **Banks' capital and liquidity positions remained high, with a solid LCR of 161% in Q3 2023 at a substantially higher level than the 100% minimum requirement, but decreased slightly.**
- **Robust capitalisation and ample liquidity helped the banking sector to navigate through challenges such as in March 2023 and amid a challenging economic outlook.**

### Higher interest rates boosts profitability...

- **Monetary policy tightening helped banks to increase net interest income thanks to higher net interest margins. RoA and RoE were reported at highest levels since the global financial crisis, reaching 0.71% and 10.9% respectively in Q3 2023.**

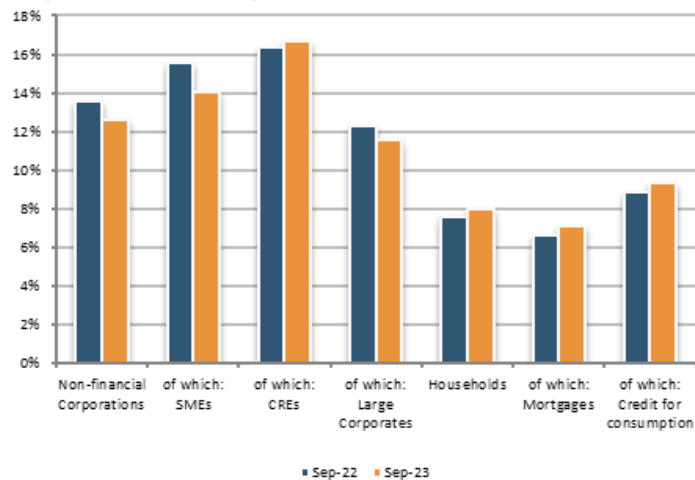
### ...but pose some medium-term challenges

- **Significantly increasing bank wholesale funding costs in 2022 and 2023, but rather stable so far in 2024.**
- **Monetary transmission of higher interest rates leads to lower demand for lending and may have implications on asset quality amid borrowers' abilities to service loans.**
- **Monetary tightening has increased interest rate risk in banking books, including the impact of rate changes on fixed rate assets. Strong interest rate risk management capabilities are important in the current uncertain interest rate environment.**

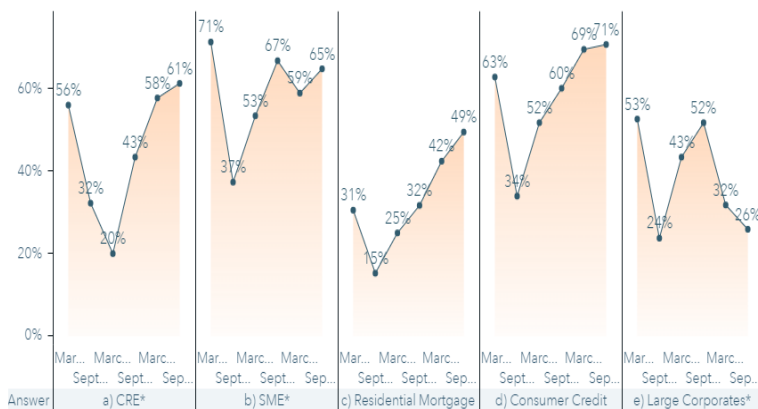
# Banking sector

## Deteriorating outlook for asset quality and profitability

IFRS stage 2 allocations by loan portfolio of EU banks, Sept 2022 and Sept 2023



Loan portfolios whose asset quality EU banks expect to deteriorate in the next 12 months



### Banks prepare for asset quality deterioration

- **Asset quality remained robust**, with a low NPL ratio of 1.8% reported in Q3 2023, though NPLs are marginally increasing.
- **Loan growth remains subdued** amid tightening lending standards and weak demand.
- EBA surveys suggest expectations of **asset quality deterioration across most lending portfolios**, as well as reluctance to increase lending exposure.
- **Residential and commercial real estate (CRE) exposure appears more vulnerable**, as reflected in both increasing IFRS stage 2 allocation EBA survey responses.

### High interest rates translated into strong profitability, but the outlook has deteriorated

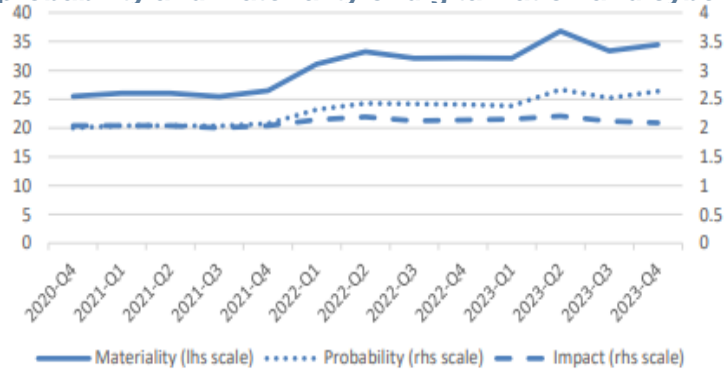
- **EU banks reported highest profitability since the great financial crisis.** High net interest income (NII) driven higher net interest margins (NIMs) may not be sustainable amid lower interest rates and as banks face pressure from repricing.
- **The profitability outlook is also affected by slower loan growth**, high costs, and from implications of a challenging macro environment.



# Innovation and digitalisation risks

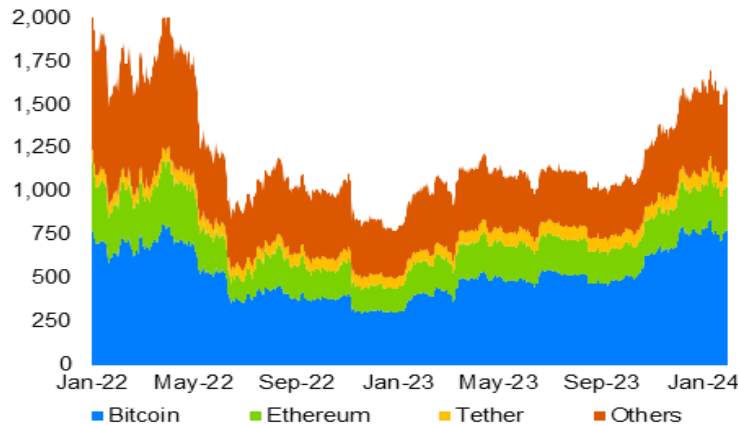
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Source: EIOPA Insurance risk dashboard – Feb. 2024

Crypto market capitalisation markedly up but still below 2021 historical peak



Note: Market capitalisation of Bitcoin, Ethereum, Tether and other crypto-assets, in EUR bn.  
Sources: CoinMarketCap, ESMA.

### Innovation and risks

- **Cyber threats have become more aggressive**, with an increasing number of attacks attempting to disrupt services or attain unauthorised access to data and services, including ransomware. The impact from cyber attacks has to date been limited.
- **From an insurance cyber underwriting perspective**, cyber-related claims keep increasing. The frequency and severity of attacks has led the (re)insurance industry to further strengthen pricing techniques and risk transfer mechanisms. Though supply is increasing, there still is a protection gap in the market.
- **In the banking sector**, it will be important to reflect on findings from cyber resilience testing currently underway.
- A combination of heightened geopolitical instability and increased reliance on digital solutions is increasing cyber insecurity. Looking forward, **reliance on IT outsourcing is expected to drive cyber activity in 2024**.
- **Developments highlight** the importance of the ESAs jointly addressing risks connected to cyber resilience and have strengthened the expectations on the application of the Digital Operational Resilience Act (DORA).

### Crypto and digitalization

- **Crypto-assets**: total market cap more than doubled year-over-year, at EUR 2tn in Feb (2021 peak: EUR 2.6tn); rally largely driven by spot Bitcoin ETFs approval in the US; risk levels remain very high.
- **Artificial intelligence**: growing use in financial services for productivity and to assist decision-making, even though dedicated AI tools remain limited.

