European Banking Authority

eiopa European Insurance and Occupational Pensions Authority

ESMA European Securities and Markets Authority

JOINT COMMITTEE OF THE EUROPEAN SUPERVISORY AUTHORITIES

JC 2024 65

JOINT COMMITTEE REPORT ON

RISKS AND VULNERABILITIES IN THE EU FINANCIAL SYSTEM

AUGUST 2024

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EXECUTIVE SUMMARY AND POLICY ACTIONS

In late 2023 and early 2024, continuing declining inflation has led central banks to begin the shift towards looser monetary policy, with financial markets performing strongly in anticipation of rate cuts and an improving macroeconomic outlook, until the short-lived but sharp equity price dip in August. Considerable uncertainties nonetheless remain on the future path of economies globally, inflation and monetary policy and how these will develop across different jurisdictions. While interest rates are expected to fall, these will likely stay 'higher-for-longer' relative to pre-pandemic levels. In the context of continuing geopolitical events such as the Russian aggression against Ukraine, the war in the Middle East, the military tensions between China and Taiwan, and elections in the EU and the US, there is potential for sudden shifts in economic outlook and market expectations. More recently, European parliament election results and consequential developments, e.g. snap election announcements, have resulted in ensuing initial market volatility, and demonstrated the impact of geopolitical uncertainty on financial markets. In sum, the current highly uncertain environment continues to present material financial stability and operational risks that necessitate vigilance from all financial market participants.

Against this background, the Joint Committee advises the European Supervisory Authorities (ESAs), national competent authorities, financial institutions, and market participants to take the following policy actions:

- **Financial institutions and supervisors should remain prepared for facing the impacts of continued high interest rates on the real economy.** Higher re-financing costs will continue to challenge the real economy and financial markets. The full effect will materialise over time, particularly with refinancing needs remaining elevated in coming years, with certain firms being more vulnerable, such as the highly-indebted and those with weak cashflows.
- **Credit risk should continue to be monitored and carefully managed as its potential crystallisation remains a concern.** This includes adequate provisioning levels and forward-looking provisioning policies, while prudent and up-to-date collateral valuation remain important. Amid rapid expansion of private credit, transparency for non-bank lenders should be improved, while their risk management and loan origination standards may require further scrutiny.
- **With ongoing deep uncertainties and recent increases in asset valuations, financial institutions need to be flexible and agile** and have proper plans and processes in place to address unexpected short-term multi-fold challenges, particularly sudden changes arising from geopolitical risks, which can materialise though many channels, such as credit risk, market corrections and operational risks.
- **Financial institutions and supervisors should remain vigilant regarding the impact of inflation on product development.** In the insurance sector, premia repricing can negatively affect businesses if not done in a timely way and paired with claims inflation. To avoid this, inflationary trends should be considered as a fundamental element in the Product Oversight and Governance process. Financial institutions and supervisors should also ensure that consumers are aware of the effects of inflation on real returns, not only in the context of insurance, but for savings and investments generally. Particularly in the context of institutions for occupational retirement provision (IORPs), for defined-benefit IORPs, supervisory monitoring on liabilities and indexation to inflation is key, and for defined-contribution IORPs where the risk of the weak final performance of investments and thus lower retirement income, is borne by their members.
- **Financial institutions and supervisors should remain vigilant to operational and financial stability risks that could arise from cyber-risks.** Cyberattacks have been increasing, including successful ones, and the sophistication of attacks is growing. The global IT disruption in July from the CrowdStrike update also shows the extent of vulnerabilities to operational risks. Given DORA, entities operating in the financial sector and their supervisors should address cyber risks more holistically, leveraging on risk management, incident reporting, threat led penetration testing and supervisory cooperation. Entities and supervisors should also be prepared to address challenges brought by new technologies such as artificial intelligence.

1 Overview on Risks in the Financial System

In late 2023 and early 2024 falling inflation increased expectations of monetary policy loosening, with EU forecasts for growth and inflation being revised downwards. In spring, the European Commission lowered its EU growth estimate for 2024 to 1.0% (from 1.3% of the 2023 autumn forecast) and for 2025 slightly down to 1.6% (from 1.7%). The more recent Eurosystem staff projections[1] for both headline and core inflation have been revised slightly upwards for 2024 and 2025. In this context, the ECB cut its key rates by 25bps at its June meeting, while market expectations suggest limited future rate cuts.

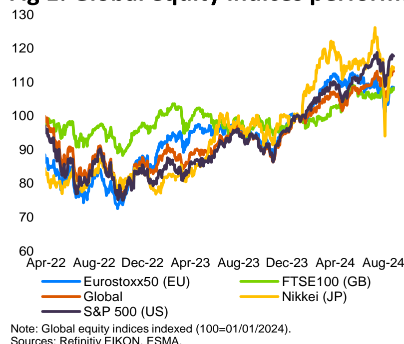
Compounding uncertainty on monetary policy, uncertainties remain high from numerous geopolitical tensions, such as the Russian invasion of Ukraine, the war in the Middle East, US-China tensions, and the elections in the EU and in the US. Sudden unexpected developments on these could lead to rapid adjustments in economic outlook and risk appetite which could drive market corrections. In this context, the continued stability of market infrastructures remains central. In its recent CCP stress test, ESMA found that CCPs have robust lines of defence to withstand significant market shocks and are resilient to substantial liquidity stress events, though some gaps persist in the coverage of concentration risk across CCPs and across asset classes, notably for commodity derivatives.

Macroeconomic and monetary conditions have affected the growth of EU/EEA banks assets, which slowed down to 0.8% in Q1 2024 (year on year). Loan growth already slowed down since late 2022 and was not least affected by tightening credit standards. Geopolitical risks may have discouraged lending as borrowers delayed long term investments, while revised expectations in real estate markets have lowered the demand for housing loans.

Despite the uncertainties, the expectations of interest rate cuts and a soon-to-be improving macro-outlook increased market valuations in 2024, with signs of search-for-yield. In the first half of 2024 equities prices trended upwards with low volatility, indicating market expectations that inflation is moving towards central bank targets without a deep economic contraction (a 'soft landing'). However, the high market volatility in August demonstrated the continued potential for sudden shifts in outlook and market expectations. After falling in late 2023, bond yields in sovereigns and corporates increased in the early months of 2024.

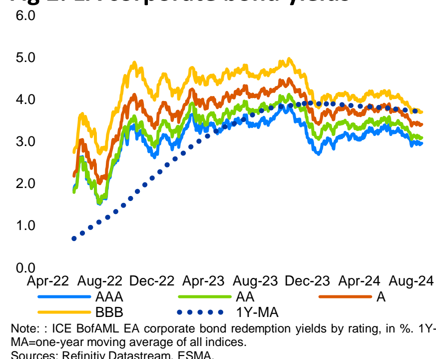
The corporate yield distribution remains compressed overall as investors search-for-yield ahead of interest rate cuts. In H1 2024, corporate bond yields increased both for investment-grade (IG) and high-yield (HY) by +40 bps and +35 bps respectively. As in 2023, HY bonds continued to perform better than IG, reflecting strong investor demand to lock in high yields ahead of anticipated rate cuts.

Fig 1: Global equity indices performance



Note: Global equity indices indexed (100=01/01/2024).
Sources: Refinitiv EIKON, ESMA.

Fig 2: EA corporate bond yields



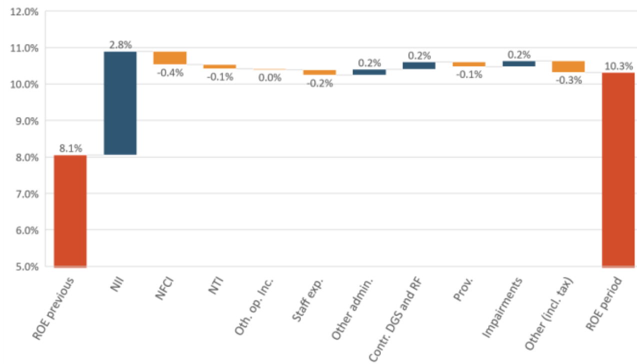
Note: : ICE BofAML EA corporate bond redemption yields by rating, in %. 1Y-MA=one-year moving average of all indices.
Sources: Refinitiv Datastream, ESMA.

EU/EEA banks' profitability increased substantially in 2023, driven by a large YoY rise of net interest income (NII). The share of NII to total net operating income increased by 7.6% in 2023. The NII increase, which was

[1] See the Eurosystem staff projection, June 2024

particularly significant in the first half of the year, was mainly supported by rising net interest margins rather than loan growth. On average EU/EEA banks were able to take advantage of the rising interest rates environment and expand their margins, as the repricing of the asset side was faster than the repricing of the liability side. Return on equity (RoE) peaked at 11.1% in Q3 2023. Following a stabilisation of the NII in the mid of 2023, RoE has begun to decline and reached 10.6% in Q1 2024.

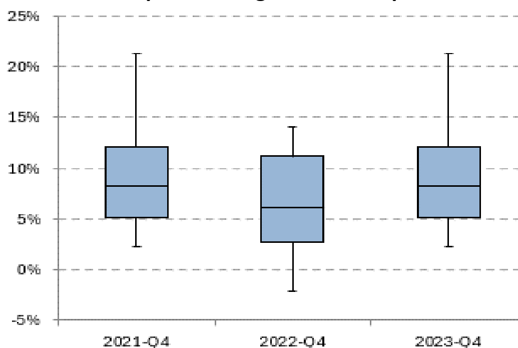
Fig3: EU/EEA banks' return on equity (RoE) and contribution of the main Profit & Loss items to the RoE; comparison between end-2022 and end-2023



Source: EBA supervisory reporting data

The profitability of insurers improved in 2023 given the higher returns gained in their investment portfolios. Higher interest rates and high inflation impact profitability through their effect on the value of investments and their returns. The median return on assets and the median return on excess of assets over liabilities (a proxy for return on equity) moved upwards. Looking ahead, the investment portfolio of EEA insurers could be negatively impacted via market corrections, in particular for those with higher exposure in alternative assets including real estate and private credit. Profitability might be also affected by interest rate movements. However, the observed reduction in the duration gap between assets and liabilities reduces the potential negative impact of interest rates cuts.

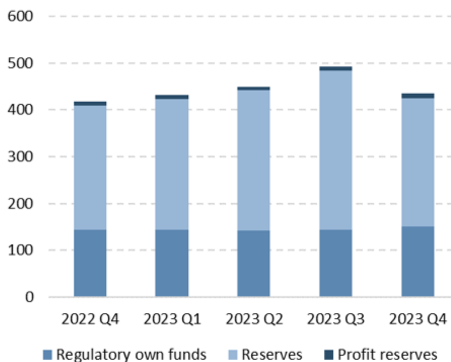
Fig 4: Return on Excess of Assets over Liabilities in %, median, interquartile range 10th & 90th percentile



Source: EIOPA Quarterly Financial Groups (Templates S.39.01.11 and S.02.01.02).

The European sector for occupational pensions stayed resilient. The inflation movements triggered by the geopolitical events and the monetary policy decisions has been driving IORPs allocation towards holding sufficient levels of liquidity to make sure the hedging process for the duration mismatch based on interest rate derivatives functions without disruptions. Concerns on the developments observed regarding the pension gaps remain high. Although total assets of IORPs increased, mainly driven by bonds and share holdings in the portfolios, the increase in the value of liabilities exceeded the increase in the value of assets and the financial position of IORPs in the EEA slightly deteriorated.

Fig 5: Components of IORPs Excess of Assets over Liabilities (in bn EUR)



Source: EIOPA Occupational Pensions Statistics – Balance Sheet, quarterly. Reference date: Q4 2023

Investment fund markets showed positive performance in early 2024, with flows into bonds funds. Equity fund returns over 12 months rose to 1.5% in Q1 2024 from 1.2 % in H2 2023. There were inflows to funds exposed to fixed income instruments, with bond funds and money market funds recording inflows in H1 2024. There is a perception in the market that falling credit risk has offset the increase in rates. Yet, bond fund portfolio credit quality, measured by average credit rating has continued to weaken, raising risks of future disorderly repricing of funds with riskier assets.

Retail consumers' confidence in future market conditions also increased, bolstered by an improving aggregate financial position for households. The average performance of retail investments improved in 2023 but remained below inflation. Consumers continued net purchases of bonds amid higher interest rates. Digitalisation in retail markets also continued to grow. Social media is an increasingly prominent source of information, particularly for younger investors, with participants offering advice, corporate news or investment strategies and advertising financial services. Digital financial intermediaries, such as 'neo-brokers', have also grown rapidly in recent years, offering clients innovative, online-only investment services.[2] While these developments promise benefits such as improved market access and participation, there are risks such as market manipulation and increased trading in unsuitable or unduly risky products.

Credit quality continues to weaken for high-yield corporates, particularly associated with commercial real estate (CRE), with downgrades and default rates continuing to increase. Given the anticipated surge in refinancing needs in the period between 2024 and 2028 at rates that (even with future cuts) are likely to be significantly higher than existing debt, credit risk continues to rise and remains elevated . This stands in contrast to the recent tightening of corporate spreads due to search-for-yield and suggests possible underestimation of risks for some high-yield debt. Risks associated with credit risk are discussed in depth in section 2 below.

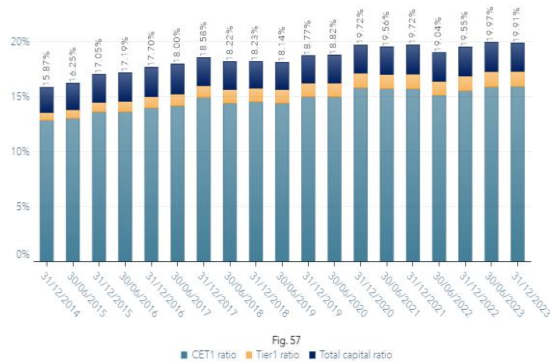
For banks, the share of non-performing loans (NPL) slightly increased for all loan segments amid a positive volume growth in NPLs in 2023, and an increasing NPL ratio to 1.9% in Q1 2024. While still low in a longer-term comparison, it increased by 10bps since end-2023, the increase in NPL was broad based across lending segments and indicates deteriorating asset quality. On lending segment level, the biggest increase in NPL ratios in Q1 2024 was reported for loans to small and medium enterprises (SME).

EU/EEA banks maintain solid capital positions. The CET1 ratio (fully loaded) increased from 15.7% in Q1 2023 to 15.9% in Q1 2024. The increase was primarily driven by the volume of CET1 capital, which was supported by retained earnings in spite of rising payouts. Overall, capital ratios are well above requirements and this is important to guard against asset quality deterioration and potential implications from geopolitical- and other

[2] See Colesnic, Harris and Lorusso (2024), 'Neo-brokers in the EU: developments, benefits and risks', ESMA TRV Risk Article, July.

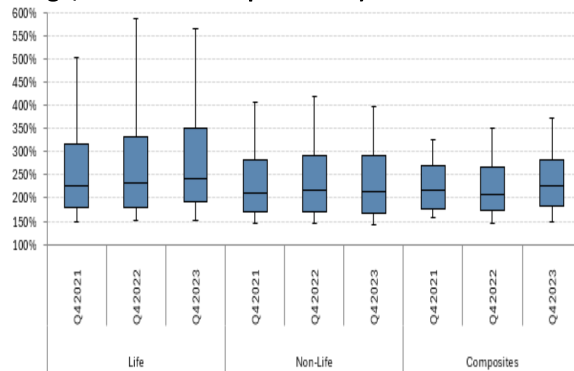
macroeconomic shocks. Banks' plans indicate a further rise in payouts this year, amid higher capital buffers and high profitability compared to the past. A continuously cautious stance concerning payouts is nevertheless very important while risks and uncertainties remain elevated.

Fig 6: EU/EEA banks' capital ratios (transitional definitions, December 2014 – December 2023)



Source: EBA supervisory reporting data

Fig 7: Insurers SCR ratio (in %; median, interquartile range, 10th and 90th percentile).



Source: EIOPA Quarterly Reporting Solo. Reference date: Q4 2023.

The European insurance sector maintained a solid capitalization throughout 2023. At the end of 2023 the median SCR ratio for life (243%) and composite (225%) insurers improved with respect to a year ago. The SCR ratio for non-life insurers remained solid with a stable median (215%).

Geopolitical risks could influence European insurers' risk assessment, pricing decisions, coverage offerings, and investment strategies. In addition, these tensions could weaken economic conditions and lower the demand for insurance products and triggering lapses with negative effects on profitability solvency. This could in turn result in losses in the investment portfolios of insurers. The economic consequences of a re-intensification or prolongation of geopolitical tensions on the insurance sector is currently being tested in the 2024 Insurance Stress Test Exercise, developed by EIOPA. Its primary goal is to assess the resilience of participants to an adverse scenario that goes beyond the regular resilience required under Solvency II and provide supervisors with information on whether these insurers are able to withstand severe shocks. EIOPA will also assess potential sector-wide vulnerabilities.

Cyber risks remain high in the tense geopolitical context with incidents in the financial sector growing over recent years. Russia's war on Ukraine has given rise to widespread cyberattacks against entities based in the EU. In the banking sector, operational risk capital requirements increased by 8% YoY in Q1 2024 and account for over 10%, at a level last reported in December 2020, when operational risks were high amid the COVID-19 pandemic.[3] The EBA's Risk Assessment Questionnaire (RAQ) shows that cyber risks and data security rank the highest among operational risks, followed by conduct and legal risks as well as fraud. According to EIOPA Insurance and IORPs Bottom-Up Surveys Spring 2024, the materiality of digitalisation and cyber risks were ranked third across all risks and are expected to remain a key risk in the future. While in ESMA's June risk survey of NCAs, cyber risks were the third most cited risk, with risks to infrastructures, particularly trading venues and central security depositories, being highlighted as a concern.

[3] Higher operational risk capital requirements may also be driven by higher income in 2023.

2 CROSS SECTORAL DEEP DIVE ON CREDIT RISK

Credit risk is important for the three ESAs. The EU/EEA banking sector is exposed to credit risk[4] to a large extent by its lending activities, as borrowers could default. Banks are also exposed to credit risks by debt securities they hold, and by further risk exposures such as, e.g., counterparty credit risk for derivatives holdings. For insurers and pension funds, credit risk is important part of asset quality which plays a crucial role in insurers' financial health, as it directly impacts their ability to meet policyholder obligations and maintain solvency.[5] In securities markets, debt securities are issued and traded to support the issuance and allocation of debt capital (and in the process credit risk) through the financial system. This debt is generally rated by credit rating agencies which fall under ESMA supervision.

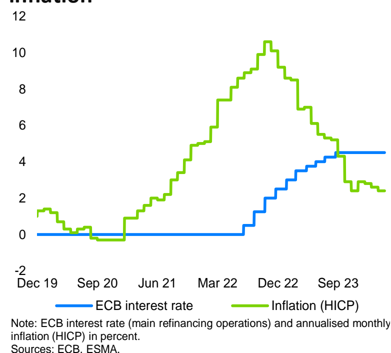
2.1 WHY IS CREDIT RISK CURRENTLY A CONCERN?

Interest rate rises since 2022 have added significantly to borrowing and debt-servicing costs. As the pandemic receded, inflation picked up globally. Central banks in Europe, the US and elsewhere responded with a series of rises that increased interest rates to levels not seen since the Great Financial Crisis.[6] These substantially increased the costs of new borrowing, refinancing and of servicing variable-rate debt. Along with the dampening effects of the rate increases on economic activity, debtors were put under increased strain to make debt payments, increasing credit risk.

The crystallisation of credit risk has been limited so far, but concerns remain. Looking at credit ratings for debt instruments publicly issued in the EEA, there are signs of credit deterioration since 2022, particularly for instruments issued by non-financial corporates, where recent credit ratings drift has been negative and trending downwards. Default rates have also been rising, approaching levels last seen during the pandemic.

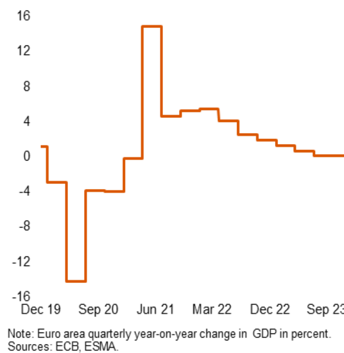
The real estate sector is a particular credit risk concern. Higher interest rates and tighter lending standards have led to falls in prices of both residential real estate (RRE) and commercial real estate (CRE). Moreover, changes in working patterns since the pandemic have had a significant additional impact on CRE in Europe and globally. According to the IMF, CRE prices globally dropped by 12% in 2023.[7] Refinancing existing debt has also become more challenging for CRE firms. These have increasingly raised capital through asset sales, often at a discount, either to manage refinancing risk or reduce pressure from leverage as a result of structural and cyclical change. RRE prices fell to a lesser extent during 2023, and appear to have broadly stabilised in Q1 2024.

Fig 8 – Euro area interest rates and inflation



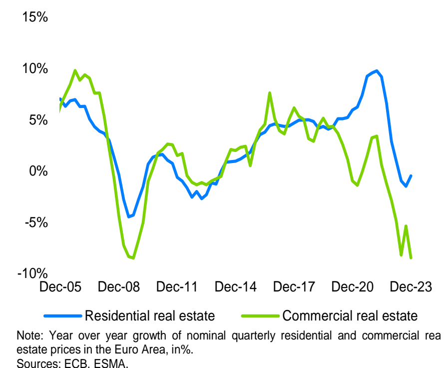
Note: ECB interest rate (main refinancing operations) and annualised monthly inflation (HICP) in percent.
Sources: ECB, ESMA.

Fig 9- Euro area change in GDP



Note: Euro area quarterly year-on-year change in GDP in percent.
Sources: ECB, ESMA.

Fig 10 - Euro area real estate price changes



Note: Year over year growth of nominal quarterly residential and commercial rea estate prices in the Euro Area, in%.
Sources: ECB, ESMA.

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[4] Credit risk is defined in the Basel 3 framework as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

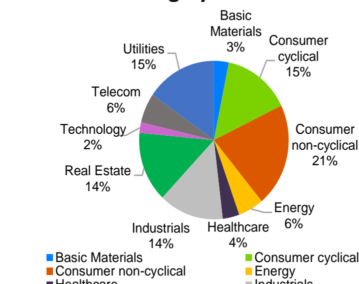
[5] According to Solvency II, insurers must ensure that their investment decisions align with the prudent person principle to safeguard policyholder interests and maintain solvency. Insurers must avoid overexposure to any single issuer, sector, or asset class and are subject to stringent eligibility criteria for assets held within their investment portfolios.

[6] Global financial crisis of 2008 - 2009

[7] See IMF: Financial stability and risks – April 2024.

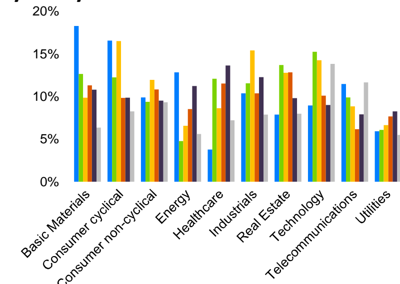
As regards corporate bond debt, a significant amount is due to mature over the next three years. Strong issuance in fixed income markets during the long period of low interest rates led to significant amounts of outstanding bonds with low coupon rates. Of this, EUR 790bn of corporate bonds issued by non-financial corporations is due to mature over the next three years, representing 34% of the total outstanding.[8] The maturity profile differs across economic sectors, with basic materials, consumer cyclical and energy companies that will face a higher share maturing in 2024 (18%, 16% and 13% of outstanding debt, respectively). Technology, real estate and healthcare companies face a higher share of debt maturing in 2025 (respectively 15%, 14% and 12%).

Fig 11 – Distribution of NFC corporate debt outstanding by sector



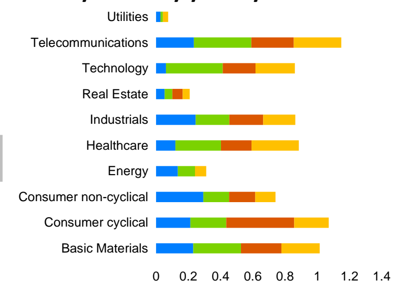
Note: Share of outstanding amount of corporate bonds issued by non-financial corporations in the EEA30, as of April 2024, by TRBC economic sector.
Sources: Refinitiv EIKON, ESMA.

Fig 12- NFC corporate bond maturity year by sector



Note: Proportions of total outstanding amount of corporate bonds issued by non-financial corporations by TRBC economic sector and year of maturity.
Sources: Refinitiv EIKON, ESMA.

Fig 13- High yield NFC corporate bond debt by maturity year by sector



Note: Total outstanding of high-yield corporate bonds issued by non-financial corporations by TRBC economic sector and year of maturity, as a proportion of each sector maturing.
Sources: Refinitiv EIKON, ESMA.

Amid expectations of higher for longer interest rates in the EU, refinancing these bonds could become too expensive, potentially sparking an uptick in defaults. In this context, corporate debt sustainability remains a significant risk, especially for high-yield (HY) debt and in more vulnerable sectors, such as real estate. A total of EUR 154bn HY debt is due to mature in the next three years, 31% of the total rated debt[9].

Loan modifications and extensions remain a key channel through which borrowers address their refinancing needs. Companies have also issued more convertible debt in 2023 compared to 2022,[10] as this type of asset class offer borrowers lower rates than traditional bonds, though not without risks.[11]

2.2 FINANCIAL INSTITUTIONS KEY EXPOSURES TO CREDIT RISK

Exposures through lending

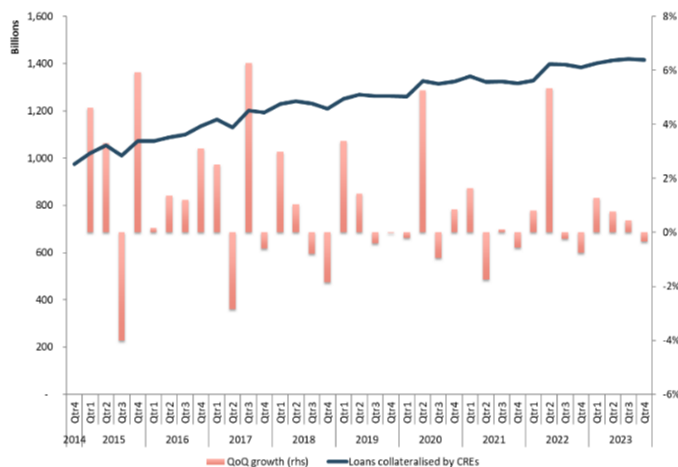
Total loans and advances to households and non-financial corporates (NFCs) in the EU/EEA banking sector marginally increased by 0.5% over the course of 2023, significantly below the rise in 2022. They accounted for EUR 13.2tn in Q1 2024. The trend reversed in Q1 2024 and banks reported decreasing outstanding loans and advances into households and NFCs by -0.2% quarter on quarter. Contracting loan volumes were not least affected by banks' limited willingness to take risks and grow their balance sheets in the weak economic environment, which led to stricter credit standards. Subdued real estate markets have affected demand for housing loans, while geopolitical risks may have also encouraged corporate borrowers to delay long-term investments. Loans from investment funds to NFCs have increased by 3% year-on-year but they only represent a fraction of total loans (EUR 60bn).

[8] Outstanding as of end April 2024.
[9] The total amount of rated debt maturing in the next three years stands at around EUR 489bn. The remaining EUR 301bn is either not rated or the rating information was not available.
[10] According to data from LSEG, global issuance of convertible bonds in 2023 reached USD 90bn from less than USD 50 bn in 2022. The estimates for 2024 are between USD 100bn and USD 110 bn of global issuance.
[11] If the share price does not rise and conversion does not occur, then the issuer must have the cash flow or access to new funds to redeem the bonds. Typically, share price weakness reflects deteriorating financial performance for the entity or the overall market, which is frequently accompanied by a worsening credit outlook and higher interest costs. If the conversion option is out-of-the-money due to the share price falling, credit spreads may concurrently rise, especially because of the need to redeem or refinance at maturity.

Banks reported exposures towards small and medium-sized enterprises (SMEs) of EUR 2.55tn as per March 2024, broadly unchanged YoY. Total loans towards NFCs accounted for EUR 6.3tn, down by 0.2% YoY. This was mainly driven by a decrease in loans towards large corporates.

EU/EEA banks have considerable CRE exposure with over EUR 1.4tn of loans collateralised by CREs, in December 2023, following continued growth in recent years, which accounts of close to 23% of the total loans towards NFCs (or 11% of total loans if household loans are included). More than EUR 200bn of CRE related exposure were towards non-EU/EEA counterparts, thereof ca. EUR 75bn towards counterparties domiciled in the US. CRE-related exposures were less than EUR 1tn in 2014, signalling a more than 40% increase in these exposures within less than a decade.

Fig 14: EU/EEA banks' exposures to loans collateralised by CREs – December 2014 to December 2023



Source: EBA supervisory reporting data

On average, EU/EEA banks' CRE exposures are less than 100% of their equity. However, several banks, mainly smaller in size, have CRE exposures that reach multiple times of their equity which makes them more vulnerable to downturns in CRE markets. These banks are mostly specialised CRE lenders, and therefore have a large portion of their loan portfolio towards CRE firms. More positively, CRE loans often come with a considerable cushion against property price declines in times of economic downturns or market corrections, due to their relatively low LTV (loan-to-value) ratios. EU/EEA banks reported that about 64% of CRE exposures have an LTV of less than 60%.

The insurance and IORPs sectors are also involved in lending activities, which are limited with few exceptions. Insurers typically invest a limited portion of their assets in loans and mortgages, around 6.7% of their portfolio in Q4-2023. Nevertheless, the share has been slightly increasing over the past 4 years. For IORPs lending activities are also moderate with the median and weighted average remain below 1.5% of total assets for IORPs, with a stable share until Q4 2022 and a slight increase in Q4 2023. There are also countries where lending activities for insurers are relatively more significant. In the Netherlands, Malta, and Belgium, insurers' lending activities are more substantial reaching 24%, 15% and 13% respectively in Q4-2023. The majority of insurers total lending activities are related to the real estate sector.

Insurers and IORPs exposures to private debt and private equity are under close monitoring. In Q4 2023, insurers still had a significant allocation to alternative assets, comprising 16.0% of their investments. Among these alternative assets, real estate exposures (5.7% of total investments) stands out, particularly through investments funds, and via mortgages and property (respectively 2.4%, 2.1% and 1.2% of total investments). Within alternative assets, insurers exposures to private debt and private equity are under close monitoring**,** given the global growth of those lending channels. In particular, insurers exposure to private debt (including non-traded bonds and uncollateralised loans) is 2.6% of their investments, and to private equity (including

private equity and unlisted equity) is 1.9%. Further details on private credit development are provided in the box.

<u>Exposures through debt securities</u>

Alongside loans, debt securities are another major vehicle for debt exposure and credit risk. Debt securities, such as fixed income instruments and structured finance products, provide another channel for issuers to raise debt capital and for investors to lend. Unlikely direct lending, investments in debt securities occurs widely across the financial system by banks, insurers, pension funds, investment funds and other institutions.

Overall, insurers have a large portion of investments in debt securities which remain relatively stable compared to the past year. Insurers' investment portfolios are heavily weighted towards fixed-income assets, constituting over 50% of their EUR 6.6 trillion investments[12] almost equally split between sovereign and corporate bond (28.1% and 28.4% respectively). Those figures include bonds held within funds, while insurers direct investments in corporate bonds is 22% of total investments[13] mainly domestic or within EU/EEA countries.

Focusing on insurers' direct investments in debt securities, they withheld from increasing exposures on corporate bonds issued by non-financials since Q2 2022. Up to Q2 2020, insurers were net buyers of non-bank issued bonds. The lower purchases from 2020 Q3 to 2022 Q1 could be a re-adjustment. Then, since Q2 2022 the trend has changed, and insurers have been net sellers of non-bank corporate bonds. The net sales of bonds issued by non-bank corporates continued until Q3 2023; only in Q4 2023 small purchases of 0.3% can be observed again**.**

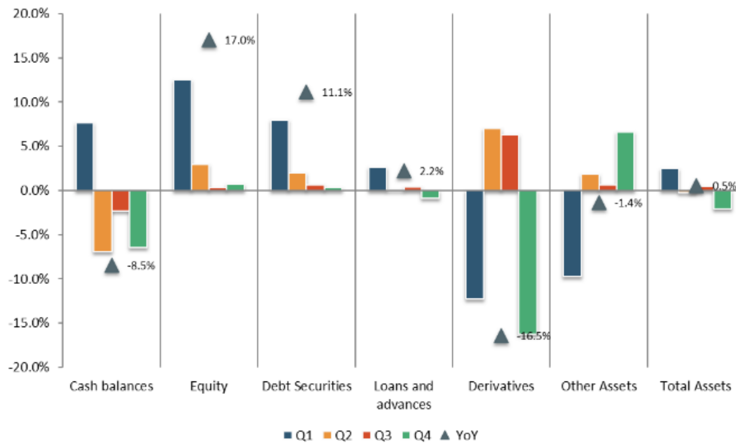
Insurers also hold significant exposure to corporate bonds via their investments in other non-bank financial institutions, such as bond funds and money market funds (MMFs). Approximately 23% of insurers' non-unit linked portfolios are allocated to funds, such as bond funds (37% of total fund exposure) and MMF (8% of total fund exposure) whose primary investment focus are respectively corporate bonds and short-term commercial papers.

The predominant exposure to debt securities for EEA IORPs are via investments in non-financial institutions. Investment funds represents 39% of total assets of IORPs at the end of 2023. IORPs investments in government and corporate bonds accounts for less than 35% of total investments. In the last year, bonds holdings and their share in the portfolios increased (14.4% increase in government bonds amounts).

Debt securities held by EU/EEA banks strongly increased in 2023, by 11.6%. The increase was mostly driven by sovereign exposures, although they are not a major source of credit risk. EU/EEA banks exposures of around EUR 3.4tn towards sovereign counterparties increased by 8% compared to December 2022 (EUR 3.1tn). Almost half of these exposures were towards domestically domiciled counterparties, while 27% were towards other EU/EEA countries. Over the last few years, the maturity profile of sovereign debt held by banks has moved towards the long end.

[12] EIOPA statistics. Excluding unit-linked and index-linked portfolios.
[13] Excluding unit-linked and index-linked portfolios

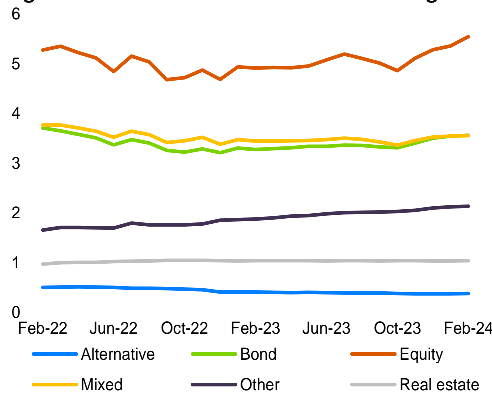
Fig 15: Quarterly and yearly growth rates in asset components (in %), December 2022 to December 2023



Source: EBA supervisory reporting data

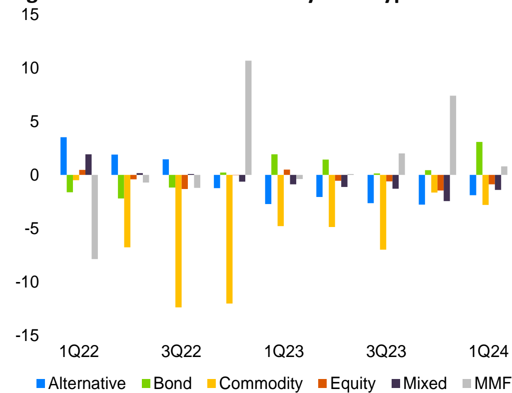
Bond funds and money market funds are also significant holders of debt securities, with recent inflows to higher-yielding funds. In the EA bond funds have stable aggregated asset under management (AuM) of around EUR 3.9tn in March 2024, making them the second-largest fund category in the EA, after equity funds. Money market funds at the end of 2021 stood about EUR 1.5tn. Moreover in 2024, bond funds were the only fund category to record significant inflows in the first half 2024, representing 3% of NAV. Within bond funds, corporate bond funds benefited from similar inflows (3% of NAV) reflecting positive returns due to the increase in the risk-free rate, which compensated for the decrease in credit spreads. The trend towards higher-yielding fixed-income assets is particularly visible in money market funds, with inflows representing 3% NAV amid rapidly increasing returns (median monthly return of 0.36%, up from negative returns in 2022).

Fig 16 – Euro area fund assets under management



Note: NAV of EA investment funds by fund type, EUR tn.
Sources: ECB, ESMA.

Fig 17- Euro area fund flows by fund type



Note: EU27 fund quarterly net flows, in % of NAV.
Sources: Refinitiv Lipper, ESMA.

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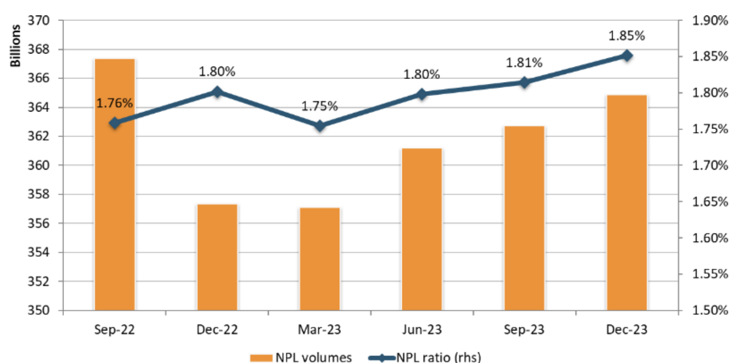
2.3 Asset quality - credit risk trends

Credit risk trends in loans

After years of steady improvement, signs of deteriorating asset quality began to cautiously appear in 2023 in the EU/EEA banking sector. Inflation and high interest rates have put some pressure on borrowers' servicing capabilities. A slightly positive net NPL inflow was reported in 2023, and the volume of NPL increased across loan segments by nearly EUR 10bn to EUR 365bn at end-2023. The NPL ratio was 1.9% as of March 2024, similarly increasing compared to year-end 2022 (+10bps).

Fig 18: Trend of EU/EEA NPL volumes (EUR bn) and ratio, September 2022 to December 2023



Source: EBA supervisory reporting data

The deterioration in the asset quality spanned across all portfolios of NFC and household lending, but was more profound in CRE related loans. The biggest increase in NPL ratios was reported for loans collateralised by CRE (4.3% in Dec-23 vs 3.9% in December 22). In December 2023, EU/EEA banks reported EUR 58bn of NPLs, an increase of over 12% compared to last year (EUR 51bn in December 2022). For other segments the increase was more moderate at ca. 10bp. For example, for loans collateralised by residential real estate (RREs), banks reported only a marginal increase. The share of fixed rate loans – at least in biggest jurisdictions – for mortgage loans presumably acts as a safety net for borrowers.

EU/EEA banks not only reported a higher inflow of NPLs in their balance sheets but also reported a lower outflow of NPLs. In 2023, a total NPL inflow of EUR 187bn (EUR 168bn in 2022) was reported, and a total NPL outflow of EUR 178bn (EUR 202bn in 2022). The change in NPLs over the last year varied significantly across countries.

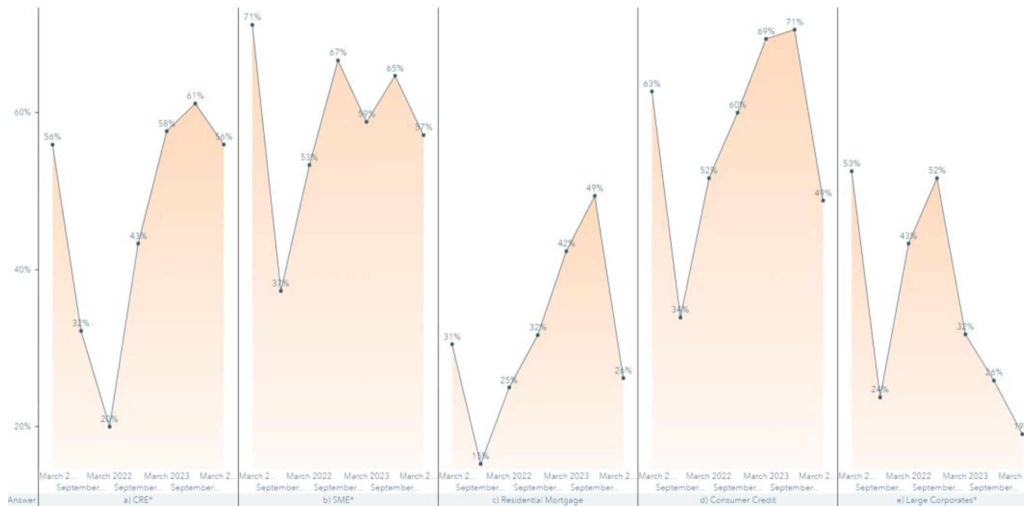
Banks also reported a similar increase in the allocation of loans in lower quality IFRS credit risk stages. Loans allocated in stages 2 and 3 increased by more than 3% in 2023. Stage 3 loans stood at EUR 340bn. Stage 2 loans rose by more than EUR 50bn and stood at EUR 1.5tn as of December 2023. The share of stage 2 loans to total loans was at 9.6%, the highest level ever reported by EU/EEA banks in EBA supervisory reporting. As regards CRE loans, their share allocated in Stage 2 rapidly increased since the outset of the pandemic. In December 2023, EU/EEA banks reported more than EUR 240bn CRE loans allocated to IFRS 9 stage 2 (+8% year on year increase), and increased them by more than EUR 10bn in the last quarter of 2023 alone, signalling a rising pace in this trend.

The reported unrealised losses of EU/EEA banks' debt securities recognised at amortised cost were substantially lower despite higher exposures towards debt securities. In December 2023, EU/EEA banks reported EUR 52bn of unrealised losses compared to more than EUR 99bn a year earlier. On average unrealised losses represent less than 3.5% of the EU/EEA banks' equity.[14]

Looking ahead, the spring 2024 EBA Risk Assessment Questionnaire (RAQ) suggests that banks' expectations for asset quality have stabilised, and partially even improve from the subdued outlooks in previous questionnaires. Expectations for asset quality of household exposures have improved significantly, probably supported by continued strong labour markets and expectations of declining interest rates. However, for NFC exposures, the majority of banks still expect deteriorating asset quality for SMEs and CRE lending.

[14] Financial assets held at amortised cost is an accounting classification, which is subject to certain conditions, such as for instance a bank's objective to hold the respective assets in order to collect contractual cash flows (see the IFRS Foundation's overview of IFRS 9 Financial Instruments). This makes it possible to reduce the sensitivity of the accounting profit and loss statement (P&L) to e.g. interest rate changes.

Fig 19: Banks' expectations on possible deterioration in asset quality in the next 12 months by segment

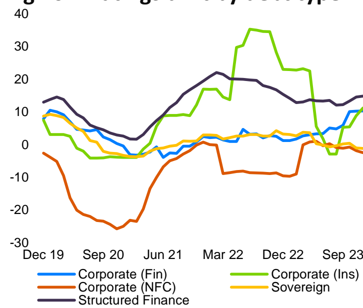


Source: EBA supervisory reporting data

Credit quality trends in debt securities

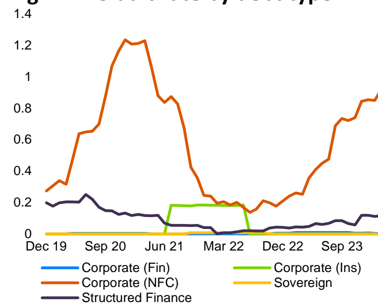
Corporate non-financial debt instruments have been most affected by a downturn in credit quality. Looking at credit ratings for debt instruments publicly issued in the EEA, there are signs of credit deterioration since 2022, particularly for instruments issued by non-financial corporates for which the ratings drift, a metric of the overall direction and pace of rating changes, has been negative and trending downwards, which implies that the downgrades have been increasingly outpacing upgrades. The default rate for these has also been rising, starting to approach levels last seen in the pandemic. As expected, the poorer credit quality is not seen in covered bond issuances, where drift for non-financials has been stable and very close to zero, indicating little rating change. Instruments issued by financials and insurers have also generally maintained positive ratings drift with very low or zero default rates.

Fig 20 – Ratings drift by debt type



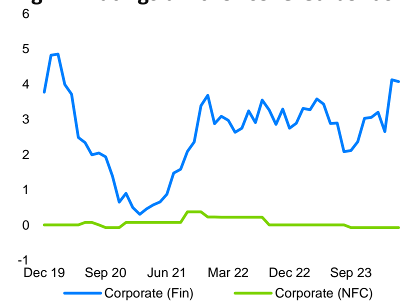
Note: 12 month ratings drift for EEA-issued debt instruments by debt type in percent..
Sources: RADAR, ESMA.

Fig 21- Default rate by debt type



Note: 12-month default rate for EEA-issued instruments by debt type in percent.
Sources: RADAR, ESMA.

Fig 22- Ratings drift for covered bonds

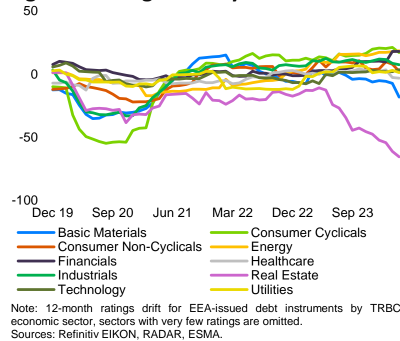


Note: 12 month rolling EEA-issued covered bond corporate ratings drift in percent, split by financials and non-financials.
Sources: RADARs, ESMA.

Among non-financial corporates, the real estate sector has been particularly affected.[15] Higher rates typically drive a downturn in real estate and this is what has happened in this economic cycle. Moreover, the current downturn has been exacerbated for commercial real estate by a fall in the demand for office space from increased working from home following the pandemic. In terms of credit quality, the real estate sector has been the sector within non-financial corporates that has been most impacted, as visible in its strongly negative and falling ratings drift. It has also experienced the highest jump in default rates across different sectors.

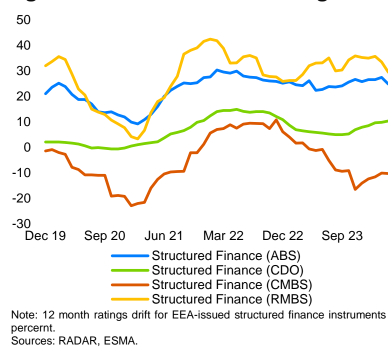
[15] See ESMA - Real estate markets – Risk exposures in EU securities markets and investment funds – January 2024.

Fig 23 – Ratings drift by sector



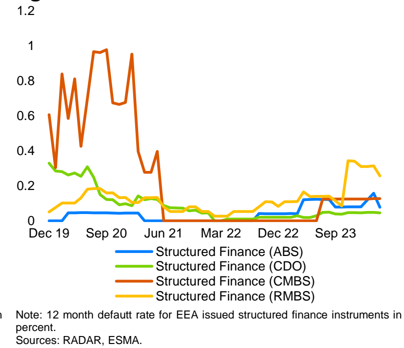
Note: 12-month ratings drift for EEA-issued debt instruments by TRBC economic sector, sectors with very few ratings are omitted.
Sources: Refinitiv EIKON, RADAR, ESMA.

Fig 24- Structured finance ratings drift



Note: 12 month ratings drift for EEA-issued structured finance instruments in percernt.
Sources: RADAR, ESMA.

Fig 25-Structured finance default rates



Note: 12 month default rate for EEA issued structured finance instruments in percent.
Sources: RADAR, ESMA.

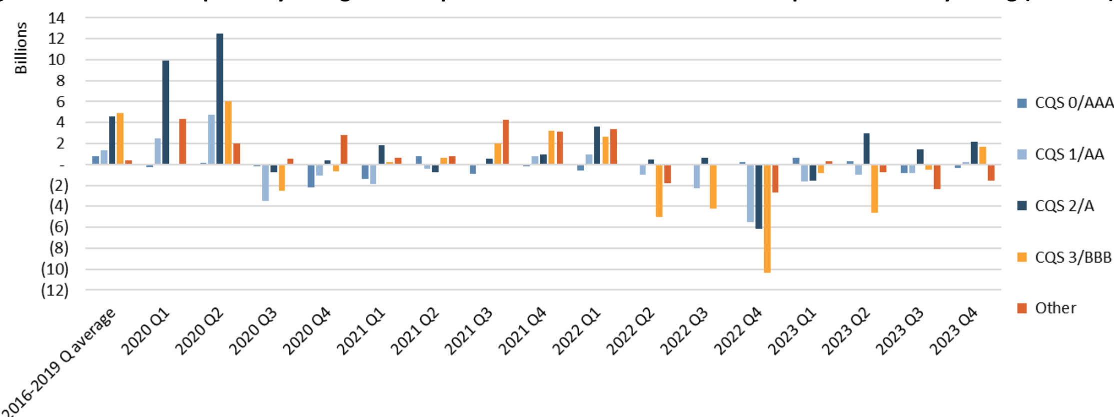
Signs of credit quality deterioration have also appeared for EEA commercial mortgage-backed security (CMBS) and residential mortgage-backed security (RMBS) structured finance instruments. CMBS ratings drift has fallen as interest rates have risen, in contrast to other structured finance instruments. The recent deterioration in ratings drift in CMBS also aligns with continuing challenges facing the commercial real estate from both higher interest rates and continuing occupancy levels below those observed before the pandemic. Nonetheless default rates, after jumping for CMBS during the pandemic, have remained low, indicative that the relatively small CMBS market is now likely to be of higher quality than it was before the pandemic. Interestingly given its continued positive drift, RMBS experienced a jump in default rates recently, showing that some RMBS tranches have nonetheless defaulted.

Overall, the credit quality of insurers' and IORPs' investments remained high and both have moderate exposure to low rated investments (CQS>3). The median Credit Quality Steps of insurers' assets at around 2, corresponding to AA S&P rating. The median share of their assets below investment grade is low and around 1.1%. The distribution of credit quality of the bonds held by European insurers overall has been stable across quarters. The share of investment grade bonds with BBB, which have the highest risk of being downgraded below investment grade, has slightly decreased. Nevertheless, the risk of massive rating downgrade could significantly impact the market value of bond portfolios and, at the same time, increase the solvency capital requirement for spread risk and remains under close monitoring.

IORPs' investments have on average a CQS of 1.5, corresponding to an S&P rating between AA and A. The median exposure of IORPs to below investment grade assets (with a CQS higher than 3) is low (0% in the fourth quarter of 2023), though when considering the weighted average the figure increases (5.3%), indicating higher exposures for larger IORPs.

In 2023 insurers did not increase exposures on corporate bonds issued by non-financials, but some rebalancing across rating categories has taken place. Except Q1 2023, insurers have been net buyers of A rated bonds and throughout the year they have been net sellers of BBB rated and below investment grade bonds. This trend has already been observed since the mid-2022. A possible explanation is that insurers have been reducing exposures towards credit risk in reaction to the increase of the interest rates, in anticipation of a potential economic slowdown and of an increase of credit risk.

Fig 26: Break down of quarterly changes in the position of insurers in non-bank corporate bonds by rating (bn. EUR).



Source: EIOPA Quarterly Solo and EIOPA calculations. Reference period: 2016 to Q4 2023

However, some caution should be considered in drawing conclusion regarding the credit quality trends. EIOPA has limited information on the creditworthiness of bonds held in insurers' and IORPs portfolios through funds.

The risk of materialisation of credit risk also remains elevated for bond funds in the high-yield segment. The credit quality of high-yield portfolios stabilised between BB- and B+ on average since 2021, showing a deterioration, compared to BB on average pre-pandemic. In contrast, MMF tend to invest in short-term cash-like instruments (government bonds, money market instruments, repos) with relatively low credit risk. However, these are vulnerable to other risks, particularly liquidity, as explored in depth in a recent ESMA article.[16]

Credit risk could lead to liquidity risk for real estate funds, which could drive losses for investors. A worsening of credit quality and downgrades in the real estate market might trigger heavy redemptions, which would lead to heightened liquidity issues for real estate funds, especially for open-ended funds with daily or weekly redemption terms and low liquidity buffers. Furthermore, the recent US case of Starwood Real Estate Investment Trust (Sreit),[17] one of the largest unlisted US property funds, also shows how falling property valuations in a high interest rate environment can lead to funds' liquidity issues.

However, systemic risk at EU level from real estate funds remains low. In terms of valuation and flows of real estate funds, valuation adjustments occurred at EU level in 2023, with positive effects so far in 2024. Real estate funds faced mild outflows since the beginning of 2024, which currently are not pointing to a stress situation for the industry overall. Within the largest jurisdictions at EU level the risk of unrealised losses and disorderly outflows appear limited. Some sign of stress has been observed in smaller jurisdictions.

Private credit in Europe

Private credit investments are debt-like, non-publicly traded instruments provided by non-bank entities, such as private credit funds or business development companies (BDCs), to fund private businesses (FED). It benefits the economy by providing an alternative source of long-term financing to corporate borrowers, and suffers limited vulnerabilities due to its modest leverage, locked-up capital funded loans and limited interconnectedness (IMF).[18] For borrowers, increased competition tends to improve access to finance and reduce financing costs. For the wider economy, better risk sharing and more opportunities for projects to be financed may translate into more investment at the macro level.

Recently, private credit has become a particular focus amid the rapid expansion of lending volumes. Globally, the private credit market doubled in size since 2015 and now weighs at least USD 1.7tn worldwide[19]. In the EU,

[16] Bouveret (2021), 'Vulnerabilities of money market funds', TRV article 2021, no.1.
[17] Since the beginning of 2023 Starwood faced heavy redemption requests from investors. To raise the necessary liquidity, it has drawn almost all of its unsecured credit facility lines and in May it has imposed gates.
[18] See IMF (2024), 'Global Financial Stability Report', April.
[19] See IMF (2024), 'Global Financial Stability Report', April.

direct non-bank lending nevertheless remains relatively modest compared to the US, with an AUM of USD 460 bn in the European private debt market, compared to USD 982 bn in the US market[20].

The private credit market is very diverse, with a focus on direct lending, particularly in sectors such as professional services and technology (S&P). Direct lending by non-banks to non-financial sectors has become a particular focus recently amid the rapid expansion in lending volumes. Market participants value private credit for its confidentiality, flexible structuring, and efficiency of execution.[21]

Several factors have contributed to the growing private credit market. The Basel III regulatory reform may have impacted bank lending and created incentives for banks to adjust balance sheets to comply with the new requirements **and may have involved refocusing of activities of individual banks, including reducing certain more capital-intensive business.** From the borrowers' perspective, the sharp increase in interest rates and the subsequent tightening of bank lending standards, created challenges especially for firms and households with weaker balance sheets. The higher interest rate environment also adversely affected the cost of debt financing for funds active in the mergers and acquisitions (M&A) and buyout markets, pushing asset managers and private equity funds to seek alternative ways of deploying capital. These developments also contributed to an environment where many borrowers with higher risk profiles were facing steeply higher financing costs, and new alternative credit providers were looking to enter the lending market.

Nonetheless the market's increase in size and continued opaqueness could transform fragilities into financial stability risks, for example, if unexpected and sudden waves of defaults or delinquencies need to be absorbed. The private credit market has also expanded rapidly with varying or without prudential and conduct oversight. The new players in the lending market may also apply less prudent lending standards than banks or other established lenders. Lending from less regulated and transparent markets also involves the use of unrated assets whose valuation is infrequent and relies on mark-to-model pricing methods. As a result, the evaluation of credit quality is more challenging and private credit lenders are thus exposed to a higher risk of runs in a downturn.

If non-bank providers of private credit were to capture meaningful market shares in some lending segments, such as consumer credit or SME lending, **several borrowers could withdraw simultaneously in the event of economic downturn or market stress and create unforeseen financial stability risks**. There are also questions about the resilience of non-banks to cyber risk, their ability to protect sensitive customer data, and to comply with anti-money laundering and customer identification rules. Shareholders of some non-bank lenders may moreover follow more short-term incentives of, e.g., expected returns than their peers in the banking industry. The ability to provision for expected losses and to withstand unexpected losses may be weaker than that of banks which have the experience of managing risks throughout the full credit cycle.

Risks also stem from the market's opacity. Evidence suggests that the amount and frequency of repeat-defaults is high among private credit borrowers (FED, S&P). However, scarcity of data makes it very difficult to monitor developments and identify early warnings of potential issues.

The banking sector is strongly intertwined with non-bank providers of private credit. This increases the risks that these providers might pose to banks. Banks are linked to non-bank providers via asset and liability exposures in loans and deposits, while non-bank providers of credit are major holders of bank-issued debt securities. The links of the banking sector to these credit providers are somewhat more pronounced on the banks' liabilities side (i.e. funding links). Banks provide mostly short-term liquidity in the form of short-term loans such as repos. Non-bank providers also hold over 25% of total short- and long-term debt securities issued by banks. On the side of counterparties of banks, the "other financial institutions sector" and the "investment fund" sector each hold ca. 12% of all bank-issued short- and long-term debt securities. Large banks have stronger links to the non-bank sector, with exposures amounting to 11.1% of total consolidated assets, followed by medium-sized banks (6% of total assets), and small banks (5.2% of total assets).[22]

In the insurance sector, private credit represents a modest percentage of Insurers' investment portfolios on average, with exceptions for bigger undertakings. Private credit, defined as exposure to corporate bonds and

[20] See S&P (2023), 'Credit FAQ: How Private Credit's European Expansion Brings Rewards And Risks', November.

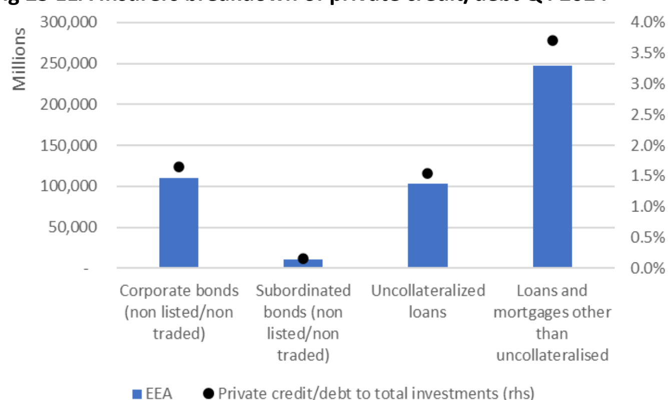
[21] The ECB estimates that as of the third quarter of 2023, assets under management of euro area private market funds (including private equity and private credit) stood at EUR 960bn, or 6% of the euro area investment fund sector's total assets, which is substantially smaller than in the US. The compounded annual growth rate of the private credit segment is estimated at 14% (see e.g. ECB Financial Stability Review from May 2024 and ECB IVF statistics).

[22] The asset exposures are concentrated in loans classified in non-trading portfolios (4.3% of total assets), followed by OTC derivative assets (1.9% of total assets), loans for trading activities (1.6% of total assets), reverse repos (1.3% of total assets), debt securities (1.2% of total assets) and equity exposures (0.4% of total assets).

subordinated bonds[23] that are non-traded/non-listed and uncollateralised loans, corresponds to 3.4% of total investments.

As private credit continues to expand in both size and influence, the cumulative effect of the risks in the private credit market may have significant economic implications. A case in point includes the change in the approach to reinsurance where the ceded risks include underwriting as well as investment risk. This change in business model, which might imply cross-border interlinkages with private equity owned reinsurers, intensifies credit risk and increases the complexity of its assessment. Should the asset class persist in its opacity and grow exponentially without prudential oversight, the inherent risks within the private credit industry could become systemic.

Fig 25 EEA Insurers breakdown of private credit/debt Q4 2024



Note: Breakdown of private credit/debt by private (i.e., non listed/non-traded) bonds [CIC XT21-28 and XL21-28] and uncollateralised loans [CIC 81] and share of private credit/debt to total investments. Source: EIOPA Central Repository and EIOPA calculations. Quarterly reporting solo.

2.4 Conclusions

Credit quality has deteriorated as interest rates have risen and economic conditions have become more challenging. Effects have varied. Banks have experienced some deterioration in loan quality, but this has been limited and there are early signs banks expect the situation to improve over the coming year. Some sectors experiencing more significant impacts, particularly commercial real estate, high-yield corporate debt securities and CMBS. Elevated levels of refinancing in the coming years and continuing 'higher-for-longer' rates, even with rate cuts, will mean credit risks will remain an issue for more vulnerable firms.

Robust credit risk management remains key including up to date collateral valuation for banks and for non-bank firms exposed to credit risk. Adequate and timely provisioning in anticipation of credit quality deterioration can protect lenders and holders of debt securities from negative hits to profitability. The latter can happen if asset quality deterioration is addressed too late. Banks need to apply proper lending standards, including in the CRE segment when other lending providers step out from respective financing. It is also important that banks maintain a continuously cautious stance concerning payouts while risks and uncertainties remain elevated.

Non-bank lending has increased in relevance. Transparency on private credit should be improved. Risk management and loan origination standards applied might require further scrutiny, to make sure that expected and unexpected losses are sufficiently covered and that credit allocation to the economy remains efficient. To detect potential contagion channels from private credit early on, supervisors and macro-prudential authorities also need to have a particular focus on the direct and indirect linkages between banks and non-bank lending.

[23] (CIC 2.1 and 2.8 in Solvency II reporting)