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JOINT COMMITTEE REPORT ON

RISKS AND VULNERABILITIES IN THE EU FINANCIAL SYSTEM

MARCH 2021

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EXECUTIVE SUMMARY AND POLICY ACTIONS

The COVID-19 pandemic continues to weigh heavily on the recovery prospects. While the roll-out of vaccines has started, continued COVID-19 infections, risks related to virus mutations, and concomitant containment measures are weighing on short-term recovery prospects. Uncertainty about the further trajectory of the pandemic remains extremely high. So far, swift and broad-based policy support measures across the EU have helped stabilise household incomes and mitigate adverse implications on the corporate sector. But these support measures are likely to become more targeted and will expire at some point—not least depending on the fiscal space of governments.

The financial sector has so far proven resilient to the impact of the COVID-19 crisis. Although risks concerning valuation, liquidity, credit and solvency have increased across the board in 2020, financial institutions continued to fulfill their role in the economy. However, the longer the pandemic continues, the greater will be its impact on households and the non financial corporates (NFC) sector as well as the spillover effects on financial institutions. Large uncertainties about the economic consequences of the pandemic are still leading to a fragile market environment going forward. Financial markets are vulnerable to volatilities and market players should be prepared for possible further market corrections. Currently, a potential decoupling of financial market performance from underlying economic activity not least raises questions about the sustainability of the recent market recovery. **The pandemic has also added to pre-existing profitability challenges of financial institutions, led to liquidity challenges in segments of the investment fund sector, and is expected to result in deteriorating asset quality in the EU banking sector.**

In light of the above mentioned risks and uncertainties, **the Joint Committee advises the ESAs, national competent authorities, financial institutions and market participants to take the following policy actions:**

1. **Financial institutions and supervisors should be prepared for an expected deterioration of asset quality**. Banks should adjust their provisioning models to adequately address the impact of the economic shock of the pandemic, and to ensure a timely recognition of adequate levels of provisions, having at the same time an appropriate allocation of financial instruments within the IFRS 9 impairment stages. It is also important to engage at an early stage with struggling borrowers to efficiently restructure overindebted, but viable exposure and NFCs . In addressing non-performing or non-viable exposure, banks should apply the most suitable strategies early on, which may, e.g., include an effective restructuring or the sale of non-performing exposures to credit acquiring companies. As part of the European Commission's action plan to tackle the expected rise of non-performing loans (NPL), the EBA will, work on improving NPL data quality and comparability, on data infrastructures needed for development of secondary markets for distressed assets, and revise its NPL data templates. **To supervisors, banks' provisioning policies should continue to be a point of particular attention** to ensure a consistent and high-quality implementation of the relevant accounting requirements, and to ensure that provisioning policies reflect the underlying deterioration in asset quality, including for loans that are currently covered by loan repayment moratoria. Other financial institutions should monitor their investments in corporate bonds and into private lending.

2. **Supervisors, policy makers and financial institutions should continue to develop further actions to accommodate a "low-for-long" interest rate environment and its risks.** While low interest rates are important to support economic activity, they negatively impact banks' interest income and remain the main risk for the life insurance and pension fund sector. They contribute to the further build-up of valuation risks in securities markets through search-for-yield strategies and the potential decoupling of valuations and underlying economic activity. For insurers, it is important that the regulatory framework also reflect the steep fall of interest rates experienced in the last years and the existence of negative interest rates. Proposals to this aim, as well as other proposals aiming to keep the regulatory framework fit for purpose have been sent by EIOPA to the European Commission in its Opinion on the Solvency II 2020 review.

Financial institutions should also continue to monitor and be prepared to changes in interest rates, especially in light of the recent upward shifts of long-term interest rates and the consequent concerns about re-emerging inflationary pressures.

3. **Notwithstanding the importance of continued lending in the crisis, banks should ensure sound lending practices and adequate pricing of risks**, which should be monitored by supervisors. Banks should continue to make thorough risk assessments to ensure that lending remains viable in the future, including after public support measures, in particular loan moratoria and public guarantee schemes (PGS), will expire.
4. **Financial institutions should continue to follow conservative policies on dividends and share buy-backs. Particular prudence is required to maintain sufficient** capitalisation as a necessary condition for the continuous financing of the economy. Any distributions should not exceed thresholds of prudency and institutions should ensure that the resulting reduction in the quantity or quality of their own funds remains at levels appropriate to the current and prospective levels of risk.

5. **Investment funds should further enhance their preparedness in the face of potential increases in redemptions and valuation shocks.** To this end the alignment of fund investment strategy, liquidity profile and redemption policy should be supervised, as well as funds' liquidity risk assessment and valuation processes in a context of valuation uncertainty. Further, there is a need for additional specifications for liquidity profiles and reporting and an increase of the availability and use of liquidity management tools, which should be taken forward in the context of the Alternative Investment Fund Managers Directive (AIFMD) review and the harmonisation between the UCITS and AIFMD frameworks to ensure greater protection of investors, the consistent use of these tools and a consistent reporting frameworks, to support ultimately greater protectionof investors.

INTRODUCTION

Macroeconomic conditions improved in the second half of 2020, but the resurgence of the COVID-19 pandemic since Q4 2020 has compounded economic uncertainty. The start of the rollout of vaccinations provides a crucial anchor for medium-term expectations, but insufficient production capacities and delays in vaccine deliveries as well as risks related to mutations of the virus are heavily weighing on short-term recovery prospects. In its Winter 2021 forecast, the European Commission estimated a -6.3% contraction of the EU GDP in 2020, with output continuing to contract for the first quarter of 2021. The EU GDP growth forecast was slightly revised downwards for 2021 (to +3.7% from +4.1%), while it is stronger for 2022 (+3.9%).[1] Output should reach pre-crisis levels earlier than expected in mid-2022, but the speed of the recovery will be uneven across countries. Important measures in response to the COVID-19 crisis were introduced at the European level. The ECB increased its Pandemic Emergency Purchase Programme (PEPP) of private and public sector securities up to EUR 1.85tn and extended it until at least March 2022[2]. Further public support measures, in particular the EUR 750bn EU recovery and resilience instrument "NextGenerationEU" introduced to address to the immediate economic damage brought about by the pandemic, are playing an important role in mitigating the impact of the crisis. Yet these measures also led to a sharp increase in government debt.

Macroeconomic uncertainty was generally not reflected in asset valuations and market volatility which recovered to pre-crisis levels, thus highlighting a continued risk of decoupling of valuations from economic fundamentals. The profitability of banks and insurers is expected to remain weak, although capital and solvency positions have remained sound for now. Banks are facing added pressure on profitability amid increased

1 https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/winter-2021-economic-forecast-challenging-winter-light-end-tunnel_en
2 See https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.mp201210~8c2778b843.en.html

provisioning and low revenues. They are moreover facing long term challenges from the ongoing margin compression in a low yield environment, high operating costs, the need for technological transformation of their business models and related required further expenditures, as well as overcapacities. Insurers' profitability is affected by the prolonged low(er) interest rate environment and by both lower revenues and higher claims resulting from confinement measures

Against this background, this report focuses on the impact of the COVID-19 pandemic on the financial sector and the risks going forward amid widespread uncertainty around the recovery. The report also provides a brief update on Brexit implications.

1 MARKET DEVELOPMENTS

Equity markets have continued their recovery during the second half of 2020, albeit at a slower pace compared to the rapid gains after the COVID-19 related market stress. Overall, EU equity market valuation increased by 10% in this period. The market recovery was backed by fiscal, monetary and supervisory support, as well as by the stronger-than-expected rebound in economic activity in the third quarter following the easing of containment measures. However, the resurgence of COVID-19 infections together with uncertainty related to the US election led to a sharp decline in valuation of around -5% and heightened volatility in October. This trend was quickly reversed in November, driven by positive news related to the development of coronavirus vaccines. The subsequent elevated asset valuations in equity, but also fixed income markets continue to raise concerns about the sustainability of the market rebound, in the context of a deep recession and uncertainty around the speed and size of the economic recovery.

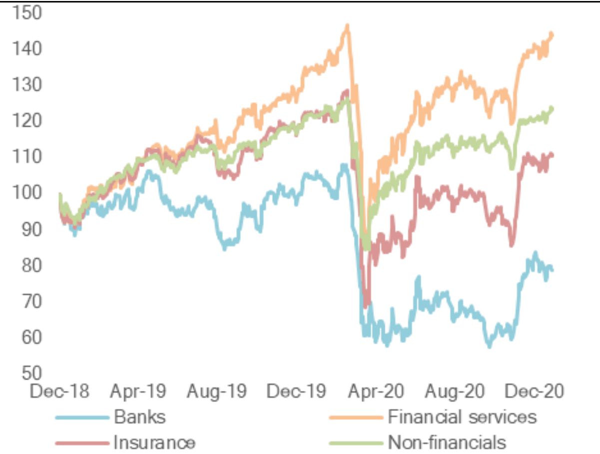
Retail participation in equity markets has risen during lockdowns across Member States. Likely drivers of this development include the widespread availability of online and mobile investment tools and a rise in households' overall savings rate as a result of decreased consumption opportunities. Furthermore, recent episodes have seen certain US stocks (e.g. Gamestop, AMC) experience high price volatility based on information shared on social media. An increased participation of retail investors in stock markets is welcome for the development of the Capital Markets Union. Nonetheless, retail investors have to be careful when taking investment decisions based exclusively on information from social media and other unregulated online platforms, if they cannot verify the reliability and quality of that information. Retail investors can face significant risks when investing in stocks characterised by very high price volatility, including when stocks are subject to heavy short selling. Although market rules and structures are different in the EU, it cannot be ruled out that similar circumstances may develop here. In consequence, ESMA has released a statement highlighting risks connected to social media driven trading decisions for retail investors.[3] ESMA and the NCAs will continue analysing market events and consider adopting further initiatives aimed at preserving investor protection and market integrity as appropriate.

The recovery of financial markets is uneven among sectors and countries. Some sectors appear to have benefited from the crisis, such as the technology or consumer sectors, whilst financials remain behind and other sectors (leisure, travel and tourism) face significant challenges. The dispersed impact of the crisis on European countries is observed through significant variations in equity market performance across member states, ranging from +18% in Denmark to -19% in Spain, reflecting the impact of the pandemic and the containment measures as well as sectorial specialisation. Across sectors, banks' valuations remain particularly low (Figure 1). In the banking sector, increased lending volumes to the real economy since the start of the pandemic are providing

[3] https://www.esma.europa.eu/sites/default/files/library/esma70-155-11809_episodes_of_very_high_volatility_in_trading_of_certain_stocks_0.pdf

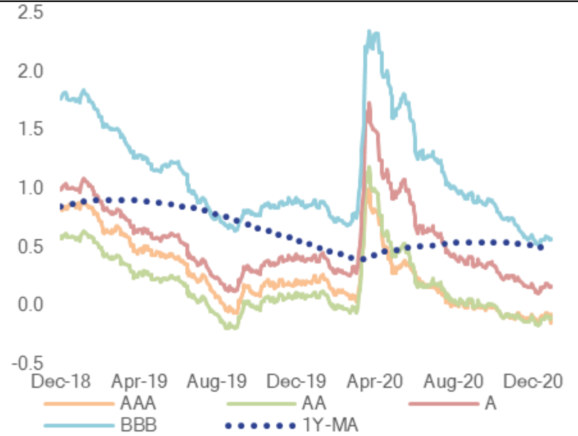
important support in the downturn. Yet volumes of new lending might not be sustainable once public support schemes such as PGS expire, or for banks with high levels of legacy NPL from before the pandemic.

Figure 1: European financials return indices



Note: STOXX Europe 600 sectoral return indices. 01/12/2018=100.
Sources: Refinitiv Datastream, ESMA.

Figure 2: EA corporate bond yields

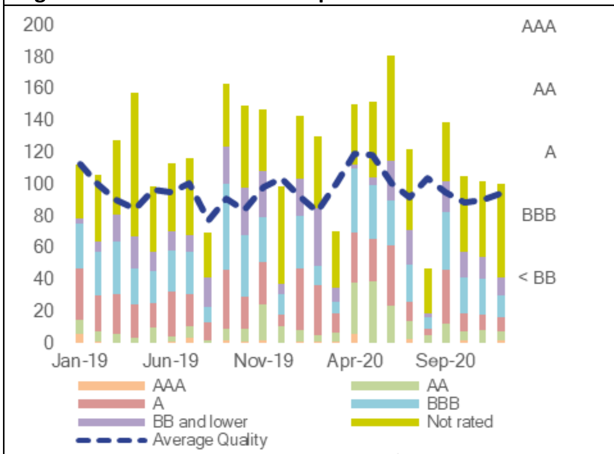


Note: : ICE BofAML EA corporate bond redemption yields by rating, in %. 1Y-MA=one-year moving average of all indices.
Sources: Refinitiv Datastream, ESMA.

In line with equities, **fixed income markets also continued to recover in the second half of 2020, with strong valuation increases over the summer and a surge in bond issuance**, especially for riskier segments such as emerging market and high-yield (HY) debt, all ending the year above pre-crisis levels. Particularly, EA corporate bond spreads declined below pre-crisis levels across all rating categories (moving below zero since October 2020 for AAA- and AA-rated corporates) indicating renewed search for yield behaviour (Figure 2).

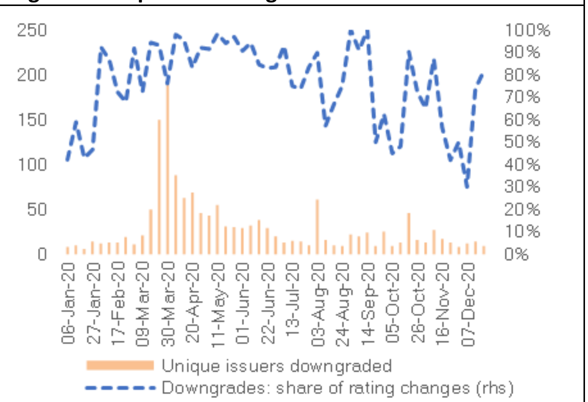
The extension of monetary and fiscal support measures, as well as the necessity for companies to meet their liquidity needs, combined with the continuing low interest rate environment are drivers for elevated corporate debt issuance in 2020. Overall, 75% of the issued rated corporate bonds were IG, amounting to a total market size of EUR 260bn. In the HY corporate segment, issuance activity increased from June onwards to a total of EUR 40bn. Overall, the average credit quality of issued bonds has deteriorated to BBB towards the end of the year, compared to an average rating of A during 2Q20 (Figure 3).

Figure 3: Gross issuance of corporate bonds



Note: Monthly corporate bond issuance in the EEA30 by rating, EUR bn, and average issuance rating (rhs).
Sources: Refinitiv Eikon, ESMA.

Figure 4: Corporate downgrade ratio and levels



Note: Number of EU27+UK corporate issuers with at least one bond downgraded, and ratio of dowgraded corporate issues over upgrades and downgrades (rhs). First and final weeks of 2020 omitted due to very limited rating activity in those weeks.
Sources: ESMA, RADAR

Following the policy interventions, and the relaxation of confinement measures in many jurisdictions over the summer with the associated recovery in economic activity, **the pace of downgrades slowed reflecting an improving credit risk outlook.** Furthermore, the ratio of downgrades to all rating changes continued to trend downwards in late 2020 (Figure 4).[4] However, levels of downgrades among corporate issuers remained higher and more volatile in October and November than the pre-crisis period. This reflects continuing uncertainty as to the possibility, extent and timing of future waves of the pandemic and the extent to which economic activity will be able to return to more normal levels, particularly in more vulnerable sectors. Corporate rating activity continues to show strong differences across sectors.[5]

The increase in rating downgrades led to "fallen angels" and continues to do so, especially in corporates. Partly as a result of downgrades, partly due to relatively high share of BBB-rated debt issuance in recent months, the share of corporate ratings that are just investment grade (BBB) and just high yield (BB) grew. The increased share of ratings at the BBB-level highlights the continuing relevance of the risks related to "fallen angels".

BOX: Brexit update

As the UK's transition out of the EU ended on 31 December 2020, major economic disruption for EU Member States was avoided, in part due to the trade deal that was agreed between the EU and UK before the end of the year. In financial services, the end of the transition period did not lead to any major negative impact on EU markets. Due to the preparations undertaken by the ESAs, NCAs and market participants in the lead up to the end of the transition period, there was a high degree of readiness and contingency planning by EU firms. For UK firms who wished to continue providing services in the EU after losing access to the single market, many of them had taken the necessary steps by attaining EU authorisation to do so. NCAs, in coordination with the ESAs, will closely monitor the activities of relocated entities to ensure they now adhere to their agreed establishment plans. Similarly, risks of unauthorised business being provided in the EU by UK-based firms will be monitored and addressed where identified.

In the areas of central clearing and settlement, the time-limited equivalence decisions by the Commission, and subsequent recognition decisions by ESMA mitigated the possible financial stability and disruption risks. Three UK CCPs are now permitted to continue providing services in the EU for 18 months, while one UK CSD is permitted to continue providing services in the EU for 6 months. Regarding the trading of shares and derivatives, following the ESMA statements on the STO and DTO in October and November 2020, no major issues were identified as disrupting trading activity or market operations when markets reopened on 4 January 2021. At the beginning of the year, there was an immediate and significant shift of EU share trading from UK trading venues to EU trading venues, representing around €6.3 billion of trades.

2 DEVELOPMENTS IN THE FINANCIAL SECTOR

The asset management industry continued to see high inflows in H2 2020 across fund types. Cumulated flows during 2020 into bond funds amounted to 8.3% of NAV, of which 4.9% in H2 2020, compared with 5.6% for equity funds (4.5% in H2 2020) and 3% for mixed funds (2.4% in H2 2020). The difference in flows across fund types can be partly explained by the relative performance of the strategies. In H1 2020, the performance of fixed income markets has been higher than for equities while it was the reverse in H2 2020, with higher equity returns

[4] The fall in downgrades relative to upgrades was also seen in asset classes other than corporates.
[5] S&P scenario modelling analysis of European corporate credit risk. See https://www.spglobal.com/marketintelligence/en/news-insights/blog/european-corporate-credit-risk-outlook-covid19-pandemic-and-macroeconomic-scenarios

and high inflows into equity funds. For EM and HY bond funds, inflows have been substantially higher than what would be expected based on returns. One factor could be that the flow-return relationship might be stronger for riskier funds.[6] Liquidity risk in corporate bond funds as well as in real estate funds was particularly investigated in response to a recommendation issued by the ESRB.[7]

BOX: Liquidity risks in corporate debt and real estate funds

On 6 May 2020, the General Board of the ESRB adopted a Recommendation to ESMA to coordinate with NCAs a focused supervisory engagement with investment funds that have significant exposures to corporate debt and real estate, in order to assess their preparedness to potential future redemptions and valuation shock.

The exercise included: i) an analysis of how funds have reacted since the onset of the Covid-19 pandemic (between February and March 2020), ii) an analysis of their situation in June 2020, iii) an estimation of their resilience to a future shocks (stress testing), and iv) consideration on whether additional actions are needed to foster asset managers' preparedness.

ESMA published the results of this supervisory engagement in November.[8] The report includes an assessment of corporate bond funds resilience to a future shock based on ESMA's fund stress simulation framework (STRESI).[9] Results show that UCITS and AIFs exposed to corporate debt and real estate funds under review overall managed to adequately maintain their activities when facing redemption pressure and/or episodes of valuation uncertainty. However, the results should be interpreted with caution since the redemption shock was concentrated over a short period of time, amid significant government and central bank interventions. Some vulnerabilities emerged, especially:

- **Liquidity risk and management**: Some funds presented potential liquidity risks and deficiencies in liquidity risk management or valuation processes; only few funds have adjusted liquidity processes in light of the Covid-19 market stress.
- **Asset valuation**: Concerns over valuation of portfolio assets have clearly emerged, especially. for real estate funds with; a significant impact over the longer term. The availability of **liquidity management tools (LMTs)** varies considerably across EU jurisdictions, depending on national rules and adoption by the funds. In addition, the adoption of LMTs by real estate funds is more limited and additional risks from loan covenants have been identified.

Against this background, ESMA identified five priority areas to further enhance the preparedness of corporate debt and real estate funds to potential future redemptions and valuation shocks. Three priority areas relate to key provisions that management companies should strictly observe such as (i) the requirement to align the fund's investment strategy with the redemption policy; (ii) the quality of the liquidity risk assessment; and (iii) valuation processes in a context of valuation uncertainty.[10] NCAs are encouraged to pursue the ongoing

[6] ESMA (2019) found that a 1% increase in returns leads to close to 2% of inflows for HY bond funds, while for mixed funds inflows would amount to less than 1%.

[7] On 6 May 2020, the General Board of the ESRB adopted a Recommendation to ESMA to coordinate with NCAs a focused supervisory engagement with investment funds that have significant exposures to corporate debt and real estate, in order to assess their preparedness to potential future redemptions and valuation shock.

[8] ESMA, Report on the Recommendation of the ESRB on liquidity risks in investment funds, November 2020.

[9] See 'Fund stress simulation in the context of COVID-19', ESMA Trends Risks and Vulnerabilities report No.1 2021, pp. 86-91.

[10] In response to the COVID-19 crisis, ESMA has reinforced its coordination role regarding investment fund supervision through the organisation of frequent exchanges with NCAs to discuss market developments and supervisory risks, in particular on liquidity issues. ESMA has also organised regular data collection on the use of LMTs by EEA UCITS and AIFs. From a financial stability perspective, ESMA considers that the priority areas aiming at reducing the liquidity and valuation risks at the level of the investment fund should reduce the risk and the impact of collective selling by funds on the financial system. ESMA will continue to monitor this risk through regular assessments of the

monitoring of compliance with these rules, while ESMA will pursue its coordination work to foster supervisory convergence in these areas. Another priority area is the increase of the availability and use of liquidity management tools (LMTs), which should be taken forward in the context of the AIFMD review. Both the ESRB and ESMA have recommended already earlier the adoption of harmonised rules regarding LMTs in the UCITS and AIFMD frameworks to ensure greater protection of investors and the consistent use of these tools. The last priority area relates to the enhancement of fund liquidity profile reporting under the AIFMD, to support a risk-based supervision of liquidity risks.

Capital buffers of insurers remained solid throughout 2020, while signs of deterioration for insurers' profitability, subsequent to the COVID-19 impact, are already observed. Capital buffers were strong at the end of 2019 (median SCR ratio 213%) and proved resilient during the COVID-19 related market stress, declining in Q1 (203%) and reverting upwards again in Q2 2020 (210%). In addition, the median exposure to return on excess of assets over liabilities slightly declined to 5.9% in Q2 2020 (from 7% in Q4 2019). The outlook for the insurance and pension fund sectors depends critically on the future development of the pandemic and on the resilience of the economic recovery. Life undertakings are affected the most in the long term. The prolonged period of ultra-low yields and financial market volatility is negatively affecting the profitability prospects of insurers' investment portfolios, due to reinvestment risk. In addition, the continued risk of deterioration of corporate ratings could affect the market value of insurers' corporate bond holdings.

IORPs' investments had suffered significant losses in the wake of the COVID-19 pandemic, followed by a recovery in the second quarter of 2020. At the same time, investment allocations and strategies of IORPs in Europe are quite diverse. The international macroeconomic environment, coupled with the prolonged period of low interest rates, continued to lower both the investment performance and discount rates, resulting in lowered income and increased DB pension obligations. In addition, both IORP's sponsors and members of IORPs are potentially facing severe financial difficulties to maintain contributions and so to ensure the sustainability of the pension promise. Deteriorating funding ratios of Defined Benefit IORPs require supervisory monitoring and potential actions, which usually entail setting up recovery plans and close coordination with the NCAs.

European banks are also maintaining overall strong capital- and liquidity positions during the crisis. The Common Equity Tier 1 (CET1) ratio is well above regulatory requirements, and increased to 15.1% in Q3 2020 compared to 14.4% in Q3 2019 (fully loaded)[11]. The leverage ratio similarly increased from 5.4% in Q3 2019 to 5.6% in Q3 2020. A wide range of regulatory measures introduced in response to the crisis such as the release of countercyclical capital buffers, the Capital Requirements Regulation (CRR) "quick fix"[12], and public guaranteed loans have helped to preserve capital resources and to reduce risk weighted assets. Reduced capital buffer requirements and a pragmatic approach on Pillar 2 Guidance in most jurisdictions are also providing some further headroom for further financial support to customers, or to absorb additional credit losses. Supported by ample central bank funding, the liquidity coverage ratio (LCR) increased to 171.3% in Q3 2020, from 147.7% in Q3 2019. **The outlook for profitability, however, is structurally very challenging.** Bank sector profitability has been structurally low already before the pandemic. With the pandemic, increased provisioning against credit losses and pressure on interest margins are further depressing profitability. Operating revenues are under additional pressure in the economic downturn.

resilience of the fund sector. Stress simulations are one tool to assess the potential implications of correlated behaviour by funds beyond the individual level.

[11] See the EBA Risk Dashboard Q3 2020

[12] See the Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic.

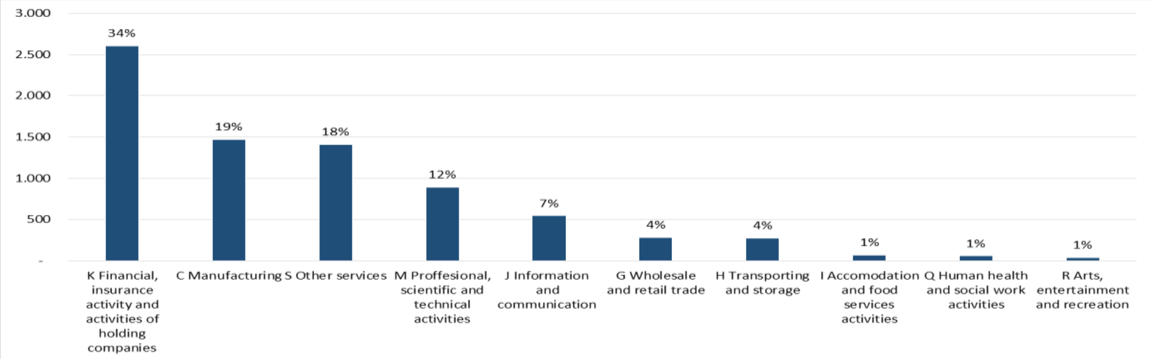
3 RISKS RELATED TO THE IMPACT OF COVID-19

3.1 EXPOSURES TO SECTORS IN THE REAL ECONOMY

Financial sector exposures to the real economy take on various forms. On the asset side, investment funds, insurers and pension funds are mostly exposed via their investment portfolios, whereas banks are exposed via their lending portfolios. On the liabilities side deposits and insurance policies are affected.

Insurers' exposures to the most severely hit sectors at the peak of the Covid-19 shock are mixed.[13] Insurers' exposure to consumer goods, which experienced that highest market losses in March 2020, is relatively limited, with 16.7% of direct investment to 'consumer services' and 3.7% to wholesale retail trade (Figure 5). The largest exposure of insurers in terms of direct investments is towards the financial services sector, which also experienced high losses in March 2020, before recovering from the second quarter 2020. The second largest insurers' exposure is in the manufacturing sector, whose performance didn't fall as sharply in Q1 2020, however it continued to slowly deteriorate in the following quarters .

Figure 5: Insurers ' direct investment breakdown by NACE code (EUR billion, December 2019)



Source:EIOPA Solvency II reporting. List of assets S.06.02. NACE code is used for the breakdown. Note: The charts refer to the EUR 7,645bn of direct investments. . Collective investment undertakings are excluded. Consurmer services include professional,scientific and technical activities, accommodation and food services activities, transporting and storage, art, entertainment and recreation.

Looking at insurers' corporate bond portfolios, which represent a share of 32% of total insurers' investment portfolio (EUR 11,357 bn. of assets)[14]**, insurers tended to sell downgraded bonds in the pre-pandemic period and during the first two quarters of 2020**. The net selling is more pronounced for bonds downgraded from BBB (-7.8% in Q1 2020 and -6.9% in Q2 2020). The sale of downgraded bonds may be triggered by capital require-ments, reflecting a de-risking behaviour by insurers, but it may also be driven by other reasons such as investment mandates. The magnitude of the selling of downgraded corporate bonds remains largely contained without evidence suggesting significant pro-cyclical effects triggered by insurers' response to the crisis. **However, the ongoing crisis coupled with many new country lockdowns, in response to the second wave of the pandemic, indicate that more downgrades could be expected in the upcoming quarters when the fiscal and policy measures, introduced in support of the economy, might be phased out.**

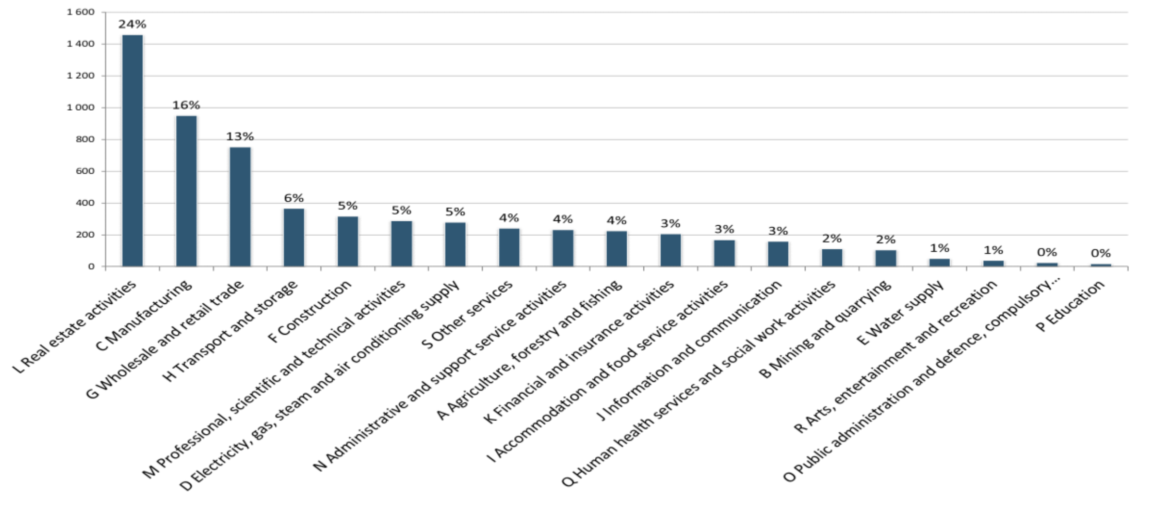
Corporate bond funds which kept downgraded bonds in their portfolio or increasing their exposures to lower-rated issuers experienced a deterioration in the credit quality of their holdings. At the same time, since the HY market has outperformed the IG market in 2020, valuation effects will increase the value of such HY holdings, further contributing to an observed deterioration of the credit risk profile of IG bond funds. For HY bond funds, the increase in the credit quality partly reflects an improvement due to fallen angels. As a consequence of the

[13] EIOPA FSR, July 2020
[14] Data: EIOPA Statistics, Solo prudential reporting Q4-2019. Look-through approach is applied.

increase in fallen angels, the share of BB issuers in HY indices has increased from 55% a year ago to 61% as of December 2020. As a result, HY funds using indices as benchmarks would tend to increase their exposures towards BB issuers, thus improving their credit risk profile.

On the other hand, bank lending to the real economy has increased in the pandemic, and is providing important support in the economic downturn. The total volume of loans and advances at amortised costs on banks' balance sheets has increased by 4.6% between Q1 2020 and Q3 2020, mainly driven by a 7.3% increase of lending volumes to small and medium enterprises (SME). Growth in household lending volumes, including mortgages, was muted only, while lending volumes to NFC other than SME slightly contracted between Q1 2020 and Q3 2020. During the second and third quarter of 2020, **banks increased their loan exposures to some sectors that were the most affected by COVID-19-related confinement measures**. These include accommodation and food services industries, arts and entertainment, education, and transport and storage. The highest sectorial exposure was to real estate activities (around 25% of total NFCs loans), followed by manufacturing and wholesale as well as retail trade. It will be important going forward that banks do not restrict their lending to viable corporate borrowers, as to prevent potential failures of such borrowers due to cash flow shortfalls. Looking forward, the ECB Q4 2020 Bank Lending Survey[15] indicates decreasing demand for corporate lending and consumer loans amid tightening credit standards, while demand for housing loans is increasing.

Figure 6: Banks distribution of NFC exposures by industry (NACE code) (EUR billion), September 2020

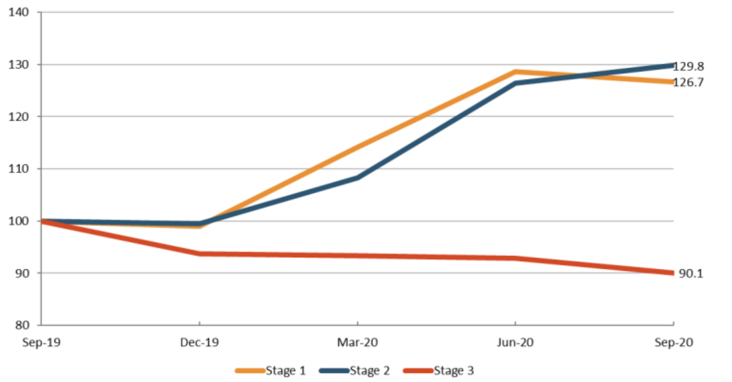


Source: EBA supervisory reporting

Just as corporate bonds portfolios of investment funds and insurers can be affected by downgrades, volumes of NPL at banks are also expected to increase. So far banks report that the NPL ratio been rather stable in the pandemic. Mainly driven by an increase in total lending, the NPL ratio stood at 2.8% in Q3 2020 compared to 2.9% in Q3 2019. Effort of banks to dispose portfolios of NPL are also contributing to a stable NPL ratio to date. Yet several other metrics indicate that asset quality is deteriorating. The volume of forbore loans has strongly increased to EUR 350 billion in September 2020, while the forbearance ratio for loans increased from 1.8% in Q3 2019 to 2.0% in Q3 2020, which indicates increasing challenges for some borrowers in the adverse economic environment.

[15] See ECB Q4 2020 Bank Lending Survey

Figure 7: Accumulated loan impairments by IFRS 9 stages (September 2019 =100)



Source: EBA supervisory reporting

Banks provisions on performing loans increased by over 65% between Q3 2019 and Q3 2020 to a volume of EUR 105 billion. While differing significantly between countries and banks, this resulted in a markedly higher average cost of risk, which, at 0.74% in Q3 2020, was significantly above 0,46% as in Q3 2019.

Asset quality deterioration is a key risk in the pandemic, and rising levels of impairments presumably reflect the expectation of defaults to come. **Banks' asset composition is expected to determine the extent to which they will be affected by the crisis.** In the past few years, **EU banks have on average significantly increased their exposures towards potentially riskier portfolios, such as towards SMEs or consumer financing**. Exposures towards these segments grew by 8% and 9%, respectively, in 2019 alone. Lending volumes to SMEs have further increased in the pandemic, and are providing important support in the economic downturn. Yet at the same time banks significantly increased their loan exposures to some NFC sectors that were the most affected by COVID-19-related confinement measures also renders bank more vulnerable to the crisis. **The phasing out of Covid-19 related policy support measures, in particular loan moratoria, will very likely expose a deteriorated asset quality.**[16]

The allocation of loans by IFRS 9 impairment stages provides a view on banks' expectations how the credit quality of their loan portfolios will deteriorate. Banks have markedly increased the classification of loans in stage 2, for which credit risk has increased significantly since initial recognition of loans. Stage 1 loans decreased at an equivalent level (Figure 7). In September 2020, EU banks classified 88.6% of their loans and advances recognised at amortised cost into stage 1 (89.5% in September 2019), 8% into stage 2 (6.8% in September 2019), and 3.4% into stage 3 (3.7% in September 2019). Of loans under moratoria, ca. 20% were classified as stage 2 loans, which is more than double the share of stage 2 loans for all loans.

BOX: Loan moratoria

Legislative and non-legislative moratoria on loan repayments across European countries in response to the crisis were an important tool to provide breathing space to borrowers. Moratoria allow, under certain conditions, for suspension, postponement or reduction of payments within a specified period, when operations of many businesses and individuals are limited or suspended resulting from the impact of COVID-19. The EBA has in April 2020, issued the guidelines on payment moratoria, aimed at clarifying the requirements for moratoria. If fulfilled, the requirements help to avoid the classification of exposures under the definition of forbearance or as defaulted under distressed restructuring. In response to the second wave of the pandemic, the EBA has in December 2020 reactivated its Guidelines on legislative and non-legislative moratoria[1]. In particular, these revised Guidelines ensure that loans, which had previously not benefitted from these Guidelines, or which applied the treatment proposed in these guidelines for less than 9 months, can now also benefit from them until the 9 months cap on the maximum length of the suspension, postponement or reduction if payments is reached, can now also benefit from them. In addition, credit institutions are requested to document to their supervisor their plans for assessing that the exposures subject to general payment moratoria do not become unlikely to pay.

[16] See "Asset quality trends in the EBA's Risk Assessment of the European Banking System, December 2020

The use of moratoria is particularly widespread for portfolios of SMEs and commercial real estate, but is also important for mortgage loans in some countries. As of September 2020, a nominal loan volume of EUR 587 billion was under current moratoria on loan repayments which had not yet expired, down from EUR 811 billion in June 2020. About 9% of total NFC loans and ca. 6% of total household loans were under current EBA compliant moratoria. The use of moratoria was widely dispersed across countries and banks[17], with a few banks reporting that almost 50% of their total loans to NFCs and households were subject to moratoria. As of September 2020, 85% of the loans under moratoria were due to expire by the end of Q1 2021. The EBA monitors closely developments, including asset quality challenges the expiry of loan moratoria is expected to reveal, and receives quarterly reporting data on loan moratoria and PGS.

3.2 Exposures to governments and banks

Next to the exposures to the real economy, exposures to governments, direct or via public guarantees, and of insurers towards banks can also lead to vulnerabilities. Although the coronavirus crisis originated outside the financial sector, and spillovers to financial institutions have so far remained limited, the large-scale intervention by governments and central banks can lead to deteriorating public finances and debt sustainability risks could consequently rise.

Within the fund sector, **money market funds (MMFs) are particularly exposed to the financial sector on both side of their balance sheets**. On the asset side, MMFs are mainly exposed to banks (EUR 921bn out of EUR 1,445bn in total assets). According to ECB statistics, as of end-2020, non-euro area resident banks account for 33% of MMFs assets, followed by EA banks for 31% of assets. On the liability side, around half of MMF shares are held by non-residents and for EA residents, institutional investors such as insurance corporates, pension funds and investment funds account for a large share of holdings.[18]

Insurers hold large amounts of government bonds, 33.3% (EUR 2.5 tn. of assets)[i] of their investments, particularly in the composite and life segment. While euro area governments benefitted from relative benign financing conditions, rising sovereign debt in the wake of the pandemic has renewed concerns about debt sustainability. **The significant exposures of insurers towards the banking sector, and their home bias, could potentially become a channel of risk transmission and contagion to insurers**. Insurers show different levels of exposures towards banks across countries, but on average approximately 15.6% of their total investment is concentrated towards banks. The levels of home bias differ across countries but the concentration on EU/EEA countries is dominant, with only few exceptions. Insurers also hold large amounts of domestic government bonds. As the creditworthiness of banks is linked to its sovereign and vice versa,risk exposures to the banking sectors could in some countries be potentially amplified by the sovereign-bank nexus.

Insurers are carefully considering their exposure towards credit risk. In general, both in pre-Covid and during Covid time insurers tend to be net buyers of corporate bonds, while insurers' trading activity on bank bonds shows a trend of reducing exposures from the third quarter of 2019 onwards , by not rolling over their investments. **During the outbreak of the Covid-19 crisis, insurers have been net sellers of downgraded bank bonds especially in Q2-2020 when their selling surpassed the one of downgraded bonds issued by other sectors. In any case, the magnitude of the observed selling of downgraded bonds remains largely contained without evidence suggesting significant pro-cyclical effects triggered by insurers' response to the crisis.**

[17] See the EBA's thematic note on moratoria and government guarantees on the country-by-country use of moratoria.
[18] See 'Vulnerabilities in money market funds', ESMA Trends Risks and Vulnerabilities report No.1 2021, pp. 60-72.

Next to their exposure to the public sector via investment portfolios, banks are additionally indirectly exposed to the public sector through lending supported by PGS introduced in response to the pandemic. PGS support banks to provide new lending to many corporates impacted by the crisis. Loans subject to PSG were mainly granted to NFCs. SME lending has particularly benefitted from PGS. Since the beginning of the pandemic, sectors with strongest loan growth were those that made more use of PGS[19]. As of Q3 2020, newly originated loans subject to PGS amounted to EUR 284 billion, representing nearly 2% of total loans. Usage of PGS varies widely across countries[20], and some countries reported very low volumes of loans or no loans subject to PGS. **Going forward it will be important that banks continue to be in a position to maintain adequate lending volumes, also after a significant share of PGS for new lending is scheduled to expire**.

[19] See the EBA's thematic note on moratoria and government guarantees.

[20] See the EBA's thematic note on moratoria and government guarantees on the country-by-country use of PGS.