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JOINT COMMITTEE REPORT ON
RISKS AND VULNERABILITIES IN THE EU FINANCIAL SYSTEM

AUGUST 2023

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EXECUTIVE SUMMARY AND POLICY ACTIONS

Recent years have presented a series of adverse events, i.e., the pandemic, related supply chain disruptions, the Russian aggression against Ukraine, the energy crisis, the Gilt crises in the UK and US mid-sized banks turmoil, which most financial institutions have navigated well. This was partly supported by sound fundamentals such as robust capital positions. Nonetheless, the European economy continues to experience a period of heightened uncertainty which presents material financial stability risks that necessitate vigilance from all financial market participants.

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

- **The broader impact on financial institutions and market participants from strong increases in policy interest rates and sudden rises in risk premia should be closely monitored and accounted for in risk management.** Rising rates have affected all sectors simultaneously. They reduced the value of fixed income assets and negatively impacted insurers' profitability. Insurers and pension funds remain well capitalised on aggregate, but monitoring of developments is needed. Moreover, while rising rates are currently improving the net interest income and interest margins of banks, the medium-term implications from a higher interest rate environment might be less beneficial. Higher interest rates and potentially rising risk premia are expected to further increase funding costs and adversely affect funding conditions at a time when banks are replacing substantial amounts of central bank funding with other funding sources and still build up or replace loss absorbing capacity of MREL¹. Increasing interest rates also present market risks and liquidity risks for the asset management sector. The use of interest rate derivatives contracts should also continue to be closely monitored, though potential risks are moderated by increasing levels of central clearing. Although market infrastructures held up well through the recent spikes in volatility, the uncertain economic and geopolitical situation could put potential strain on them and could affect funding and securities issuance, as seen recently during the banking turmoil.
- **Financial institutions and supervisors should remain prepared for a deterioration in asset quality in the financial sector.** Against the background of high macroeconomic uncertainty, the risk of a recession, persistent inflation, volatile energy and commodity prices and the prospect of further interest rate increases, supervisors should continue to closely monitor asset quality and loan loss provisioning. Higher interest rates and potentially higher risk premia result in higher funding costs and operating costs. Rising interest rates with an expected repricing of loans further affect the ability of highly indebted borrowers to service their debt, in addition to the adverse effects of inflation and the subdued economic environment. Most affected assets would include real estate lending, unsecured lending to consumers, assets that benefitted from support measures related to the pandemic, and assets of sectors that are particularly vulnerable to rising inflation as well as to volatile energy and commodity prices.
- **Financial institutions and supervisors should be aware of and closely monitor the impact of inflation risk.** Inflation not only impacts financial institutions by its effects on asset quality and valuation, but also through rising expenditures and rising funding costs as a result of higher interest rates and other channels. Depending on their ability to adjust their premia in a timely fashion, insurers could be negatively affected by claims inflation (in particular those with long-tail business). Moreover, inflation is not only relevant from a risk perspective but can also have an impact on the appropriateness of products. Inflationary trends should thus be taken into account in product testing, product monitoring and product review phases. Financial institutions and supervisors should make extra efforts to ensure investor awareness on the effects of inflation on real returns of assets and on how these can vary across different types of assets. Consumers

¹ Minimum requirement for own funds and eligible liabilities

might be impacted by inflation risk through the widening of pension gaps in case future benefits are not increased or do not fully compensate for the lower purchasing power.

- **Recent bank problems in the US and Switzerland highlight the importance of effective risk management and governance arrangements for financial institutions, in particular in relation to liquidity risk and interest rate risk.** After the coronavirus crisis had already underlined the relevance of adequate capital buffers, recent US bank challenges underline the continued need for supervision. Financial institutions need to remain resilient to the impact of future substantial interest rate changes. For example, a range of different scenarios of increases of interest rates should be considered in interest rate risk management. In particular for deposits, banks and supervisors should remain vigilant on the underlying assumptions used in interest rate risk management for customer behaviour and deposit durations. Regarding liquidity risk, the adequate implementation of requirements and supervision should ensure that banks, insurers and other financial institutions are prepared for possible stress situations. In an increasingly digital world it is moreover highly important that supervisory guidance and standards continue to be based on realistic assumptions and remain up to date.

INTRODUCTION

Macro financial conditions eased in the first half of 2023 despite continuing substantive uncertainties in the financial sector, high inflation, and the ongoing implications from Russia's aggression against Ukraine. Nonetheless, the IMF confirmed its expectations of a pronounced slowdown in real **GDP** growth, from 3.4% in 2022 to 2.8% in 2023 at global level. In the EU, the European Commission projected growth of 2% in 2023 and 1.7% in 2024 in its spring economic outlook ². While the overall EU growth projections have been revised upwards, supported by declining energy prices and a resilient labour market, the EU experienced a technical recession in 1Q23 and the development across Member States is uneven. The unemployment rate remained at an all-time low (6.1%) in the first half of 2023. For 2024 the GDP growth is expected to be 1.7%. **However, the economic outlook remains fragile, not least amid persistently elevated geopolitical risks and an uncertain macro-financial outlook.** Inflation has continued to decline from its October 2022 peak (of 11.5% year-on-year in the EU), falling to 6.4% in June (5.5% for the Euro area) with forecasts now set at 6.4% for 2023 in the EU (5.6% in the EA) and 2.8% for 2024 (2.5% in the EA). Core inflation has remained high and reached a historic peak in March 2023 (7.6%), but is also forecast to gradually decline, standing at 6.2% in June 2023 in the EU. **Monetary policy has** tightened further to address inflation pressures. In the euro area, the European Central Bank (ECB) further increased policy rates, by 175bps in 2023, contributing to a cumulative increase of 425bps since monetary tightening started in July 2022.

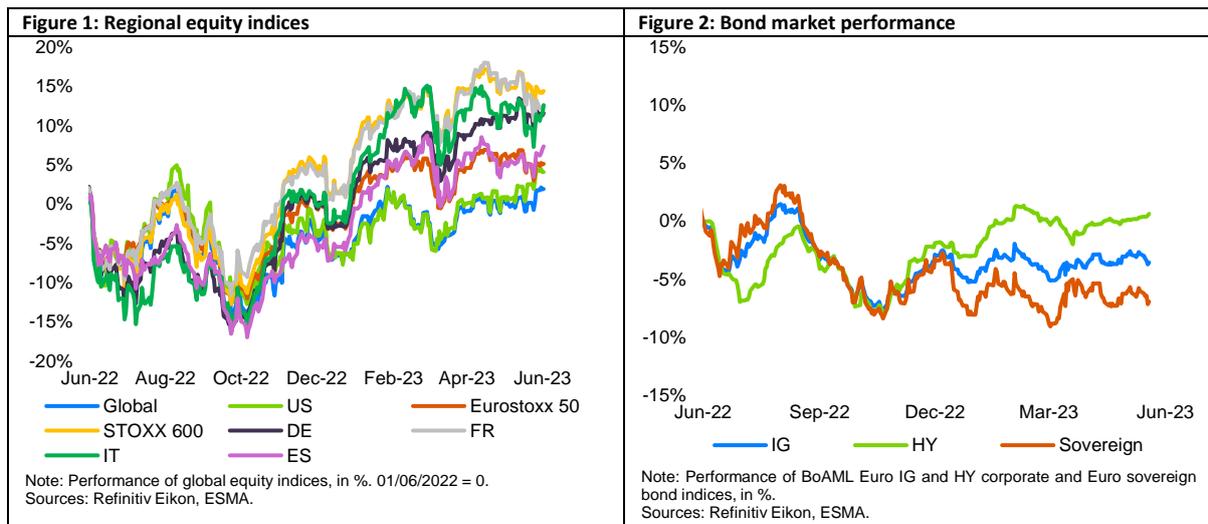
Global financial conditions reflected the transmission of the monetary conditions into higher borrowing costs, while credit flows decreased. The **March 2023 turmoil in the banking sector** following the failures of some mid-sized US banks and Credit Suisse in Switzerland lead to a temporary sharp market reaction and a sharp temporarily decline in European bank share prices, though to a lesser extent than US regional banks, amid temporary contagion concerns. Market implications from the events in March also highlight the continuing sensitivity of the European financial system to exogenous shocks and the high ongoing market uncertainty. Market nervousness and bad news about parts of the financial system could spread rapidly and lead to a general jump in risk aversion. In spite of the benefits of the increase in interest rates for banks' net interest income, some concerns persist on the potential for unrealised losses in fixed-income securities, valuation of real estate assets, but also on private finance services.

² IMF (2023), [World Economic Outlook – A rocky recovery](#); [European Commission's Spring 2023 Economic Forecast](#) from May 2023 (version as of 7 June 2023).

The current **uncertainty** is also exacerbated by the continuing high level of geopolitical risk. While the initial economic impact of the war in Ukraine has receded, there is no sign yet of an end to the conflict. Moreover, tensions between the US and China remain high. Eventually, this could lead to further fragmentation of global trade, with significant economic impact for the EU.

1 MARKET DEVELOPMENTS

European equity markets rose by 19% in H1 2023, in line with the global increase in equity markets (Figure 1). This is despite the **market nervousness** linked to the March turmoil in the US banking sector, where the overall EU equity market valuations experienced peak-to-trough declines of -6.5%, with falls of -17.5% for the EU banking sector. The overall growth trend is linked to increased confidence associated with the revised growth expectations and declining energy concerns. European valuations increased in all sectors compared to their end of the year 2022 levels. Moreover, despite the March turmoil, European banking sector valuations increased by 16% in H1 2023, driven by improved earnings. During the second week of March, the collapse of three US regional banks, the distressed sale of Credit Suisse and the sharp volatility of some bank CDS spreads coincided with a surge in volatility in equity markets in March (+9pp)³. The spike was temporary and lower than that observed in March 2022 at the start of the Russian invasion and the consequent energy commodity crisis. The market impact of these concerns on liquidity appears sustained. Bid-ask spreads increased significantly and have remained above their 5-year averages.



With a certain exception of Additional Tier 1 (AT1) bonds which were most strongly affected by the bank-related market stress, **fixed income markets** nearly recovered after the SVB/CS induced events. Yet they have been very volatile (Figure 2) and characterised by heightened uncertainty, mostly stemming from the stress in the EU and US banking sectors and investor expectations of further monetary policy tightening. As of end-June, **European sovereign bond yields** stood slightly below end-2022 levels. After an increase linked mostly to uncertain macroeconomic conditions, the market tensions in March led to a temporary drop in yields with investors moving from equity markets to sovereign bonds (considered a ‘safe haven’ asset). In the EA, the largest YTD declines were observed for IT (-64bps to 4%), ES (-27bps to 3.4%), and FR (-18bps to 2.9%). **Corporate bond markets** were also sensitive to the banking turmoil. However, in contrast to sovereign bonds, both investment grade (IG) and high yield (HY) bond yields increased in mid-March but recovered afterwards. The first half of 2023 also saw a bifurcation between HY and IG, with overall changes in yields of -14bps and +19bps respectively. Credit spreads also peaked in March and then progressively fell back to end-2022 levels. The write down of Credit Suisse’s AT1 bonds linked to its emergency merger with UBS was transmitted to AT1-valuations in the EU. The price of AT1 bonds issued by European banks experienced a peak-to-trough fall of 18% in March and have

³ Please see ESMA Trends Risks and Vulnerabilities report No.2 2023 for further insights on CDS liquidity during banking turmoil.

continued to trade at relatively low levels since then (recovered by 9% since 28 March, standing -8% below end-2022 levels).

Commodity prices remained elevated from a longer-term perspective, but generally retreated from their high 2022 levels. Natural gas prices fell by more than 50% compared to October 2022, below their pre-war level, due to lower-than-expected gas consumption and increased diversification of supply sources. In particular, natural gas futures prices have remained well below the activation thresholds for the market correction mechanism (MCM)⁴. Oil prices fell to around USD 80 per barrel from the peak reached in mid-2022 (USD 120), despite the OPEC+ announcement in April of a supply reduction.

The market for **ESG products and sustainable investment** in Europe continued to grow robustly, despite concerns that the increased focus on banking sector risk could draw investor and policymaker attention away from the financing of the transition to a low-carbon economy. The total value of ESG bonds outstanding reached EUR 1.7tn in June 2023, up 28% in one year. However, issuance slowed, with volumes issued across all ESG bond types down 8% in H1 2023 as compared to volumes issued in H1 2022. The drop in private sector issuances also continued: corporate ESG bond issuance decreased 26% from H1 2022, while the overall corporate debt market increased by 50%. Unlike the private sector, public sector issuance volumes grew in H1 2023, increasing 22% compared to 1H 2022, led by green bonds. The latter also continued to dominate the ESG bond market with a 63% share. However, these too saw slightly lower issuance volumes in H1 2023 as compared with H1 2022 (-12%). The forthcoming EU Green Bond Standard agreed upon in February may further support market growth by tackling transparency issues and strengthening credibility in the market⁵

The assets under management of EU ESG funds rebounded in H1 2023 after the decline seen in 2022. In parallel, the share of **ESG products in the EU fund industry** continued to grow, reaching 20% in H1 2023. The appetite for sustainable investment products remained strong, particularly for vehicles with stronger ESG credentials. Since the entry into force of the Sustainable Finance Disclosure Regulation (SFDR) in March 2021, the aggregated monthly net flows received by funds disclosing under Article 9 (i.e., funds with a sustainable investment objective) have remained positive. However, the picture was quite different for funds promoting environmental or social characteristics (Article 8) or funds that are not sustainability-oriented (Article 6). These two kinds of funds received significant net inflows in 2021 but then faced important outflows in 2022 (these outflows represented around 70% of the 2021 inflows for Article 6 and 45% for Article 8 funds).

Crypto-asset valuations rebounded in early 2023, after the sharp decline in 2022 following several prominent failures, including the collapse of global crypto exchange FTX in November 2022. The total crypto-asset market capitalisation rose from EUR 800bn in December 2022 to EUR 1.15tn in June 2023, a 40% increase year-to-date. Nonetheless, prospects for the industry remain muted at this point amid rising interest rates, concerns about compliance with AML/CFT rules and restrictive measures, the failure of several US banks more exposed to crypto-assets and new technologies, including Silicon Valley Bank, which may restrict access to banking services for crypto firms, and a toughening regulatory stance globally, including in relation to compliance with AML/CMF rules. In June 2023, a series of enforcement actions by the US SEC, including against Binance and Coinbase, two of the largest crypto exchanges globally, sent the price of a wide range of crypto-assets down by up to 25% in a few days. In the EU, the publication of the MiCA regulation in the Official Journal in June 2023, which is intended to provide a comprehensive regulatory framework for previously unregulated crypto-assets, set the clock running for compliance for mid/end June 2024, when it will enter into application.

The volume and scope of **cyberattacks** was high in H1 2023. The potential for escalation of Russia's war of aggression in Ukraine involving cyberattacks remains, and the effects of a successful attack on a major financial

⁴ For further information on the MCM, see ESMA (2023a), ['Effects Assessment of the impact of the market correction mechanism on financial markets'](#), March.

⁵ European Council (2023): [Provisional agreement reached on European green bonds](#).

institution or on a critical infrastructure could spread across the entire financial system.⁶ The ESAs continue their preparations for DORA, including consulting on several regulatory technical standards on key areas such as ICT risk management, ICT-related incident management and reporting, digital operational resilience testing and the management of ICT third-party risk.⁷ As part of these efforts the ESAs are preparing for the gradual development of a pan-European Systemic Cyber Incident Coordination Framework (EU-SCICF), in line with an ESRB Recommendation on the topic.

2 DEVELOPMENTS IN THE FINANCIAL SECTOR

After the historically large decline in EA investment funds assets in 2022 (EUR-2tn or -10%), the fund sector rebounded slightly in H1 2023 (+3%) as a result of valuation effects. In terms of size, it remains EUR 1.4tn below the end-2021 level. Fund performance also reflected this evolution, with most fund categories reporting noticeably better returns than in 2022. Equity funds exhibited a 12-month average monthly performance of 0.9% in H1 2023, up from -1.3% in December, and bond and mixed funds reported 0% and 0.3% respectively (vs -0.9% and -1.1% in 2022). In contrast, commodity funds which had been outperforming the rest of the industry for the last two years reported negative figures for the first time since 2020. Performance was down to -1% (vs +1.2% in 2022) against a background of falling commodity prices. There was no clear trend in terms of equity fund flows in H1 2023 reflecting uncertainty among investors. Equity fund flows were muted in H1 2023 which contrasted, on the one hand, with the significant inflows into ETFs (+5.1% NAV) and, on the other hand, with the outflows experienced by mixed funds (-1.6%).

Fixed-income bond funds experienced significant inflows (1.9%), in contrast to the outflows of 2022 (-4.7%). This may indicate that the investors who withdrew from bond funds in 2022 due to the monetary tightening are now anticipating a slowdown in central bank interest-rate rises.

In terms of performance, EU money market funds (MMFs) still exhibited zero returns on average despite the rise in money market rates. However, there were signs that they have been adapting to the new interest rate environment. First, the weighted average maturity (WAM) of EU MMFs reached a 10-year low in Q4 2022, down to 18.7 days, significantly reducing exposure to interest rate risks. Then in H1 2023 the WAM increased again, up to 29.1 days, while remaining below historical average. This could indicate that, after reducing their interest rate exposure, managers are now positioning to benefit from the higher returns of money market instruments.

The episode of March banking sector stress resulted in large deposit outflows from some US banks. In the US, some of the deposits moved to government MMFs, while Prime MMFs (which invest mainly in bank debt) saw some outflows. Similar trends were observed for EU USD MMFs, mainly used by non-EU investors. In particular, public-debt CNAV, which invest in US Treasuries, saw inflows of USD 33bn (20% of NAV), while USD MMFs exposed to bank debt recorded outflows of a similar amount (USD 34bn, 8% of NAV, Chart 22). This points to a migration within EU USD MMFs towards government funds. **No such trends, however, were observed for EU MMFs in EUR and GBP, which saw only small inflows during the period.** One factor might be that there are almost no public debt CNAV in those currencies, following a prolonged period of negative rates which has made the business model of CNAV challenging. In the case of US banks, unrealised losses on banks bond portfolio triggered the withdrawals. Such a scenario is less plausible in the fund sector, as investor behaviour is not analogous to that of depositors. Nonetheless, valuation issues may still happen in areas not subject to mark-to-market valuation, such as in real estate (EUR 900bn NAV) and private equity funds (EUR 640bn)⁸.

⁶ New sources of cyber risk could also originate from systematic use of AI models in securities markets. Please see ESMA TRV risk analysis article on [Artificial intelligence in EU securities markets](#).

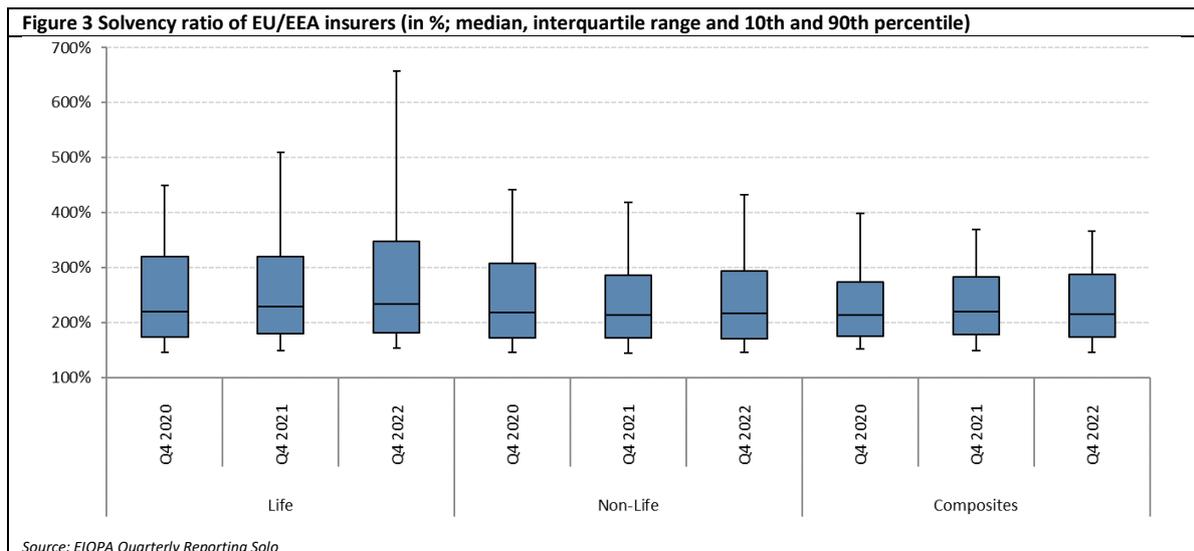
⁷ See [ESAs consult on the first batch of DORA policy products](#)

⁸ For further analysis on risks related to MMFs, please refer to ESMA TRV analysis article on [Stress testing MMFs in the EU – First evidence from fund reporting](#).

Insurers maintained their solvency position during 2022 despite losses on fixed income and equity investments. Solvency metrics for life and non-life improved slightly: the median SCR ratio for life continued to improve from 228% in Q4 2021 to 234% in Q4 2022 as a result of higher risk-free interest rates. The median SCR ratio for non-life insurers also improved from 213% to 216%.⁹ The median duration gap (i.e. the difference in the duration of assets and liabilities) of insurers in the EEA was around - 5 years at the end of 2022¹⁰. This allows to have positive effects on the excess of assets over liabilities and solvency positions as the value of technical provision decreased more in relative terms than the value of their assets.

Insurers' profitability was negatively impacted by interest rate and inflation risks. Higher interest rates and high inflation decreased in the value of investments and their returns. Underwriting profitability was lower in 2022, driven by increases in the claims to be paid to policyholders, especially for those non-life contracts with liabilities that have a relatively longer duration. An indication of the size of these losses was the scale of holdings in debt assets that have fallen in value: at the end of 2022 EEA insurers held 66.4 % of their investments in government and corporate bonds, 4.4 percentage point less than in 2021. While insurers were also net sellers of government and corporate bonds in Q4 2022, the decrease is explained by a drop in the market values of the fixed income holdings. Going forward, while the outlook on financial markets remains highly uncertain, medium- to long-term benefit of upward trending interest rates would be an improved profitability of fixed-income portfolios as maturing bonds are replaced with higher coupon bonds.

Figure 3 Solvency ratio of EU/EEA insurers (in %; median, interquartile range and 10th and 90th percentile)



Regarding Defined Benefit (DB) IORPs, the sector improved its already strong financial position, however concerns related to pension gaps might create broader financial stability implications in the long-term. Similarly to the insurance sector, as the drop in the value of liabilities exceeded the decrease in the value of assets in relative terms, the financial position of DB IORPs in the EEA improved.¹¹ The total assets for DB and Defined Contribution IORPs combined dropped during 2022 by EUR 362 bn (from EUR 2.740 bn to EUR 2.378 bn). This was mainly driven by losses on their derivatives portfolios and by lower values for their fixed income investments also via investment funds. At the same time the value of their technical provisions dropped year-on-year from EUR 2.327 bn to EUR 2.033 bn.¹² The improved financial positions allowed many IORPs to compensate their members fully or partially for the effect of inflation where this is conditional on a minimum funding ratio. The penetration of the IORPs sector, and hence the relevance of Pillar II an occupational pension, varies largely across Member States but should be considered together with the structure of the pension system at national level. Nevertheless, it is

⁹ The SCR figures are from the June 2023 EIOPA Financial Stability Report (p. 38).

¹⁰ EIOPA Risk Dashboard

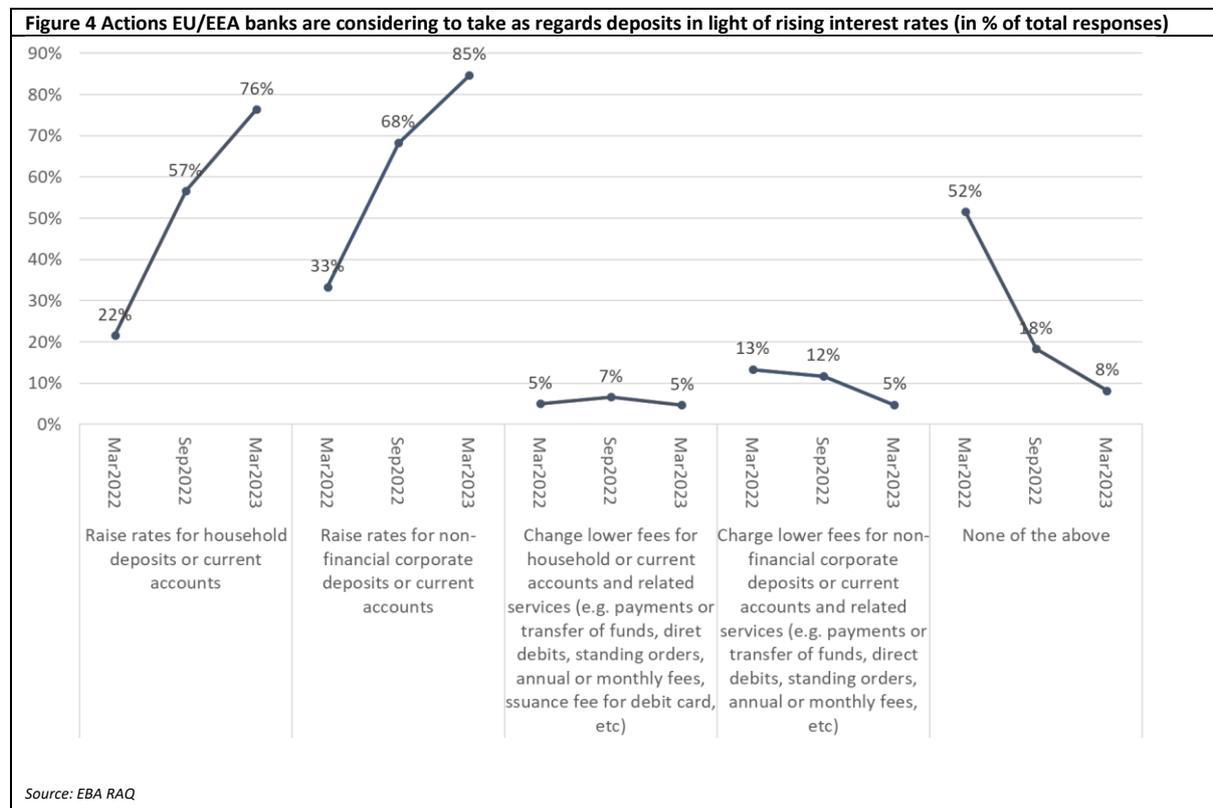
¹¹ See EIOPA Occupational pensions statistics Q4 2021 and Q4 2022.

¹² See June 2023 EIOPA Financial Stability Report (p. 47-48).

important to raising citizens' awareness of their future retirement income, enhancing the monitoring of national pension systems and ultimately towards closing pension gaps.

The EU banking sector has demonstrated its overall resilience against banking sector uncertainties, especially those emerging in March 2023. The sector is supported by overall sound capital and liquidity positions of banks **A strong regulatory framework applying to institutions of all sizes and categories has also contributed to the resilience of the sector.** The faithful and proper implementation of Basel III in the EU, on which an agreement was reached in June as part of the CRR3/CRD6 banking package, is important in this context. The banking sector has so far benefitted from the rising interest rate environment, with rising profitability and further improving capital ratios. The average Common Equity Tier 1 ratio (CET1) ratio increased to 15.7% in Q1 2023, on a fully loaded basis, from 15.0% in Q1 2022. The rising ratio was supported by increasing capital amid rising profitability and roughly flat risk weighted assets (RWA). Rising capital ratios with considerable capital headroom over regulatory requirements will be important in supporting banks to continue adequate lending to the real economy during challenging times.

After years of increases, deposit volumes as largest source of funding of EU banks have levelled, with a slight decline in client deposits (ca. -1%) reported in Q1 2023. The decrease was mainly driven by decreasing deposits from non-financial corporates (NFC). Deposit rates have reprised slowly since the interest raising cycle started, and deposit repricing has remained comparatively low in the EU, compared to, e.g., the US and UK. Deposits at EU banks have demonstrated to be much stickier than at US banks, which has contributed to rather low deposit betas. Yet, amid differences across EU/EEA countries, deposit rates have started to increase cautiously. A growing share of banks indicated in the spring 2023 EBA risk assessment questionnaire (RAQ) that they intend to increase rates for household and NFC deposits. Increasing deposit rates might have a material impact on net interest income (NII) going forward. Some depositor behaviour has also started to change, with, e.g., moves from sight deposits to fixed-term deposits.



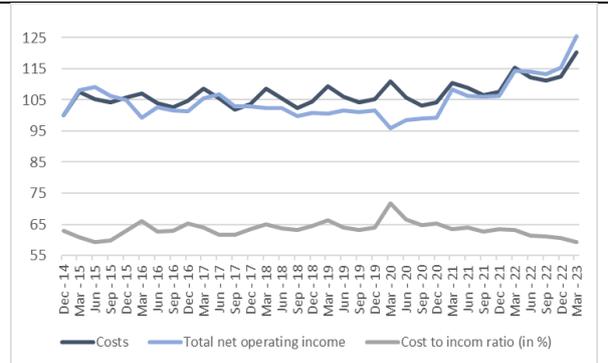
EU banks' lending volume has stopped growing, following the growth observed during the pandemic and after the beginning of the Russian aggression. Volumes of lending to households and NFCs were roughly stable in Q1

2023 compared to the previous quarter, reflecting both subdued demand for loans by households and corporates as well as bank tightening of credit standards, as, e.g., lending surveys have indicated.¹³ Loan rejection rates also increased.

Macroeconomic uncertainty, high inflation and increasing interest rates have affected consumer and business confidence while at the same time lowering banks’ risk appetite. These drivers were particularly evident in residential real estate and SME lending, in which outstanding loans were slightly lower in Q1 2023 compared to end of year volumes. **Going forward, a strongly growing share of banks indicate in their responses to the EBA RAQ plans to decrease large portfolios of lending to SMEs, corporates, consumer credit and residential mortgages in the next 12 months.** Reduced lending would have an immediate impact on banks’ income but could also have longer-term negative implications for the economic growth, with risks of a negative feedback loop. In light of the challenging economic environment, impacts will depend on loan demand and the extent to which banks maintain adequate lending capacity to the real economy and consumers while maintaining sound lending standards.

In spite of the uncertain economic environment, EU banks increased their profitability, mainly supported by rising net interest income and higher net interest margins in the rising interest environment. Average annualised return on equity (RoE) was reported at 10.4% in Q1 2023, compared to 6.7% in Q1 2022, and in double digits for the first time since the global financial crisis. The biggest driver of increased profitability was NII, which increased by 23% compared to Q1 2022. Net interest margins increased to 1.55% in Q1 2023, compared to 1.25% in Q1 2022, as banks benefited from increasing interest rates and slow deposit repricing. However, costs also increased by 4.3% compared to Q1 2022, partly driven by inflation, which to some extent offset higher interest income. The reported average cost-to-income ratio was below 60%, for the first time since June 2015.

Figure 5 Cost-to-income ratio of EU/EEA banks (in %), numerator and denominator trends (December 2014 = 100)



Source: EBA supervisory reporting

EBA 2023 EU-wide bank stress test results

The EBA 2023 EU-wide stress test assesses the resilience of 70 banks from 16 EU and EEA countries representing about 75% of EU banks’ total assets. The results show that European banks remain resilient under an adverse scenario which combines a severe EU and global recession, increasing interest rates and higher credit spreads.

This resilience of EU banks partly reflects a solid capital position at the start of the exercise, with an average fully-loaded CET1 ratio of 15%, allowing banks to withstand the capital depletion under the adverse scenario. The capital depletion under the adverse stress test scenario is 459 bps, resulting in a fully loaded CET1 ratio at the end of the scenario of 10.4%. While the decline in the aggregate capital ratio is smaller this year than in the previous stress test, the dispersion across banks has increased.¹⁴ Higher earnings and better asset quality at the beginning of the 2023 both help moderate capital depletion under the adverse scenario.

Earnings increase the capital ratio by 356 bps at the end of 2025 under the adverse scenario. Net interest income (NII) is the largest contributor. The interest rate increases under the adverse scenario contribute positively to banks’ NII as loans reprice. To ensure sufficient prudence, NII is capped in the stress test and is not allowed to

¹³ See the [ECB April 2023 bank lending survey](#).

¹⁴ The sample of banks in the EBA stress test increased from 50 banks in 2021 to 70 banks in the 2023 EU-wide stress test

be higher than at the starting point. Similarly, deposits have a prescribed repricing which reduces NII, an effect that is higher for term deposits than for sight deposits.

Despite combined (credit, market and operational risk) losses of EUR 496bn, EU banks remain sufficiently capitalised to continue to support the economy also in times of severe stress. The increase in credit risk losses is the main negative contributor. The impact from credit risk is lower than in the previous stress test. This reflects that banks start the 2023 stress test with better asset quality than in the previous stress test. In addition, banks begin the 2023 exercise with higher provision overlays due to the current uncertain macroeconomic and geopolitical outlook. These additional provisions also mitigate the impact of the adverse scenario. Corporate and SME exposures account for most credit losses. The new information on the sectoral allocation of banks' corporate and SME exposures shows that the stress impact varies significantly across firms.

Market risk including counterparty credit risk losses under the adverse scenario amount to an average CET1 ratio decline of 112 bps while operational risk losses amount to an average CET1 ratio decline of 62 bps. The market risk impact has increased compared to the previous stress test. This is driven by the increase in rates and higher credit spreads. The operational risk impact has decreased compared to previous stress tests. This reflects banks own lower projected losses.

3 MAIN RISKS IN THE FINANCIAL SECTOR

The ESAs identify interest rate risk, liquidity risk, and credit risk to be of high importance across various sectors within the financial industry. These risks pose challenges to banks, insurers, asset managers, and other financial institutions, and their proper management is crucial for maintaining financial stability and adequately mitigating systemic risk. Thus far, European financial institutions have generally been able to prepare and adapt in the face of foreseeable risks. However, systemic stress could well arise through unanticipated shocks that materialise rapidly, as, e.g., observed in events linked to liability-driven investment (LDI) stresses or the US banking turmoil.

3.1 INTEREST RATE RISK

The end of the low-interest rate environment and the associated increases in fixed-income yields can be beneficial to financial institutions across the board. However, during the transition to this new environment, bondholders are exposed to significant interest rate risk. It is important that consumers, financial market participants and supervisors remain vigilant while the financial sector adjusts to a high interest rate environment after over a decade of very low interest rates.

Increasing interest rates imply a decrease in prices for debt securities, which not only affects the economy but also the balance sheets of financial institutions. For banks part of this decreasing value is factored in equity, or in profit and loss statements for assets that are held at market value. Life insurers and defined benefit pension funds have liabilities which have mostly longer durations than the debt securities they hold, which also drop in value if interest rates increase.

Insurers hedge their capital positions against interest rate movements by means of derivatives on interest rate risk. Due to the assets and liabilities structure of their balance sheets, insurers' derivative positions are structured to protect against a drop in interest rates, reducing de-facto the duration gap. However, sudden large moves in interest rates trigger variation margin calls which serve to mitigate risks from derivative markets. As recently experienced in the UK these can result in losses on the derivative position of insurers and IORPs. Such entities hold large pools of highly rated liquid investments which can be sold to generate cash. Compared with pension funds in other jurisdictions, however, EEA entities active in the derivatives markets are on average much better diversified in their government bond holdings. Based on end 2022 data, EIOPA performed an analysis of the additional variation margin requirements that would have been triggered on interest rate derivatives from sudden increases and decreases in interest rates of up to 100 basis points for the EEA insurers

with the highest usage of these instruments. The results showed that in aggregate these would have had no difficulty in providing variation margin, even in case of such significant up- and downward rate movements.

In the investment fund sector asset allocations designed for the extended period of low interest rates will adjust to reduce interest rate risks. Bond funds, for example, have markedly decreased the maturities of their portfolios. In H1 2023 the average effective maturity was down to 7 years for IG and 3.7 years for High Yield funds, an 8-year low. Likewise, the duration of the EUR Investment Grade Corporate Bond Index declined year-on-year from 4.8 to 4.5 years in H1 2023 while the duration of the EUR High Yield Corporate index shortened from 3.5 to 3.1 years since H1 2022. The reduction in duration reduces interest rate risk going forward. For the preceding two corporate indices, for example, the potential valuation impact of a 100bp yield shock has decreased by 0.3 and 0.4 percentage points respectively.

For debt securities that are held at amortised cost by EU banks, which represent ca. EUR 1.3 trillion, the decrease in value from higher rates is not reflected in profit and loss statements of banks¹⁵. Potential unrealised losses of EU banks' bond holdings at amortised costs, calculated as the difference between the carrying amount and the fair value of amortised cost debt securities, appear contained. As of February 2023, the EBA estimates aggregate net unrealised losses of EUR 75bn for EU banks. In the absence of a liquidity shortfall, potential losses are moreover not expected to be realised and are to a certain extent benign. Also, as part of their interest rate management, banks actively manage these portfolios.

High and increasing interest rates are expected to support profitability in the medium term. EBA spring 2023 RAQ results indicate banks' expectations that increasing interest rates further boost their profitability in the next 12 months. There are nevertheless challenges for banks to maintain high returns, and the medium-term outlook for sustained bank profitability is uncertain. Deposit pricing is expected to increase as depositors become more sensitive to rate developments and move from sight to term-deposits. Impairments as credit risk rises might also increase. Increased market funding costs could also feed through banks' cost base at the same time as banks face increased costs through other channels, including wage inflation, necessary costs for digital transformation, and potentially higher compliance costs. In the medium-term, subdued loan growth could also mitigate the impact of wider margins and exert pressure on NII.

It is important that banks manage their interest rate risk well. The EBA has provided additional guidance on interest rate management with the publication of its final standards and guidelines on interest rate risk arising from non-trading book activities (IRRBB).¹⁶ The Guidelines complement two Regulatory Technical Standards (RTS) specifying technical aspects of IRRBB positions. The two RTS lay out detailed criteria for (i) evaluating risks arising from changes in interest rates that affect both the Economic value of equity (EVE) and Net Interest Income (NII), (ii) specifying parametric assumptions and supervisory shock scenarios for identifying institutions at risk of significant declines in Economic value of equity (EVE) or net interest income. IRRBB should not least help banks to test a range of different scenarios of increases of interest rates. Banks' IRRBB disclosures show that the EVE impact from a parallel move up of the yield curve seems to be limited on broad average.¹⁷ This indicates that banks have hedges or other measures in place to limit the impact on their EVE in such case.

The ESAs have published an interactive **factsheet targeting consumers to help the public understand how the recent increases in inflation and interest rates can affect their finances.** This includes implications on the financial products and services that consumers currently hold or plan to buy, such as loans, savings, financial investments, insurance and pensions.¹⁸

¹⁵ The sample banks of this EBA analysis is the same as the for the 2023 EU-wide stress test (70 banks).

¹⁶ See [EBA Guidelines on IRRBB and credit spread risk arising from non-trading book activities \(CSRBB\)](#), October 2022

¹⁷ Based on an EBA analysis based on a sample of around 50 banks

¹⁸ See [ESA fact sheet "How do inflation and the rise in interest rate affect my money?"](#)

3.2 LIQUIDITY RISK

Recent events have again put the spotlight on liquidity risk. The recent experiences at some mid-sized US banks and Credit Suisse show the extent to which banks can be vulnerable to a rapid and sudden outflow of deposits. They also show that control of liquidity risk by all financial institutions is even more important now that a period of abundant liquidity is coming to an end.

In the banking sector liquidity positions remain at strong levels but continue to decrease slightly. The liquidity coverage ratio (LCR) decreased from 167.9% in Q1 2022 to 163.7% in Q1 2023. An increase in high-quality liquid assets (HQLA) was outweighed by higher net outflows. Amid the slightly decreasing liquidity buffers, it will be important that banks continue to ensure comfortable liquidity buffers, not least while they are using these buffers to partially repay outstanding volumes of central bank funding (TLTRO-3). The EBA RAQ indicates that using current liquidity is and will be the most common strategy for banks to repay TLTRO-3, ahead of issuing covered bonds and using short-term funding. Bank funding plans moreover indicate banks' expectations that economic and monetary trends will continue to reduce banks' LCRs and net stable funding ratios (NSFR) going forward.

The events in March have also shown implications of the digital age on bank liquidity, as information, as well as deposits can move very fast. While EU banks' deposit base has remained stable, including during the March events, supervisory monitoring of liquidity positions and the behaviour of depositors going forward remain important risk mitigators. Beyond the LCR, supervisors should also use further tools available to, e.g., monitor maturity mismatches or concentration of funding. The EBA has provided guidance to supervisors via, e.g., the Internal Liquidity Adequacy Assessment Process (ILAAP) that foresees detailed information on funding risk and strategy, on liquidity buffers, collateral management, and intraday liquidity risk.

Although insurers have no deposits which can experience a deposit flight, policyholders may cancel their contracts. The current economic environment could generate incentives for policyholders to surrender policies weakening the liquidity position of insurers. Based on the latest EIOPA dashboard, lapse rates have increased over time (e.g. lapse rates in life business increased by 0.4% y-o-y to 3.8 % in Q4 2022). The reasons and the theories driving the increase vary and depend on the specificity of each market. Lapses might be triggered by lower disposable income (high inflation) for the less wealthy segment of the population, or, for the wealthier part, by the reallocation of investments towards short-term, more profitable opportunities outside of the insurance market. Risks here are mitigated by insurers having large pools of highly rated, liquid investments. In Q4 2022 the liquid asset ratio stood at 45.6 %.¹⁹ However, insurers might generate a footprint on other markets in the case of large sales of common assets to meet sudden liquidity needs. Potential liquidity strains might be generated also by the hedging positions of insurers, and associated margin calls, as explained above.

In 2022, bond funds faced elevated liquidity risk due to the elevated level of redemption requests in some jurisdictions. However, in H1 2023, they have not faced the same challenges, but some funds reduced their portfolio liquidity. In particular, liquid assets slightly decreased for HY bond funds while portfolio liquidity improved for IG bond funds. Moreover, corporate bond funds (both IG and HY) also decreased cash holdings from 2.8% to 1.9% in H1 2023.

3.3 CREDIT RISK

Credit risk indicators from credit rating agencies (CRAs) for European debt began to show some signs of credit quality deterioration in the first half of 2023. This was particularly true for sovereigns, whose rating drift turned negative toward the end of the reporting period, driven by downgrades to France, Hungary, the Czech Republic and Poland. Fallen angels grew strongly relative to the previous half year but remained below historical averages:

¹⁹ EIOPA [May 2023 Risk Dashboard 1.pdf \(europa.eu\)](#)

0.1% of corporate (up from 0.03% in 2H22) and 0.13% (up from 0.7%) of structured finance investment grade ratings were downgraded to high-yield in 1H23, with no fallen angels in sovereigns.²⁰ There was also an increase in the proportion of corporate high-yield ratings experiencing defaults. Looking ahead, short-term credit risks remain elevated, given the potential for further interest-rate rises, as inflation costs continue to feed through, and as more issuers need to refinance.

For some investment funds the risk of materialisation of credit risk remains high, despite improvements in the macroeconomic outlook . Credit risk remained elevated in H1 2023 for HY funds, with the credit quality of HY portfolios reaching a five-year low. These now have a rating of between BB– and B+ on average. Credit risks are also elevated for funds exposed to commercial real estate. More generally, concerns related to the solvency of indebted companies in a context of increasing interest rates also persist.

For insurers, credit quality is only slightly deteriorating. The median average credit quality for investments of EEA insurers where a rating must be provided in regulatory reporting remains constant at around 2 (corresponding to an S&P rating between AA and A) amid signs of deterioration at the low end of the distribution. In particular, the 90th percentile increased from 2.6 to 3 indicating a decrease in credit quality in 2022. Lower quality bonds could potentially be a risk transmission channel since they expose insurers to higher credit risk. The median exposure to loans and mortgages remained below 0.5 % throughout the year.

While asset quality is stable for the time being, banks should nevertheless be prepared for a possible deterioration. High and further increasing interest rates and persistent inflation could potentially adversely impact overindebted households and corporates and affect debt servicing capacities. Credit risk is expected to deteriorate going forward across all lending segments, albeit from a good starting point. In some loan portfolios, such as real estate portfolios of both residential real estate (RRE) and commercial real estate (CRE) a correction in asset prices is already being reported. Furthermore, slightly increasing exposure to CRE in Q1 2023 compared to the previous quarter may pose risks in light of falling real estate prices and rising rates. Other portfolios, such as consumer lending or sectors that have not fully recovered from the pandemic and from the economic impacts of the Russian aggression may also have to cope with new challenges. Accordingly, EBA RAQ results indicate banks' expectations of deteriorating asset quality for most large loan segments in the next 12 months. As asset quality is expected to deteriorate, **adequate provisioning levels and forward-looking provisioning policies remain important for banks**, alongside timely recognition of loan losses with corresponding impairments. A large share of banks also has provisioning overlays in place, and no major increase in cost of risk is expected, as banks would make use of these overlays in case of materializing asset quality deterioration.

²⁰ Fallen angels are ratings downgraded from an investment grade category (BBB or greater) to a high-yield category (BB or lower). Fallen angels are important because some investment mandates can limit investments to investment grade debt. Thus, fallen angels could potentially drive divestments in affected debt, which, if widespread, could have destabilising impacts. For further analysis on credit rating see [ESMA Market Report on EU credit ratings market 2023](#).