

26 August 2019

JC 2019 54

JOINT COMMITTEE REPORT ON
RISKS AND VULNERABILITIES IN THE EU FINANCIAL SYSTEM
AUTUMN 2019

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EXECUTIVE SUMMARY AND POLICY ACTIONS

The need to prepare for the impact of a no-deal Brexit on financial activities continues to require attention from the public and private sector in light of the postponement of the Brexit date. Although there seems to be a “Brexit fatigue” in the financial sector, supervisors continue to encourage institutions to prepare contingency plans for a no-deal Brexit and have themselves set further steps in motion to minimise negative impact on financial markets.

Risks related to the low interest rate environment continue to put pressure on the financial sector and concerns regarding search for yield behaviour have resurfaced. While the monetary policy response to weakening growth and inflation outlook has helped restore the confidence in financial markets in the short term, over the medium run persistently low interest rates, combined with flattening yield curves, put pressure on the profitability and returns of financial institutions, incentivise search-for-yield strategies and increase valuation risks. Search-for-yield strategies can be observed for investment funds, with some UCITS having liquidity issues related to large fund outflows and investments in illiquid assets. Markets for risky corporate debt have grown strongly in recent years, in particular the market for leveraged loans. Also, the share of low rated bonds in the total outstanding amount of corporate bonds has increased.

Climate change poses different risks to the stability of the financial system. The economy and the environment are interconnected. The intensive use of fossil fuels continues to contribute to climate change. Floods and other extreme weather events can cause billions of economic losses. A disorderly transition to a low-carbon economy could potentially generate a disruptive scenario in terms of financial stability and could possibly create challenges to business model viability in the longer term for institutions which have high exposures to climate sensitive sectors. In this regard, financial institutions can play a role in ensuring a gradual transition to a more sustainable economy.

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

- 1. Financial institutions and supervisors should continue their work on contingency planning and assurance of business continuity in the case of a no-deal Brexit.** Contingency plans should be implemented by 31 October 2019 at the latest. Considering the variety of measures undertaken by the ESAs and national supervisory authorities and other competent authorities, the industry in the EU should be well informed and prepared to manage risks from a micro-perspective.
- 2. Supervisors and financial institutions should continue taking into account a “low-for-long” interest rate scenario and the risks that such a scenario can bring with it.** Low interest rates are an important driver of low bank profitability and remain the main risk for the insurance and pension fund sectors. They contribute to the further build-up of valuation risks in securities markets as well as to a move into less liquid and more leveraged investments through search-for-yield strategies. On the investment fund side, a convergent application of the rules on liquidity management and (for UCITS) eligible assets as well as a consistent use of stress testing will be important supervisory tools.
- 3. There is a need to further address unprofitable banks and their business models in order to increase the resilience of institutions to a more challenging economic environment.** Further investments into financial technologies and exploring opportunities for bank sector consolidation are among responses to low profitability. Transparency and the consistent application of common prudential requirements and supervisory rules across jurisdictions are preconditions which could contribute to the use of opportunities cross border consolidation may offer.
- 4. Risks related to the leveraged loan market and Collateralized Loan Obligations (CLOs) in the global financial sector should be further explored and identified.** There is a lack of clarity about the total volume of leveraged loans outstanding and about the ultimate holders of risks of many CLO tranches. Supervisors have raised concerns about a possible underpricing of risks (see Box 2).
- 5. European supervisory authorities and financial institutions should continue the work on identifying exposures to climate related risks and facilitate access to sustainable assets for investors wanting to invest in the transition to a low-carbon emission economy.** As a starting point, the development of a taxonomy of green activities, as is currently being undertaken by the European Commission, can enable capital markets to identify and respond to investment opportunities that contribute to environmental policy objectives.¹ Scenario analysis and stress testing are important tools which can be set in by supervisors to identify risks to the financial sector, with a goal to incorporate sustainability considerations into risk assessment and risk analysis. This should help the supervisory authorities to assess to which extent the build-up of buffers accounting for these risks is needed. The ESAs are currently developing these tools. Financial institutions should incorporate climate risk (and other environmental, social and governance (ESG) factors) into their risk management framework and policy decisions, if such risks are relevant, and should play a stewardship role by taking into account the impact of their activities (investment, lending and insuring) on ESG factors. Going forward, the ESAs should take a proactive stance in fulfilling upcoming tasks and mandates on sustainable finance, including on how ESG considerations can be incorporated into the regulatory and supervisory framework of EU financial institutions.

¹ [EC Taxonomy technical report, June 2019.](#)

INTRODUCTION

Euro area and global economic prospects have weakened somewhat since the publication of the Spring 2019 Joint Committee Report on Risks and Vulnerabilities. Political risk related to Brexit remains an important source of uncertainty in Europe, while increased trade tensions and the risk of further escalation of protectionist measures contribute to growing political uncertainty and weakening of the global growth outlook. Global economic growth has slowed in recent months, with the IMF estimating global economic growth this year at 3.2%; 0.1 percentage point lower than projected in the April WEO projections.² Correspondingly, the interest rate outlook has also moderated, pointing to a prolongation of the current low interest rate environment in Europe, which may further add to the build-up of risks. Along with challenges related to high indebtedness, these risks represent key concerns for the global economy and financial stability together with the resurfacing of concerns regarding search-for-yield strategies and increased-risk taking as a consequence of the prolonged low interest rate environment.

Against this background, the risks related to (i) the UK's decision to withdraw from the EU and (ii) the effects of the low interest rate environment are considered as key risks to the EU financial system in this report. Lastly, in line with the high importance and attention given to Climate Change and Sustainable Development Goals in the international agenda³, the report also highlights risks associated to exposures towards sectors considered not sustainable.

1 RISKS RELATED TO THE UK'S DECISION TO WITHDRAW FROM THE EU

The Brexit date has been postponed until October 31, 2019, and the risk of a no-deal Brexit has not yet subsided. Financial institutions should continue to plan for a no-deal Brexit scenario. On 10 April 2019, the European Council decided to postpone the UK's date of exit from the EU to 31 October 2019 at the latest. Before this date, the UK and the EU must have ratified the conditions under which the UK will leave the EU. The transition period up to the end of 2020 that the EU and the UK agreed at an earlier stage - and which comes into effect after ratification of the exit agreement – is not adjusted. If it is not possible to ratify the exit agreement before 31 October, the UK will leave the EU without agreement and without a transition period. Such a no-deal Brexit can be accompanied by sharp corrections on financial markets, such as falling asset prices and rising risk premia. This can in particular negatively affect institutions which are significantly interconnected, such as, but not limited to CCPs.

In light of the delay, following the adoption of the amended equivalence decisions in relation to three UK central counterparties (CCPs) and one central securities depository (CSD) by the European Commission on 3 April 2019, ESMA issued new recognition decisions to make sure that the UK CCPs and the CSD will be recognised in the event of a no-deal Brexit. ESMA also continues to monitor the relocation of financial services activities from the UK and promote convergent authorisation and ongoing supervision practices through the established Supervisory Coordination Network (SCN). In recent months, a slowing trend in Brexit-related authorisation activities has been observed. This may be because of firms postponing the transfer of all or part of their activities, or firms re-opening discussions with NCAs to scale down the transfer of their activities and resources.

In order to reduce the potential adverse effects of the application of the trading obligation for shares (STO) under MiFIR in a no-deal scenario, ESMA issued a public statement on 29 May 2019, providing clarification on the scope of the approach previously outlined on 18 March 2019. This approach will limit market disruption, while also ensuring Article 23 of MiFIR is adequately and consistently applied across the EU.

² [IMF WEO update, July 2019.](#)

³ Paris Agreement on climate change and the UN 2030 Agenda for Sustainable Development.

ESMA encourages all firms to continue their contingency planning, as the risk of a no-deal Brexit remains. In the event of the no-deal Brexit, the existing ESMA-coordinated Memoranda of Understanding (MoUs) between UK authorities and European securities regulators, including ESMA, will help avoid significant cliff-edge risks.

As outlined in the Spring Report, EIOPA has urged insurance undertakings and national supervisors to make contingency planning and take the necessary steps to ensure service continuity on cross-border insurance contracts in the event of a no-deal Brexit. The UK insurers with the largest cross-border business have taken action and are implementing contingency measures. In the meantime a number of EU27 member states⁴ introduced transitional measures at national level allowing UK undertakings to run-off residual business in the respective countries after the Brexit date without further measures. When following up on the developments, EIOPA has observed that UK insurers are making use of these options. In this context, EIOPA issued Recommendations to national competent authorities providing guidance on the supervisory treatment of residual insurance business with the objective to minimise the detriment to policyholders with such cross-border insurance contracts.⁵ EIOPA and its members agreed MoUs with relevant UK authorities covering supervision of insurance undertakings and occupational pensions institutions, in order to ensure sound prudential and conduct supervision and maintain financial stability in a no-deal scenario.

The EBA continues to work with competent authorities to monitor Brexit-related developments and associated contingency planning by financial institutions to understand and mitigate potential risks. In particular, this focuses on the issues established in the EBA's Opinions published in October 2018, June 2018 and March 2019, which include: (i) access to financial market infrastructure; ability to perform contractual obligations under the existing contracts, including performance of ancillary services or actions, (ii) access to funding markets, (iii) use of UK law in issuances of MREL eligible instruments, (iv) relocations and authorisations, and (v) that depositors in the branches of UK credit institutions in the EU are adequately protected by the EU deposit guarantee schemes in case of the cliff-edge scenario.

In addition to the risk assessment and monitoring of the industry preparations, the EBA has been active in the preparations for post-Brexit cooperation agreements, where the focus has been three-fold: (1) cooperation among supervisors, (2) cooperation among resolution authorities and (3) cooperation between the EBA and the UK authorities. In all these three areas, the EBA has developed MoUs which were concluded with UK authorities in spring 2019⁶. All of these MoUs are considered as cliff-edge MoUs to be set in place in case a cliff-edge scenario materialises, and ensuring that the supervisory and resolution cooperation between the EU and the UK is proportionate to the integration of both financial sectors.

2 RISK RELATED TO THE LOW INTEREST RATE ENVIRONMENT

A. Market developments

In the first half of 2019, the global macroeconomic environment improved, following a pronounced deceleration in business activity last year. However, faced with lower inflation expectations, major central banks have adjusted their policy guidance early in the year, easing the monetary stance and leading to changes in investor expectations.

Financial conditions recovered during the first half of 2019, with major asset classes posting strong market performance (Figure 1) and declining volatility through the first four months. However, volatility picked up again

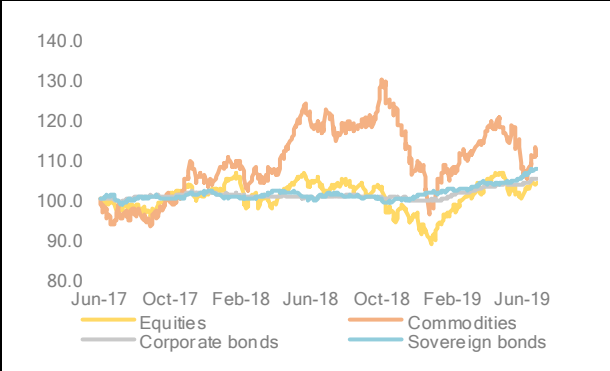
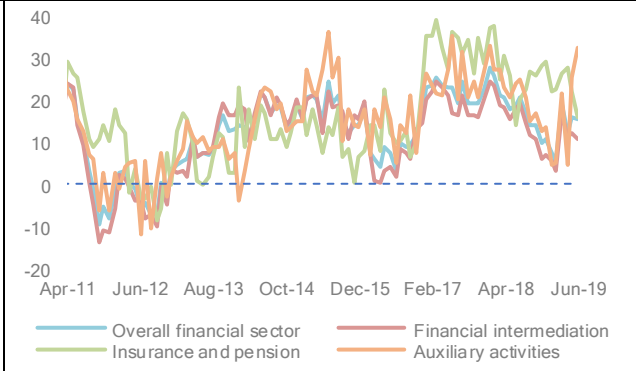

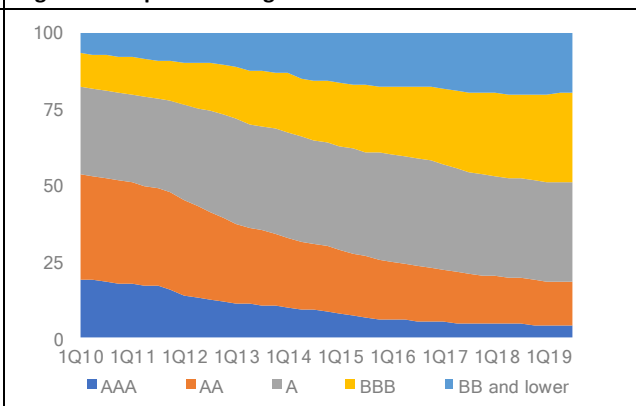
⁴ e.g. DE, ES, FR, IE, IT, LU.

⁵ [EIOPA Recommendations for the insurance sector in light of the United Kingdom \(UK\) withdrawing from the European Union without a withdrawal agreement, 19 February 2019.](#)

⁶ [EBA Board of Supervisors agrees a template for the MoU, 20 March 2019.](#)

in May against the backdrop of global trade tensions, in particular between the US and China. EU market confidence continued its gradual decline, although it remained positive on a net basis (Figure 2).

Narrowing bond spreads signal the possible return of search-for-yield strategies and increasing valuation risks in a sign of increased risk-taking by EU bond market participants. European bond spreads have narrowed again since the beginning of the year, spurred by changes in monetary policy expectations and investor repricing of the forward rate curve, reversing some of the decompression witnessed in the course of 2018 (Figure 3). Corporate bond yields are around their all-time lows and experienced a significant decline of 50bps on average through the end of April, including 79bps for BBB-rated bonds.

<p>Figure 1: Market performance</p>  <p>Note: Return indices on EU equities (Datastream regional index), global commodities (S&P GSCI) converted to EUR, EA corporate and sovereign bonds (iBoxx EUR, all maturities). 01/06/2017=100. Sources: Refinitiv Datastream, ESMA.</p>	<p>Figure 2: Market confidence</p>  <p>Note: European Commission survey of EU financial services sector and subsectors (NACE Rev.2 64, 65, 66). Confidence indicators are averages of the net balance of responses to questions on development of the business situation over the past three months, evolution of demand over the past three months and expectation of demand over the next three months, in % of answers received. Sources: European Commission, ESMA.</p>
<p>Figure 3: Corporate bond spreads</p>  <p>Note: EA corporate bond option-adjusted spreads by rating, in bps. Sources: Refinitiv Datastream, ESMA.</p>	<p>Figure 4: Corporate rating distribution</p>  <p>Note: Outstanding amount of corporate bonds in the EU as of issuance date by rating category, in % of the total. Sources: Refinitiv EIKON, ESMA.</p>

This comes against the backdrop of a gradual deterioration in the credit quality of outstanding corporate bonds from EU issuers over the last decade (Figure 4). While investment-grade issuance remains the norm, the share of BBB-rated bonds outstanding has expanded from less than 10% in 2009 to almost 30% in 2019, reflecting a combination of rating downgrades and increased issuance from lower-rated corporates. Correspondingly, the share of AAA-rated bond dropped from 19% in 2009, to less than 4% in 2019.

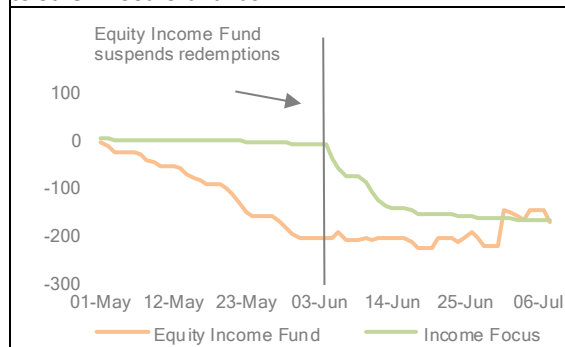
B. Risks in the investment fund sector

The potential comeback of search-for-yield strategies implies that investors are likely to pile up again in risky assets, while the average portfolio quality of EU investors has already significantly deteriorated over the past decade⁷. More recently, the situation appears to have stabilised within the investment fund industry, with the credit quality of assets held in bond fund portfolios stable year-on-year, and more than 60% on average of bond portfolios rated investment grade. In the context of search-for-yield and the prevailing environment of low interest rates the liquidity of fund assets has also been a key concern for regulators.

BOX 1: LIQUIDITY RISK IN INVESTMENT FUNDS AND INVESTMENT FUND STRESS TESTING

Two events affecting UCITS in June 2019 heightened liquidity risk concerns for investment funds. First, LF Woodford Equity Income Fund, a UCITS domiciled in the UK, decided to suspend redemptions to protect remaining investors. In a context of increased outflows (EUR 2bn over the preceding twelve months), the fund faced redemption orders of 8% of its NAV on one day. This led to it suspending redemptions. This action was taken with the objective of protecting investors. Otherwise, the fund would have had either to sell unquoted and less liquid stocks at prices below current values. Alternatively, it would have had to sell the remaining most liquid assets, leaving investors exposed to a less liquid portfolio potentially in breach of the 10% limit on illiquid assets. After the suspension, another fund managed by the same manager, albeit with a more liquid investment strategy, also experienced large outflows, thus pointing at a possible contagion effect (Figure 5). UK funds with similar investment styles (“UK Equity Income”) have also experienced large and sustained outflows over the last year without facing liquidity issues. Outflows totalled EUR 16bn over the last 12 months (22% of their AuM). UK Equity Income funds had AuM of EUR 52bn as of end-May 2019, against EUR 67bn a year ago.

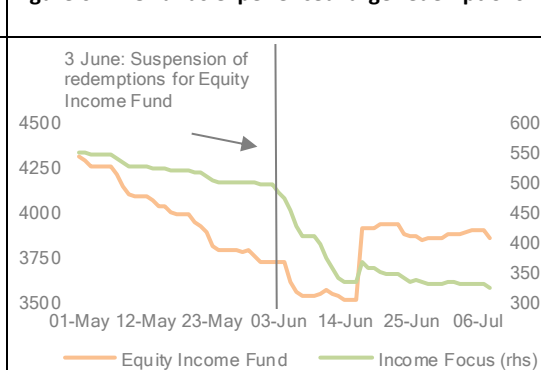
Figure 5: Woodford fund redemption suspension – spillover to other Woodford funds



Note: Cumulated net flows since 1 May 2019, in GBP Mn.

Sources: Morningstar, ESMA.

Figure 6: H2O funds experienced large redemptions



Note: AuM in GBP Mn. Sources: Morningstar, ESMA.

Second, a range of UCITS managed by H2O, also experienced large outflows in June, totalling 30% of NAV in one week. Cumulated outflows in June amounted to EUR 6.5bn (34% of NAV) and the funds had a combined decline in NAV of EUR 6.9bn (36%). The large redemptions affecting H2O UCITS were not caused by poor performance as in the Woodford case, but rather by concerns over potential illiquid bonds exposures (Figure 6). To mitigate the impact of redemptions on remaining investors, the asset management company announced on Monday 24 June the use of a liquidity management tool (swing pricing) on its UCITS. This measure, together with the suspension of entrance fees for new investors introduced at the beginning of 2019, has contributed to stopping outflows from the funds.

In this context, it is of utmost importance that asset managers properly manage liquidity risk in their funds by applying the regulatory provisions on liquidity management. Moreover, when it comes to UCITS funds, the existing requirements on the eligibility of the assets into which these funds are allowed to invest (in

⁷ ESRB Report on “Macprudential policy issues arising from low interest rates and structural changes in the EU financial system”, November 2016.

particular, the obligation for a UCITS to be invested in liquid assets), while properly applied, should be able to alleviate liquidity concerns.

In addition, investment fund stress testing is also an important supervisory tool and ESMA has been pursuing an investment fund stress test strategy encompassing three workstreams where final outcomes have been published during this summer:

- The liquidity stress test guidelines set out criteria on the practice to be followed by managers for the stress testing of liquidity risk for individual AIFs and UCITS, with a view to promote convergence in the way NCAs supervise funds liquidity stress testing across the EU⁸.
- The MMF stress testing guidelines include a methodology and stress test scenarios, the results of which have to be reported to the NCAs and ESMA.⁹
- The ESMA Economic Report on stress simulation for investment funds, which introduces ESMA's fund stress simulation framework and provides a case study looking at liquidity risks for bond funds. The report finds that most EU bond funds are largely resilient to severe outflows resulting from redemptions, with pockets of vulnerabilities concentrated in funds exposed to less liquid assets, such as high-yield and emerging market bonds.¹⁰

The recent economic slowdown has increased potential credit risk arising from rating migration. In Q1 2019 corporate bond fund portfolios comprised 48% of BBB-rated bonds, which are the most susceptible to migrate to high yield and become so-called "fallen angels". While the average share of BBB-rated corporate bonds downgraded to high-yield is historically below 5% per year, it peaked to 16% in 2009¹¹. Should a large number of BBB bonds be downgraded to high yield, some investors may be forced to sell them. For example, investment funds tracking an investment-grade index may be forced to sell downgraded securities excluded from an index. Eventually, significant sales could affect bond prices beyond fundamentals and put additional pressure on funding conditions.

C. Risks in the insurance and pension fund sector

The EIOPA qualitative Spring 2019 Survey¹² reveals that low interest rates remain the main risk for both the insurance and pension fund sectors. Within insurance, life business is typically the most affected segment in an environment of prolonged low interest rates, given their higher propensity for duration mismatches.

Life insurers, who rely on investment returns to cover long-term policyholder obligations with guaranteed rates issued in the past, remain under pressure and they are trying to adapt by lowering guaranteed rates and focusing on unit-linked products. Nevertheless, the legacy products with guaranteed rates still make up the majority of technical provisions in the EEA (approximately two-thirds of the total life best estimate in the EEA have some form of guaranteed rate).

The prolonged low interest rate environment continues to challenge the profitability of the European insurance sector, which has deteriorated further in 2018. The median return on investment decreased significantly in 2017 to only 1.95%, compared to 2.83% in 2016. Furthermore, the median return on excess of assets over liabilities dropped from 5.6% in 2017 to 4.9% in 2018.¹³

⁸ [Guidelines on liquidity stress testing in UCITS and AIFs, 2 September 2019.](#)

⁹ [Guidelines on stress test scenarios under the MMF Regulation, 19 July 2019.](#)

¹⁰ [ESMA Economic Report on Stress simulation for investment funds, 5 September 2019.](#)

¹¹ See ESMA central repository (CEREP) for rating activity statistics and rating performance statistics of credit rating agencies.

¹² The survey was carried out in February – March 2019 and only reflects market developments until then. Therefore, the survey does not reflect concerns over the recent market developments such as sovereign spreads widening for some countries.

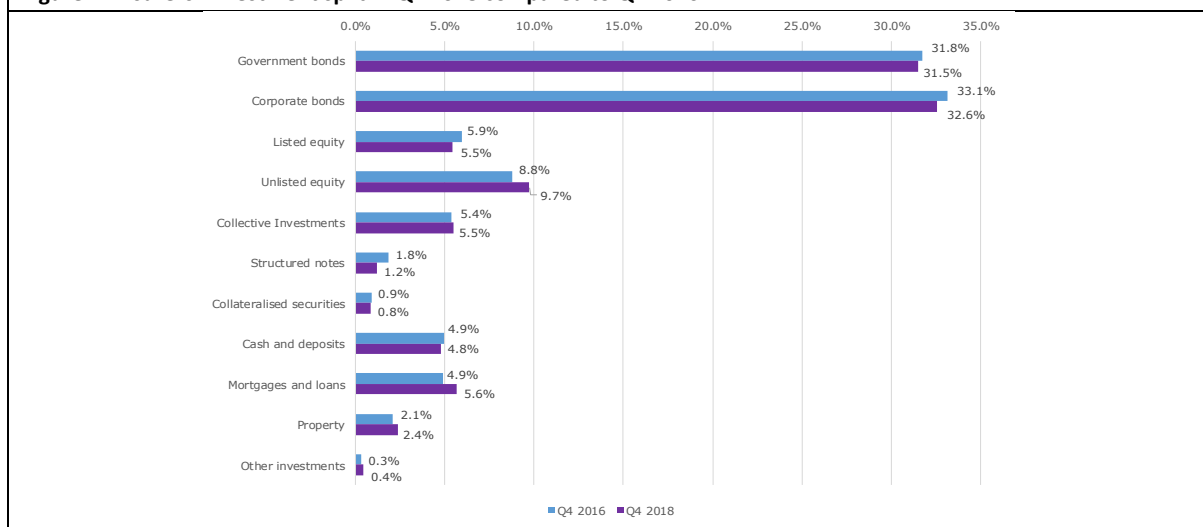
¹³ The return on excess of assets over liabilities is used as a proxy for return on equity.

Despite lower profitability, the European insurance sector remains well capitalized. The solvency position of life insurers has slightly improved in 2018 due to a slight increase in the interest rates used for discounting liabilities¹⁴. On the other hand, non-life insurer’s capitalization remains generally at the same level in 2018, while the median SCR ratio for composite insurers slightly decreased from 220% in 2017 to 204%.

The European occupational pension fund (PF) sector also continues to be negatively affected by the persistent low interest rate environment. Additionally, in 2018 the sector came under increased pressure by the fall in stock values pertaining to significant losses in IORPs’ equity investments. Providing long-term guarantees becomes expensive in an environment with low long-term interest rates, so that PF’s balance sheets promoting Defined Benefit schemes are primarily affected, as they provide employees with a pre-defined level of pension. Also PF’s promoting Defined Contribution schemes have lost value and are affected by the low interest rate environment. Here, the investment risk is with the member and beneficiary of the pension fund and will have to cater for the consequences in their savings.

The challenges posed by the low interest rate environment might be an incentive to search for yield behaviours. In the EIOPA’s 2017 investment behaviour report, some trends could be identified related to increased exposure of insurance groups towards more illiquid investments including non-listed equities and loans and lower credit rating quality fixed income securities.

Figure 7: Insurers’ investment split in Q4 2018 compared to Q4 2016



Note: Look-through approach applied. Assets held for unit-linked business are excluded. Equities include holdings in related undertakings.

Source: EIOPA Quarterly Solo. Reference Date: Q4 2018.

Insurance companies’ investments in fixed income assets have slightly decreased during the last three years while unlisted equity as well as mortgages and loans have increased (see Figure 7). However, insurers remain heavily invested in government and corporate bonds, making them vulnerable in case of a sudden reassessment of risk premia and increase in credit spreads. Government and corporate bonds make up around two-thirds of the total investment portfolio, with life insurers relying most heavily on fixed-income assets due to the importance of asset-liability matching of their long-term obligations.

¹⁴ It should be noted however that the increase in the discount rate is primarily due to a higher Volatility Adjustment, as the risk free rates have slightly decreased in 2018. Furthermore, the Ultimate Forward Rate (UFR) used in the derivation of the risk free rate curve for discounting long-term liabilities under Solvency II was lowered by 15bps as of 1-1-2018, following the application of the [EIOPA methodology](#) to derive the UFR. This has counterbalanced the observed rise in interest rates for long-term liabilities.

BOX 2: COLLATERALISED LOANS OBLIGATIONS (CLOs) AND COLLATERALIZED MORTGAGES OBLIGATIONS (CMOS)

The Spring Report already highlighted that the leveraged lending market and collateralised loans and mortgage market have increased significantly over the last few years and warrant increased attention by authorities. Direct and indirect exposures to CLOs and leveraged loans have raised concerns due to a potential underpricing of risk by investors and their underwriting standards.

While most CLO tranches outstanding have a high credit rating, CLO collateral quality and structural protections have weakened recently. Around 60% of the CLO tranches outstanding are rated AAA, while the riskier tranches, which include both sub-investment-grade and unrated equity tranches, account for around 20%, or USD 140 billion.

Banks typically purchase AAA senior and upper mezzanine tranches, while insurance companies buy upper mezzanine tranches, and hedge funds purchase the riskiest tranches, including equity. While AAA and high-rated upper mezzanine tranches are unlikely to incur losses even in severe stress, they are subject to significant downgrade risks. Moreover, banks holding these tranches and applying internal ratings-based approaches for the computation of capital charges would be exposed to significantly increased capital charges should more severe stress scenarios materialise. Indirect exposure such as commitments to syndicate leveraged loans or funding facilities extended to leveraged borrowers, or to vehicles with leveraged concentrations, pose additional risks to banks concerned.

Overall, EU funds exposures to CLOs are limited, amounting to EUR 54 billion. UCITS exposures to CLOs were around EUR 36bn end-2018 across 3,843 funds. However, the data also include Collateralised Debt Obligations (CDOs) and should therefore be interpreted as a maximum. Regarding Alternative Investment Funds (AIFs), exposures to CDO/CLOs amounted to EUR 17bn, which corresponded to 5% of the CLO market at that point in time. Exposures are spread across more than 500 AIFs, with a combined NAV of EUR 475bn, accounting for less than 10% of all AIFs.

The exposure of European insurers to CLOs and CMOS is still limited at an aggregate level, representing about 0.06% of total investment assets, while overall collateralized securities are slightly below 1% of the total investment assets¹⁵. In terms of credit quality the bulk of the exposures corresponds to AAA and AA, though the proportion of non-investment grade has somewhat increased since the beginning of 2017. When looking at an individual level some undertakings seem more significantly exposed. This justifies monitoring of potential developments in exposures over time, especially at a microprudential level.

In 2019 ESMA will review the quality of CLOs' rating process and rating methodologies. Among others, ESMA will look into the rigorousness, validation and historical back-testing of CLO rating methodologies, their systematic application as well as the adequacy of CRAs' arrangements to timely incorporate new information into CLO ratings.

D. Risks in the banking sector

The prolonged low interest rate environment has been a key factor contributing to subdued profitability in the EU banking sector. Although profitability has been on an increasing trend since 2014, it has levelled in recent quarters, and the current average return on equity (RoE) of 6.8% in Q1 2019 is at the same level as in Q1 2018. However, current profitability often appears insufficient to guarantee long-term sustainability of banks' prevailing business models, while efficiency in the banking sector has further deteriorated. The cost-to-income ratio has risen from 65% in Q1 2018 to 66.3% in Q1 2019, and is mainly driven by a 1.4% increase in costs.

¹⁵ There might be some degree of underestimation as it is not possible to assess exposure through investment funds.

Increasing costs underpin the need for banks to further reduce other operating expenses which are not primarily related to ICT investments, which are necessary for future competitiveness and resilience. In addition, conduct and legal risks, including those related to money laundering and terrorist financing, remain high, and litigation costs and costs related to governance issues can also negatively affect profitability.

In line with reinforced expectations of a continued low interest rate environment and flattening yield curves, the outlook for interest income and profitability remains subdued. Accordingly, the share of participating banks in the EBA risk assessment questionnaire (RAQ) expecting increasing profitability is low. Only about 25% of respondents expect an overall increase in bank's profitability in the next 6 - 12 months, compared to 29% expressing such expectation in the December 2018 RAQ.

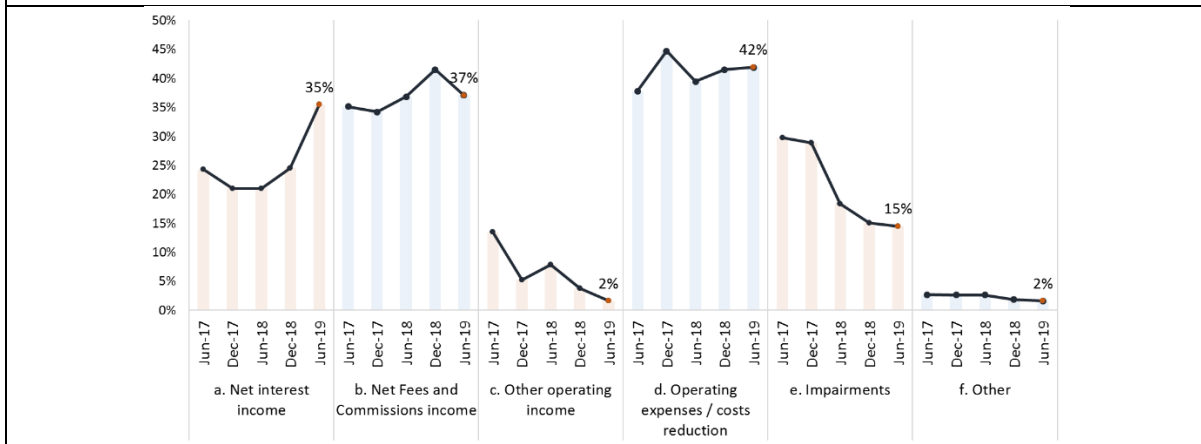
Net interest income (NII) is the most important source of bank income, but has decreased by 6.2% from March 2015 to March 2019 (EUR 347bn¹⁶) during the prolonged low interest rate environment, and in spite of growing lending volumes. Slightly increasing NII has nevertheless been observed since Q1 2018. Accordingly, in their responses to the EBA RAQ, the share of participating banks targeting interest income to improve profitability has increased to 35%, compared to 21% in June 2018. Increasing interest income may nevertheless be difficult to attain in an environment of a further continued low interest rates, and amid growing competitive pressure within the banking sector and from financial technology (FinTech). The net interest margins have also decreased further, and tightened by 5bp in Q1 2019, to 1.42%, its lowest level reported in the EBA risk dashboard. Reduced net interest margins are the main driver of subdued NII, and point to challenges to increase interest income. Repricing of new loans at lower interest rates is also affecting NII and may continue to put pressure on NII as market participants renegotiate lending terms to reflect renewed expectations that interest rates will not increase in the medium term.

Beyond NII, net fee and commission income, as the second most important contributor to EU banks' profitability, has decreased by 1.7 percentage points between Q1 2018 and Q1 2019. This decrease can be observed against banks expressed intentions in earlier iterations of the EBA RAQ to primarily target fee and commission income to improve profitability, and underlines general profitability challenges for EU banks. Net trading income strongly increased in Q1 2019 amid very volatile financial markets in this quarter, which tend to support trading income. Trading income nevertheless only accounts for a minor share of EU banks' income sources.

To increase net fee and commission income (37% of EBA RAQ responses) and to reduce operating expenses (42% of responses) are primary targets of banks to increase profitability, according to the June 2019 EBA RAQ. Automatisation and digitisation are key areas for EU banks to reduce operating expenses (90% of responses), ahead of overhead- and staff cost reductions (79% of responses), but require costly investments into IT and financial technology first (see Figure 8).

¹⁶ Based on a stable sample of supervisory reporting banks, annualised.

Figure 8: Target areas for EU banks to improve profitability in the next few month, June 2017 to June 2019



Source: EBA Risk Assessment Questionnaire.

BOX 3 : CHALLENGES TO CONSOLIDATION IN THE EU BANKING SECTOR

The EU banking sector is perceived to have scope for consolidation, as economies of scale and of scope appear not fully utilised in the EU banking sector, and the current business model often does not support long-term sustainable profitability. However, there has been very little merger and acquisition (M&A) activity in the years since the crisis, and in particular across borders. The number of M&A transactions has rather been on a steady decline in the past years, and transaction values reached the lowest level in H1 2017.

Reluctance for cross border M&A may to some extent be a legacy from the financial crisis, where one response of EU banks was to reduce cross-border activity and focus on their core, mostly domestic, business, and national approaches often prevailed. Examples of not very successful M&A transaction in the EU banking sector in the past may also contribute to reluctance. When looking at present reasons for reluctance for cross-border consolidation, low margins, low profitability, cultural aspects and an identified lack of business cases for potential M&A are often being mentioned. Legal barriers as well as regulatory restrictions to freely allocate capital and liquidity across borders are also being mentioned.

To assure that the opportunities, which cross border consolidation offer, can materialize, it will be important that supervisory authorities across jurisdictions consistently apply the common rules and regulations binding to all. Supervisors should strive to further harmonise supervisory practises, including on Pillar 2. On a policy level, further steps to develop the banking union in a single jurisdiction would be important.

Transparency and reliability of prudential requirements before and after mergers appear to be a pre-condition for predictable pricing in M&A processes. Clear and stable supervisory expectations on operational integration in a post-merger setting are an important consideration when evaluating potential M&A, against perceptions that supervisory actions at a national level trap resources within jurisdictions, at the expense of efficient cross-border group allocation. There are further perceptions that clarity on internal MREL requirements and resolution, and further transparency for defining and applying Pillar 2 requirements would be conducive to facilitate bank sector consolidation. To attain sustainable consolidation at an institutional level, the ability to integrate different IT-systems is an important element of post-merger integration, and often underpins the realisation of projected M&A gains.

3 SUSTAINABLE FINANCE AND ESG RELATED RISKS

There is now a broad consensus that climate change and the transition to a low-carbon economy can constitute significant risks to financial stability¹⁷. Climate related risks are typically divided into two categories, physical risks and transition risks, with the former referring to actual climate change disrupting the economy and affecting the value of assets all over the world, while the latter refers to risks resulting from an abrupt transition (be it political, technological or from consumer demand) to a more sustainable, low-carbon economy. Consequently, climate related risks and sustainable finance are increasingly important on the international financial agenda, as awareness is growing that financial stability risks can be mitigated by encouraging a timely and steady transition.

Through the review of the European Supervisory Authorities Regulations¹⁸ sustainable finance has become a key consideration for the ESAs. In performing their tasks, the authorities will have to take account of risks related to ESG related factors and provide guidance on how to embody sustainability considerations in relevant EU financial legislation and promote coherent implementation of these provisions.

Investors are also increasingly integrating ESG assets into their portfolios and are considering ESG factors alongside traditional financial factors in the investment decision-making process.

EU-based investors are showing a growing interest in green and sustainable finance, which is reflected in the strong expansion (both in terms of size and market coverage) of the global green bond market. Since 2007, when the European Investment Bank issued the first green bond, the EU green bond issuance has been increasing and reached an outstanding amount of EUR 210 billion in May 2019. As of January 2019, 36% of the outstanding green bonds have been issued by the financial sector, almost 20% by international agencies and around 15% by each of the following: supnationals, sovereigns and non-financials. Compared to total bond issuance, green bonds represent a limited, but fast-growing share of the overall market. According to recent industry research, green bond issuances represent more than 2% of the global bond issuances in the last two years, rising to 4.4% in the last quarter of 2018.¹⁹ A recent EIOPA empirical study also suggests that announcements of European insurance companies on issuing green bonds or launching green bond funds are positively priced by market investors²⁰.

Financial institutions have a stewardship role in ensuring a gradual transition to a more sustainable economy, ultimately contributing to avoid any potential financial stability implications. This is not only through the incorporation of ESG factors in their investment decisions, but also through their engagement with the economic actors via their business activities (investment, lending and insuring) and the use of ESG risk-based underwriting and pricing practices.

ESMA continues to deliver on the March 2018 European Commission's Action Plan on Financing Sustainable Growth. With the objective to integrate sustainability considerations into the EU financial policy framework, ESMA is focusing on the following tasks:

- In parallel with other ESAs, ESMA is developing a report (advice) which will present initial evidence on potential undue pressures from the financial sector on corporations to prioritise near-term shareholder interests over long-term growth of the firm.
- ESMA includes provisions on sustainability preferences in its guidelines on the suitability assessment. Namely, by now ESMA published i) a Consultation Paper with the draft technical advice to the EC on

¹⁷ Network for Greening the Financial System (April 2019), A call for action - Climate change as a source of financial risk, pp. 11-17.

¹⁸ The ESA review was agreed in March 2019.

¹⁹ [2019 Global Green Bond Outlook, Moody's Investor Services, 31 January 2019.](#)

²⁰ Jakubik, P. and Uguz, S. (2019): Impact of green bond policies on insurers: Evidence from the European Equity Market, EIOPA Financial Stability Report June, pp. 66-75.

suggested changes to MiFID Level 2, and suggested changes to the ESMA guidelines on suitability and ESMA guidelines on product governance; ii) a Final Report with the final technical advice to the EC on suggested changes to MiFID Level 2.

- ESMA continues supporting investment decision-making in the context of sustainable finance by promoting supervisory convergence at European level in the area of non-financial disclosures by issuers in accordance with the Non-Financial Reporting Directive²¹. In this context, in its Annual Report on the enforcement and regulatory activities of accounting enforcers published in March 2019, ESMA summarised the findings from the reviews conducted in 2018 by national supervisors on the first non-financial statements of European issuers addressing non-financial matters, including environmental, social and governance (ESG) aspects.²² The report highlighted ESMA's expectation that the quality of the disclosures be significantly improved in the subsequent reporting periods and emphasised the need to review the applicable disclosure requirements in order to improve their enforceability. In 2019 ESMA will continue to focus on strengthening the supervisory culture on the disclosures of non-financial information.
- With regard to Credit Rating Agencies, ESMA assessed current practices in the credit rating market, how ESG considerations are taken into account; and prescribes how ESG information should be disclosed.

For the banking sector, the EBA has developed its work plan to translate the European Commission's Action Plan on Financing Sustainable Growth into specific steps and publications. The work follows a sequential approach whereby a market analysis, a review of Pillar 3 and then Pillar 2 frameworks will be considered first before potentially reviewing Pillar 1 regulation and discussing prudential treatment of green and social assets.

In 2019, the EBA prioritises its technical preparatory work on sustainable finance including monitoring market practices related to sustainability and engaging with relevant stakeholders and the industry. In this respect, the EBA has initiated a joint survey with the ECB SSM to identify how EU banks incorporate ESG considerations into their strategy, governance, products and disclosures. The EBA also monitors green banking market practices through its RAQ. First results for Q1 2019 show that the EU green finance market is gaining attention, with a high share of EU banks having or planning to develop products and services based on ESG considerations.

The EBA's preparatory work is intended to lay the foundations for the delivery of future EBA legal mandates included in the revised CRR/CRD framework, in (i) the areas of disclosure of ESG-related risks (Pillar 3), in (ii) assessment of potential inclusion of ESG risks in the SREP (including broader Pillar 2 considerations like risk management and stress-testing) and (iii) assessment of prudential treatment for green and social assets. (National) competent authorities are involved in this work through the recently established EBA Sustainable Finance Network.

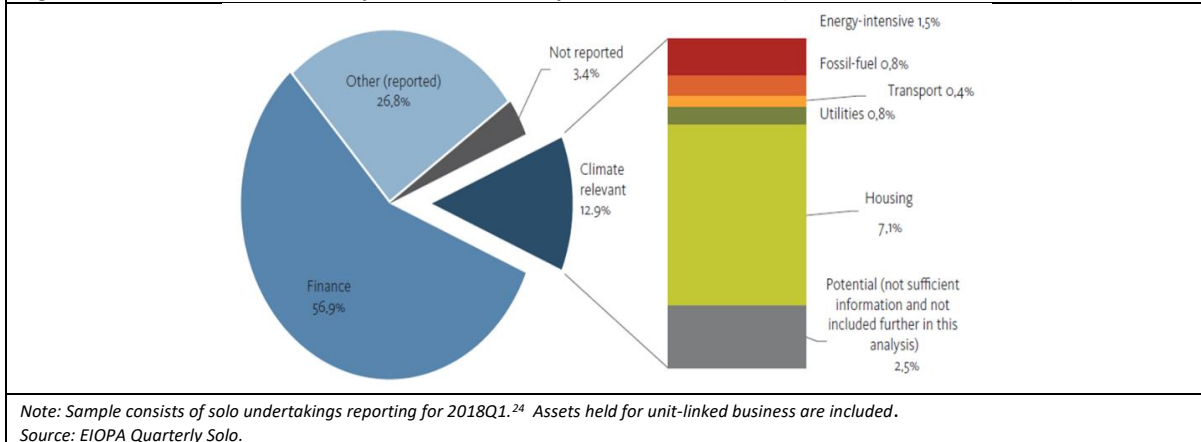
EIOPA has analysed the asset exposures of insurers to climate-related risk, with the aim of assessing the investments that could be at risk in a transition to a more carbon neutral economy. Overall, up to 13% of the assets held by insurers may be vulnerable in a climate-related transition scenario (Figure 9). This amounts to more than 1 trillion euro in assets and corresponds to almost two-thirds of total own funds in the EEA.²³

²¹ Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

²² [EU enforces focus new ifrs standards and non financial information, 27 March 2019.](#)

²³ The approach developed by Battiston et al (2017) has been applied by EIOPA in order to analyse the investment exposure of European insurers to climate-sensitive sectors.²³ This framework defines five climate-relevant sectors (fossil fuel, utilities, energy-intensive, transport and housing) based on their greenhouse gas emissions, their role in the energy supply chain and the so-called carbon leakage risk classification, and provide a mapping at NACE Rev2 4-digit level. For further details on the methodology please refer to [EIOPA FSR, December 2018.](#)

Figure 9: Climate relevant asset exposures of the European insurance sector (% of total investment assets)



EIOPA’s action plan on sustainable finance foresees the development and implementation of a scenario analysis for climate related risks. This analysis would be based on more detailed asset-level information than the sector-level data available in Solvency II reporting. Furthermore, EIOPA aims to further leverage on the experience of (re)insurers, data scientists and the risk modelling industry to establish good practices for climate scenarios to be used by insurers as part of a forward-looking risk assessment under Solvency II, for example in the Own Risk and Solvency Assessment (ORSA).

Moreover, EIOPA is engaging with stakeholders on various sustainability related risks. In June 2019 a consultation on a draft opinion was launched that aims at integrating sustainability risks, in particular those related to climate change, in the investment and underwriting practices of (re)insurers.²⁵ The draft opinion builds on EIOPA’s earlier advice on the integration of sustainability risks and factors regarding organisational requirements and operating conditions in the delegated acts under the Solvency II Directive and the Insurance Distribution Directive.²⁶ Also, EIOPA is concerned about risks of a widening protection gap²⁷ for natural catastrophe risks. In light of climate change, the risk of an increasing frequency and severity of natural catastrophes becomes apparent, and the impact of a protection gap on households, businesses, as well as on the financial system may become systemic.

In the context of the 2019 Occupational Pensions Stress test exercise, EIOPA will also analyse in a qualitative manner how the occupational pensions sector (i.e. IORPs) contributes to mitigating ESG risks. Moreover, IORPs are requested to provide an indication of the exposure to ‘brown’ assets and carbon footprint in their portfolios.

²⁴ Assets for which the reported NACE code does not allow to either exclude or include them in the “climate relevant” category are classified as “potential”.

²⁵ [EIOPA consultation on opinion on sustainability within Solvency II, 3 June 2019.](#)

²⁶ [EIOPA Technical Advice on the integration of sustainability risks and factors in the delegated acts under Solvency II and IDD, 30 April 2019.](#)

²⁷ The protection gap is the difference between insured losses and economic losses, or uninsured losses.