Joint Committee Update on Risks and Vulnerabilities in the EU Financial System – Spring 2025

EFC-FST meeting (27/28 March 2025)

Petra Hielkema, Chair of EIOPA and of the Joint Committee of the ESAs

eba European Banking Authority

eiopa European Insurance and Occupational Pensions Authority

ESMA European Securities and Markets Authority

Background and content

Joint Committee ESAs Update on Risks and Vulnerabilities

The Joint Committee is a forum with the objective of strengthening cooperation between the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), collectively known as the three European Supervisory Authorities (ESAs), and the European Systemic Risk Board (ESRB). Under the Joint Committee, the ESAs prepare a cross-sectoral risk assessment to the Economic and Financial Committee- Financial Stability Table (EFC-FST) which is summarised in this presentation.

Spring 2025 ESAs update on risks and vulnerabilities

- Executive summary with focus on implication of geopolitical risks, and policy recommendation.
- Annex with outlook and risks, details on implication of geopolitical fragmentation and the risks of AI in the financial stability context.

Impact of geopolitical risks on financial sectors (1/3)

Heightened geopolitical risks…

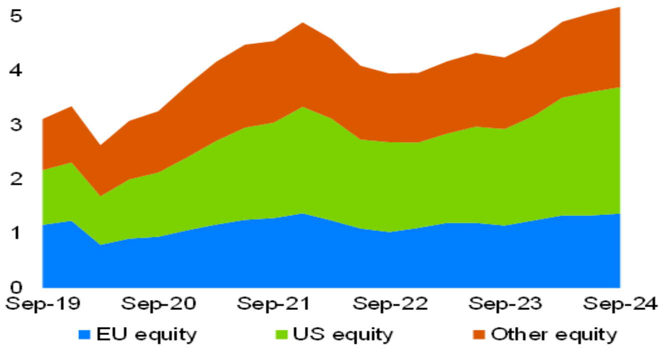
- Trade tensions, global policy uncertainty, fast evolving dynamics of international cooperation are furthering geopolitical fragmentation and adding uncertainty to the macroeconomic outlook.
- European growth is improving more slowly than expected, with uncertainty on the extent and timing of future rate cuts, and potential divergence in rate cutting between EU and US.
- Europe could see an increase in cyber attacks

…heightened financial stability risks

- Increased geopolitical uncertainty and unexpected developments can amplify market volatility, liquidity risk, and increased credit spreads in debt markets.
- Sudden changes in global trade conditions can drive rapid capital relocation and currency volatility.
- Increasing risk of global fragmentation in financial markets.

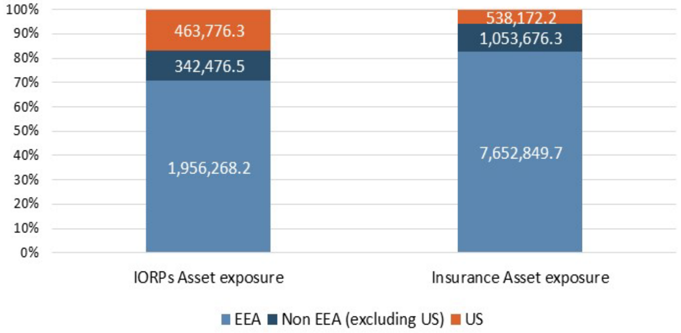
Impact of geopolitical risks on financial sectors (2/3)

Euro area equity fund exposures to US equities rising



Note: Equity held by of EA equity funds, by region of issuance, EUR tn.
Sources: ECB, ESMA

Insurers and IORPs investment by geographical areas



Source: EIOPA Public statistics, Q3 2024

Investment fund exposures outside EEA:

- 77% of the flows in EU equity funds (excl. ETFs) directed to US equity holdings over the last five years.

Financial market infrastructures:

- Significant presence of US entities / groups, in areas such as CRAs, CCPs, with varying degrees of substitutability of services

Insurer and IORP exposures outside EEA:

- Around 17%-30% of insurers assets outside EEA, of which 6% in US. 29% of IORPs exposure outside EEA, of which 17% in US.
- Insurers' non-EEA gross written premia (GWP) is ca. 5% of the total, mainly in UK, Switzerland and China for European insurers. This percentage is an underestimation, as it doesn't include exposure via non-EEA branches.

Bank exposures outside EEA:

- Nearly EUR 5 tn of EU/EEA bank exposures to non-EEA counterparties (23.4% of total), up EUR 350bn (7.9%) YoY. Indirect exposures can pose additional risks.
- The US is the largest counterparty (ca. EUR 1.3 tn), followed by the UK (ca. EUR 900 bn).
- EU/EEA banks' direct exposures to countries exposed to geopolitical risk events is above EUR 500 bn, ca. 2.5% of the total exposure.

Impact of geopolitical risks on financial sectors (3/3)

Banks

- Direct exposures to sectors vulnerable to geopolitical risks.
- Heightened credit risk from counterparties in risk countries.
- Potential increase in operational and legal risk, cyber risk, AML/CFT.
- Possible indirect effects, e.g. from supply chain disruptions and reduced demand due to tariffs.
- Potential higher liquidity needs of clients. Investment risks also in derivatives segments. Potential implications for USD funding.
- Increased interconnections with NBFI could also become source of vunerabilities.
- Potential increase of global regulatory divergence and market segmentation

Insurers and IORPs

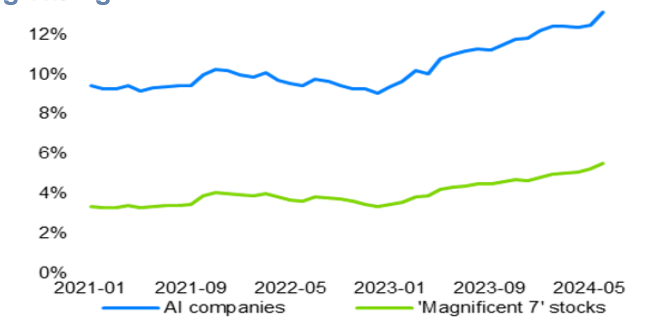
- Heightened investment risk and business growth challenges.
- Mixed effects for Trade Credit Insurance & Non-Life.
- Increase in reinsurance costs due to currency volatility. Higher claims costs in foreign currencies.
- Potential increased exposure to extreme weather, cyber risks, and pandemics due to lower cooperation.

Securities markets, asset management and infrastructures

- Risk of disproportionate reactions to surprises given recent record high US stock valuations and historically low EU corporate bond spreads
- Recent record high crypto valuations and volatility in the context of increasing interconnections to traditional financial markets
- Rising leverage of alternative investment funds and exposure to US equities. Risks of shocks to funds with a liquidity mismatch
- Disruption in market infrastructures (e.g. margin breaches, settlement fails). High cyber risks, growing digitalisation, concentrated reliance on few providers (e.g. AI, cloud use).

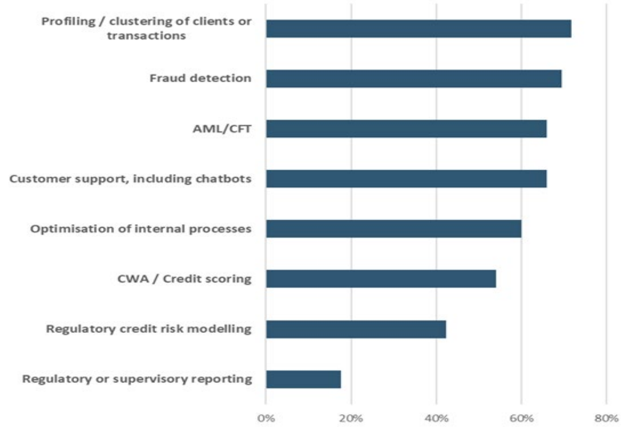
Zooming in AI and cyber risks in the geopolitical context

EU funds' exposure to AI and Mag7 stocks growing



Note: Share of AI companies and of 'Magnificent 7' stocks (as a % of the NAV) in the portfolio of EU equity investment funds. "AI companies" refers to 83 constituents from 7 AI-sector indices. "Magnificent 7" refers to Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia and Tesla.
Sources: Morningstar, ESMA

Uses of AI by EU/EEA banks, per use case, autumn 2024



- **The rapidly changing geopolitical context is increasing cyber risk**
  - The realignment of geopolitical relations could further heighten cyber risks in the EU

- **At the same time, artificial Intelligence (AI) is transforming the operational landscape of financial services**
  - AI is used to enhance investment decisions, algorithmic trading and risk management.
  - In the insurance sector, it is used in areas such underwriting, pricing, claims management and fraud detection and it is increasingly mentioned under operational risks.
  - In the banking sector, it is advancing and enhances efficiency in areas such as customer segmentation and the detection of illicit activities.

- **Beside noticeable benefits, in the current geopolitical context AI could amplify cyber risks through**
  - Market correlations
  - Model risk, data quality, and governance
  - Third-party dependencies and service provider concentration (hardware, cloud services and models)

Policy recommendations

Relevant authorities and financial institutions should be ready to respond to geopolitical challenges

- Prepare for market volatility, liquidity risk, and risks of increasing credit spreads in both sovereign and corporate debt markets.
- Stay ready to adapt in case of trade and supply chain disruptions, declines in global trade volumes and recessionary pressures negatively impacting business. Adequate provisioning is important.
- Monitor macroeconomic and geopolitical risks in risk management frameworks, including scenario analysis of the potential impacts on exposures, capital, liquidity, funding, business models and operational resilience.
- Be ready react to risks, including plans (e.g. recovery plans and adequate provisioning) to address challenges

Relevant authorities and financial institutions should prepare for and manage cyber and AI-related risks

- Improving data governance is crucial for managing the complexities associated with AI adoption in the financial sector. Implementing robust data governance frameworks ensures the accuracy, reliability, and security of data used in and outputs of AI models, alongside regular audits and assessments of data quality.
- The EU AI Act lays down a legal framework for the development and use of AI. Its first elements came into effect in February. In this context, AI impacts need to be monitored in appropriate ways (e.g. on operations, market dynamics, regulatory compliance, interconnectedness, resilience) to assess the evolving progress and risks of AI in the financial sector.
- DORA provides important tools to address heightened cyber and ICT risks. It is important to continue to roll out and implement DORA provisions in a timely and thorough fashion.

Risk and Vulnerabilities – more details

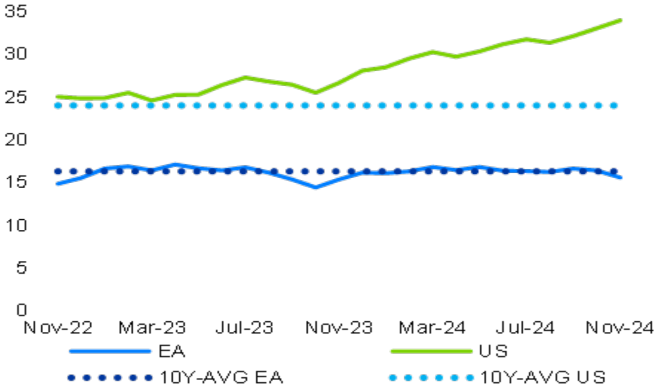
eba European Banking Authority

eiopa European Insurance and Occupational Pensions Authority

ESMA European Securities and Markets Authority

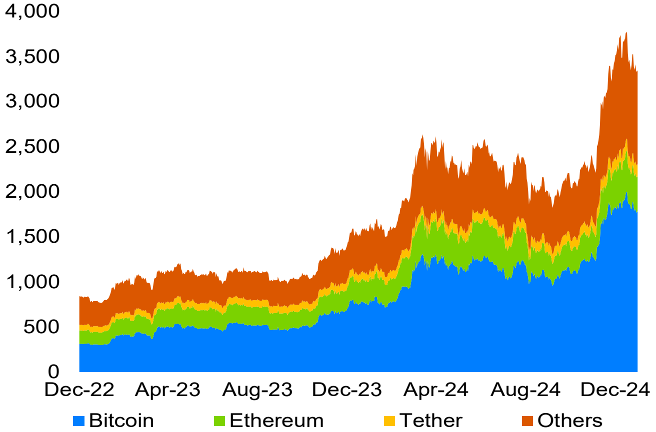
Key trends in market developments and funds

PE ratios: EU and US equities diverge



Note: Price-earning ratios based on average inflation-adjusted earnings from the previous 10 years (cyclically adjusted price-earning ratios). Averages computed from the most recent data point up to 10 years before.
Sources: Refinitiv Datastream, ESMA.

Record-highs in crypto valuations



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

Growth sluggish amid growing geopolitical uncertainties

- **Growth improving more slowly than expected**, with intra-EU divergence and uncertainty on extent / timing of future rate cuts, and potential divergence in rate cutting between EU and US.
- **Major geopolitical uncertainties continue** from ongoing wars, new US policies increasing economic fragmentation, and government instabilities in EU.

EU equities volatile and diverging from US; bond yields rise as spreads tighten

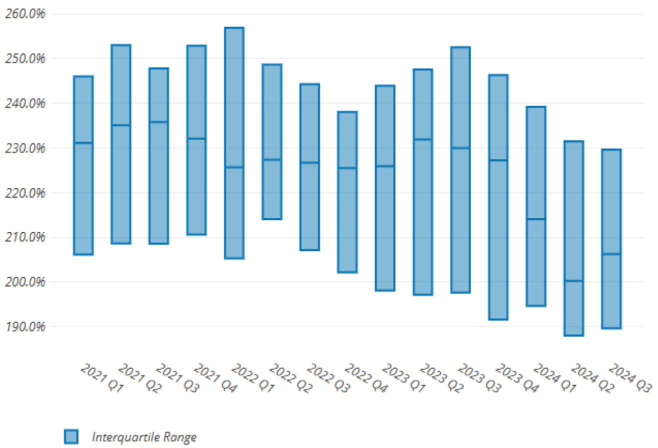
- **Equities**: Since the start of 2025, EU equities, particularly banks, have been broadly increasing, whereas US equities, have been flat and volatile. Overvaluation and concentration concerns remain esp in tech (Mag 7, AI).
- **Bonds**: Sov yields up from October, narrowing spreads, buoyed by demand. Corporates yields decreasing slightly and spreads narrowing, possible under-pricing in riskier segments. In early March 2025, both sovereign and corporate yields jumped on the announcement that Germany would increase borrowing for defence.
- **Commodities**: Natural gas (TTF) rose end of 2024 with colder winter and end of Russian gas transit through Ukraine. Lower storage levels suggest greater demand in summer 2025.
- **Crypto**: Volatile crypto-asset valuations, driven by expectations of US deregulatory policy agenda; increasing interconnections to traditional financial markets
- **Credit quality**: Annual default rate for non-financials peaked in July, but ongoing high refinancing needs could still drive downgrades in vulnerable sectors (e.g. real estate). Slightly deteriorating asset quality outlook in the banking sector.

EU investment funds reach 2-year high with muted flows in 2H24

- **Positive returns across fund types:** EU equity funds increasingly exposed to US and strong performance in 2024 contrasts with EU equity indices which flattened.
- **Leverage, valuation related risks remain:** leverage continuing to increase for alternative funds; RE funds have kept value despite CRE and RE seeing sizeable falls.

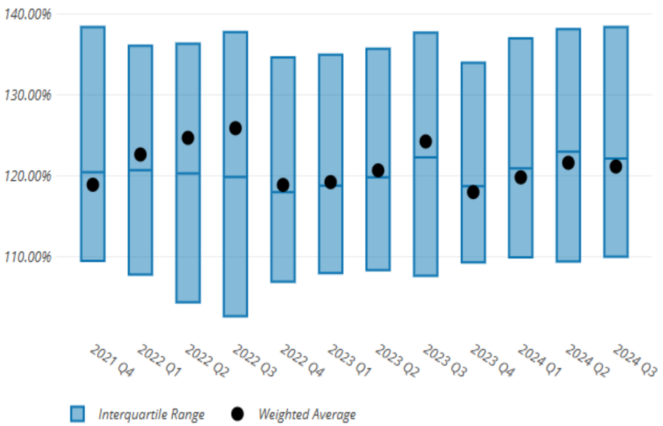
Capital positions in the insurance and IORPs sectors remain strong, despite macroeconomic uncertainty

Solvency Ratio - Groups



Source: Solvency II, Reference date: Q3 2024

Funding Ratios (DB schemes)



Source: Occupational Pensions Statistics, Reference date: Q2 2024

Insurance and IORPs remain strong, despite macroeconomic uncertainty amid inflationary pressures combined with drops in interest rates and subdued growth

Insurers slightly increased their capital position while keeping profitability stable

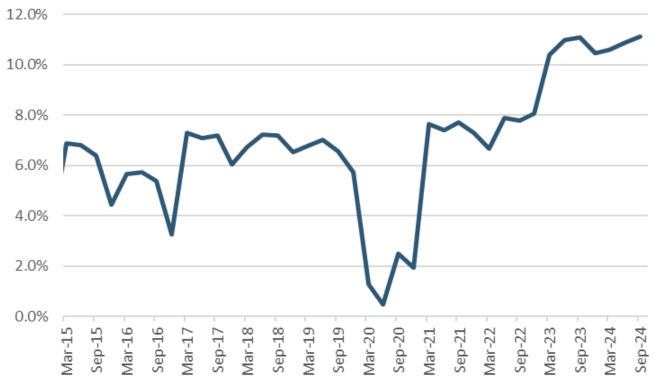
- Solvency and profitability risks remain stable, with improved solvency ratios for both insurance groups and non-life undertakings
- Solvency ratios improved for insurance groups from 200.3% in Q2 2024 to 206.3% Q3 2024 and for non-life from 211.6% to 214.8%, while it remained broadly stable for life around 230.5%

Financial positions of DB IORPs' staid robust in Q3 2024

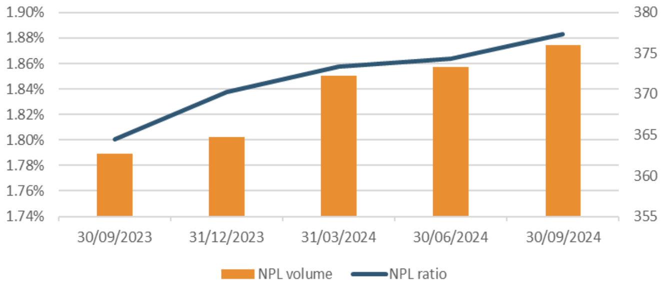
- After having improved for 2 quarters, the median funding ratio, calculated as assets over technical provisions remained stable at 122.1%
- Similarly, the ratio Excess of assets over Liabilities was above 20%, as from previous quarter, after having increased from three consecutive quarters (form Q4 2023 to Q2 2024)

EU/EEA banks' profitability remains high, but costs are sticky. Asset growth is sluggish, and asset quality is slowly deteriorating

EU/EEA banks' return on equity, Q1 2015 – Q3 2024



EU/EEA banks' NPL ratio (lhs) and volume (rhs), Q3 2023 – Q3 2024



EU/EEA banks' return on equity (RoE) remains high (at 11.1% in Q3 2024)

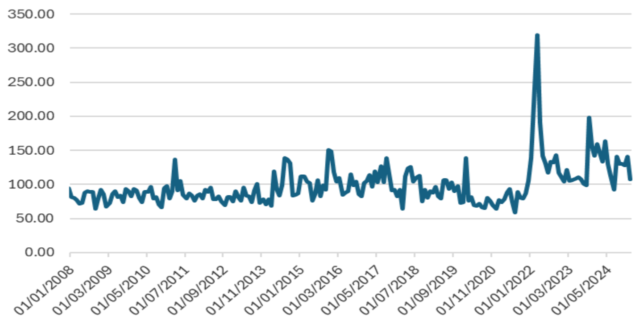
- Banks' CET1 ratio slightly declined by 10bps to 16.0% in Q3 2024, and capital ratios remain solid and well above requirements across all member states.
- Net fee and commission income (NFCI) and net trading income (NTI) increased by close to 8% and 18% YoY, respectively, supporting profitability which also benefited from lower contributions to deposit guarantee schemes and resolution funds.
- Reflecting high profitability, strong equity performance of listed EU banks in 2025
- Growth in net interest income (NII) has slowed down markedly (ca. 3.5% YoY) as interest rates cuts feed through assets and liabilities. Net interest margin was reported lower QoQ for the first time in 4 years (1.66% vs 1.68%).
- Profitability is expected to be affected by some margin pressure, slow loan growth, as well as higher expenses and credit costs.
- Costs remain high, not least impacted by necessary investment into cybersecurity and digitalisation and pressure on wage inflation. Curbing expenses remains important.

Loan growth is subdued and asset quality is slowly deteriorating

- Loan volume towards households remained stable in Q3, while the outstanding loans towards NFCs decreased of ca. 1.5% QoQ , mainly driven by large corporate lending.
- NPL ratio slightly increased by 2bps to 1.88% in Q3 2024, driven by consumer credit and SME loans. CRE loans' NPL ratio remained steady, but with the highest IFRS stage 2 allocation (18%).

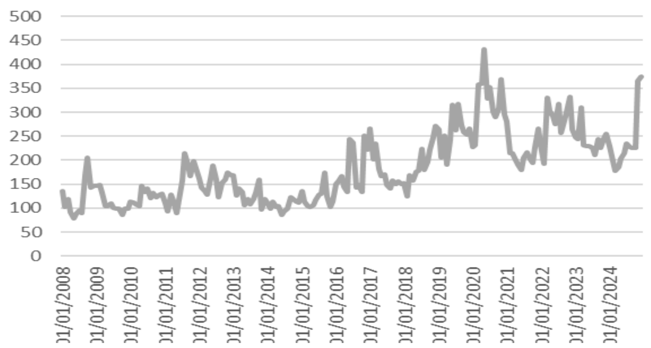
Trade tensions and other geopolitical risks are furthering geopolitical fragmentation

Geopolitical Risk Index



Note: tracks geopolitical threats based on media reports. Source: Caldara, Dario, and Matteo Iacoviello (2021), "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve Board, November 2021"

Global Economic Policy Uncertainty

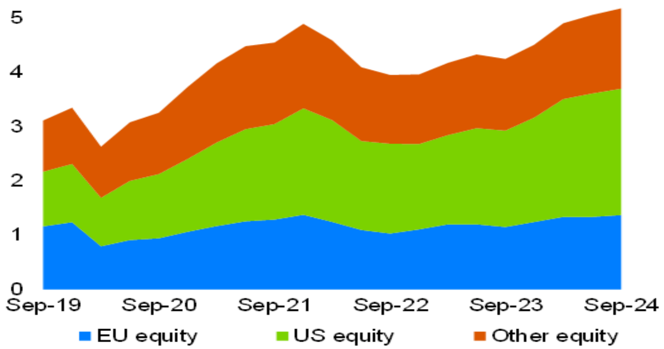


Note: measures the level of economic policy uncertainty around the world, based on a combination of factors such as trade policy, monetary policy, and regulatory policy. Source: Davis, Steven J., 2016. "An Index of Global Economic Policy Uncertainty," Macroeconomic Review, October"

- **Geopolitical risks have escalated in recent years, driven by international conflicts, cybersecurity threats, and economic nationalism**
  - In the past seven years, the US-China trade disputes, Russian war, the COVID-19 pandemic have reinforced the trend toward reshoring supply chains, trade protectionism, and economic nationalism.
  - Several global geopolitical indicators, such as the Geopolitical Risk indicator, reflect this heightened risk environment.
- **Tariffs threats are furthering uncertainty and tensions**
  - Trade Openness Index and FDI (Foreign Direct Investment) Trends show a decline in global economic integration.
  - The world is moving from economic integration to geopolitical fragmentation, where national security concerns increasingly influence economic and trade policies.
- **Economic Fragmentation implication for financial stability**
  - Geopolitical Risks & Market Volatility: Increased geopolitical uncertainty has potential to lead to heightened market volatility, liquidity risk, and increased credit spreads in both sovereign and corporate debt markets.
  - Impact on Monetary Policy & Interest Rates: Central banks may need to adjust policies in response to inflationary pressures, altering borrowing costs and investment returns.
  - Currency Risks & Capital Flows: Currencies volatility and capital relocation can impact EU financial stability, influencing currency hedging and international trade financing.

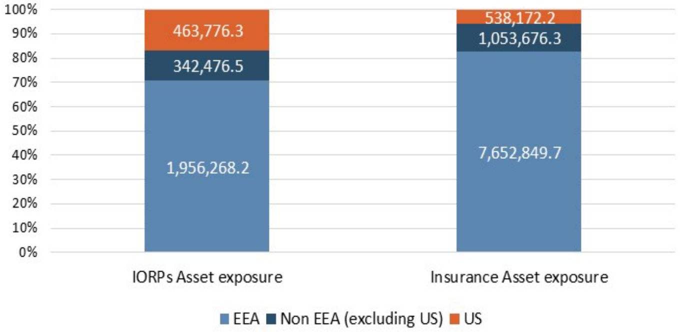
Substantial exposures outside EEA, including to the US

Euro area equity fund exposures to US equities rising



Note: Equity held by of EA equity funds, by region of issuance, EUR tn.
Sources: ECB, ESMA

Insurers and IORPs investment by geographical areas



Source: EIOPA Public statistics, Q3 2024

- **Equity fund exposures:**
  - Over the last five years, 77% of the flows in EU equity funds (excluding ETFs) are directed to US equity holdings. The stronger performance of equity funds vs EU indices is consistent with the growth of the US equity market.
- **Insurer and IORP exposures:**
  - Around 17% -30% (depending on calculation method) of insurers assets are outside EEA , of which almost 6% in US (split in 48% bonds, 33% equities, 19% others). IORPs the exposure is double: almost 30% outside EEA of which 17% in US (split in 27% bonds, 56% equities, 17% others).
  - The proportion of insurers' non EEA gross written premia (GWP) is around 5% of the total, mainly concentrated in UK, Switzerland and China. This percentage is an underestimation, as it doesn't include exposure via non-EEA branches
- **Bank exposures:**
  - EU/EEA banks have exposures of nearly EUR 5 tn to non-EEA counterparties (23.4% of total), up EUR 350bn (7.9%) YoY. Indirect exposures and intra EU/EEA exposures, e.g. to corporates with non-EEA trading, can pose additional risks. Indirect effects from, e.g., imposed tariffs and supply chain disruptions may pose additional risks.
  - The US is the largest counterparty of the banking sector, at EUR 1.3 tn (11.8% YoY increase), followed by the UK (EUR 900 bn). Exposures to emerging markets increase to about the same level as UK exposures.
  - Exposures to China are at EUR 80 bn, while combined exposures to Russia, Ukraine, and Belarus are below EUR 45bn, and only account for a small part of total exposure.
- **Beyond direct exposures, vulnerabilities can manifest in operational, market, liquidity and other risks**
  - Significant presence of US entities / groups, in areas such as CRAs, CCPs, with varying degrees of substitutability of services

Long term effects more significant, especially in case of breakdown of economic and political integration

Trade & GDP effects

- Tariffs reduce EU exports to the U.S., potentially lowering GDP growth and credit risk may rise for industries heavily affected by tariffs, leading to potential downgrades in bonds.
- Trade Credit Insurance & Non-Life Business mixed effect: can experience increase demand due to supply chain disruptions. However, a decline in global trade volumes and recessionary pressures may reduce demand for insurance products.

Currency Risks

- Tariff-induced trade imbalances and diverging monetary policies may lead to euro depreciation or volatility against the U.S. dollar.
- Potential higher reinsurance costs for insurers as more exposed to currency volatility, and increased claims costs for insurers, particularly if in foreign currencies.

Market Volatility

- Global market performance and volatility in US markets will have spillover effects on the EU markets.
- US market gains may be short-lived, with valuation declines likely in the long term. Investment returns are expected to deteriorate especially on sector heavily exposed to supply chains.
- Liquidity risks especially in case of US or tech market correction are a concern for the fund sector

Regulatory and market fragmentation

- Geopolitical fragmentation can increase global regulatory fragmentation, and affect financial stability, competition and the financial market level playing field
- Geopolitical fragmentation enhances financial market fragmentation, including implications on financial market infrastructure, valuations and interest rates

Climate, cyber & health risks

- Decreased global cooperation hinders collective action on climate change and cybersecurity threats, leaving EU insurers and other financial institutions more exposed to systemic risks like extreme weather events, cyberattacks on critical infrastructure or pandemics.

Increase use of AI to be monitored also in financial stability context

Artificial Intelligence (AI) is transforming the operational landscape of financial services.

- AI is used to enhance investment decisions, algorithmic trading and risk management.
- In the insurance sector, it is used in areas such underwriting, pricing, claims management and fraud detection.
- In the banking sector, it is advancing and enhances efficiency in areas such as customer segmentation and the detection of fraudulent activities such as, e.g., payment fraud and fraudulent credit transfers.
- AI can facilitate disinformation.
- Generative AI can generate misleading “hallucinations”, enhance ICT risk, and facilitate spread of misinformation.

The adoption of AI introduces both opportunities and risks that could affect the financial stability of these institutions and, by extension, the broader financial system.

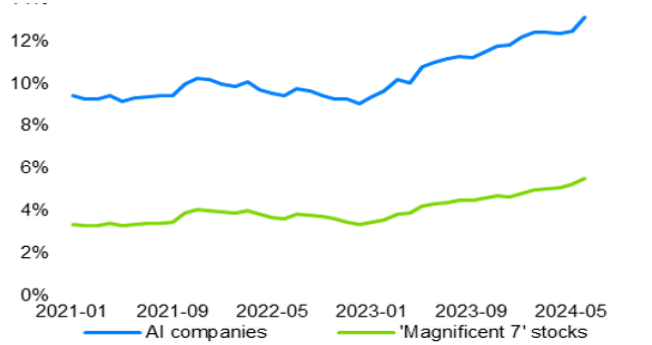
Increasing use of AI brings benefits to financial markets…

- Superior risk management.
- Improved market liquidity.
- Improved market monitoring by both market participants and regulators.

…but the following dimensions should be considered

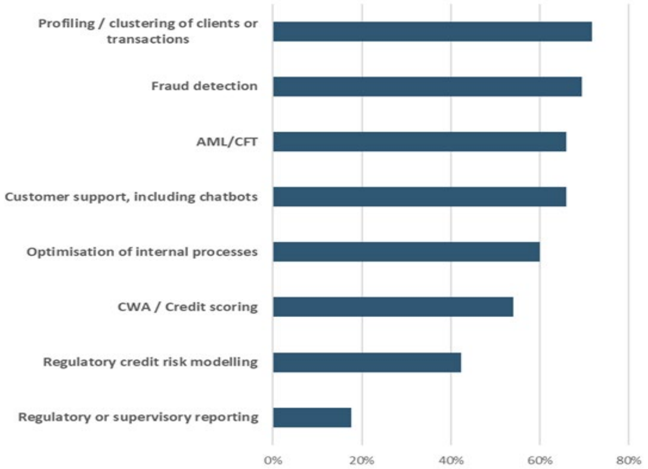
Vulnerability to cyber attacks remains high, while the use of AI can increase risks at financial entities

EU funds' exposure to AI and Mag7 stocks growing



Note: Share of AI companies and of 'Magnificent 7' stocks (as a % of the NAV) in the portfolio of EU equity investment funds. "AI companies" refers to 83 constituents from 7 AI-sector indices. "Magnificent 7" refers to Apple, Microsoft, Amazon, Alphabet, Meta, Nvidia and Tesla.
Sources: Morningstar, ESMA

Uses of AI by EU/EEA banks, per use case, autumn 2024



- **Market valuations and correlations**
  - EU investment funds' exposure to a set of AI-related companies has grown significantly since 2023, with stake held by EU funds amounting to EUR 470bn as of June 2024.
  - Valuations are sensitive to changes in expectations in a fast-evolving and uncertain landscape, which might be correlated across companies, amplifying market risk.

- **Vulnerability to cyber attacks**
  - Cyber threats consistently ranked as a top risk globally. While the number of incidents recently receded, the frequency of events remains a concern, as does their growing sophistication.
  - Volumes and sophistication of cyberattacks on EU/EEA banks remains high.
  - Hacktivism has seen steady expansion (according to ENISA). Severe events could have a strong impact on banks' reputation and earnings.

- **Model risk, data quality, and governance:** AI-driven underwriting can amplify exposure to systemic market shocks due to over-reliance on similar data sources and models. General-purpose AI (GPAI) relies on extensive datasets that may lack quality, while unclear data collection practices by GPAI model developers can complicate data governance by banks. Skills shortages and storage limitations can pose additional challenges in AI governance.

- **Beyond the use of AI, third-party dependencies and service provider concentration (**hardware, cloud services and models) can pose risks beyond the use of AI: High cyber liability risks due to reliance on third-party cloud systems. Financial institutions need to ensure sufficient in-house expertise.

eba European Banking Authority

eiopa European Insurance and Occupational Pensions Authority

ESMA European Securities and Markets Authority

Thank you

European Banking Authority

European Insurance and Occupational Pensions Authority

European Securities and Markets Authority