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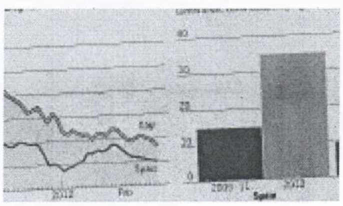
Europe banks hungry for second helpings

By David Oakley, Mary Watkins and Miles Johnson

It has been likened to a sugar rush for markets, especially for government bonds issued by heavily indebted eurozone nations. But will the European Central Bank's second offer of cheap three-year loans to banks on Wednesday inject new life into the rally?

The answer to one of the most important questions for markets is expected by analysts shortly after 10am London time on Wednesday. The reaction will be closely watched. Mario Draghi's ECB has been credited with the improved sentiment this year, not just in eurozone sovereign debt but in other risky assets too.



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"The success of the ECB's loans has taken a lot of people by surprise," says Alan Wilde, head of currency and fixed income at Barings. "Second time round it is unlikely to have such a dramatic effect, but it is likely to keep stabilising yields in the eurozone debt markets."

Analysts expect banks will borrow about €500bn in the second so-called longer-term refinancing operation (LTRO), a similar amount to the first scheme in December that saw €489bn lent out by the ECB.

The first LTRO mainly benefited eurozone sovereign bonds and helped shore up bank balance sheets as banks primarily used the money to pre-fund maturing debt or park it in government debt, says Huw van Steenis, banking analyst at Morgan Stanley.

He thinks banks will deploy the LTRO money similarly the second time round. Italian lenders, for example, are expected to buy a further €60bn in eurozone government bonds following Wednesday's LTRO, Morgan Stanley estimates. Spanish banks could buy a further €25bn-€60bn, the bank says.

Figures from the ECB this week have reinforced this view. They show that a large chunk of the money from the first LTRO was channelled into Italian and Spanish government bonds as banks used the cheap loans to profit from buying higher yielding sovereign debt in a "carry" trade.

Spanish and Italian banks increased their holdings of sovereign bonds by a record amount in January.

From the start of December to the end of January 2012, Italian banks increased their holdings in sovereign bonds by 13 per cent to €280bn, while Spanish banks raised their sovereign bond holdings by 29 per cent to €230bn.

As this increase in holdings, particularly in January, coincided with Spanish and Italian banks borrowing from the ECB's three-year loan facility, analysts are concluding that much of that money has gone into buying government bonds. Italian banks borrowed €116bn in the first LTRO, according to the country's central bank. Spanish banks borrowed about €110bn, according to strategists.

Carlo Mareels, senior banking analyst at RBC Capital Markets, says some of the LTRO money has also found its way back to the ECB as commercial banks have decided to deposit cash at the central bank. This would explain the elevated levels of cash being held at the ECB. An average of €430bn has been held at the central bank's daily facility since the end of December, nearly double the amount held there before the three-year loan operations were announced.

Strategists say that LTRO money appears not to have been used to buy equities or other assets such as subordinated bank debt, although the improved sentiment created by the ECB's action has played a big part in the rally in these markets.

On the impact of the second LTRO on markets over the coming weeks, many strategists say it should continue to support eurozone government bonds and aid sentiment in equities and other assets.

However, some fear that too much faith is being placed in the programme, adding that the central bank money should be used to "fix" banks and not to prop up the sovereign debt markets. A liquidity shot on its own cannot solve the eurozone crisis, say critics.

"Our view is that the Spanish banking system is troubled and it has used the LTRO money in part to avoid essential reforms," says Alastair Ryan, banking analyst at UBS in London.

"Italy is complex because the banks' challenges there are driven by the sovereign rather than the banks themselves. It is possible that the LTRO will buy Italy enough time. In Spain, the LTRO may only help to defer bank reforms."

That need for structural change, combined with a deteriorating growth outlook for the second half of the year, could limit any feelgood effect from Wednesday's announcement.