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Europe's smaller banks approach ECB

By James Wilson in Frankfurt

The greatest difference between the three-year loans offered by the European Central Bank on Wednesday and the first such round in December may not prove to be the slightly larger volume demanded – €530bn compared with €489bn – but the identity of the banks sucking up this liquidity.

In particular, the fact that many of the eurozone's smaller banks appear to have taken part may change the way the funds offered by the ECB are used.

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About 800 banks bid for funds – half as many again as in December. Most of these were from "core" eurozone countries led by Germany, not the peripheral nations where funding problems are presumed to be most acute. Talk from some banks of a possible stigma in using the longer-term refinancing operation (LTRO) does not seem to have been a factor.

Greater participation by smaller banks, including carmakers' financing arms, was, in effect, invited this time by the ECB, which relaxed requirements on collateral compared with December. The take-up is seen as potentially good news for the supply of credit, since smaller banks are often those with the closest relationships to the continent's host of small and medium-sized companies.

But it may take months to see improvements to recent gloomy numbers on net lending.

Huw van Steenis, banking analyst at Morgan Stanley, said he was cautious on how much LTRO money would filter through to the real economy. "Banks will be reluctant to overextend themselves, given unknown refinancing risk three years out," he said.

Germans worry about inflation risk

The European Central Bank's policy of cheap liquidity for banks is likely to face the most criticism in Germany, where public opinion is suspicious of anything that smacks of turning on the printing presses and risking inflation, **write James**

A fear of a credit crunch for businesses in the "real" economy as lenders drew in their horns was one of the reasons why the ECB launched its twin longer-term refinancing operations in December. Another was a wall of imminently maturing bank debt, with no confidence that banks could refinance that debt in jittery financial markets.

Such doubts increased tension about the vulnerability of banks and the risk of a catastrophic failure. A further fear was of a

Wilson in Frankfurt and Gerrit Wiesmann in Berlin .

Not only is the German economy in better health than much of the eurozone – unemployment this month remained at its lowest in two decades – but credit is abundant for most companies that want to borrow.

Cheap borrowing for banks and households fuels popular concern that the ECB could be laying the ground for inflation with its three-year longer-term refinancing operations, which appear to have been widely taken up by German banks. With the ECB having to maintain a "one size fits all" policy, its main interest rate is also arguably too low for Germany, where the Bundesbank opposed the ECB's last rate cut.

Nevertheless, Dirk Schumacher, economist at Goldman Sachs, says the LTRO is "not in principle antithetical to the way the Bundesbank would conduct monetary policy".

Holger Schmieding, chief economist at Berenberg Bank, says the ECB is not buying assets outright and liquidity will revert to the bank when the three-year operation expires. "Banks will probably use only a modest amount to buy securities. In that sense, it is very different from quantitative easing."

"disorderly deleveraging" – asset fire sales by some banks that could have spread weaknesses to other bank balance sheets.

In terms of covering banks' refinancing needs, the LTROs appear to have produced results commensurate with presumed demand. In December's LTRO, banks asked for €210bn in net new money – that is, deducting amounts rolled into the LTRO from banks' existing borrowing at the central bank – compared with about €230bn of refinancing needed in the first quarter. Wednesday's net inflow of liquidity was about €310bn, compared with some €360bn of bank debt due until the end of the year.

As in the first LTRO, there is an expectation that some liquidity will also be recycled by banks buying higher-yielding government debt in a "carry trade". The holdings of debt by Spanish and Italian banks have jumped since December, and demand has helped to cut risk spreads for Spanish and Italian debt.

However, that brings a risk that the LTROs reduce pressure to reform on both governments – by supporting demand for their debt – and on banks, by backstopping their finances.

That is one reason why eurozone leaders are asking banks to bolster their capital ratios – the European Banking Authority, a pan-European regulator, is assessing banks' plans to do so by June. And further confidence in banks is essential for another vital piece of the puzzle to fall into place: a return of a healthy level of interbank lending. So far, the eurozone's normal channels of financing are not working properly. Between €450bn and €500bn is coming back overnight from banks to the ECB, at rates below banks' costs of borrowing – indicative of continued stress.

Long-term LTRO loans "cannot replace a functioning interbank market or solve the sovereign debt crisis", said Michael Kemmer, of Germany's association of commercial banks.

Might an "LTRO 3" yet be required? The ECB is likely to proceed with caution. But Jürgen Michels, senior euro area economist at Citi, says that if there were further serious funding strains in the banking market, it could not be ruled out.

"The ECB is likely to be pretty pragmatic," he said. "It has generally been more willing to support liquidity rather than other outright measures."

Regardless of any individual bank's funding needs, the significant supply of liquidity to banks has dramatically reduced any fears of a Lehman-style collapse. "The prospect of a bank run in the euro area has been removed by the activity of the ECB," Sir Mervyn King, Bank of England governor, said on Wednesday.

Additional reporting by Gerrit Wiesmann in Berlin and Mary Watkins in London

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