FINANCIAL TIMES

By Patrick Jenkins and Christopher Thompson

EU regulators overseeing next year's long-awaited stress tests of the region's banks are preparing to penalise any lender that remains reliant on the European Central Bank's landmark cheap funding scheme.

The move will cause further friction in the banking sector as it underlines the tension between the need to maintain liquidity to lenders and attempts to wean them off their dependence on ECB support.

The European Banking Authority, the EU's umbrella regulator, plans to measure banks' reliance on the ECB's long-term-financing operation, or LTRO, according to people familiar with the watchdog's thinking.

Details of the test are still being drawn up but the plan would see the EBA mark down any bank that uses LTRO by comparing the subsidised scheme's low financing costs with the real market funding rates the bank would otherwise have to pay.

Such treatment risks stigmatising usage of the LTRO scheme, analysts say. "[This] could reduce [LTRO's] attractiveness," Morgan Stanley analysts wrote in a recent note to clients.

The LTRO scheme was introduced in late 2011 as one of Mario Draghi's first decisive policy initiatives as ECB president. The move was key to settling nervy market sentiment towards eurozone lenders. As a result, banks' cost of funding in bond markets fell and lenders that had been frozen out of the market altogether subsequently found it easier to raise money.

But over the past year or so banks have increasingly complained about being awash with liquidity, unable to find commercially viable investment opportunities for the money they have raised from the LTRO and in the markets.
Banks' early repayment of the three-year LTRO funds has accelerated as a result, more than doubling over the past nine months. An aggregate €352.9bn of the original €1.1tn has been returned to the ECB. A total of €665.7bn remains outstanding, with Italy's top seven banks the most exposed, sitting on an estimated aggregate €120bn.

But as LTRO repayments gather pace to meet the first deadline late next year money market rates are predicted to keep rising, potentially threatening the eurozone's fragile economic recovery.

“A facility will be needed for the smaller guys – the need for official assistance is still acute in some cases although for the big guns it’s not necessary,” said Suki Mann, head of credit strategy at Société Générale.
Philippe Waechter, chief economist at Natixis Asset Management in Paris, said: “Something has to be done to stabilise money market interest rates. We are still in an adjustment process in the euro area with very low growth rates ... another [LTRO] will not solve all the issues but it will help improve the situation and at this point in the business cycle that’s still the role of the monetary authorities.”

Mr Draghi has hinted that the current LTRO programme, due to end in early 2015, could be extended in order to stabilise weaker banks, though no firm commitment has yet been made.

Analysts said an extension would be the elegant way out of a potential point of tension over the issue between the ECB, which is focused on averting crisis, and the EBA, whose priority is to test the system’s weak points. An extended timeframe for the LTRO programme would mean the EBA would not need to consider the “cliff risk” of banks shifting from cheap financing to more expensive or non-existent market funding.