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Strong take-up of ECB loans expected

By Tracy Alloway in London and Ralph Atkins in Frankfurt

The European Central Bank is expected to report strong demand for an offer of unlimited three-year loans after banks were urged to take the funds as part of concerted efforts to ease severe strains across the eurozone's financial system.

Lenders across the region have been locked out of public funding markets in recent months due to fears of a worsening of Europe's sovereign debt crisis. However some banks have historically been keen to avoid turning to the ECB for fear of signalling weakness to their peers.

ECB president Mario Draghi said last week: "We see no stigma attached to the use of central banking credit provisions: our facilities are there to be used." The ECB announced the emergency three-year loans, known as longer-term refinancing operations, or LTROs, earlier this month, in an attempt to help banks overcome €720bn worth of funding due to mature next year.

The previous largest amount allocated in a single ECB operation was the €442bn in one-year loans offered back in June 2009. Some analysts think demand for three-year liquidity could exceed that figure given current severe financing strains for banks – although the median forecast is lower.

"Our banks team believes that banks are being actively encouraged by policy makers to use the LTRO in size to reduce stigma for banks which use it; and to underpin [lending to businesses," Morgan Stanley analyst Huw van Steenis wrote in a note to clients. "We expect many will use the three-year LTRO in case [public] funding markets were to remain closed for 2012."

One market participant said: "Large banks have been given a call by national central banks, encouraging them to use the LTRO to cover next year's funding needs ... They're trying to reduce the stigma. It all feels very well orchestrated."

The take-up of the LTRO, which is offered against collateral, will be announced on Wednesday. Analysts say the result is difficult to forecast as it involves gauging funding and liquidity pressures within the eurozone banking system and also predicting banks' behaviour.

Banks have historically been reluctant to use ECB facilities because of the perceived stigma attached to them, even though the central bank does not reveal details about individual banks' borrowings.

Analyst estimates have veered between €100bn and €550bn, with consensus now at €250 to €350bn.

Markets have also been debating how Europe's banks will use the loans. The ECB has suggested that the facility is aimed at covering banks' hefty financing needs next year.

A large take-up, the central bank hopes, would avoid banks having to shrink their balance sheets because of funding pressures and encourage them to lend to the wider European economy.

But banks used previous one-year LTROs to engage in a profitable carry trade – taking the cheap ECB loans to buy higher-yielding government bonds. About half of the €442bn 2009 LTRO went towards buying government debt, according to Deutsche Bank estimates.

A repeat of the 2009 experience could help ease some pressure on debt-ridden eurozone members in the short-term.

Large European banks are unlikely to buy more government bonds, given increased focus on their holdings of sovereign debt, bankers say. Technical factors including the cost of hedging the bonds and availability of collateral could also dampen demand for the trade.

However, the success of recent Spanish government bond auctions has raised eyebrows. Spain sold €5.64bn of three-month debt on Tuesday, with the yield paid to investors falling to 1.735 per cent, down from the 5.11 per cent seen in a similar auction last month. Brokers say smaller Spanish banks may be loading up on bills to use as collateral at the ECB operations.

Additional reporting by David Oakley