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ECB Lends Banks $645B, Exceeding Forecast

By Gabi Thesing and Rainer Buergin - Dec 21, 2011 1:57 PM GMT

The European Central Bank will lend euro-area banks a record amount for three years in its latest attempt to keep credit flowing to the economy during the sovereign debt crisis.

The Frankfurt-based ECB awarded 489 billion euros ($645 billion) in 1,134-day loans today, the most ever in a single operation and more than economists' median estimate of 293 billion euros in a Bloomberg News survey. The ECB said 523 banks asked for the funds, which will be lent at the average of its benchmark interest rate -- currently 1 percent -- over the period of the loans. They start tomorrow.

"It was obviously an offer the banks could not refuse," said Laurent Fransolet, head of fixed-income strategy at Barclays Capital in London. "It shows the ECB is not out of ammunition and it gives banks security on liquidity for a few years. On the other hand it means banks will rely on the ECB for longer."

Europe's debt crisis has increased the risk of government and bank defaults, making institutions wary of lending to each other and driving up the cost of credit. The ECB is trying to ensure that banks have access to cheap cash for the medium term so that they can keep lending to companies and households. In addition to the longer-term loans, the ECB has widened the pool of collateral banks can use to secure the funds.

New Money

Barclays estimates today's operation will inject 193 billion euros of new money into the system, with 296 billion euros accounted for by maturing loans. The ECB also lent banks $33 billion for 14 days in a regular dollar offering, up from $5.1 billion a week ago, and 29.7 billion euros for 98 days.

The euro jumped half a cent to $1.3198 before retreating to $1.3092 at 1:25 p.m. in Frankfurt.

"More important than the size of the operation is what banks do with this cash," said Simon Smith, chief economist at foreign-exchange broker FXPro Group Ltd. in London. "The dichotomy between size and use explains why the euro struggled to maintain its initial positive reaction to the news."

Spanish two-year notes extended a decline, snapping an eight-day gain and sending yields 14 basis points higher to 3.49 percent. Italian notes also dropped, pushing the yield 29 basis points higher to 5.27 percent.

'Through the Backdoor'

Yields on government bonds in Italy and Spain fell in the days after the ECB announced the loans on Dec. 8 as banks bought the securities to use them as collateral in today's tender. French President Nicolas Sarkozy has suggested banks could use the loans to buy even more government debt.

Simon Derrick, chief currency strategist at Bank of New York Mellon Corp, said the loans amount to quantitative easing "through the backdoor."

"What the ECB is doing is providing ultra-cheap money to banks, which in turn are going to be in there buying the sovereign debt up," Derrick told Linzie Janis on Bloomberg Television's "First Look" earlier today. "That's good news in the sense that it's clearly going to help sovereigns in the near future, but it's also printing more money. That's going to start to weigh on the euro over time."

Martin van Vliet, an economist at ING Group in Amsterdam, said banks are more likely to use the loans to "finance credit to the private sector or to repay maturing bank debt."

"We doubt whether the money will be used extensively to fund purchases of peripheral debt," he said.

Refinancing Needs

ECB Vice President Vitor Constancio in a Dec. 19 interview predicted "significant" demand for the loans as banks face "very high refinancing needs early next year." Some 230 billion euros of bank bonds mature in the first quarter of 2012 alone, ECB President Mario Draghi told the European Parliament this week.

"Banks represent about 80 percent of lending to the euro area," Draghi said. "The banking channel is crucial to the supply of credit." He predicted banks will experience "very significant funding constraints" for the "whole" of 2012.

Banks from the 17-nation euro region need to refinance 35 percent more debt next year than they did this year, according to a Bank of England study. Lenders have more than 600 billion euros of debt maturing in 2012, around three quarters of which is unsecured, the study says.

Focus on Banks

The ECB is focusing on greasing the banking system to fight the debt crisis as it resists calls to increase its bond purchases to reduce governments' borrowing costs. Today's lending exceeded the 442 billion euros awarded in the ECB's inaugural 12-month loan in 2009.

The ECB said 123 banks shifted a total of 45.7 billion euros into the three-year loan from an existing one-year facility allotted in October. The central bank will offer a second three-year loan on Feb. 28 and borrowers have the option of repaying the funds after a year.

"It's very significant and very helpful for the banks," Jacques Cailloux, chief European economist at Royal Bank of Scotland Group Plc in London, told Bloomberg Television. "But it's not going to bring about a turning point in this crisis."

As long as Europe's leaders fail to agree on the right policy mix, which should include sovereign-debt restructuring or a move to common bonds, the ECB's measures won't end the turmoil, Cailloux said.

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