European Banks See ECB Exams as Step to Unlocking Lending

By Nicholas Comfort, Sonia Sirletti and Macarena Munoz - Oct 19, 2014

The European Central Bank’s unprecedented inspection of lenders’ books will help end a slump in lending that’s dogged southern Europe for years, said executives at some of the region’s largest banks.

“After the comprehensive assessment, when worries about capital levels are clarified, banks will be more open with credit,” said Giuseppe Castagna, 55, chief executive officer of Italy’s Banca Popolare di Milano Searl. He’s targeting annual loan growth of about 5 percent through 2016, following a 4.2 percent drop last year.

ECB President Mario Draghi is using the yearlong review to restore confidence in the financial system before taking over banking supervision in November. The ECB studied the accounts of about 130 of the euro-area’s largest lenders to ferret out bad loans and ensure they have enough capital to withstand economic shocks. The results will be released on Oct. 26.

Draghi told lawmakers in Brussels last month that while the ECB’s exercise probably worsened Europe’s credit contraction as firms prepared for the exams, banks would be better able to boost lending when the cleanup was complete. A pickup in lending, especially in southern Europe, is crucial to fending off the euro area’s third recession since 2008.

“It is like a wound that needs to be disinfected immediately,” Draghi said of healing Europe’s banks. “Although there may be some more loss of blood once it has been properly taken care of, the illness will disappear. The banks will return to lending in a much more robust position.”

ECB Loans

The 18-nation euro bloc posted no growth in the second quarter as Germany, France and Italy failed to expand. The region is at risk of becoming “the major issue” facing the world economy, the International Monetary Fund said this month after cutting its global growth estimates.

Concerns that the region’s economy may contract contributed to a 7.5 percent drop in the 49-company Stoxx 600 Banks Index this month.

Loans to consumers and companies shrank 1.5 percent on an annual basis in August, the 28th
consecutive monthly drop, ECB data show. Credit to Spanish companies and households stood at the lowest since 2006 in August, while loans in Portugal touched a seven-and-a-half-year low and credit in Italy and Greece lingered this year at levels last seen in 2010, the data show.

**Lending Reticence**

A reticence to lend while the ECB pushes banks to shore up their finances probably cut demand for the cheap long-term funds the central bank offered lenders last month to help stimulate the economy, said Jose Manuel Gonzalez-Paramo, 56, a management board member at Banco Bilbao Vizcaya Argentaria SA. (BBVA)

The ECB allotted 82.6 billion euros ($105 billion) at a rate of 0.15 percent in the first round of the four-year program tied to the size of banks’ loan books. Banks will be more eager to tap the ECB cash at the next round in December, when the review is over, Paramo said in an interview last month.

“The banks are quite happy to request this money,” said Paramo, who served as an executive board member at the ECB before joining Spain’s second-largest bank last year. “You see pent-up demand for loans.”

Some question whether the ECB’s measures will lead to a recovery unless governments take steps to improve competitiveness.

“As long as there aren’t structural reforms, investments won’t rebound,” Juergen Fitschen, 66, Deutsche Bank AG (DBK)’s co-CEO, told reporters in Washington this month. Even so, he described the ECB’s assumption of the banking supervisor role as “a milestone for a stable and safe European finance industry.”

**Bank Mergers**

The ECB used findings from a review of bank asset quality to conduct a stress test last month. Firms will have six months to raise equity to cover shortfalls identified in the review or the milder of two stress-test scenarios, and nine months to fill capital holes resulting from the tougher scenario. Estimates of the system’s new capital needs have varied widely, from zero to as much as 767 billion euros.

Banks the ECB will supervise directly already have “strengthened their balance sheets” by almost 203 billion euros since mid-2013, Draghi, 67, said this month. They sold stock, hoarded earnings, offloaded assets, set aside provisions for bad loans and issued bonds that turn into equity when capital levels fall too low, he said.

The conclusion of the ECB’s test may also prompt banks to acquire local competitors and help boost earnings over the next two years, said Olivier Lefevre at the asset-management arm of French
bank Natixis SA.

‘Too Fragmented’

“In certain countries, especially Italy, you’re going to see consolidation between domestic banks,” said Paris-based Lefevre, who manages 1 billion euros of European equities, including bank shares. “It’s too fragmented and profitability is quite poor.”

Any recovery will depend on companies and consumers, said Pierfrancesco Saviotti, the 72-year-old CEO of Verona-based Banco Popolare SC. (BP) “There is a lot of liquidity in the system, so if demand recovers, banks will be ready to lend,” he said.

Popolare, Italy's fourth-largest lender, plans to borrow 2.7 billion euros from the ECB in December and use it all for lending, Saviotti told reporters in Milan on Oct. 15.

Like BBVA’s Paramo, UniCredit SpA (UCG) CEO Federico Ghizzoni predicts that once the stress tests are out of the way banks will be more willing to tap the ECB for long-term funds and boost lending.

“Several banks will return to the ECB to take up liquidity and raise loan supply following the comprehensive assessment,” Ghizzoni, 59, said in Milan this month.

Italy's largest bank set aside more than 13 billion euros for bad loans in the run-up to the ECB exams last year, leading to a 14 billion-euro annual loss, among the biggest ever in Europe. UniCredit's loans to customers declined 10 percent to 182 billion euros in 2013.

This year, “we’re increasing our lending business and plan to boost it further,” Ghizzoni said. Milan-based UniCredit borrowed 7.75 billion euros from the ECB in September and has already loaned almost 2 billion euros to customers, he said.

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