Banks Face Bind Over Cash Pile

By DAVID ENRICH And FRANCESCO GUERRERA

DAVOS, Switzerland—After receiving nearly half a trillion euros in cheap loans from the European Central Bank last month, the Continent's banks face a dilemma: to invest the money in lucrative but potentially risky government bonds or hoard the cash at a loss.

The choice reflects the uncertainty surrounding Europe's financial system at a time when dark clouds continue to hover over the euro-zone economy and its common currency. Regardless of whether banks use the money to buy bonds or simply stash it at the central bank for safekeeping, consumers and businesses are unlikely to see much of the funds pumped back into the economy in the form of loans.

The ECB in December extended about €489 billion ($640.88 billion) in three-year loans to hundreds of banks that operate in the euro zone. The loan program was primarily designed to fend off a potential cash crunch. European banks face hundreds of billions of euros of debt coming due this year and, with funding markets shut to all but the strongest institutions, some banks faced the prospect of serious liquidity problems.

Bankers and government officials gathered in Davos, Switzerland, this week for the World Economic Forum are virtually unanimous that the ECB's loans have eliminated such fears, at least for now. And the ECB is poised at the end of February to offer banks another chance to take out the loans. Bankers and analysts expect them to borrow hundreds of billions more.

The ECB loan program provides "a very significant degree of breathing space to banks," said Adair Turner, chairman of the U.K.'s Financial Services Authority, in an interview here.
But bank executives say lenders are taking radically different views on how to use the money.

Some are squirreling it away. In at least some cases, that means parking the funds back at the ECB in a facility that houses bank deposits overnight.

Francisco Gonzalez, chairman of Banco Bilbao Vizcaya Argentaria SA, says banks are awash with cash.

Thanks to the ECB loans, the banking industry is "awash with liquidity, although I have to admit that most of that liquidity goes back to the ECB overnight," said Francisco Gonzalez, chairman of Spanish lender Banco Bilbao Vizcaya Argentaria SA.

That sentiment, echoed privately by other senior European bank executives in Davos this week, also is apparent in the amounts housed in the ECB's overnight deposit facility.

They have been climbing since the loan program was launched last month, peaking on Jan. 17 at €528 billion, the largest sum on record. (They fell slightly this week to about €485 billion.)

The downside is that leaving the money in the deposit facility is a money-losing proposition. The ECB pays a paltry 0.25% interest rate—less than the 1% that banks were charged to borrow from the ECB in the first place.

But it offers banks the comfort of knowing their funds are safe. Industry experts said this week that such safety is more valuable in the current environment, especially for lenders in troubled countries such as Italy, Spain and Portugal. "'Survival first' will have to be the mantra for most banks in peripheral European countries," analysts at RBC Capital Markets wrote.

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“Those [banks] with liquidity are parking it with central banks. Those without liquidity are borrowing from central banks,” said Peter Sands, chief executive of U.K. bank Standard Chartered PLC, which didn't borrow funds from the ECB. "So instead of being the lender of last resort in times of crisis, central banks have become the central actor."

Other bankers and investors said several lenders are using the funds to snap up large quantities of government bonds in stressed countries. The theory: The banks could pocket a tidy profit thanks to high interest rates on the government bonds.

That, in turn, could defuse governments' financial problems and simultaneously help repair banks' balance sheets by boosting their profits.

This so-called carry trade resembles the way U.S. banks rebuilt their capital and profitability levels after the financial crisis by using cheap funds from the Federal Reserve and capital from the U.S. government's Troubled Asset Relief Program to buy higher-yielding assets including Treasurys.

But it exposes banks to the risk of drops in the price of the bonds, particularly if the European crisis takes a turn for the worse.

"We are really seeing clear signs that this money is not simply staying in the deposit facility, but is circulating in the economy," ECB President Mario Draghi said earlier this month, pointing to the declining yields of some European government bonds as a sign that banks are using the funds to buy the bonds. "By and large, the banks that have borrowed the money from the ECB are not the same as those that are depositing the money with the deposit facility of the ECB."

Even if banks are using the funds to buy government debt, that won't necessarily provide permanent relief to cash-strapped European governments. "Without greater demand from nonbank investors, the level of supply absorption may not be sustainable," said Guy Mandy, a European rates strategist at Nomura, on an investor call Thursday.

Some bank executives said they are loath to publicly confirm they are using ECB funds to buy government bonds for fear of public criticism that they are using central banks' money for a quick buck rather than to help kick-start the European economy by lending the funds to customers.

Some bank executives said the ECB money will eventually trickle down into loans to businesses and individuals.

"The cost of funding is going down very rapidly. That will put more money in the margins of the banking system, which is good because in order to give credit you need strong banks," said BBVA's Mr. Gonzalez. "We are in the process of filtering that money down to the real economy."

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