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Will European Banks Get Hooked on Easy ECB Cash?

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Aimed at bolstering beleaguered eurozone lenders, the European Central Bank's one trillion euro long-term refinancing operation has been credited with bringing calm to Europe by removing the immediate threat of a frightening banking collapse.

But some are fearful it will backfire, much like how prescribing painkillers to a burn victim could potentially lead to a debilitating addiction. They're worried the ECB's extraordinary liquidity injection will cause European banks to become hooked on the central-bank cash being lent at the ridiculously-low rate of 1%.

"LTRO is a sweet poison. Why should a bank go to the open market and borrow money when you can go to the trough and borrow at 1%? The LTRO creates a dependency on the ECB," Campbell Harvey, a finance professor at Duke University, wrote in a blog posting.

LTRO Eases Jitters

Taken out of a page of Ben Bernanke's 2008 playbook, the ECB's LTRO is essentially the central bank stepping in as the lender of last resort.

Eurozone banks, which are crippled with distressed sovereign bonds from the likes of Greece and Portugal, have been locked out of the interbank lending markets, raising fear of a Lehman-like event bringing down the European financial system.

To solve this problem, the ECB unveiled in December plans to offer banks a pair of three-year loan facilities, the second of which completed this week, lending out 530 billion euros to 800 eurozone lenders.

The results have been widely successful as eurozone bond prices, which move in the opposite direction of yields, have eased below danger levels and the cost to insure these countries' sovereign debt has retreated. For example, the yield on Italian two-year bonds slipped below the 2% level on Thursday for the first time since October.

Addiction Threat Looms

While panic has subsided and the threat of a banking crisis is reduced, the LTRO has really just bought European policymakers yet more time to solve the overarching structural problems.

"This helicopter drop does not solve the eurozone's problems: it merely delays them. The ECB is treating the symptoms not the disease," Harvey wrote.

Some are concerned that big European banks like France's Societe Generale or Spain's Banco Santander may become hooked on the LTRO cash.

"How long can the ECB provide back up? How long can the ECB ignore that many of the banks are zombie? Is the next page in the playbook, the BOJ strategy of the 1990s?" Harvey wrote, referring to the Bank of Japan and that nation's lost decade.

How Will Regulators Respond?

But it seems that the threat of addiction can be mitigated by the ECB and European regulators.

“A lot will depend on how regular an event this becomes,” said Bridget Gandy, co-head of European financial institutions at Fitch Ratings.

Marc Chandler, global head of currency strategy at Brown Brothers Harriman, said he’s not worried about creating a dependency because there are few signs of a third LTRO in the near future.

“There’s not going to be another LTRO unless the situation deteriorates significantly from here,” said Chandler. “Are they addicted or are they just taking advantage of the situation?”

Still, even if there is not another LTRO in the cards, European banks may like to pretend they’re not still on the hook to the ECB for a boatload of money in three years.

Gandy said a dependency or at least amnesia could set in if European regulators don’t require banks to come up with a plan to pay back the money, especially with looming Basel III rules on the way calling for stricter capital requirements.