Final exams – Fiat Euro! 30/2014

Except for few unfortunate, high schoolers have already finished their key exams. European banks have not.

Large part of 1600-member crew of ECB officials, 6000 officials in member states and plenty of hired external consultants have occupied 128 key banks in euro area for some time now. They are working on asset quality review. For example, evaluating how the banks assess the risk of loans defaults. The second phase will begin in early August. ECB is supposed to disclose then more details about how gained data are going to be used in the upcoming stress test. In the second half of October, its results are supposed to show us the health of European banking system. Problematic banks must then present their plan to raise additional capital – whether via market or public bailout.

We have already had several stress tests in the past. They ended up like a joke, when some banks identified as healthy requested bailout couple of months later. This time, ECB looks more serious. And that might be because this is an important step in building bank union which is currently the most important euro area project. Banks have already started manoeuvres earlier. They are ridding of non-performing loans (or at least they are trying to) and are looking for additional capital at the market. This year alone, sales of new shares attracted 26 billion euro, another billions strengthened capital thanks to witholding profit or selling assets by banks. ECB has revealed some details already. For assessing the assets quality it set ratio of capital to risk-weighted assets to 5% and 8% for the stress test. But it is still not entirely clear how exactly the assets are going to be valued.

Banking system is facing two problems pushing against each other. First one is its health. For the last six years, keeping European banking system alive has cost approval of state aid worth 5 trillion euro (about 1,6 trillion euro have already been used). Although the acute series of big bank collapses quieted down for now, it is all quiet on the western front just like in the book by Remarque. First, the Bulgarian banks stumbled and now Portuguese Banco Espirito Santo is on the razor's edge. Its owner Espírito Santo International filed for protection from creditors. Its bonds were purchased by plenty of the bank's clients and they should get compensation worth 225 million euro. This only applies to retail clients, corporate investors must help themselves. For example, Portugal Telecom holds now receivable claim worth almost 850 million euro. BES alone has claims against parent company worth 1.2 billion euro but is allegedly prepared to take the loss. Problems are already affecting subsidiaries of the bank in Panama and Angola.

And that's just Portugal. In Spanish banking system, the growth of non-performing loans stopped after several years at 13.5%. However, some experts warn that other assets (so-called non-performing assets) should be noted as well, for example, seized and unsaleable properties owned by banks. With these counted, according to pessimistic estimates the share of bad assets in Spanish banking system could be worth up to 433 billion euro, i.e. 40% of the Spanish GDP.

Greek banks are expectedly doing much worse. Non-performing loans account for more than one-third of the loan's portfolio and banks only survived because of huge money injections from EFSF. The country itself is in expectation of the third bailout. Also Cyprus wants to open negotiations on debt restructuring.

It is better not to think that gigantic Italian banking sector could have any problems. This country has decent experience with economic woes and how to wriggle out of them. Nevertheless, last year's collapse of Monte Paschi (third largest Italian bank) raised some concerns. Local banks hold 165 billion of bad loans and suffered loss worth 20 billion euro in 2013. However, they managed to increase their capital by raising more than 10 billion euro this year. Italian banks would also like at least one-fifth of new LTRO loans by ECB.

And now we are getting to the second problem. While the first two series of LTRO loans, worth more than 1 trillion euro, were supposed to stabilise the sovereign bond market, second program worth one trillion is set to revive bank-to-business lending in Europe.

Although banks are already filled with liquidity by ECB for couple of years now, it somehow doesn't reflect in the economy. Well, actually it is reflecting, but not in the private sector. Banks spend this super-cheap money on government bonds rather than investing in private sector. Mostly because it is simply profitable. Government bond carry a nice yield and can be used at ECB as a fine collateral. Unlike corporate loans, the perception of government bonds risk by regulator is significantly shifted in the favour of bonds.

Mario Draghi said last week that such carry trade would be with the new Targeted LTRO way more difficult. Although, it is not clear how since it sets an obligation only to keep lending to private sector, not lend more. And violation of this really soft rule is only "punished" by maturity shortening of loans.

With new Brussels structure, Frenchman Moscovici and Spaniard de Guindos would love to get two key posts – Commissioner for Economy and Eurogroup boss. Even if they didn't pass, new "eurogovernment" would hardly come with some significant reforms. So as always we will see what is market going to do to European banks.

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