Trend Macro

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MACROCOSM

Stop Stressing, Start Lending

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Donald Luskin with research input from **Lorcan Roche Kelly**

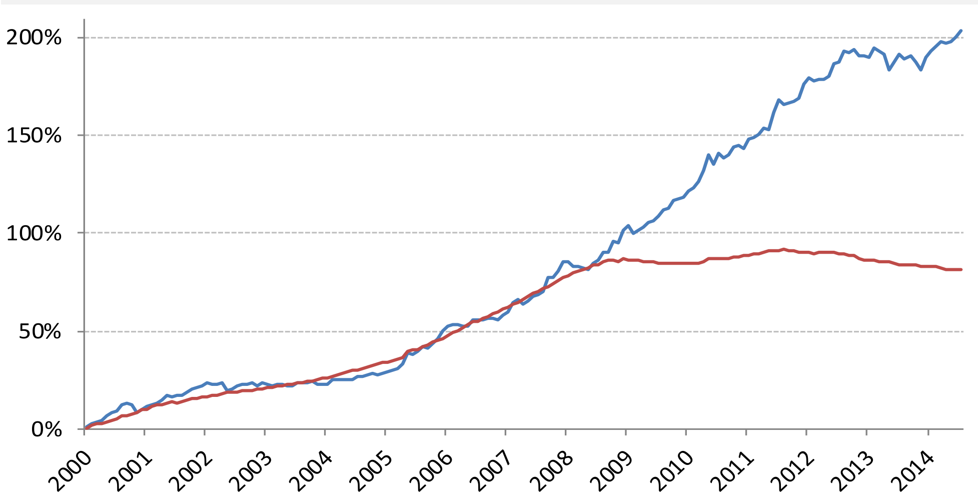
Europe's banks have completed six years of massive deleveraging. Enough is enough.

Rumors are flying today about the results to be released Sunday for the European Central Bank's Asset Quality Review and the European Banking Authority's "stress tests." One story claims that leaked ECB documents show 25 out of 130 banks failing.

- It's probably more like 10, actually. 25 may indeed have failed in the first stage of a two-stage process, based on capital at year-end 2013. The second stage reflects capital raised through month-end September -- nine more months for banks to have complied during which capital and reserves have grown by more than 7% to a new all-time high, after a gradual decline over several years (please see the chart below).
- *Indeed, this reflects a little-known yet very important fact about Europe's banks, which according to the dominant narrative, are hideously over-leveraged and have done nothing about it since the financial crisis of 2008-2009. The reality couldn't be more different. Since the crisis, Europe's banks have more than doubled capital and reserves, while loan growth has stayed basically unchanged. This is a vast deleveraging* (again, please see the chart below).

Euro area banks Growth from 1/31/2000

Capital and reserves **Loans to households and non-financial firms**



Source: ECB, TrendMacro calculations

Update to strategic view

EUROPE FINANCIAL STOCKS, ECB, EUROPE MACRO: Nerves are on edge for Sunday's release of results for Europe's bank stress tests. We think no more than 10 banks will fail -- capital and reserves have grown considerably all year. Indeed, they have grown relentlessly since the global banking crisis, while lending has stayed flat -- a massive deleveraging of Europe's supposedly over-leveraged banks. Once we are beyond the sword of Damocles of the stress tests, we think it will be time to declare "enough is enough." Banks can start lending again -- meeting a palpable increase in credit demand -- based on significantly increased capital, multiple support programs from the ECB, and the removal next year of substantially all barriers to cross-border banking.

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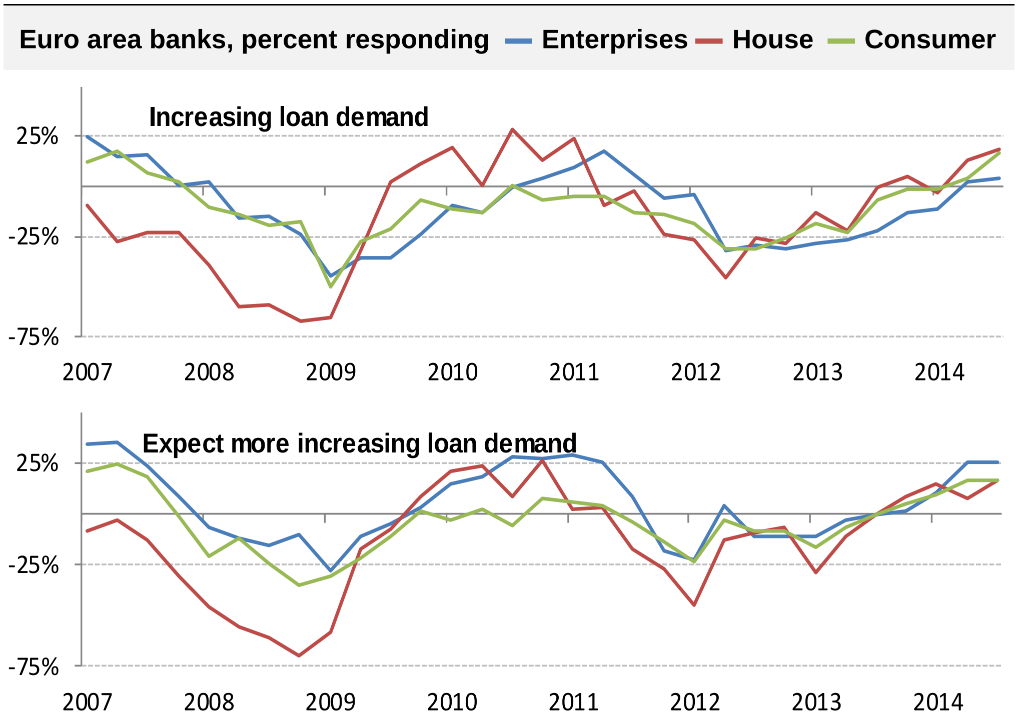
When the deleveraging process is complete, presumably euro area banks can start lending again -- after all, loan demand has demonstrably recovered (please see the chart below, and "So Close to Recovery, So Close to Doom" August 7, 2014).



Source: ECB, TrendMacro calculations

But when will the euro area's deleveraging be complete? When can we declare "enough is enough"?

- *Such a call is inevitably arbitrary. But we're going to make it right now.*
- While it's easy to mock Europe's past stress tests (see "Stress Test for Europe's Banks, and Its Politics" October 11, 2011), this one is likely to be different, being the first one performed under the aegis of the ECB as Europe's new Single Supervisory Mechanism (SSM).
- Credible stress tests can make an enormous difference to behavior by borrowers and lenders -- and the markets. Consider the transformative effect of the Federal Reserve's stress tests in March 2009 or, for that matter, the Roosevelt administration's in 1932 -- both of which catalyzed broad-based recoveries.
- If nothing else, just getting beyond this regulatory sword of Damocles -- and presumably surviving it mostly -- will to some extent restore confidence.

Additionally, the ECB has already put into action -- or at least into the pipeline for action in the coming months -- multiple programs designed to stimulate lending.

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- The negative interest rate on ECB deposits makes cash a "hot potato" that needs to be handed off quickly to more productive use (see "On the ECB June Policy Decision" June 5, 2014).
- The Targeted Longer-Term Refinancing Operations (TLTRO) conducted this year give favorable funding for existing loans, but all the operations after year-end will apply to new lending only.
- The third Covered Bond Purchase Programme already begun (CBPP3) and the Asset Backed Securities Purchase Programme to begin, we think, in December (ABSPP) will allow banks to increase total lending by taking risky assets off their loan books.

But perhaps the most important element going forward is the quantum leap in regulatory reform that will come next year with the ECB as the first true pan-European bank regulator. It will be nothing less than a *de facto* "banking union" to go along with the currency union.

- Banks will no longer suffer under regulatory constraints imposed by individual national governments, which had always functioned as a form of protectionism favoring local banks against cross-border competitors.
- Under the new euro area-wide Single Resolution Mechanism for dealing with bank failures, national governments will no longer be individually on the hook for a bank headquartered elsewhere.
- And under the new Single Europe Payments Area conventions, bank customers can now operate as seamlessly between euro area banks in different nations as US customers can between banks in different US states.
- This could usher in a revolution in competition in an industry and in a part of the world not always friendly to competition.
- That can lead to a revolution in the efficiency of economic activity long promised under the common currency but never fully delivered in the domain of capital.

For euro area banks, the pump is now primed. The six-year regime of stagnant lending is set to reverse. If some banks are unwilling to increase lending, there will be others, either within the same nation as the borrower -- or from other euro area countries -- that will take the business.

Bottom line

Nerves are on edge for Sunday's release of results for Europe's bank stress tests. We think no more than 10 banks will fail -- capital and reserves have grown considerably all year. Indeed, they have grown relentlessly since the global banking crisis, while lending has stayed flat -- a massive deleveraging of Europe's supposedly over-leveraged banks. Once we are beyond the sword of Damocles of the stress tests, we think it will be time to declare "enough is enough." Banks can start lending again -- meeting a palpable increase in credit demand -- based on significantly increased capital, multiple support programs from the ECB, and the removal next year of substantially all barriers to cross-border banking.