Is an improving backdrop for European banks on the horizon?

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The autumn calendar is shaping up to be an eventful one for Europe's banks, and the impact should be beneficial for the sector and the broader economy.

First we have the first European Central Bank (ECB) Targeted Long-Term Refinancing Operation (TLTRO) on 18th September then, in mid-October, we can expect the release of the conclusions of the Asset Quality Review and Stress Test. Finally, on 4th November the ECB will assume its responsibilities as the lead regulator for eurozone banks. All should be important catalysts to aid Europe's economic recovery.

The TLTROs will allow banks to borrow potentially significant sums at extremely low interest rates (just 0.25%) which will then be lent on to the eurozone corporate sector. Initially up to €400 billion will be available (comprising 7% of euro area loans to non-financial corporations and households excluding mortgage lending). This can be drawn down in two allotments – 18th September and 11th December. Thereafter banks can draw down additional amounts of up to three times their targeted volume of new lending (technically up to three times the improvement in lending for those banks that have seen a shrinking loan book over the year to end-April 2014).

Banks therefore face two incentives to lend. First, the more banks lend the more TLTRO funding they will be able to receive. Second, those banks that show growth in non-mortgage lending balances will be able to retain TLTRO funds for four years; those that do not will have to repay the ECB by September 2016. This mechanism should, therefore, offer an important financial stimulus to the eurozone economy.

The way in which TLTRO benefits banking systems within the eurozone will vary by country. Italy stands out as a clear winner in the sense that Italian banks' loan books tend to be overweight corporate and SME (small and medium enterprise) lending with the banks also continuing to suffer higher funding costs than elsewhere in the eurozone. Indications from the ECB's latest Bank Lending Survey (July 2014) are that credit standards in Italy are beginning to ease, a process which should be underwritten by TLTRO deployment. Meanwhile, in the 'core' of Europe, banks in countries such as France, Germany and Holland may see little direct benefit from cheap TLTRO funding (these banks typically have low funding costs in any case), but that does not mean that the TLTRO is an irrelevance. Banks will be able to grant cheap four-year loans to larger corporates at cheaper rates than are available in the bond markets. This could help to spur wider M&A amongst corporates in these countries should conviction levels in economic recovery rise.

Meanwhile, the Asset Quality Review (AQR) and Stress Test process should, if deemed credible, help to underpin the broader performance of the sector. Importantly, this is no slam-dunk – the process has taken a year to complete and covers 127 banking groups and, according to the ECB, will cover €3.7 trillion in risk weighted assets, involving some 135,000 credit files. The ECB has every incentive to conduct this exercise properly so casualties can be expected. As investors in European bank shares we are certainly treading carefully in this regard. However, failures should be the exception not the norm. For the system as a whole it is likely that the AQR and Stress Test process will foster greater confidence in equity and credit markets into the year-end.

Finally, the Single Supervisory Mechanism begins in November with the ECB assuming its role as the eurozone banking system's lead regulator. In time this should foster greater fungibility of liquidity and capital across Europe's borders as well as greater consistency in regulatory approach and disclosure. Clarification of capital requirements should be an important catalyst in allowing the better capitalised and more capital generative banks in the sector to pay a healthy stream of dividends to shareholders – highly attractive in a low interest rate world.

In a wider market context, Europe's nascent earnings recovery is better served by a well-capitalised banking sector which can support the return of credit driven GDP growth. This should in turn help to remove the spectre of eurozone deflation and expose the region's mispriced opportunities.

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