The long odds whitepaper series

If a country leaves the Euro...

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If a country leaves the Euro…

Executive Summary

Setting the scene

- This occasional paper looks at a highly unlikely event which would, if it came to pass, have a significant impact upon investment banks. This paper is NOT a predication or forecast, it is an examination of the sorts of issues that would need to be addressed if the event under discussion transpired.
- We are not seeking to enter into a debate about the likelihood of any event. For the purpose of this paper, the event described has occurred. The question we are considering is what is to be done as a result.

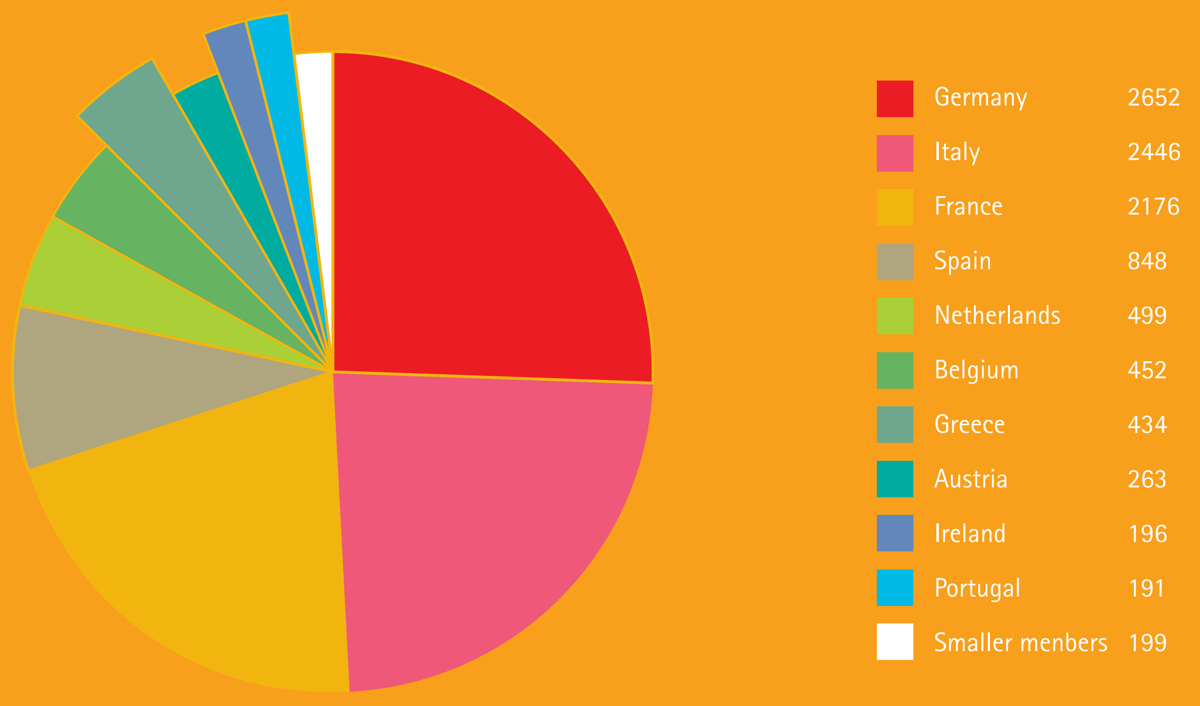
Key points

- The euro was introduced in stages over a number of years; the ejection of a member, if it occurs, may take place over the space of a weekend.
- Given the potential impact and challenges resulting from a country leaving the Eurozone, we believe organizations should begin to plan and prepare their response to such a scenario.

Potential implications include

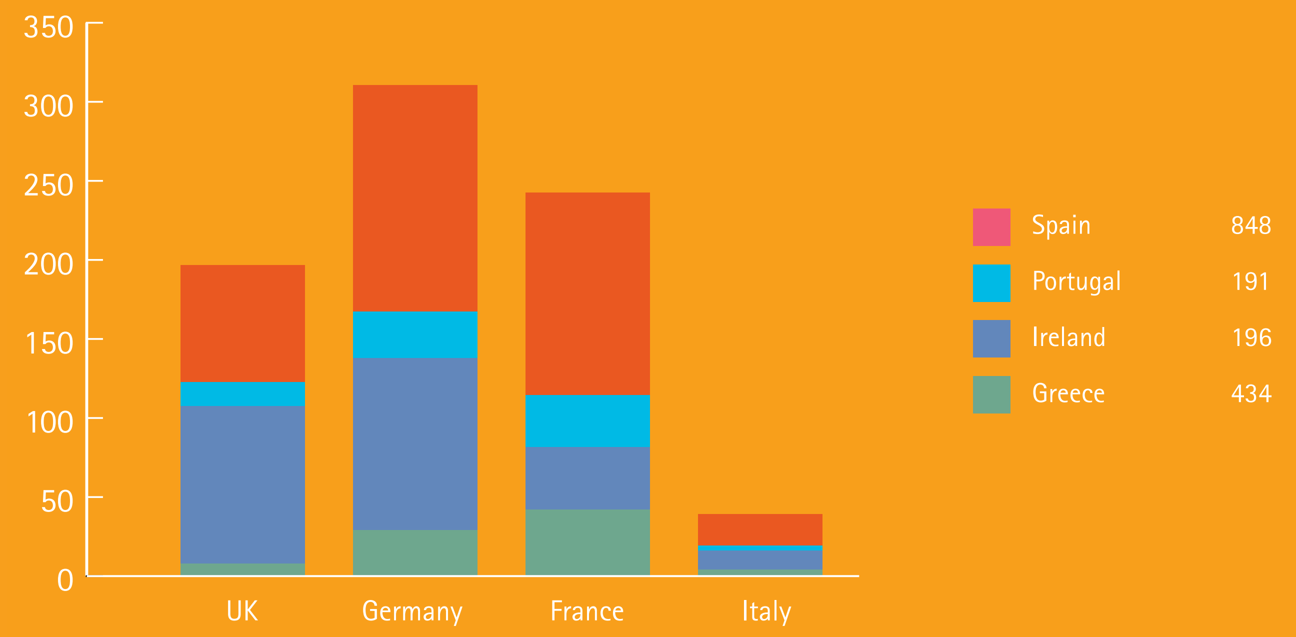
- Bank balance sheets would once again come under pressure as a wide range of assets were revalued.
- Assets would need to be segregated into differing currencies and accounts.
- There would be a spike in trading activity, at the same time tactical solutions to clearing and settlement in a new currency would have to be implemented.
- Fear of inflation and further devaluations would drive demand for euro denominated bank accounts.
- Counter-party concerns would emerge as domestic banks of the countries affected face funding difficulties.
- Increased collateral would be necessary for certain products and there would be a need to recalculate risk exposures.
- There would be a need to establish new reference data benchmarks.
- New foreign exchange desks would be needed to handle up to $58 billion in foreign exchange transactions likely to be needed for Greece, Ireland and Portugal alone.
- Increased corporate financing opportunities will emerge as corporations in countries leaving the euro would seek to refinance, or hedge their FX exposure, an opportunity worth over $2,500 billion for Greece, Ireland and Portugal.

Eurozone Sovereign Debt (Billions of Euro)



Source: IMF

Bank Exposure to Selected EU Countries



Source: Citi, BIS

Just how plausible is a breakup of the Eurozone?

Just how plausible is it that a country would leave the Eurozone? For much of its first decade of existence, the answer was clear – not at all plausible. The architects of the euro had meant it to be irreversible, to the point where a mechanism was designed whereby countries can leave the European Union itself, yet not the euro. More recently the ECB has opined that, leaving the euro would be tantamount to leaving the EU altogether[1].

Clearly the irreversibility of the euro was initially thought of as being crucial to financial market credibility. And credibility was achieved, to the immense benefit of the members of the Eurozone. The biggest benefit accruing to those governments where, because of a history of inflation or comparatively small financial markets, borrowing costs had traditionally been high. However the idea that the lowering of debt servicing costs would be used by governments to consolidate finances proved sadly misplaced. Instead lower borrowing costs were used to prolong unsustainable fiscal policies to the point where the system itself has become imperiled.

One of the most common refrains from financiers is why the politicians in the Eurozone do not simply let a sovereign borrower default. The answer seems to be the political fear of just how far the ensuing disaster and associated contagion would spread. In particular there is a desire to support the balance sheets of a wide range of Eurozone banks. If there is one lesson that has been learnt from the Lehman Brothers crisis, it is that financial markets are far more interconnected than had been previously thought and no plan, however detailed, is likely to be able to figure out fully the impact of an economic shock. The view of an increasing number of economists is that the longer such a situation goes on without addressing the underlying factors that are causing the strain, the more likely the result is going to be sudden and shocking[2]. Quantifying the problem, it is useful to consider that the three most troubled countries (Greece, Portugal and Ireland) constitute 6% of the Eurozone GDP and 8% of the Eurozone's sovereign debt.

The euro was ratified under the Maastricht treaty of 1992, introduced on 1 January 1999 with notes and coins implemented three years later. So after an introductory period of more than seven years, a country's exit of the Eurozone may take place over a weekend. If a country were to leave the euro, a short transition timeframe may be necessary as there may be significant capital flight as soon as any plans are announced (investors anticipating a significant devaluation). A scenario could be complete denial of any plans to withdrawal until the moment of actual leaving. In this scenario, the need for secrecy would mean there could be no printing of bank notes or minting of coins before the event.

While there are any number of potential scenarios that might come about in the euro area, from a complete break-up, to a country being ejected (or "deciding" to leave, which amounts to the same thing). We are going to briefly examine the scenario discussed most frequently: a financially recalcitrant country being asked to leave or departing as it refused to meet the requirements enabling it to stay.

Euro exit would be traumatic; countries would try to devalue assets as well as liabilities and would want to respond to populist pressures to ease austerity plans

If a country were ejected from the euro, it would need to establish an electronic currency, while continuing to use euro notes and coins

Immediate Questions

Clearly if a country were to abruptly leave the euro, its domestic finances are almost certain to be under extraordinary pressure. Government budgets are likely to be strained and attempts at fiscal consolidation are likely to have been severe and have recently failed, most likely through a combination of a refusal of investors to buy more debt, or social unrest, or both[3].

Thus the immediate aftermath of a departure from the euro is going to see a reversal of these policies and rapid easing of austerity policies with predictable falling of exchange rates. There are numerous examples of countries departing from an 'irreversible' currency peg. Breaking such a pegging arrangement is simply a matter of declaring the link dead and letting the markets determine a new exchange rate. Leaving the euro would be much less straight-forward.

With no possibility of printing new notes in anticipation of a withdrawal from the euro, one likely option would be to create a new electronic currency (NEC). This would be a purely electronic currency, existing much like the euro did between 1999 and 2001. The most crucial question is which instruments should be shifted to the NEC and which should remain denominated in euros. This would be a matter for considerable legal argument, but it seems reasonable to suppose all payments and salaries would move to this new electronic currency. Debt is more difficult, but given that the devaluation of debt was the reason to have the euro in the first place, it seems a reasonable assumption that all public debt, savings and private debt in domestic banks, as well as the assets and liabilities held in branches of domestically registered foreign banks would be denominated in NEC.

Implications for Financial Services

Domestic banks of a country that exited the euro would obviously be in serious difficulties, with significant portions of their balance sheets effectively devalued, although it must be remembered that many of their liabilities would be similarly marked down. How all of this would be worked out is an unanswerable question and largely beyond the scope of this paper. What can be said is that governments would have to seek to keep a payments system operating, either through direct nationalization of key banks, or a state guarantee of core parts of the banks.

For corporate borrowers, the degree of financial integration that has taken place over the past decade means a division of assets and liabilities into relatively safe euros and devalued NEC leaving scope for a considerable confusion and prolonged argument. Are loans with non domestic Eurozone banks to be denominated in NEC or continued on as euro loans? We now turn to at least some of the major issues that would have to be confronted in the event of a country leaving the euro.

Implications for Investment Banks

The effects of adopting the NEC would be felt across nearly all functions of an investment bank. While these will clearly vary in significance, banks should prepare for both the immediate impacts – predominantly covering increased trading activity and various tactical fixes – and the medium term implications, requiring them to reconfigure systems and reference data, to implement strategic changes to processes across the full trade lifecycle, and to assess their appetite to trade in the NEC.

Immediate Impacts

- **Bank Balance** sheets would once again come under pressure. The lesson from the 2008 credit crisis was that financial markets severely punished those in most trouble, but that all banks suffered to a greater or lesser extent. Exposure to any potential euro crisis varies by geography and by bank within those geographies.
- **Trading** desks will see spike in activity, notably through demand to trade in and out of the NEC felt by FX desks and through the need to refinance called bonds and exercised CDS contracts. Longer-term, banks will need to develop new NEC-denominated products and restructure desks if they want to support the NEC.
- **Cash Management & Payments** teams will need to reconcile in-flight transactions (particularly those part way through 3 day settlement cycles, or the one day cycle which will come into force from 1 January 2012) in the short term, before establishing new models to process payments to local institutions. This would necessitate establishing correspondent banking models for NEC payments to local institutions, requiring new Nostro and Vostro accounts, and re-routing payments to new euro-denominated accounts for those companies wishing to continue to process payments in euros. A tactical solution would be required until these new payments routes had been established, similarly requiring tactical Confirmations and Clearing & Settlement processes to support these transactions.
- **Risk** will need to re-calculate exposures to NEC-denominated products, as well as credit exposures to local institutions and to other banks with significant exposure to the NEC. This will need to be supported by new calculation frameworks and models that support the NEC and may also require other trading and credit limits and issues such as living wills to be examined following this credit event.
- **Data Management** reconfiguration will be required to ensure that reference data supports the NEC. Similar impacts will be felt across Technology as the capability to support data, processes and calculations in the NEC will mandate widespread reconfiguration across all systems. In many cases, this will result in duplication of processes (both manual and automated), for example through the need to issue confirmations in a new currency.
- **Settlement Systems** will have to be reintroduced. A real time gross settlement system, Target2, has for the past two years been used in all Eurozone countries for high value interbank payments, it is no longer multi-currency.
- **Finance** will see both immediate and long term impacts, through the need to segregate assets between the euro and NEC – a complex task that will likely result in months, if not years, of legal wrangling.
- **Asset Liability Management** will come under immediate pressure to allocate increasing capital to cover the higher collateral requirements associated with more risky NEC-denominated products, which will result in a spike in Collateral Management processing. This will be challenged by capital reserves falling as NEC holdings devalue.
- **Research** teams must be also be prepared to meet immediate and ongoing demand for NEC-focused analytics and reports, which will be a challenge in the early days of the NEC but an important source of information in an uncertain environment.

Withdrawal from the euro could mean:

Renewed pressure on banks balance sheets

Spike in trading activity

Reconciliation of transaction in process

Reevaluation of risk exposures

New reference data point

Withdrawal from the euro could mean:

Establishment of new solutions for cash management, clearing and settlement

Fear of inflation

Refinancing of bank and bond debt

Need to onboard significant numbers of new accounts

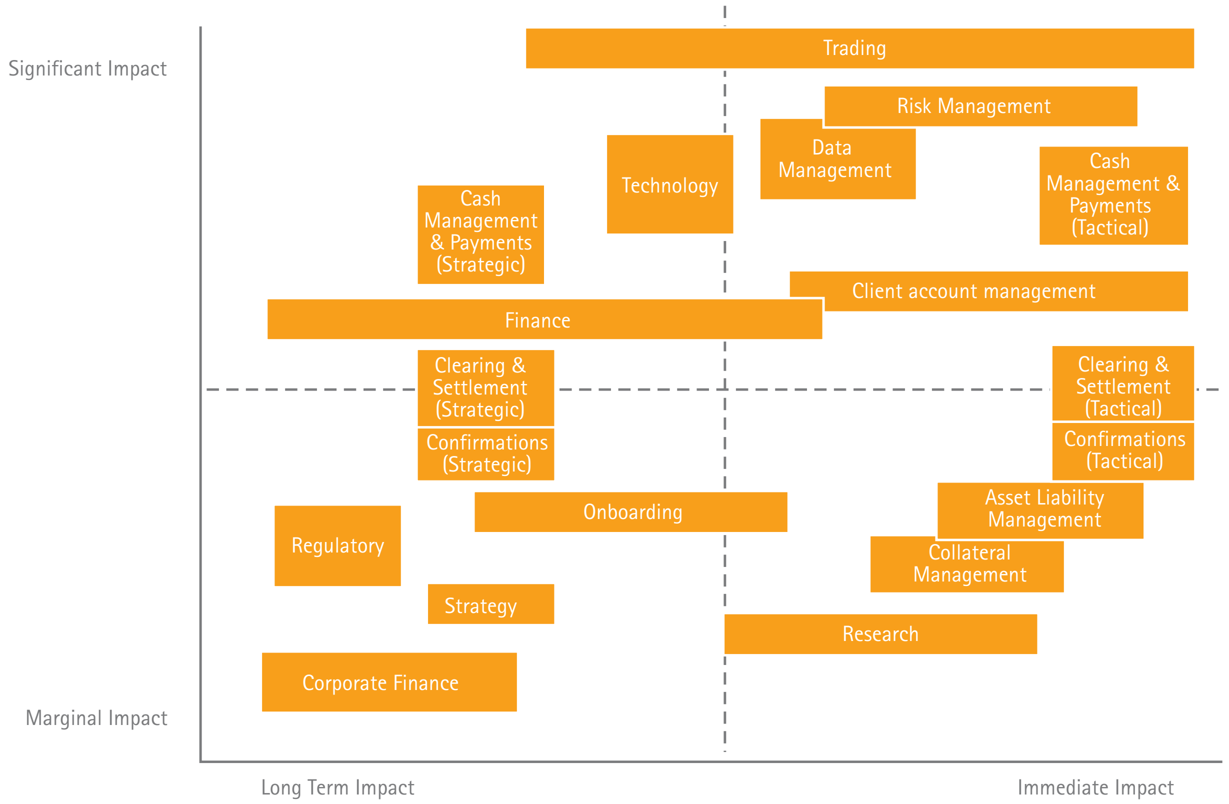
Opportunities for FX

Long-term Impacts

- Following the adoption of short-term tactical fixes, strategic solutions to cater for the NEC will be required across the full trade lifecycle, notably including Cash Management & Payments, Clearing & Settlement and Confirmations.
- There is a possibility that the devaluation following introduction of the NEC would be inflationary. This has three consequences:
  - Surge in demand for foreign or euro denominated banks accounts as citizens and businesses tried to protect accumulated wealth, with consequential impact upon non domestic banks client onboarding systems.
  - Difficulty in domestic banks in funding, as savings fled to euro denominated accounts, likely to be in non domestic banks. This would be similar to the situation seen in Latin America during the 1970s – 1990s where savings were held in US dollars, in US bank accounts, with consumers only drawing cash into an inflation prone currency as they needed it.
  - The NEC would have to circulate alongside euro notes and coins. This is likely to result in a variant of "Gresham's law", with bad (electronic) money driving out good (non inflationary) paper currency. The result would be a preference to pay in electronic currency resulting in a significant shift to electronic payments. Cash payments account for approximately 70% of financial transactions across Europe. This figure rises to 90% in Italy. It is likely that those countries that might leave the Eurozone all have a greater number of cash transactions than the Eurozone average.
- **Onboarding** teams will face an increased workload through the need to establish new accounts, which will include following "Know Your Client" procedures establishing new clients into new NEC-denominated products as they become available. To support this however, banks must assess their appetite, and client demand, to trade in the NEC and to trade with local institutions – a risk and opportunity assessment that will require evaluation from Strategy teams.
- **Bond Debt** - The introduction of a NEC is almost certain to count as a material change to a bond contract, allowing for the bond to be called. Therefore the need to refinance bond debt could be considerable. Bank for International Settlements data indicates that amounts of outstanding domestic and international bond and debt securities in December 2010 was $586 billion in Greece; $1,474b in Ireland and $455b in Portugal.
- **Bank Debt** – While bank debt is unlikely to be called in, there is likely to be a desire by Corporates to align the currency of revenues and debt payments. The latest Bank for International Settlements data records external loans and deposits in banks in Greece were $115 billion ($9b of which was to the non bank sector), for Ireland the figure was $460b ($187b of which was to the non bank sector) and Portugal $85b ($19b of which was to the non bank sector)[4]. At the very least, many companies would seek to hedge their new bank debt FX exposure.
- **Forex** - An opportunity for regional players to expand foreign exchange operations. Given that for smaller EU states, total daily FX (spot, forward and swaps) equates to between 4% and 12% of GDP, this implies for Greece average daily FX would be approximately $24 billion, for Portugal $18b and for Ireland $16b.
- **Regulatory** functions will also need to comply with likely detailed reporting requirements of holdings in, and exposure to, the NEC, especially while the fear of contagion following the default exists. Regulators are further likely to stipulate banks to conduct wider-ranging scenario stress tests to ensure they are prepared for the risks of further defaults across the Eurozone.

These implications will clearly vary depending on banks' exposure to the NEC. There will be opportunities to take advantage of market dislocation but on top of both rapidly implementing strategic fixes, and implementing strategic solutions over the longer term, banks must assess their appetite for the NEC. This option will not be available in the medium term to those banks with significant NEC exposures however, and they will be especially hurt by devaluing capital bases. Local banks will similarly feel the impacts of this devaluation but the most agile will be able to take advantage of the opportunities presented by the creation of new local financial markets.

Breakup of the Eurozone: IB Operating Model Impacts



Source: Accenture

Ireland

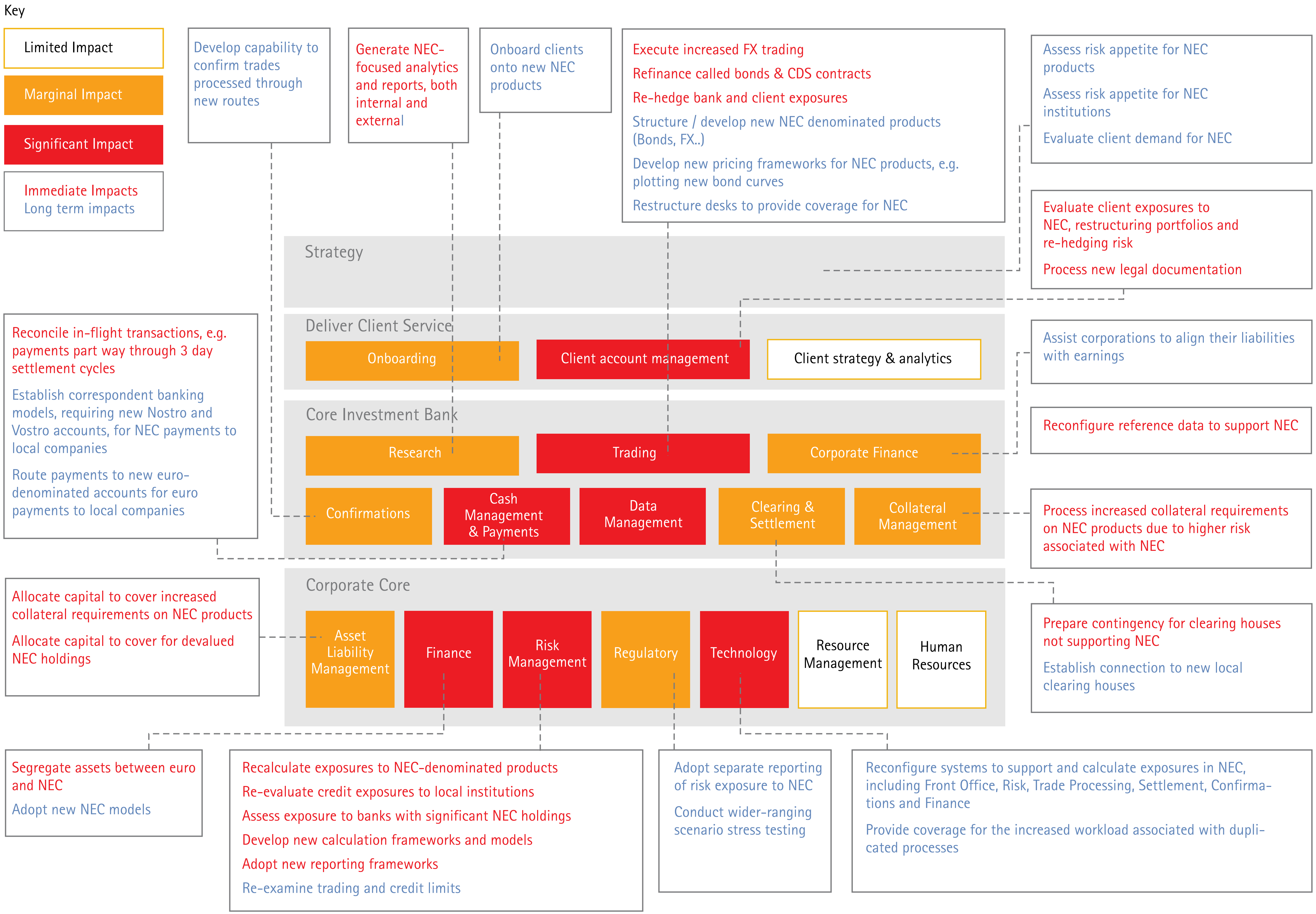
Ireland could well be a special case. For any country contemplating departure from the euro, the creation of a "New Electronic Currency" is a leap into the dark which is always a daunting prospect. Uniquely, however, for Ireland there is an exit from the euro available to no other members – rejoining sterling. While for many people this would be politically upsetting, it has to be set against the potential prospect of years of recession that may well ensue as the Irish try to recapitalize their financial system. Moreover it should be remembered that the Irish Punt was linked to sterling from 1922 to 1979. Political objections to British Bank notes could potentially be overcome through the issuance of Irish banknotes, which like Scottish or Northern Irish notes, are of different design, but carry the same value.

In order to take this route, the Irish would need to declare that they were rejoining sterling below the prevailing £/€ exchange rate. Effectively, Ireland would create a "New Electronic Currency", devaluing their assets and liabilities and then subsuming their NEC into sterling in one swoop. Rejoining sterling would neatly answer the problem of how to instill market credibility, allowing the Irish government and of course Irish businesses, to obtain financing at non-penal or distressed interest rates.

For financial services firms, the additional advantage of this path is that adding the Irish into existing sterling structures would be easier, and less expensive, than establishing a new currency.

Ireland has a unique exit from the euro: they could rejoin sterling, rapidly regaining financial market credibility

Mapping the Effects of a withdrawal from the Euro



Conclusion

Even if departing the Eurozone is still long odds, it has to now be considered as a possible scenario. Given the potential impact and challenges resulting from a country leaving the Eurozone, we believe investment banks should internally stress test such a scenario.

This paper makes no predictions about the likelihood of this long odds event, but it does look at a number of the key challenges that would face financial services firms were a country to be forced to leave the euro. These range from coping with the reaction of a naturally nervous public to corporate refinancing, to the likely size of any foreign exchange markets that might eventually emerge.

References

[1] Athanassiou, Phoebus; "Withdrawal and Expulsion from the EU and EMU"; ECB Legal Working Paper Dec 2009

[2] Roberts, Richard; "EMU – Fuse or Split?"; Lombard Street Research; Oct 2010

[3] Mayer, Thomas; "The politics of the euro" Deutsche Bank Research; July 2011

[4] BIS Quarterly Review: June 2011 Table 3A: External loans and deposits of banks in all currencies vis-à-vis all sectors

About Accenture

Accenture is a global management consulting, technology services and outsourcing company, with approximately 211,000 people serving clients in more than 120 countries. Combining unparalleled experience, comprehensive capabilities across all industries and business functions, and extensive research on the world's most successful companies, Accenture collaborates with clients to help them become high-performance businesses and governments. The company generated net revenues of US$21.6 billion for the fiscal year ended Aug. 31, 2010. Its home page is www.accenture.com

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