Euro contingency planning

Stressed financial markets

December 2011

Change in market sentiment

Media headlines increasingly contemplate a country secession from the Euro or a wider Euro event

Thinking the unthinkable on a Euro break up

It has suddenly become respectable to ask the question: what would happen if the euro broke up? (FT 27 Nov 11)

Europe fails to reach the summit.

Friday's deal falls short of the real, comprehensive fiscal union needed to restore faith in the euro and end the crisis

(FT 11 Dec 11)

Eurozone pact fails to restore confidence

A European summit deal to strengthen budget discipline in the euro zone failed to restore financial market confidence on Monday, forcing the European Central Bank to step in again gingerly.

(Reuters 12 Dec 11)

The terrible consequences of a eurozone collapse.

(FT 7 Dec 11)

Global businesses make contingency plans for possible eurozone break-up

Import costs and legal impact considered.

(FT 30 Nov 11)

Greece get lifeline despite talk that it will quit the euro

The eurozone threw Greece a long-delayed €8bn lifeline last night. [...] But analysts in London speculated that Greece could leave the euro next year as policy makers struggle to come up with a resolution to the worsening crisis.

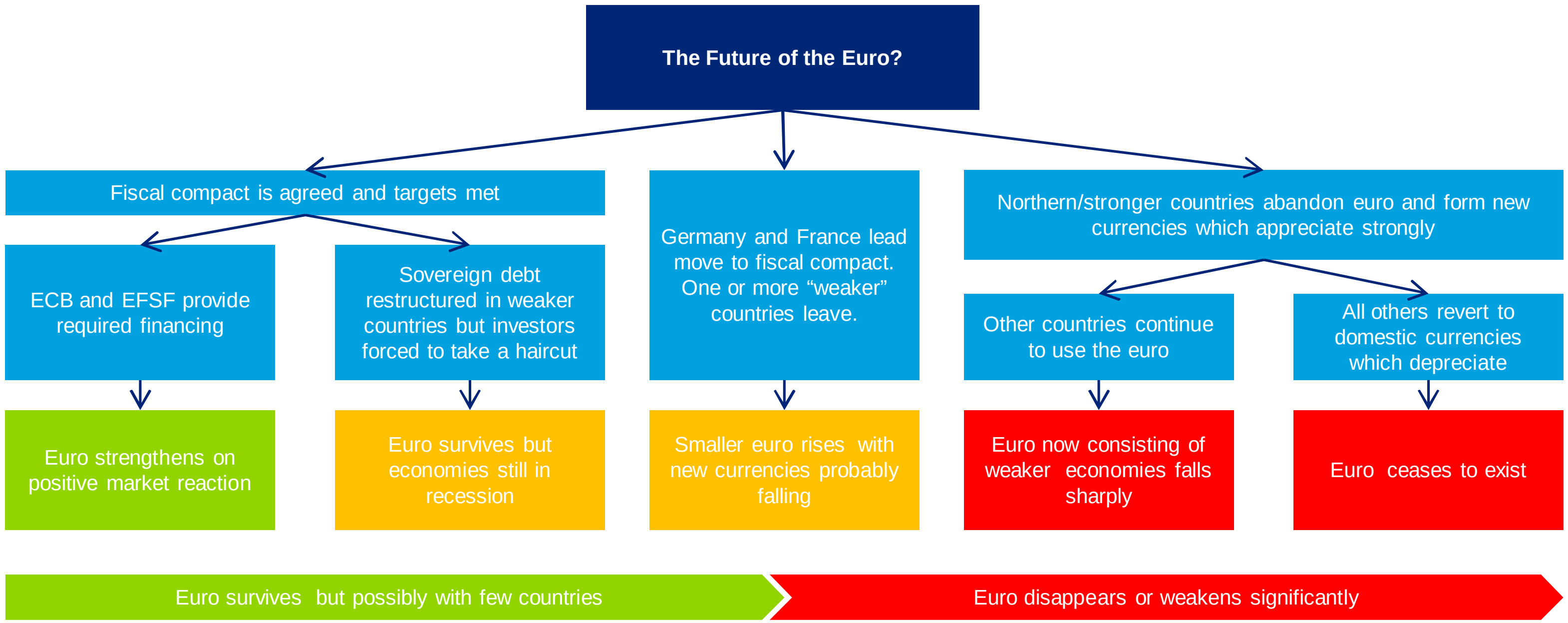
(Times 30 Nov 11)

Range of possible outcomes

Different scenarios have been considered by the markets. The outcome remains unknown

Company treasurers around the world may well have already been asked by their boards for a brief on the implications of a euro break-up or a unilateral secession by one country (irrespective of whether and how that could be achieved in a legal manner). Some companies have even started to put in place some mitigating or contingency steps.

In addition to many complex legal questions, some of which are explored further, the challenge for companies is to determine which scenario to prepare for (see chart below). Is a secession by weaker economies more likely, or indeed will the stronger countries wish to separate? Could the Euro survive with a sovereign debt re-structuring for the weakest countries? The chart below sets out some of the scenarios envisaged, with some arguably more likely than others.



Key questions

Many questions, mainly of a legal nature, remain unanswered

- There is no legal or jurisdictional basis for a Euro collapse or a unilateral secession by one country, let alone for a country to be expelled. Article 50 of the "Lisbon Treaty" provides for a country leaving the EU but not the Euro alone. A change to the Treaty would therefore be required to enable a secession and this would be a complex and lengthy process. The alternative would be a unilateral repudiation of the European treaties – i.e. an illegal secession.
- A country leaving the Euro would need to introduce new legislation, for example to ensure contracts denominated in Euro continue to be valid and enforceable, and to provide for redenomination into the new currency. This type of a currency secession is unprecedented, and hence one can only "guess" at the details of such new legislation.
- It will not be easy to determine whether contracts will remain in Euro or be redenominated to the new currency. Factors such as the contractual law (local or English law), jurisdictional law, place of payment, location of entities, contractual intention, etc all may impact the decision. Each contract would need to be assessed individually and conflict of laws and jurisdiction is likely.
- Will exchange controls be implemented by seceding countries? In order to prevent a flight of capital, seceding countries may make it illegal for persons to make cross-border Euro payments which could complicate the recovery of Euro assets held in those countries by non-residents. Conversely, will trade restrictions be placed on these countries by the remaining Euro members?
- In addition to these legal questions, entities will be facing many economic and financial uncertainties. Will there be further bank defaults? What would happen with inflation? Will credit markets tighten even further? The objective of any contingency planning is to assess these risks and be prepared, to the extent possible.

This briefing paper does not aim to address these legal uncertainties or indeed any of the wider economic or fiscal considerations and implications of a potential disorderly event in the eurozone. Whilst it identifies a number of commercial considerations at a high level, its main focus is on treasury issues, in particular on financial assets and liabilities (primarily cash, debt and financial derivatives) and financial risks such as foreign exchange exposures. The aim of this document is to highlight how treasurers in companies with operations or transactions in the eurozone need to take an active role in preparing their company for any potential eurozone event.

Overview of commercial and business risks

Potential risks, questions to consider and possible mitigating actions and contingency plans

Corporate Treasurers need to be aware of the effect of a eurozone event on economic activity across Europe and how that would in turn impact their own business. Companies will be exposed to increased risk of financial failure in their customers and suppliers and in their own business due to disruption to sales and purchasing and to external financing sources. Changes in foreign exchange parities will change the relative economics of cross border trade causing changes to the levels of sales and preferred sources of purchases. Structural changes to industries will follow eventually.

What's at risk

- Customers no longer able to pay, including possible defaults.
- Reduced future sales as changed FX rates make exported products too expensive for some markets.
- Supply chain breaks down due to financial failures or FX changes.
- Sales volumes collapse due to supply chain problems or global economic recession.
- Trade severely disrupted by trade tariffs and exchange controls.
- Lack of finance to support new commercial activities.
- Economic value of subsidiaries in affected countries reduced.

How to assess your exposures

- Work with sales teams to understand customer base by country and strength of individual major customers
- Work with sales teams to review your company's own relative competitive position in a world with changed economics
- Liaise with procurement to assess strength of supply chain and changes to expected stock levels – both input and output
- Run stressed scenarios on the business plan

Potential actions

- Consider if you can assist critical links in supply chain with prompt payment, reduced trade credit terms, or supplier finance programmes.
- Consider if extra precautionary stocks of raw materials help conserve future production or could end up redundant if sales collapse, and hence change financing needs.
- Review and where possible amend duration of supply contracts. Consider amending commercial contracts to allow for new currencies following exit from euro.
- Look for new business opportunities arising.
- Treasury to take a place on any contingency planning committees. Read the ACT's briefing note "Contingency planning for a downturn in the economy: a treasurer's checklist" (here).
- Check monetary amounts of insurance cover remain appropriate.
- Can accounting systems cope with redenomination of some accounts.

Overview of potential treasury impacts

Many of the immediate impacts of any fallout of the euro will relate to financial matters such as the currency denomination of financial assets or liabilities held in Euros

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Trigger of problem	Impact on		
	Cash	**Debt and credit facilities**	**FX/Derivatives**
Banks failures/credit risk	• Loss of cash and bank deposits	• Debt facilities cancelled	• Loss of in-the-money derivatives and protection/hedge
	Need to update, tighten and possibly amend credit risk / counterparty risk management policies		
Weaker country/ies revert to legacy currency. Strong Euro survives in remaining countries	• Euro cash and other financial assets held in countries concerned may be converted to a weaker new legacy currency and become potentially subject to exchange restrictions	• Availability of debt is likely to dry up. • Existing Euro debt may or may not be redenominated to the new currency, depending on legal considerations, potentially creating currency mismatches, and changed affordability	• A currently hedged, cross-border, euro position may become unhedged if one country's euros convert to a different currency. • Euro derivatives may be redenominated or unenforceable • As a result, a mismatch in assets and liabilities can give rise to material FX gains or losses
Euro collapses and disappears	Similar challenges as in the scenario above across all eurozone countries, but combined with much greater economic distress and financial markets turmoil.		
Euro survives but weakens	Similar but less severe challenges as above, with key focus on the need to optimise foreign currency exposures.		

Each of these areas is discussed in further detail on the next pages.

Credit risk

Potential risks, questions to consider and possible mitigating actions and contingency plans

Irrespective of any impact on the Euro, sovereign and commercial debt write downs and continued or increased bank funding squeeze could result in bank defaults. Companies need to prepare for this risk. This is not a new requirement or dissimilar from normal best practice credit risk management but requires a different focus than many companies may currently adopt, for example the need to monitor risk and limits by country.

What's at risk

- Loss of cash, bank deposits and money market investments.
- Debt facilities cancelled.
- Banks unable to honour their obligations to lend under credit facilities.
- Loss of in the money value and protection from derivatives.
- Off balance sheet contingencies.

How to assess your exposures

- Measure credit risk by counterparty. This needs to include all exposures (cash and derivatives) but assess each individually (by country and by type) to reflect netting provisions and rights of set-off. Monitor collective investments / Money Market funds.
- Obtain regular valuations of any outstanding derivatives to understand the value at risk and impact on hedging strategies if they were lost.
- Review provisions in ISDA to understand your rights if a bank defaults or to obtain collateral in the event of a bank downgrade.
- Review how company can cope if facilities get cancelled, for example an inability to draw undrawn amount of committed lines, or inability to issue letters of credit

Potential actions

- Review credit limits for all banking counterparts and ensure stay updated on credit downgrades. Introduce a policy to cap credit risk by jurisdiction if not already in place.
- Move cash if necessary and if possible.
- Consider opening bank accounts with a different bank if concerned about the credit standing of your current bank.
- Consider using credit insurance or CDS to protect position.
- Where possible introduce netting clauses to reduce credit exposure.
- Consider the availability of undrawn committed lines.
- For certain industries, establish potential for trading without the use of LCs or bank guarantees.

Debt and credit facilities

Potential risks, questions to consider and possible mitigating actions and contingency plans

What happens to the debt held in Eurozone countries or in Euro? The risk is that debt ends up in a stronger currency than the assets it is funding. In addition, sources of credit are likely to dry up in affected countries.

What's at risk

- Availability of bank credit may dry up.
- Other sources such as Euro commercial paper and bond finance may also reduce.
- For borrowers in affected countries, euro debt located outside the country, may stay denominated in Euros whereas assets may convert to a weaker new currency.

How to assess your exposures

- Assess future funding requirements and internal cash reserves. Don't overlook contingent liabilities.
- Identify all credit facilities held in Euros and/or by eurozone entities and consider potential likelihood of redenomination.
- Check documentation of banking and debt agreements for various legal considerations such as legal jurisdiction and governing law, clauses referring to unavailability of currency, jurisdiction, place of payment, intent, etc.
- Assess the risk of ending up with Euro debt in a "strong" jurisdiction which finances assets in a "weaker" jurisdiction at risk of leaving the Euro (or being left in the weaker half of the Euro).

Potential actions

- Firm up funding requirements in advance.
- Determine whether debt can be moved in-country to be closer to the assets
- Generally match currency and location of debt to that of related assets.
- Review covenant compliance.

Example

UK Group has a subsidiary in a "weaker" eurozone country which has been funded by euro debt raised in London under English law. The risk is that the debt remains denominated in Euro yet the profits in the subsidiary are now earned in a weaker currency.

Theoretical solution is to push the debt down, by borrowing locally with a local bank. In practice this may be impossible as local banks may not be able to lend.

As a practical, minimum, solution, extraction of surplus capital should be considered.

Cash and cash management

Potential risks, questions to consider and possible mitigating actions and contingency plans

What happens to Euro cash held in Eurozone countries at risk of exiting (or even outside the Eurozone in the event of a complete collapse)? The risk is that it is redenominated to a weaker currency and becomes subject to foreign exchange controls. A Treasurer also needs to consider the impact this may have on cross-border cash management structures. Cash flow is likely to be severely disrupted as patterns of trade change, customers take longer to pay, weak suppliers seek financial support or rapid payment, and exchange rate changes alter cash flow values.

What's at risk

- Devaluation of euro held cash or deposits
- Euro cash trapped in countries that impose exchange controls
- Interruption to cross border euro pooling structures, resulting in need for greater credit lines
- Interruption to national banking systems including bank accounts
- Changed pattern and timings of cash flow

How to assess your exposures

- Analyse cash balances by country and identify surplus cash and capital.
- This should include cross-border Euro intercompany balances.
- Understand where cash pools / cash concentration structures operate cross border and how the exclusion of any one country would impact the net cash position. For example, if a country at risk of exiting the euro is the typical provider of surplus funds, will this result in a need for higher credit lines?
- Check which legal entities only have Euro bank accounts and assess the practical implications of bank accounts no longer functioning.
- Look at internal controls to consider whether they could cope with an increased usage of cash – supplier, staff payments etc

Potential actions

- Repatriate surplus cash from eurozone countries that are at risk of exiting to minimize balances that may become trapped or statutorily converted to new weak currency.
- Review capital structure of eurozone entities in the risky countries and, where appropriate, extract surplus capital, e.g. repay intercompany loans or create euro denominated upstream loans.
- Consider establishing bank accounts (euro and other currencies) outside the eurozone for entities in countries most at risk of secession.
- For selected countries prepare for receiving euro customer proceeds to eurozone entities in euro accounts or other group entities outside the country concerned.
- Examine the drivers of cash flow, financial strength of customers and suppliers and international dependencies of cash flow.

Foreign exchange and derivatives

Potential risks, questions to consider and possible mitigating actions and contingency plans

Treasurers need to revisit FX hedging policies to ensure they remain effective post a partial or full Euro break-up. One key change is that euro risk may now need to be viewed on a country by country basis rather than net across the entire eurozone.

What's at risk

- Euro positions currently deemed hedged become unhedged as certain positions convert to a new currency.
- Euro derivatives may be redenominated or unenforceable
- As a result, a mismatch in assets and liabilities can give rise to material FX gains or losses
- Failure to achieve hedge accounting

How to assess your exposures

- Understand Euro exposure by country, split between underlying exposures and FX hedges
- Understand exposures in detail, i.e. gross flows, to assess natural hedges possible within country. For example, can customers be invoiced in other currencies; or can goods be sourced in different currencies?
- Review existing hedges – who are they with? Would they remain hedges if your counterparty is in a potentially seceding euro country?
- Review your debt funding by currency, and compare to the assets it funds by currency
- Consider the impact of changed exchange rates on the relative economics of cross-border sales and purchases and hence expected business cash flows

Potential actions

- Put in place a country specific Euro hedging approach, including natural hedges where possible.
- Push down debt to match the location of the assets. The aim is to maximise the likelihood that the debt continues to be denominated in the same currency as the assets.
- Discuss with your banks their contingency plans.
- Repatriate surplus Euro where possible. Or hedge them with counterparties not in weak eurozone countries.
- If currency cash flows are to become less certain as economies go into recession consider if FX options become more suitable compared to FX forwards.

Reputational Risk

Potential risks, questions to consider and possible mitigating actions and contingency plans

In certain scenarios one could envisage many new laws, regulations and controls being introduced by various countries such as trade restrictions and tariffs, or exchange controls and restrictions on transfers of funds or movements of real cash. Responsible companies will want to ensure they are not in breach of any such new rules.

What's at risk

- Illegality or unenforceability of contracts
- Penalties or criminal prosecutions for breach of regulations
- Damage to reputation and brand

How to assess your exposures

- Keep abreast of change of law in the countries you operate in or make sales to or purchases from
- If still dealing with customers in a 'difficult' country enquire into the source of payments from them. For example do you want to accept payment from illegally held offshore funds?
- If your suppliers ask you to pay to new offshore bank accounts should you be co-operating?

Potential actions

- Agree or confirm company policies in this area
- Identify sources to keep abreast of new regulations e.g. from bankers, lawyers, government information services, trade associations or press etc.
- Brief relevant staff likely to encounter such issues
- Monitor and query any unusual patterns of cash flow or cash transfers

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