

THE DOMINO EFFECT

ARE YOU PREPARED FOR A EUROZONE BREAK-UP? AS THE CRISIS DEEPENS, SHUBHI RAO OFFERS A REFRESHER

The eurozone debt crisis was triggered in April 2010 when Eurostat, the EU statistics agency, revealed that Greece's 2009 budget deficit was €32.3bn, or 13.6% of its GDP. Since then, the entire eurozone has been plunged into unprecedented levels of uncertainty.

The region shrank by 0.3% in the last quarter of 2011, according to GDP data, while household spending, exports and imports all fell. It was stable for the first quarter of 2012, thanks to an unexpectedly strong performance by Germany. But output was weaker in Italy, Spain and Greece, prompting fears that this may only be a temporary respite from double-dip recession. And Greece remains the eurozone's weakest link. Even after being bailed out, its debt is still expected to be 120% of GDP in 2020 under what some consider to be optimistic economic and budget assumptions.

If Greece does exit the eurozone, the obvious question is, will there be

a domino effect? Market attention will turn towards Italy, Ireland, Spain and Portugal, which are viewed as vulnerable because of their high debts and high deficits.

Treasurers must be prepared for the significant and difficult changes that would occur under various scenarios as a result of exposure in the eurozone. There is likely to be a credit squeeze. Possible capital and foreign exchange controls may need to be invoked at short notice and eurozone hedging strategies may need to be stripped out by country, with aspects of those strategies losing effectiveness as new currencies are created. Additionally, treasury should understand which scenarios will cause banking covenants to be triggered and cash to be trapped, and also set parameters for exchange rate appetites if volatility increases and new currencies are created.

Customer and supplier risk is clearly a major concern. Many global organisations, especially large consumer products companies, rely on sourcing raw materials,

products and services from the eurozone countries. They also supply clients across Europe from different EU and non-EU hubs.

Companies should prepare for massive social disturbances that will probably accompany any eurozone exit or messy break-up. Strikes, infrastructure outages, demonstrations and other violent street actions are likely, especially if the crisis is seen as unfairly impacting and further impoverishing certain populations, especially in the southern EU states.

The present state of affairs leaves treasurers in a vulnerable position. But with an established, prudent risk framework, treasurers can be proactive in identifying and mitigating potential risks.

There are some key areas treasurers need to consider in order to respond to this challenge effectively:

- ◆ Risk management frameworks for working capital and cash flow forecasting need to be stress-tested and updated if necessary. There should also be an appropriate

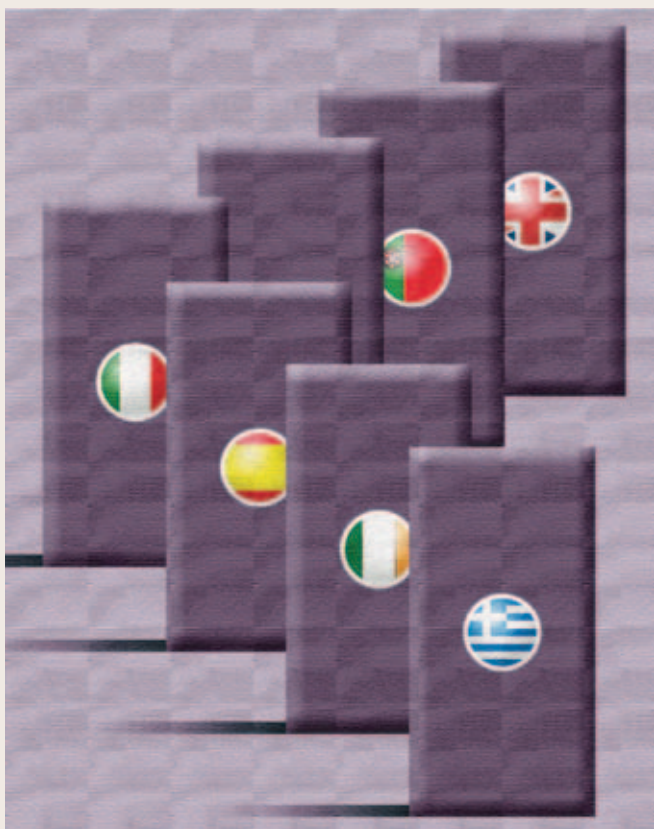
forum for discussing working capital and cash forecasting. A key question is whether counterparty risk policies and credit scoring processes have been reviewed. Is the business appropriately hedged?

- ◆ Treasurers will need to address how credit risk is currently monitored. Should changes be made to better predict and/or react to declining credit?

- ◆ They must also establish how legally enforceable are netting arrangements to reduce exposure.

- ◆ There is also a question about the availability of cash that can be moved to neutralise euro exposures, whether surplus can be repatriated and lending facilities redenominated.
- ◆ Turning our attention to the lenders, treasurers have to confirm whether the weaker eurozone banks will be able to provide local funding. What will become of local

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KIM BROSKY

deposits, if banks are no longer functioning?

- ◆ Companies may have to redirect/collect customer payments outside high-risk countries.
- ◆ Will cash pooling structures continue to be viable and efficient? Another issue rests on how increasing currency volatility impacts on foreign exchange hedging programmes.

➤ There are some serious potential downsides of failing to prepare adequately. These include:

- ◆ Diversity of funding arrangements will be

diminished, credit risk will be heightened, cash could be trapped and off-balance sheet contingencies may be triggered.

- ◆ Forecasted internal cash reserves could fall, and intercompany balances may shoot up.
- ◆ Problems with debt arrangements may arise upon currency restriction events, and banking covenant implications could also plague companies.
- ◆ Complex cross-border cash management structures could crop up and there could also be major problems with credit facility interactions.

- ◆ Working capital may be put under strain as customers take longer to pay. Suppliers will weaken without prompt payment. Foreign exchange rates may also become increasingly volatile. The enforceability of euro derivatives/country of bank counterparty may be put under strain as well, if the contagion spreads.

There may also be volatility arising from ineffective hedging strategies or hedge accounting, so companies must be 'switched on'.

It is worth noting that leading-edge treasuries are focused on ensuring that their contingency plans are up to date and have considered within these, the potential combination of risk consequences that might be associated with an event such as the break-up of the eurozone. All companies must try and do the same, so treasurers and their advisers have a key role to play. ♣

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TOP TIPS FOR MANAGING YOUR RISK IN EUROPE

- ◆ **De-risk foreign currency holdings – move cash out of the eurozone into 'safer' currencies or investments.**
- ◆ **Manage supplier exposure in the eurozone – don't have long-term contracts.**
- ◆ **Mitigate refinancing risks – set cash aside for upcoming bond repayment or expediting refinancing.**
- ◆ **Increase cash reserves by controlling non-essential expenditures.**
- ◆ **Perform assessment of net euro exposure by country.**
- ◆ **Prepare for volatility in the exchange market by reassessing hedging strategies.**
- ◆ **Analyse impact of new currency introduction on procurement and sales contracts as well as IT support systems.**
- ◆ **Reassess current crisis and contingency management plans to ensure teams are ready to respond.**