Leaving the Party:

How Will the Financial Services Industry Respond to a Eurozone Redenomination

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In spite of the progress made with a recent, second bail-out to aid Greece with its troubled economy, uncertainty still dangles over the eurozone. Lenders have agreed to take nearly a 70% cut in the sum owed in a remarkable effort to keep Greece a viable going concern within the euro currency.

While all parties have made compromises to reach an agreement, doubts remain about Greece's economy. Forty-eight percent of young people are out of work in Greece and more than a quarter of Greeks are at risk of poverty or social exclusion. Greek debt is currently 160% of GDP after five straight years of recession.

There remains a significant amount of work to do for Greece and the "troika" behind the bailout: the IMF, the EU and the European Central Bank. Some European finance ministers are skeptical about the likelihood of Greece keeping its spending pledges, especially with elections due in April and the Greek electorate being extremely discontented with the implementation of drastic austerity measures.

It is possible that this second bailout will not settle the issue definitely and that the troika could find itself back at the table in a few months again trying to save Greece from default and ensure its continued participation in the euro. The prospect that Greece might lose its seat at the table was even voiced by Greek finance minister Evangelos Venizelos when he recently hit out at the "forces in Europe" he feels are trying to push Greece out of the euro.

Many people around Europe are working tirelessly to ensure that it won't come to an ignominious redenomination, but perhaps it is time to hope for the best and plan for the worst. In considering the recent turmoil, Eagle began examining the prospect of one or more currency redenominations in the eurozone. Such an event (or events) would have major consequences on our industry and much of our client base. We therefore recognize the enormous importance for financial services firms in acting now.

To try and shed some light on the expedient steps for preparing for a redenomination, we recently hosted a webinar for clients to address the topic of a redenomination of one or more eurozone countries. I was joined by William Filonuk, Managing Director, Head of Asset Servicing Capital Markets Research and Development, BNY Mellon Asset Servicing, and Paul Kennedy, Business Manager of Reference Data, Interactive Data Corporation, for a discussion which investigated some of the challenges relating to a possible redenomination and also sought to identify some positive steps for clients to take in order to prepare. I wanted to take this opportunity to provide a summary of some of the key points we addressed during the webinar in an effort to stimulate more discussion on the topic.

WHAT ARE THE BEST SCENARIOS TO PLAN FOR?

With Greece facing €14 billion in loan repayments, it was vital that a second bailout was agreed to in order to prevent a Greek default and an imminent redenomination. This does not signal the end of the European debt crisis, however, and it remains possible that one or more countries could be forced out of the single currency.

It is highly unlikely that the euro itself would be so badly damaged as to be discontinued across the board, as there are still many AAA rated, large, and successful economies committed to the currency.

The prospect of a redenomination sounds pretty terrifying for those involved in European currency, but a little perspective is needed. We have dealt with major conversions and disruptions before. When the nascent euro came into being in 1999 there were some pretty tricky conversions to negotiate and the currency has since absorbed eight further countries. We've also seen major structural currency changes in Europe along the way, like the rebalancing of the Turkish lira back in the middle of the last decade.

With a newly redenominated currency, new FX rates would need to be developed based on historical comparisons with old euro rates and a new LIBOR and EURIBOR rate would also have to be developed. This is certainly possible but it may take some time and there will be other significant operational challenges to overcome in the event of a eurozone redenomination. The country in question would have problems beyond mathematics as well. They would need strict border controls to prevent euro banknotes flooding out of the country and would need to get the printing press rolling on the creation of new currency for distribution.

THE UNKNOWN UNKNOWNS

Any country leaving the euro is unlikely to provide an enormous amount of lead time to allow the financial industry to ready itself at leisure as this could have a seriously detrimental effect on their borrowing costs and investment. They are likely to keep their cards close to their chests and then give the financial services a weekend, when markets are closed, to figure everything out. So preparation for this eventuality will be absolutely crucial - right down to granular considerations such as what would happen to a trade that closed on a Friday in euro and yet requires settlement on the following Monday under a redenominated currency.

We also don't know who will take the lead in policing a redenomination; the European Central Bank or the European Union? Either way, the outcome is far from certain: the architects of the euro never in their wildest dreams anticipated anyone leaving, so there is no legal framework established for how this would be achieved.

BE PREPARED

As one of the initial steps for redenomination, a new ISO currency code would have to be issued as, even if a country returns to a legacy currency, old codes would not be useable (they were officially retired). So it will be crucial to consider how quickly a new code can be incorporated into your operations.

Then comes the question of which assets that you have traded on would have to be redenominated. Some instruments would have to be redenominated immediately, but not all. Financial services firms will have to consider carefully what happens to financial contracts which perform in euros and pay in euros or reference EURIBOR in calculating payments.

For most assets it will depend upon which monetary law the instrument was originally issued under. If it can be established under English or New York law, then it may be possible to continue being paid in euros. If under the local law of the redenominating country, it would have to be in the new currency. And there could be protracted and complicated legal disputes that complicate this distinction.

Bond redenomination would be a complex affair as it will be dependent on the legal jurisdiction covering any given bond, thus requiring temporary capital and foreign exchange controls. Government Bonds and longer term bonds would have to be redenominated, but there is a practicality issue here. Short term bonds, say with 6-months left to run, might be allowed to run off in euros.

For some large asset managers it would be very tricky to convert their equity and fixed income positions. Some may go back 20 or 30 years and it is important to them to have a sense of purchase price to fully calculate fund performance. This would likely be a lengthy and complex endeavor and it therefore makes sense for firms to start thinking about the processes needed to make any necessary conversions.

HOW WILL REFERENCE DATA BE AFFECTED?

During the webinar, Paul Kennedy gave some excellent insight into how Interactive Data and other reference data providers might go about implementing currency changes in the eurozone.

It was impressive to see how engaged Interactive Data is on this issue. The company is already testing potential major changes, such as how to retire an old security master in the system and replace it with a new one assigned the redenominated currency and how to report on the security in question pre and post redenomination. Clearly Paul and his colleagues are aware of what an enormous impact this could have on a range of financial instruments and are considering how this would affect their client offerings.

Paul offered the opinion that the biggest impact might be on equities. He suggested that it might be possible to dual-list for a time, maintaining the euro listing alongside the new currency, but that would still require reference data agencies to issue new identifiers for the asset.

Interactive Data is still working through a number of practical considerations. For corporate actions, for example, reference data firms would typically only provide data in the form that it was originally announced, but would they change policy for those affected by the redenomination? At a more macro level, what will the industry do in terms of historical pricing? Previous guidance from trade bodies tends to warn against converting the history as it may cause distortions in price performance. Interactive Data would be likely to put practical measures in place, like a conversion for the day before the cut-over so that if a bond didn't trade on a particular day, there would still be an actual, valid price.

WHAT CAN THE FINANCIAL SERVICES COMMUNITY DO TO PREPARE?

Given the number of question marks, both macro and micro, which surround a redenomination should it occur, what can the financial services community do to prepare?

CONTINGENCY PLANNING AT EAGLE

Let me start by telling you what we are doing to prepare. At Eagle Investment Systems, we are aware that intense scenario planning will be absolutely critical and we're busy testing our systems against a number of the scenarios outlined above. We have tested our accounting systems, data warehousing and portfolio management solutions to piece together how we would make the necessary changes and how this would affect clients.

For whole suite users it is crucial to make sure that the solution flows end to end, from the accounting systems right through to data warehousing.

One vital commitment we have made throughout our hypothetical planning is that we will seek to make as few software upgrades as possible. Clearly, given the amount of factors that clients will be dealing with in the event of a redenomination, the last thing anybody will want is to be swamped with vendor software updates.

We are also seeking to create a dialogue with our clients at every conceivable opportunity in order to establish the likely pain points for them and how we can adapt together.

As I mentioned, our webinar the other week was one step in this direction, and it will be useful to revisit some of the main suggestions that were uncovered to help our clients be ready for a country exiting the single currency:

WHAT CAN CLIENTS DO TO PREPARE?

- Take a full inventory of European positions to establish level of exposure and identify where you need to focus.
- Examine closely any funds based in Europe that you see the need to convert into a redenominated currency and consider the legacy issues of these positions.
- Collect details on the issuing authority for securities to best understand the likely monetary law jurisdiction – is it a municipal authority, the federal government, the European Union?
- As a matter of urgency speak to your auditing firm as there could be tax implications as a result of redenomination if the law considers it to be more than a mechanical change.

Overall, our webinar identified two major points. Firstly, preparation is key. Firms must be highly prepared for any and all of the likely scenarios that might follow one of the member currencies exiting Europe's single currency.

Secondly, successful preparation depends on working together. There are many unknowns which make it difficult to prepare in silos. To be as well prepared as possible, we want to keep the discussion alive in our interaction with clients and the industry at large to identify any unforeseen scenarios that might have a significant impact. We hope you'll join us in that effort.

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