

Bank Governance Leadership Network ViewPoints

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Implications of the eurozone crisis

In a series of Bank Governance Leadership Network (BGLN) discussions in 2012, including two meetings on February 15 in New York and February 29 in London, eight chief risk officers (CROs) and six non-executive directors¹ from 12 banks discussed top and emerging risks for global banks with officials from the Federal Reserve Bank of New York, the Financial Services Authority, the Office of the Comptroller of the Currency, and the Office of the Superintendent of Financial Institutions.

Among the top risks identified by virtually all participants was the ongoing crisis in the eurozone. The potential outcomes and the implications of various crisis scenarios remain unclear. Since the two meetings, events have continued to move on, with new agreements reached and reforms imposed. On March 2, 25 of 27 European Union (EU) countries signing the Treaty on Stability, Coordination and Governance, aimed at ensuring binding fiscal rules are applied across the EU. German Chancellor Angela Merkel called this a “step towards a political union.”² Subsequently, Greece got agreement for the largest-ever sovereign debt restructuring.

Despite that progress, addressing immediate concerns and identifying long-term solutions that tackle underlying issues will require additional politically sensitive solutions and coordination. Martin Wolf, the chief economics commentator at the *Financial Times*, claimed in early March, “To varying degrees, the vulnerable countries are in lasting difficulties. Would these fiscal disciplines have saved the eurozone from its wave of crises? Will they pull afflicted countries out of these crises now? The answer to both questions is: no.”³

This *ViewPoints* synthesizes perspectives and ideas from the discussions in February – and from nearly 50 discussions before the meetings with directors, executives, supervisors, and banking professionals – at which BGLN participants discussed potential scenarios, related risks, and whether and how their institutions can prepare for the potential second and third-order implications. For participants’ views on other top and emerging risks and on improving risk identification, see *ViewPoints*, “Top and emerging risks for global banking,” and “Improving risk identification.”

Discussion centered on three main themes:⁴

- Banks can take some steps to prepare for a range of outcomes
- Many scenarios remain possible
- Longer-term implications are worrisome

¹ In this document “director” refers to members of a bank unitary or supervisory board.

² Quentin Peel and Peter Spiegel, “Eurozone States Sign up to Fiscal Pact,” *Financial Times*, March 2, 2012.

³ Martin Wolf, “The Pain in Spain Will Test the Euro,” *Financial Times*, March 6, 2012.

⁴ All discussions were held under a modified version of the Chatham House Rule that encourages sharing of perspectives but absolutely forbids attribution to individuals or institutions. All comments from participants are italicized. A complete list of meeting attendees can be found in Appendix 1, on page 8. A complete list of interviewees can be found in Appendix 2, on page 9.

Bank Governance Leadership Network ViewPoints

Banks can take some steps to prepare for a range of outcomes

In November, Andrew Bailey, deputy head of the Prudential Business Unit at the United Kingdom's Financial Services Authority, stated, "As you would expect, as supervisors we are very keen to see the banks plan for any disorderly consequence of the euro area crisis. Good risk management means planning for unlikely but severe scenarios and this means that we must not ignore the prospect of a disorderly departure of some countries from the eurozone."⁵ Supervisors are asking institutions to prepare for the worst. One said, "*We are doing contingency planning walk-throughs with financial institutions on these scenarios.*" There are many variables and many plausible outcomes in the eurozone, which may explain why participants in the two discussions had many differing perspectives on what banks could or should do to prepare.

A CRO described the challenge, and benefit, in planning for the unknown: "*You are faced with a thousand-branch decision tree, but the value of the exercise is to try and understand what are the two dozen key questions that you've got to answer to be prepared when the fire drill rings.*" Another CRO suggested that looking too many steps ahead is not productive: "*It is so open-ended ... A complete collapse overnight is so unlikely, and it is so difficult to protect yourself. We expect many stages to get there, so we are preparing for the stages.*"

Some BGLN participants stated that the risk of a complete collapse of the euro or even the exit of a strong state was remote and therefore not worth much discussion. But one director contended that discussions on emerging risks have to focus on events perceived to be less likely: "*The questions have to be low odds. The things that have high odds of happening, people are already thinking about every day. What are the things with a 1% chance of happening?*"

Participants agreed that second- and third-order risks present significant challenges. A director observed, "*It is relatively easy to see the first-order risks. It is the second and third order, e.g., interconnectivity*" that are harder to determine. But it is precisely in considering those risks that scenario planning is of greatest value.

Participants articulated several additional concerns stemming from the euro crisis:

- **Scenario planning depends on guessing others' actions.** Contingency plans only get you so far, a CRO said, because individual institutions are dependent on the actions of others, including counterparties, regulators, governments, and intermediaries: "*You are relying on everyone else being in the same place.*" Several participants raised questions about how regulators and others would act if a major disruption occurred. One asked, "*In times of stress, when will regulators insist on preemptive ring fencing?*" But contingency planning has the benefit of highlighting issues that supervisors should consider. A supervisor said, "*If people get to a point in their scenarios where they ... [need to] know what the authorities will do, they should ask. We may not know the answer, but it will at least tee the questions up so that we can be sure we have the answers when you really need them.*"
- **Legal uncertainty complicates planning.** Prior to the meetings, many wondered how contracts will be enforced if new currencies are created or pre-euro currencies are reintroduced. Asked one CRO, "What happens with banks with large exposures, with contracts under UK law, if Greece decides to

⁵ Garry White, "[Andrew Bailey: 'UK Banks Must Brace Themselves for Euro Break-up.'](#)" *Telegraph*, November 24, 2011.

Bank Governance Leadership Network ViewPoints

default?” A director raised similar questions: “*What happens if ... banks say, ‘We’re not going to honor derivatives contracts?’ ... The ability to enforce contracts – what are the rules for redenomination?*” One CRO urged firms to ensure they have proper documentation in place and are aware of “*the most contentious contracts.*”

- **Potentially significant operational and IT-systems implications arise.** The sheer scale of change involved with the reintroduction of a pre-euro currency or multiple currencies creates concern. Prior to the meetings, one director asked, “*What if there is a shift in payment systems, e.g., the Greek drachma has to come back?*” while a CRO wondered, “*How will the ATM system be affected and managed?*” At one of the meetings, a CRO recounted a disconcerting discussion with a major settlements firm: “*We asked [one organization] for a currency code, [in case a new currency is needed], but they say, ‘We are not prepared to discuss it.’*” Another CRO offered this approach to planning: “*Treat it like a Y2K problem, not an economic problem, but an operational problem. We floundered for a while considering the what-ifs. Then we shifted to focus on the operational problems – for example, can we deal with redenomination in our payment systems? I can only plan for what I can control.*”
- **Concentration risks may not be transparent.** Several CROs said before the meeting that it is difficult to have a firm understanding of “*our exposures to [certain] banks, and theirs to others in Italy, Greece, and Spain and how they are linked.*” The interconnectivity will only become fully apparent when an event occurs.
- **Discontinuities could disrupt service delivery.** One executive explained that as a consequence of considering implications of various scenarios for the bank’s operations, the executive team noticed that in one country, they depended heavily on just one or two banks as commercial partners. They realized that if either bank were to get into trouble, their own service delivery in that country would suffer.

Many scenarios remain possible

During the two meetings, participants shared perspectives on four scenarios in the eurozone and what the potential implications of each could be.

A small/weak single-state exit from the euro, presumably Greece

Participants broadly agreed that a single-state exit was indeed possible and said that in fact, the likelihood of a Greek exit could increase due to internal and external political pressures.

- **A Greek default.** A CRO asserted, “*Let’s be clear, Greece is defaulting.*” Indeed, following the two meetings, Fitch Ratings, Moody’s, and Standard & Poors downgraded Greece to selective default. But following a massive debt restructuring agreement in early March, Fitch Ratings raised Greece’s sovereign debt rating out of restricted default.⁶ Still, as the CRO noted, “*We have written down their debt 75% and expect market prices below that.*”

⁶ Ben Fox Rubin, “[Fitch Pulls Greece Out of Default Rating Following Debt Deal.](#)” *Wall Street Journal*, March 13, 2012.

Bank Governance Leadership Network ViewPoints

- **Orderly exit or not?** A CRO observed, *“The reality is that we have reduced our exposures significantly and written down the debt so far ... In the next two years, everyone will sever links with Greece; they will be isolated. Does that precipitate Greece leaving the euro? Quite possibly, but at that time it will be managed.”* Still, even a single, small-country default or exit could create significant disruption: *“If you need to create a new currency, every single company balance sheet needs to be analyzed; you need new legislation. Consultants and lawyers will make out; for everyone else, it will be a disaster.”* A CRO wondered, *“What if post-election, Greece says, ‘We won’t pay you.’ Economically, we have written it off, but legally, it may trigger a range of other contractual issues – for example, credit default swaps.”* The International Institute of Finance has estimated that a disorderly default could result in losses across the eurozone in excess of €1 trillion.⁷
- **Knock-on departures.** Those participants who still view a Greek departure from the euro as a possibility asked, *“If and when Europe pushes Greece out, or Greece pushes to get out, will that precipitate others getting out?”* Countries like Ireland, Portugal, and Spain could fall victim to a negative market reaction. While some believe that a lone single-state departure is possible, others believe the subsequent pressure on other currencies to leave the euro could be irresistible.

A larger single-state exit from the euro

Prior to the meetings, a director asserted, *“The [European Central Bank] will calculate that a large-state exit is completely inconceivable and put a number to the impact that [assumes] no possible exit of a strong state.”* But participants in both meetings were concerned with the possibility of the exit of a larger state if efforts to manage contagion are ineffective, and they turned their attention to Italy and Spain.

Participants were relatively sanguine about Italy’s ability to manage its fiscal situation and its economic strength. They thought its departure from the euro was unlikely. A director noted the progress that Italy’s government has made in recent months: *“Italy has shown very impressive movement of debt-to-GDP.”* A CRO added, *“Italy is a strong economy fundamentally. The north has a strong manufacturing base, and it will support the south.”*

By contrast there was greater concern about Spain. *“Spain is the real worry: what industry do you have there?”* asked a CRO. Another CRO said of Spain’s situation, *“This is a real problem. It has no obvious way to grow out of its problems. Unemployment is a major issue, especially youth unemployment. Social unrest is a real possibility.”*

Complete collapse of the euro over time

While some regulators have asked banks to prepare contingency plans for a complete collapse of the euro, a director suggested they were underestimating the political will in Europe to preserve the economic union, at virtually any cost. The recent signing of the Treaty on Stability, Coordination and Governance by 25 member states highlights this commitment. Furthermore, the potential implications of a complete collapse are so dire that several participants agreed with one director who said, *“If the euro would collapse, it would*

⁷ David Oakley, [“IIF Warns on €1tn Cost of Greek Euro Exit,”](#) *Financial Times*, March 6, 2012.

Bank Governance Leadership Network ViewPoints

be a disaster. You cannot model it.” A CRO explained, “The magnitude – capital controls, flight of deposits – it would not just be a severe recession, it would be a global meltdown. There is very little you can do about that as a bank. In the long run, if the euro collapses, we are all in dire straits.”

Ongoing uncertainty driven by short-term solutions that fail to address long-term issues

Another possible scenario is a continuing lack of resolution due to political and economic challenges in Europe, creating lingering uncertainty as politicians keep stepping back from the brink without addressing the underlying issues. Some commentators claim that without full political union, the new treaty lacks the teeth to hold states accountable. Already, Spain has had to renegotiate its budget because it cannot meet the deficit reductions required by the treaty, and analysts have raised questions about Spain’s ability to meet those requirements in the future: “We remain concerned that it will be very difficult for Spain to achieve this level of fiscal consolidation, especially given that the economy has already moved into recession.”⁸

Longer-term implications are worrisome

Regardless of the short-term outcome of the current crisis, long-term risks will remain. In some cases, the cure for the short-term challenges could increase other risks – for example, austerity measures could increase the risk of social and political upheaval. Participants discussed some of the long-term risks and challenges.

- **The problem of growth in Europe.** Ultimately, the only long-term solution to the euro crisis is economic growth. A director stated, “*The real issue in Europe is, why doesn’t it grow? We need 3% growth, and then we have zero problems.*” A CRO described the impediments to growth: “*The reality is, growth can only come from three places: consumption, demographics, or exports. And generally across Europe, none of those are likely to be a realistic driver. One of the three has to change.*” A director said that as governments seek to reduce spending, they may be exacerbating the challenge because “*you need to invest to grow.*” Similarly, many European countries’ economic policies may be counterproductive. Observed another director, “*It is not just debt, it is protection of jobs. Jobs protected means a slow growth rate, means very high youth unemployment. Until that changes, the economy moves very slowly. The problem with changing that is that in the transition, middle-age unemployment will increase first.*”
- **Reduced credit in Europe.** Prior to the meeting, one CRO asked, “*What impact could [the euro crisis] have on availability of credit for corporates? Trading partners? That is really difficult to measure.*” One director described specific protective actions banks can take: “*What banks can do is not lend to each other, dump peripheral [sovereign] debt, write down what you have, and reduce direct exposure to banks.*” The challenge, this director noted, is that markets may cease to function normally. The director posed a rhetorical question: “*[In that circumstance,] do we want regulators encouraging banks and money market funds to get out of Europe?*”

⁸ Victor Mallet and Peter Spiegel, “[Spain Wins More Time for Deficit Cuts.](#)” *Financial Times*, March 13, 2012.

Bank Governance Leadership Network ViewPoints

- **Overreliance on the European Central Bank (ECB).** As a CRO observed, *“At the moment, [banks] don’t trust each other, so we lend to the ECB and borrow from the ECB. That is not sustainable.”*
- **Impact on Eastern Europe.** A participant asked, *“Is [Eastern Europe’s] dependency on foreign-owned subsidiary banks ... of concern, if [the foreign-owned banks] reduce their commitment to [Eastern European] markets in light of the troubles in home markets?”* A CRO replied, *“This isn’t a major concern. Eastern Europe is quite large and breaks out into three buckets: (1) The commodity-rich countries, including petrodollar-rich countries, which are fine as long as oil stays above \$70 a barrel, and others, like the Ukraine, are commodity-rich in other areas; (2) The likes of the Czech Republic, which are industrialized and are fine; (3) The vulnerable countries like Bulgaria, which also suffer from corruption, but these are relatively small economies.”*
- **Knock-on impact on North America.** The risks and challenges associated with the euro crisis are not limited to Europe. As one director noted, *“Europe is the largest trading partner with North America, so we have to consider the economic risk [to North America]. There are long-term implications.”*
- **Social unrest and continued political polarization.** The difficult road ahead for countries like Greece, Ireland, Spain, and Portugal could prompt social and political unrest. Social and political upheaval motivated by austerity measures could lead to changes in governments and policy in smaller, peripheral countries that may offer referendums on the euro, or in large economies that may face pressure to reduce support for peripheral countries.
- **Impact on industry structure.** Banks with European operations also have to consider the implications of prolonged economic stagnation on the business model and industry structure there. Prior to the meetings, one supervisor said, *“Nobody is talking about what [the crisis] really means for the structure of financial institutions in Europe,”* while another warned, *“You could have a Pyrrhic victory where you position yourself with your securities, but the business model in Europe blows up.”*

Banks have taken steps to limit their direct exposure to peripheral-country sovereign debt, but the broader implications of the euro crisis – in both the near and longer term – are not yet well understood and are likely to have far-reaching effects. Regardless of the probability of given scenarios, playing out potential second- and third-order implications can help bank risk managers, boards, and supervisors identify questions and highlight gaps in risk analysis that will help them react more quickly as circumstances evolve.

Bank Governance Leadership Network ViewPoints



About this document

The Bank Governance Leadership Network (BGLN) addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of the mission to build strong, enduring, and trustworthy banking institutions.

The BGLN is organized and led by Tapestry Networks with the active support and engagement of Ernst & Young as part of its continuing commitment to board effectiveness and good governance. Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead. Ernst & Young is a global leader in assurance, tax, transaction, and advisory services to the banking industry.

ViewPoints aims to capture the essence of the BGLN discussion and associated research; it is produced by Tapestry Networks. Anyone who receives *ViewPoints* is encouraged to share it with those in their own network. The more board members, members of senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

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Bank Governance Leadership Network ViewPoints



Appendix 1: Meeting attendees

February 15 meeting attendees

- Michael Alix, Senior Vice President, Federal Reserve Bank of New York
- Michael Brosnan, Senior Deputy Comptroller, Office of the Comptroller of Currency
- Morten Friis, Chief Risk Officer, RBC
- Keishi Hotsuki, Chief Risk Officer, Morgan Stanley
- Karen Maidment, Director, TD Bank
- F. Edward Price, Deputy Superintendent, Office of the Superintendent of Financial Institutions
- Catherine Rein, Audit Committee Chair, BNY Mellon
- Brian Rogan, Chief Risk Officer, BNY Mellon
- Anthony Santomero, Risk Management and Finance Committee Chair, Citigroup

February 29 meeting attendees

- Nathan Bostock, Head of Restructuring and Risk, RBS
- Juan Colombás, Chief Risk Officer, Lloyds Banking Group
- Sir Howard Davies, Risk Committee Chair, Morgan Stanley
- Karl Guha, Chief Risk Officer, UniCredit
- Marc Moses, Chief Risk Officer, HSBC
- Lyndon Nelson, Director, Risk Management Division, Financial Services Authority
- Benoît Ottenwaelter, Chief Risk Officer, Société Générale
- Anton van Rossum, Director, Credit Suisse
- Anthony Wyand, Audit, Internal Control, and Risk Committee Chair, Société Générale and Internal Controls and Risk Committee Chair, UniCredit

Bank Governance Leadership Network ViewPoints

Appendix 2: Interviewees

In addition to the meeting participants, during January and March 2012, Tapestry Networks and Ernst & Young have engaged 49 risk officers, non-executive directors, supervisors and banking professionals in discussions regarding top and emerging risks. Interviewees included:

Directors and executives

BNY Mellon

- Nicholas Donofrio, Risk Committee Chair, Executive Committee Member, Corporate Social Responsibility Committee Member

CIBC

- Gary Colter, Corporate Governance Committee Chair, Management Resources and Compensation Committee Member
- Nicholas Le Pan, Risk Management Committee Chair, Corporate Governance Committee Member

Credit Suisse

- Tobias Guldemann, Chief Risk Officer, Executive Board Member

ICBC

- Sir Callum McCarthy, Strategy Committee Member, Risk Committee Member, Nominations Committee Member

ING

- Joost Kuiper, Audit Committee Chair
- Wilfred Nagel, Chief Risk Officer

JPMorgan Chase

- Sally Dewar, Managing Director, International Regulatory Risk

Lloyds Banking Group

- David Roberts, Risk Committee Chair

Morgan Stanley

- C. Robert Kidder, Lead Director, Compensation Management Development and Succession Committee Member, Nominating and Governance Committee Member
- Donald Nicolaisen, Audit Committee Chair, Compensation Management Development and Succession Committee Member

Rabobank

- Marinus Minderhoud, Audit, Compliance and Risk Committee Chair, Supervisory Board Member

RBS

- Sir Sandy Crombie, Senior Independent Director, Group Sustainability Committee Chair, Risk Committee Member

Société Générale

- Nathalie Rachou, Audit, Internal Control and Risk Committee Member

TD Bank

- Mark Chauvin, Chief Risk Officer
- Brian Levitt, Chairman of the Board, Corporate Governance Committee Chair, Human Resources Committee Member

Bank Governance Leadership Network ViewPoints



UBS

- Philip Lofts, Group Chief Risk Officer, Group Executive Board Member
- David Sidwell, Senior Independent Director, Risk Committee Chair, Strategy Committee Member

U.S. Bancorp

- Olivia Kirtley, Audit Committee Chair, Executive Committee Member, Governance Committee Member
- Jerry Levin, Compensation and Human Resources Chair, Executive Committee Member, Governance Committee Member

Regulators, supervisors, and policymakers

Federal Reserve Bank of New York

- Sarah Dahlgren, Executive Vice President, Financial Institutions Supervision Group
- Steven Manzari, Senior Vice President, Financial Supervisions Group

Financial Services Authority

- Andrew Bailey, Deputy Head of the Prudential Business Unit, Director of UK Banks and Building Societies

Swiss Financial Market Supervisory Authority FINMA

- Mark Branson, Head of the Banks Division

Ernst & Young

- Andy Baldwin, Sub-area Managing Partner, EMEIA Financial Services
- Chris Bowles, Partner, UK Financial Services Risk Management Lead
- Tom Campanile, Partner, Enterprise Risk Management, Financial Services

- Carmine DiSibio, Vice Chair and Managing Partner, Financial Services
- Patricia Jackson, Head of Prudential Advisory Practice, EMEIA Financial Services
- John Liver, Partner, Financial Services Advisory
- Marcel van Loo, Banking & Capital Markets Leader, EMEIA Financial Services
- Lawrence Prybylski, Global Practice Leader, Financial Services Risk Management
- Chris Richardson, Director, Financial Services
- Tim Rooke, Partner, Risk Advisory Services, EMEIA Financial Services
- William Schlich, Global Banking & Capital Markets Leader, Financial Services
- David Scott, Senior Manager, Financial Services Risk Management
- Donald Vangel, Adviser, Regulatory Affairs, Office of the Chairman