Euro Crisis: What Next?

The Euro crisis, regardless of its eventual outcome, poses complex challenges for the banking and financial services industry. Given the avalanche of change looming on the horizon, institutions should begin assessing the potential impact on their business and preparing for the most likely scenarios. A ‘wait and watch’ approach will almost certainly guarantee having to play catch-up for the foreseeable future.

Executive Summary

The impact of the ongoing economic downturn and the uncertainty surrounding the future of the Euro have been of grave concern to executives across the banking and financial services (BFS) industry. Austerity programs, and the governments that have enacted them, are coming under increasing pressure to scale back or are being replaced, and there is increasing likelihood of one or more countries exiting the Euro.

In our opinion, the resolution of the Euro crisis will pose major challenges for BFS CXOs. These will range from restoration of trust and limiting financial losses to dealing with increased liquidity pressures, additional capital adequacy requirements, increased business risk, major systems and process changes and lower profitability.

The Eurozone that emerges following the current crisis is likely to be structurally different from the Eurozone we know today. We anticipate one of the following scenarios:

Scenario 1: Stabilized Existing Euro

- Existing and new governments regain popular support for existing or scaled-down austerity measures.
- Monetary intervention by the IMF and European Central Bank (ECB) to inject liquidity reduces interest rates and provides stability to Euro economies. Repayment by banks under the ECB’s Long-Term Refinancing Operation (LTRO) in three years remains a risk to future stability.
- The purchase of sovereign debts by central banks and/or private bondholders taking a haircut on their holdings in low-rated sovereigns helps ailing economies repay their debt.
- Fiscal rules are implemented to realign economies to lower medium-term growth.
- Banks with exposure to the Eurozone continue to de-leverage via aggressive asset sales.
- Balance sheets improve, but profit and loss statements (P&Ls) are hit as prices soften in a flooded market.
Europe remains over-banked and banks remain undercapitalized; further consolidation and government intervention along the lines of the Bankia bailout in Spain.

**Scenario 2: Contracted Euro**

- One or more countries are compelled to leave the Euro as a result of their electorates’ rejection of austerity measures, further deterioration in their economies, escalating interest rates and a lack of market confidence.
- Agreed-upon orderly defaults and currency revaluations lead to another liquidity crunch and significant market instability due to increased counterparty risk.
- BFS institutions exposed to exiting countries’ debts face substantial financial losses.
- All BFS institutions face a substantial impact on their business and business processes and systems as they struggle to accommodate changes in existing legal contracts and currencies and/or the reintroduction of currencies in the exiting states.
- The implementation of tighter fiscal integration and monetary intervention in the contracted Eurozone builds confidence in the market, paving the way for future economic recovery.

**Scenario 3: Total Disintegration**

- Failure to find an effective solution, wholesale rejection of austerity measures and/or the bailouts of weaker countries by stronger countries leads to a decision to collapse the Euro. This is accompanied by a return to members’ currencies at their appropriate value. Such a scenario would have a significant impact on the world economy and could result in a global depression, affecting all BFS institutions.

In scenarios 2 and 3, orderly defaults have been assumed. However, in the event of unpredictable “disorderly defaults,” a significant financial meltdown could pose challenges in aligning capital for risk-weighted assets.

This paper analyzes the aforementioned scenarios in terms of the impact on operations and IT amid increasing concern about the fate of the Euro and the ability/willingness of some of the sovereigns and their counterparties to weather this storm. Our analysis seeks to predict the macroeconomic and high-level impact on business and IT processes in each of the scenarios followed by a detailed analysis of the process impact of the most likely scenario.

We believe that while every effort is being taken toward scenario 1, the most likely outcome is scenario 2, a contracted Euro, with one or more countries leaving the Euro. BFS institutions that are actively assessing the potential impact, and planning and preparing for it, will be better placed to weather this crisis. On the other hand, a failure to prepare will render these institutions unable to realign or dispose of their investments cost-effectively and/or make the necessary operational changes in time, which could have a negative impact on their financial stability.

**Euro Crisis: Current Situation**

The financial debt crisis in Europe exposed numerous loopholes in the European Union’s principles of integration, notably in the enforcement of fiscal discipline. This problem was compounded by the recent downturn in financial markets and the decrease in market willingness to lend to sovereigns and the private sector in the Eurozone.

The Eurozone agreement to stabilize the Euro through the implementation of austerity measures initially had a stabilizing effect in early 2012, despite the unpopularity of the measures in a number of countries. However, popular rejection of these fiscal policies in recent weeks has resulted in the failure of governments. Continued implementation of these austerity programs has become politically untenable in certain countries.

The likely resolution of the Euro crisis is expected to have a major economic impact on BFS institutions that are exposed to the ailing sovereigns. To understand the global impact of the Eurozone crisis, it is important to consider the level of exposure of the banks of various countries to Eurozone sovereigns (see Figure 1).

The tremors from a negative outcome of the Euro crisis will be felt by almost every country in the world and could lead to a “perfect financial storm.”

**What Could Happen to the Euro**

The Eurozone that emerges from the crisis will most likely be structurally different from the current Eurozone. This, in turn, will have significant implications for macroeconomic variables and business models. The following section illustrates the various possible scenarios, their likelihood, the corresponding impact and suggested solutions (see Figure 2 for summary findings).
The Emerging Scenario

The Eurozone reforms agreed upon in December 2011 included embracing tighter fiscal rules and monetary expansion, and were a step in the right direction to resolve this crisis. However, the austerity measures have not proved politically tenable in key countries.

Given the current challenges faced in implementing austerity measures, the downgrade of sovereign debt by ratings agencies and continued market concerns, our view is that the most likely scenario is a contracted Euro. We predict that one or more sovereigns will exit the Euro, which will lead to a bleak outlook for their economies with reduced access to international bond markets, depreciating currencies, agreed-upon defaults and economic contraction.

Consequently, financial markets are likely to experience spikes in counterparty risk, a new liquidity crunch and declining asset prices. BFS institutions will be under immense pressure to meet the capital adequacy requirements stipulated by regulators.

There is also a possibility of “disorderly” defaults which could result in a “Eurogeddon” impact on the world financial markets. BFS institutions will have very limited time in these circumstances to manage their risk and limit financial losses.

It is therefore essential that all major BFS institutions with a significant exposure to the Eurozone begin planning for the various possible outcomes of the crisis.

Banks’ Exposure to Eurozone Sovereigns

<table>
<thead>
<tr>
<th>Country</th>
<th>Germany</th>
<th>France</th>
<th>UK</th>
<th>U.S.</th>
<th>Italy</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>21.3</td>
<td>10.5</td>
<td>12.7</td>
<td>8.3</td>
<td>3.9</td>
<td>12.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>35.9</td>
<td>55.8</td>
<td>25.4</td>
<td>5.3</td>
<td>20.0</td>
<td>38.8</td>
</tr>
<tr>
<td>Spain</td>
<td>161.7</td>
<td>150.9</td>
<td>101.2</td>
<td>66.8</td>
<td>121.5</td>
<td>40.4</td>
</tr>
<tr>
<td>Italy</td>
<td>52.9</td>
<td>53.6</td>
<td>140.9</td>
<td>5.3</td>
<td>1.2</td>
<td>1.2</td>
</tr>
<tr>
<td>Ireland</td>
<td>110.5</td>
<td>32.0</td>
<td>180.2</td>
<td>30.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

**Source:** Bank for International Settlements as of end June 2011

**Figure 1**

Banking and Capital Markets: High-level Impact

The contracted Euro or total disintegration scenarios will have different macroeconomic and business model impacts on BFS institutions. Increased sovereign risks will hamper BFS institutions due to falling mark-to-market values resulting in financial losses and deteriorating liquidity positions as sovereign bonds are used as liquidity buffers and collateral. On the liability side, BFS institutions’ funding costs will rise due to limited access to funds and increased counterparty and default risks. The higher costs will be passed on to potential borrowers through tough credit standards or higher lending rates.

BFS institutions will need to assess the situation so as to limit financial losses, evaluate strategies for operating in these markets and evolve a risk framework based on the changing risk perception and appetite which will have a cascading impact on operational and IT processes. Below we lay out our view of the high-level impact on the operational and IT processes of BFS institutions. The degree of impact will vary for different BFS institutions depending on their business strategies, lines of business and exposure to specific Eurozone sovereigns.

Banking Core Processes

**Acquisition and Account Management:** Banks will need to focus on “know your customer” (KYC) and assess country risk in the client on-boarding process. Resetting of client account and portfolio currencies will be required, and any rein-
## Potential Eurozone Outcomes

<table>
<thead>
<tr>
<th>Likelihood</th>
<th>Stabilized Existing Euro</th>
<th>Contracted Euro</th>
<th>Total Disintegration</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario Details</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>All the Euro member states agree to tighter fiscal integration and none of the members opt out of the Euro.</td>
<td></td>
<td></td>
<td>Failure to reach an agreement on fiscal integration may lead to exit by major economies, trigger total disintegration.</td>
</tr>
<tr>
<td><strong>Macro-Economic Impact</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sluggish growth in short term in the Eurozone economy.</td>
<td>Contraction in GDP expected in shrunken Eurozone and exiting sovereigns.</td>
<td>Loss of trust and excessive financial losses will be marked by GDP contraction.</td>
<td></td>
</tr>
<tr>
<td>Sovereigns on negative watch list of rating agencies with risk of downgrade.</td>
<td>Sovereign’s monetary and fiscal policies need to be reviewed.</td>
<td>Sovereign’s monetary &amp; fiscal policies need to be reviewed.</td>
<td></td>
</tr>
<tr>
<td>High inflation due to monetary expansion.</td>
<td>Sovereign ratings impact for a number of Euro member states.</td>
<td>Sovereign ratings impact for a number of Euro member states.</td>
<td></td>
</tr>
<tr>
<td><strong>High-level Business and IT Impact</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increased focus on risk management and monitoring.</td>
<td>Impact on front to back office trading activities such as pricing, trading strategies, settlement and clearing in the markets exiting Euro.</td>
<td>Impact on front to back office trading activities such as pricing, trading and hedging strategies, settlement and clearing in the markets exiting Euro.</td>
<td></td>
</tr>
<tr>
<td>Levy of additional taxes to increase the sovereign wallet.</td>
<td>Enhanced risk control focusing on credit, market and sovereign risk.</td>
<td>Major impacts on asset, counterparty and sovereign ratings.</td>
<td></td>
</tr>
<tr>
<td><strong>Remediations</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Crisis management team setup – define responsibilities, pre- and post-crisis tasks, management reporting, plans and resolution.</td>
<td>Crisis management team setup – define responsibilities, pre- and post-crisis tasks, management reporting, plans and resolution.</td>
<td>Significant focus on risk management and monitoring.</td>
<td></td>
</tr>
<tr>
<td>Scenario planning - scenario discussions, impacts on line of businesses.</td>
<td>Impact analysis on business strategies.</td>
<td>Redenomination of existing positions from Euro to local currencies, recalibration of ATMs.</td>
<td></td>
</tr>
<tr>
<td>Impact analysis on business strategies.</td>
<td>Operational and IT impact assessment across lines of business covering market integration strategy.</td>
<td>Payment processing, settlement and clearing infrastructure changes.</td>
<td></td>
</tr>
<tr>
<td>Detailed client communications planning.</td>
<td>Road map planning and readiness assessment.</td>
<td>Monitoring capital adequacy requirements.</td>
<td></td>
</tr>
<tr>
<td>Road map planning and readiness assessment.</td>
<td></td>
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</tr>
</tbody>
</table>

Figure 2
Introduction of a currency will require close client management on their financial and transactional requirements.

**Channel Access:** Channels such as branch, direct, mobile, contact centers and ATMs will need to be recalibrated to account for currency changes. Withdrawal and reintroduction of new currency notes (e.g., the Drachma) and coinage will be a particular challenge for banks within countries exiting the Euro, and advance contingency planning will be required.

**Payments, Settlements and Clearing:** Payments infrastructure and systems will be heavily affected by currency changes, and the need to reconstitute agent/correspondent banking. There is likely to be a knock-on impact on European regulation such as SEPA, despite the legally binding migration deadline of February 1, 2014.

**Transaction Processing:** Changes in credit policy, re-establishment of credit lines, implications for trade financing and migration of existing contracts will be major considerations.

**Customer Communication:** Any changes in terms and conditions related to accounts and transactions will need to be planned for and communicated to clients.

The impact on pension funds could be significant. For example, the potential redenomination of long-term assets (such as government or company bonds), which had already been redenominated from the original national currency into the Euro, might pose significant challenges.

**Capital Markets Core Processes**

**Client Acquisition and Setup:** An increased focus on KYC will be required, with enhanced credit due diligence and country risk assessment during the client on-boarding process. Existing client data will need to be migrated to incorporate changes related to reference currency such as settlement instructions on markets exiting the Euro.

**Trade Identification:** Trade analytics and hedging strategies will be impacted due to additional currency and country exposure, which will mean research and analyst teams will have to provide additional supporting data.

**Trade Execution and Capture:** Margining and collateral for exchange-traded products will be impacted, including re-profiling of collateral. Listed stock currency will need to be redenominated.

**Trade Management:** Terms of confirmation and counterparty netting agreements may undergo changes due to any currency exit scenario. Multi-listed stocks netting processes will have to be revisited and increased trading volumes in these highly volatile markets will compound the operational and IT challenges.
Settlement and Clearing: Additional custody accounts in new currencies and interfacing with new clearing infrastructures may be required in the impacted markets. From the clearing house perspective, there will be additional settlement risk monitoring requirements for incorporating increased country risk.

Other Post-trade Services: Processes such as collateral management, margining and asset services on the stocks listed in these markets will be impacted due to currency conversion.

Common Core Processes
Reference Data Management: Banks will have to incorporate the price, exchange rate, ratings impact and asset price listing changes.

Product Control, Books and Records: Valuation will be a key consideration in the event of defaults on existing contracts, with increased valuation and pricing complexities for structured products that have underlying exposure in the impacted markets. Banks will need to increase focus on P&L from these markets/products to ensure that risk models are prudently aligned and as per the risk framework. Migration of existing positions including introduction of general ledger accounts for new currencies, conversion of balances, account entry processes and data warehouse(s) will pose additional challenges.

Cash and Liquidity Management: Cash and liquidity management functions will have to be managed for nostro accounts in new currencies. Defaults and a credit crunch will lead to greater focus on effective cash and liquidity management functions.

Risk Management: BFS institutions will need to review their risk framework for the identification, measurement and management of risk. Credit, market and operational risk will be key focus areas. There will be significant changes in the risk models, with the need to reevaluate/re-hypothecate models (with no historic data to reference), limits and monitoring, collateral and margining, mark-to-market (MTM) calculations and realized P&L losses, credit lines and loan drawdown facilities and capital flight from peripheral economies. More frequent stress testing is also likely.

Legal and Compliance: There will be a substantial impact on cross-border loans/derivatives contracts from a legal and compliance perspective involving multiple parties from multiple geographies. A major challenge will be to understand trade jurisdictions and entities ownership in order to decide redenomination.

Client and Regulatory Reporting: Interfaces with new local regulatory regimes and additional client reporting will be required. Client communication regarding these changes will need to be planned.

Remediation
Considering the scale of the impact on various processes, we recommend BFS institutions take the following actions:

- Set up a Euro crisis management team comprised of representatives from different lines of business. This team should drive the impact assessment, budget planning, response planning and coordination with the lines of business and change management teams.
- Focus on scenario planning and assess the potential impact on the lines of business and operating models.
- Identify the operational and IT processes that will be impacted across the lines of business.
- Estimate the size of the change for budget alignment and resource planning.
- Plan the roadmap for delivery with critical paths identified.
- Develop the market integration strategy.
- Plan the delivery and implementation.
- Assess readiness.

Such extensive changes will pose significant delivery and testing challenges and require significant coordination with external third parties for seamless transition. This might prove challenging as third parties will also be in the midst of managing the impact of the Euro crisis on their businesses.

BFS Institution Readiness
BFS institutions have been closely monitoring the Euro crisis situation but we anticipate a variable level of mobilization across the industry. Failure to conduct the required “as-is” analysis and to determine the impact of the evolving scenarios on its finances, business models, processes and systems will leave a BFS institution unable to respond effectively to the scenario that arises.
Impact of No/Late Action?

BFS institutions that do not prepare sufficiently for the Euro crisis will face significant risk and compliance issues and possible financial losses. Among the potential issues:

• An incomplete view of their positions in sovereign debt, contracts with underlying sovereign debt and their exposure to European counterparties will undermine their ability to assess assets in their portfolios across their lines of business.

• Failure to identify impacted contracts with complex legal entity structures may lead to legal issues and significant financial losses.

• Setting aside additional capital requirements corresponding to risky assets, managing this exposure and potential defaults will pose significant financial challenges.

• Inability to operate effectively and be compliant with the new regulatory regimes in the landscape that follows the Euro crisis.

• Increased operational risk due to increased manual intervention.

Moving Forward

The Euro crisis is likely to force significant disruptive changes upon BFS institutions, with both short- and long-term implications depending upon the scenario that plays out. A contracted Euro (or worse, total disintegration) will have an extensive impact on each institution’s processes and systems, requiring additional resources and experience to plan and deliver the changes in a cost-effective manner to meet the likely timescales.

To meet these challenges, some institutions will seek to partner with services providers. While this will ensure benefits in terms of identifying and mitigating the risk, the choice of partner will be a crucial decision. Institutions must look for partners with experience in the Eurozone and a track record of helping institutions with regulatory change management. Deep domain and analytical expertise across banking and capital markets, scalability, agility, responsiveness and crisis management expertise are some of the other attributes that the ideal third-party services provider will possess.

Conclusion

A resolution of the Euro crisis needs renewed political will and concerted effort to implement politically acceptable fiscal rules together with other measures aimed at boosting growth to reduce the deficit and debt.

The crisis has caused uncertainty for BFS institutions operating in the Eurozone. With unknown timescales and high risks, these institutions need to be prepared to protect themselves against the risk of government and bank defaults and counterparty bankruptcy, and limit the impact of process and systems change.

BFS institutions must focus on the imminent changes and direct sufficient resources to assess the likely scenarios. The outcome is uncertain, but it is imperative that they plan ahead to be able to meet any eventuality. Those that do so will not only be prepared for any disruption caused by the crisis, but will also be in a strong position to benefit from the changing environment.

For BFS institutions, now is the time to act.
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