The Impact of the Dissolution of or Defection from the Euro

A Roundtable of Silicon Valley based Treasury Professionals

Overview

A roundtable of Silicon Valley-based treasury professionals was held in January to discuss the impact of the dissolution of or defection from the Euro. The discussion was moderated by Hedge Trackers' founder Helen Kane.

The conversation centered on key areas of concern for treasury (operational cash issues, currency hedge programs, and derivative accounting) and more strategic concerns for the company at large (legal and reporting). Participants focused on defining the risks and areas of concern, rather than on the question of "if" there would be a Euro event. There was a consensus that should the need arise, companies will only have a weekend to manage a defection from the Euro: a stark contrast to the 2 years of preparation for the Euro rollout in 2000. This also led to a discussion of what disclosures should or might companies be making about the Euro now. Most audit firms are already requiring Euro denominated sovereign debt holders to make substantial disclosures at 12/31/11.

Most participants felt that Treasury was an island of interest and concern, reflecting their connection to the broader markets. As a result, the paramount concern of the roundtable was how to raise awareness with both peers and senior management. There was also a sense that it was the appropriate time to start communication with the Board of Directors on this issue. The types of communication included educating board members on the points of impact and outlining the company's plans in the event something does happen with the Euro.

Many of the concerns voiced with respect to strategic action were outside of Treasury's scope and included a need to review the impact of a Euro crisis on both customers and the supply chain, including looking not just at contractual terms, but the resilience of these counterparties in the face of possible market upheavals. Participants also hoped that the risk of a Euro breakup could bring some pressure to bear on the normally tax centered repatriation decisions.

The roundtable participants were also looking for cooperation from their legal departments especially in understanding the impact a breakup might have on Euro denominated contracts from a defecting jurisdiction. Questions included: Would the company, a customer or vendor be entitled to claim a force majeure (a legal excuse for not having carried out the terms of a contract) should the defecting country establish another legal currency? Would sovereign powers enable the country to re-denominate all contracts to a new currency? What protections will ISDA and shorter currency specific trading contracts provide?

In addition to touching base with the tax and legal departments, the participants in the roundtable were reaching out to subsidiaries to capture the detailed day–to-day operations in countries at most risk, generally believed to be Greece, Italy, Portugal and Spain. This information will be used to identify treasury risks (outlined below) and could be the baseline information required in future disclosures, should a break occur.

Some time was spent discussing the accounting implications and the potential need to deal with the new currency(ies) in the general ledger and sub-ledgers. A warning was shared that corporates would be better off creating a new currency rather than resurrecting a currency code that was used for that country historically, as a number of old balances may still reside out in the general ledger or sub-ledger and could present some unexpected and incorrect results if reintroduced. The potential need to change functional currency for a foreign functional subsidiary was discussed. Hedge Trackers shared how this could be done on a "topside" basis for those accounting periods before the entities functional currency could be updated in the system. Due to the economic stresses preceding and following a break from the

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Euro, treasury and/or accounting groups would need to monitor a country that dropped from the Euro for high inflation: which might drive yet another functional currency change. Treasury and accounting teams may want to start highlighting the impact a functional currency change would have on resource requirements, especially IT departments.

Treasury Concerns

Most of our attendees had given much thought to the operational risks related to cash and hedging. Participants shared stories of currency crises resulting from the fall of the Shah of Iran's government, the Asian currency crisis, various Latin American regime changes and recently the challenges surrounding treasury operations impacted by the Arab Spring. Those experiences provided valuable insights to the group overall.

The roundtable treasury discussion then turned to cash where there were many more questions than answers, but these questions helped organizations size their risk.

1. What is enough cash to take care of local operations in the event things got messy?
2. What is too much cash in the event that the sovereign decides to freeze Euro bank accounts and convert them to a new devalued currency—at a further disadvantageous rate for non-native account holders?
3. What if foreign accounts are just frozen until "things settled down"? Should the cash held locally be held with a large, multi-national institution or would a local bank be able to maneuver better and have easier access in a crisis environment?
4. Which financial institutions (local or global) could get employees paid?
5. Should petty cash reserves grow?

Participants were reminded that the US Dept of Commerce has an office in Silicon Valley that is tasked with supporting US corporations in their international operations. (You can reach the Dept at mari.felton@trade.gov or (408) 535-2747 ext104). They have colleagues on the ground in these countries and can request answers to support/challenge the information your subsidiary is providing.

Of course the risk of a break from the Euro has numerous implications related to hedge programs: some economic, others accounting focused. Economic concerns were focused on the liquidity of currency contracts and the ability to settle maturing currency contracts in the period immediately after a Euro break. Heightened scrutiny of settlement risk and counterparty exposure is anticipated. Exchange trading rather than OTC trading of currency contracts was briefly discussed in light of the substantially reduced counterparty risk (margin requirements, usually a deterrent to margin discussions, were brushed aside in light of low returns on deposits). The group also discussed the implications of a black market in a newly issued and possibly "controlled" currency.

In regards to derivative accounting a number of compliance/qualification issues were discussed, including:

1. Current documentation should be indicating the countries whose revenues/expenses are specifically being hedged by your Euro derivatives.
2. If the hedged sales/expenses are not moving through a single entity the layering needs to be clear: the order in which the Euro is applied to sales/expenses (daily) by entity should be detailed.

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3. Newly executed cash flow hedges should contemplate any uncertainty that a defection of the Euro may cause in corporate forecasts. Recall that Euro hedged items must be "probable of occurring" to receive special hedge accounting. Probability is generally interpreted as an 80% or better chance.
4. Attendees suggested this might be an appropriate time to consider "net investment hedging" under FAS133, as a hedge of assets that might be at risk.

Unfortunately, participants were concerned that the hedges, in spite of their intent, might not bring the protection that they were expecting.

The panelists held an excellent discussion highlighting the need for a renewed focus on natural hedging. Looking to exposure management techniques as basic as accelerating or delaying payables, looking to local borrowing to offset local receivables, denominating transactions in US dollars, or other non-EUR currencies, etc.

The conversation was enriched by experiences and studies of the attendees. In the end participants were reminded of Y2K and the long period they had for planning for a potential crisis--which fortunately didn't materialize. The fact that very few companies were sorry they were prepared in 2000 led participants to draw parallels and participants were energized to inject the conversation into their corporate risk assessments and contingency planning.

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