



Banks play war games as City threats pile up

As debt crisis deepens, lenders are preparing for any outcome.

By Sharlene Goff and Patrick Jenkins

Financial Times, 18 November 2011

It is Friday night, after stock markets have closed across Europe, and there is some shocking news: Greece has pulled out of the euro.

By the time markets reopen on Monday morning, UK banks must be prepared for the worst. How dangerous could this be for other eurozone governments and banks? What would it mean for customers? Investors? Would funding markets freeze instantly?

These are some of the war-game scenarios UK bankers are acting out – often in real time over a weekend – as they plan for some grim possible consequences of the eurozone debt crisis. Even though the UK is on the sidelines of Europe's problems, the potential fallout from a break-up of the eurozone – or the less severe outcome of a sharp slowdown in growth – could be devastating for the City and beyond.

UK banks have been whittling down their direct exposure to troubled eurozone countries by selling and running off sovereign bonds.

But beneath those assets lie a complex and interconnected web of indirect lending exposures – from mortgages UK banks provide to customers in Europe, to loans to eurozone banks worth billions of pounds.

Should any of the troubled European banks collapse, these loans would turn sour, inflicting large losses on the UK banks just as they are struggling to lend to households and businesses. Meanwhile, the slowdown in eurozone trading and investment banking activity is already damaging the City, the vital organ for economic growth in the UK.

Britain's investment banks derive a large portion of their revenues from trading links with Europe. The rapid drying up of activities such as equity and debt raisings and mergers and acquisitions led to a sharp fall in revenue in the third quarter of the year.

Further weakness in the eurozone would compound these falls, potentially triggering thousands more job losses in the City and a sharply reduced bonus pool – and tax bill – at the end of the year.

City bonuses are forecast to fall about 40 per cent this year, a trend expected to be mirrored in New York and across Europe.

Even a benign outcome to the eurozone crisis, with no dramatic defaults or changes to the single currency, could cause problems for the City.

Stuart Fraser, policy chairman at the City of London Corporation, warns that closer eurozone fiscal union – something he believes will follow the crisis – could sideline the City, leaving UK banks "outside looking in".

"A real danger is having a bloc dominated by Germany that can somehow impose regulations on us from outside," he says.

One example is the momentum building behind a tax on financial transactions, which George Osborne, the chancellor, has fiercely opposed. Even if the UK vetoes such a tax, Mr Fraser warns that a stronger eurozone could make it harder for City banks to muscle in on the European market. "If it is more difficult to deal with Europe from London, international banks may decide to move their European headquarters, running them out of Frankfurt, for example," he says.



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It is not all bad news, however. Analysts believe the gloom could be offset at least in the short term for hedge funds and investment banks' proprietary traders. "Any break-up of the eurozone would mean a period of intense volatility on the markets and that is typically good news for hedge funds," says **Francesco Burelli, a partner at consultancy Value Partners.**

For the broader economy the dangers of a worsening crisis in Europe arise from the contraction of credit. Weaker confidence across the continent would push up banks' funding costs – an increase that might be passed on to customers – while a fresh bout of loan losses could hit lending.

Patrick Foley, chief economist at Lloyds Banking Group, estimates that every 1 per cent fall in GDP growth in the eurozone would knock 0.75 per cent to 1 per cent off UK growth. "As well as the trade hit, the big impact is business and consumer confidence and the cost of credit."

Given the worrying fallout for UK banks it is unsurprising that regulators have recently stepped up their monitoring of lenders.

Jon Pain, regulatory partner at KPMG and a former executive at the Financial Services Authority, says authorities are monitoring banks' funding and liquidity levels daily or even twice daily using data from banks.

"As the situation worsens, they will start doing daily calls with treasurers or finance directors," he says.

At the same time, the scenarios forming the basis of banks' war games are becoming unnerving, some including the departure of one or more countries from the euro or a collapse of the single currency.

Given what is at stake for the UK, banks must hope that their fictional rehearsals remain just that.