Enterprise Risk Management analyzes the ongoing eurozone crisis

Prudent contingency planning by MassMutual

A fragile situation has developed in Europe as bailouts and bail-ins in countries like Cyprus continue to raise concerns about the financial stability and future business environment in the European Monetary Union (EMU). Other EMU countries are attempting to avoid disaster, but the question remains: Will there be another “Lehman-like” collapse?

“A disorderly, unplanned change to the euro is considered an unlikely event,” said Chief Enterprise Risk Officer Betsy Ward, “but since the magnitude of the impact to the global economy could be severe—potentially leading to global recession and civil unrest—Enterprise Risk Management is considering what contingency planning would be prudent for our policyholders.”

A summary analysis of the eurozone crisis from MassMutual’s perspective follows.

MassMutual’s risk management

MassMutual has little direct exposure to the situation in the eurozone (the economic and monetary union of 17 member countries that have a unified currency) that has emerged over the past 2 years or the current issues arising in countries like Cyprus. The company’s investment strategy emphasizes broad diversification within and across asset types and asset-liability management to reduce the impact of negative economic events. This steadily and consistently-applied strategy has served the company well over time.

However, the related market conditions caused by this situation—events such as a further decline in low U.S. Treasury rates combined with U.S. and international equity-market dives—could impact MassMutual and other insurance companies. As a result of this risk, MassMutual’s ERM is leading the proactive assessment and planning for these potential events.

“MassMutual’s ongoing stress testing and associated management actions and strong counterparty risk management across the enterprise put the company in a better position to prepare for a euro crisis,” Ward said. “The company and its subsidiaries are analyzing the situation closely to remain prepared for potential business or investment changes.”

Background

The simmering situation in the eurozone started during the 2008 financial crisis and continues to prolong uncertainty and guessing by notable economists, market experts and investment professionals. While many economists and politicians have warned of the eurozone’s escalating crisis, central banks, rating agencies and business leaders fear the contagion impact—or domino effect—of the situation.
To recap recent events:

- The U.S. consumer and investor have been more focused on domestic issues, and the U.S. equity markets do not signal concern.
- Recent bailouts have provided some short term resolution but still have not addressed the long term problems. Additionally, the Cyprus bail-in has led to greater concern in the area as its terms, including taxing uninsured deposits, were unprecedented.
- Pessimists believe the euro crisis is far from resolved and financial-services firms may still be at risk for capital and liquidity crunches.
- Central banks, financial firms and regulators are preparing for a sudden, albeit unexpected, end to the euro as part of prudent risk management.

**Assessment of events**

With no real consensus on the outcome, the direct and contagion events resulting from the current eurozone crisis are nearly impossible to predict. A well-planned, orderly change to the eurozone is unlikely to generate shock events in the economy and markets, and economists generally believe this is the most likely outcome.

Based on MassMutual’s research and analysis, a more likely resolution of this issue is that one or more eurozone countries exit in an orderly and planned fashion; this scenario may include a planned split of the eurozone. It is also possible that there will be no change to the eurozone and that none of the countries exit the euro (planned or otherwise).

As part of the company’s prudent risk-management process, Enterprise Risk Management has analyzed the potential for the “tail risk scenario,” the “black swan,” where large risk exposures may exist. While a sudden and disorderly collapse of the eurozone is an unlikely event, it also is the risk event that can lead to contagion, or domino-like events, and significant financial losses to many companies in many industries.

**Direct impact if euro (all) countries revert to former currencies**

Should countries exit the eurozone, it is assumed they would either convert to a new euro currency or revert to their original currency. As a result, there would be foreign-exchange risk exposures as well as operational considerations should trading halt as currencies are priced.

Operationally, an orderly process to revert to the original currencies would be similar to when the countries converted to the euro; in general, potential risk loss is minimal under an orderly conversion. Reverting from the euro to 17 currencies would entail more operational risks than a dual eurozone with two currencies. Operational considerations include:

- New euro-based foreign-currency hedges would be required.
- Trades originated in euros would be revalued in new currencies.
- Operations in the eurozone would require new employment and vendor contracts in new currencies.
- Systems changes would be required to update investment programs and models to include new currencies.
MassMutual’s businesses with European operations validated their preparedness for operational changes that may result from such a possible situation. Preparations include requiring risk-management plans from the company’s large vendors. These risk-management plans will be revisited if the situation worsens.

The risk of downgrades and potentially sovereign defaults in weaker eurozone countries exists. The financial impact of this risk is minimal for MassMutual given the limited exposure to sovereign European debt.

**Run on the banks in peripheral eurozone countries**

Some banks may be vulnerable in this situation, given exposures to the weaker euro countries. Further contagion events, primarily market plunges and economic distress, are the biggest concern with a run on the banks. Downgrades and defaults of European banks and sovereigns may then lead to investment losses for companies in the financial-services industry.

Contagion events of failing banks would include liquidity crises for both core and peripheral eurozone banks. If European banks fail, MassMutual’s direct exposure is relatively low. Risk-mitigation actions already in place include limiting investments in eurozone banks within both the GIA and asset managers. MassMutual closely monitors the health of its counterparties on a regular basis and manages exposure to money-market funds depending on the macro environment.

MassMutual regularly does a comprehensive review of its counterparty exposures, including reinsurers and derivatives, to ensure counterparties have high credit quality and limited concentration. Consistent with this risk management, derivatives contracts, which the company uses primarily to mitigate interest-rate risk, may be nullified and transferred to a new counterparty. The impact of this risk is estimated to be minimal and lies mostly in operational costs.

Finally, communication plans and steps to examine liquidity options in response to potential irrational markets or idiosyncratic policyholder behavior are in place should they be needed during the euro crisis.

While the situation in Europe could spread around the globe and impact markets and economies, based on analyses like these, the potential risks appear manageable today. Being prepared today, however, does not mean the risk is accepted. The businesses and Enterprise Risk Management continue to monitor the situation closely and will respond with further mitigation steps should new potential-risk events arise.

The euro situation is extremely fragile, and the potential associated-risk events change daily. However, MassMutual is prepared to withstand many possible outcomes because of its strong Enterprise Risk Management function and steady, consistent investment strategy that emphasizes broad diversification within and across asset types to reduce the impact of negative economic events.