# If the euro breaks up

**Declan O'Sullivan** and **Lindsay Trapp** outline some of the operational challenges that fund managers could face in the event of a break-up of the single currency

**Briefing Risk Management**

As euro-zone difficulties continue to cause market instability and uncertainty, it is essential that investment fund managers and fund service providers have plans for dealing with the various possible outcomes of the euro crisis to protect their investors.

Having gone through market disruption events like 9/11 and the financial crisis of 2007-08 that led to and followed the collapse of Lehman Brothers, many managers and service providers will have dealt with many of the issues that would arise in the case of a euro event – including, but not limited to liquidity, valuation and operational issues.

In addition, the European funds industry has already gone through mass redenomination with the conversion to the euro. This went smoothly at the time and service providers will already have the necessary systems, processes and expertise to address a future event.

Using the past as a guide, managers and service providers should look to develop euro-crisis plans and in this process they should consider items covering analysis of fund documentation, third-party considerations, currency considerations, subscription and redemption accounts and communication.

## Building a plan

A full analysis of relevant fund documentation should be undertaken to determine if any roadblocks or gaps exist that might prevent the fund from dealing swiftly with a euro event. To the extent possible, issues that arise should be dealt with through building flexibility into constitutional documents and prospectuses:

**Shareholder considerations.** To build a tailored plan, managers must first analyse the fund prospectus and constitutional documents to determine the extent to which investor involvement is required for any necessary changes. Examples include requirements for obtaining shareholder approval or shareholder notification.

**Investment objectives and policies.** These should be reviewed and stress-tested for a euro event. For example, is there an ability to hedge currencies, to hold defensive cash positions or requirements to hold securities of a certain credit rating which may be breached in a euro event? Custodians should also consider breach reporting requirements and discuss with local regulators what they would expect to see in relation to breaches caused by market movements. Funds should also undertake an analysis of their euro exposure which might arise directly through investment in European securities or money market instruments, but which may also arise indirectly through investment in securities that have significant European exposure or where counterparties have significant euro exposure.

**Risk factors.** Older funds may not have euro-crisis risk factors included in their documentation. Accordingly, any fund that has material direct or indirect exposure to euro-zone risks should ensure that these risks are adequately addressed in the prospectus.

**Valuation provisions.** Unless otherwise provided for in the constitutional documents, funds generally should base valuations of securities traded on a stock exchange or regulated market on the known exchange/market quotation unless it is not representative. However, most regulators will permit the use of fair-value pricing where it is considered necessary in the context of the currency, marketability, dealing costs, and so on.

Where fair value pricing is used, the rationale should be clearly documented and, when departing from stated valuation policies, boards of directors must ensure that the rationale for an adjustment will stand up in the context of the criteria set out above. Properly implemented fair-value procedures will probably address most of the valuation issues that are likely to arise. Discussing valuations with the fund's administrator is also key to ensuring that any valuation procedures and policies that may be outside the scope of the administrator's internal procedures are able to be implemented.

**Suspensions and other emergency measures.** A fundamental feature of regulated funds, particularly UCITS, is their liquidity. However, most funds are permitted to temporarily suspend the repurchase or redemption of units. Fund managers and boards should critically assess any recommendation to temporarily suspend redemption.

> *"The funds industry has the experience and the tools necessary to manage a euro event"*

Additionally, they should, on a frequent basis, reassess the suspension and the continuation of the fund as a going concern and liaise constantly with the relevant competent authorities.

In addition to suspension, managers should ensure that there are provisions for options that may also be required during a euro event including gating, redemptions in kind and winding up. All suspensions and emergency measures may only occur in exceptional cases where it is justified in the circumstances, having regard to the interest of the unit holders. A euro event would almost certainly constitute such a case.

**The extra mile.** Custody and administration services contracts should be reviewed to ensure that dealing with such an exceptional event is within the scope of the services to be provided and to be clear on liability provisions, particularly in the case of custodians that have entrusted assets to a sub-custodian. Discussions should also be held with service providers to determine their internal level of euro-event planning and to ensure they are able and willing to 'go the extra mile' for clients. In the event that additional reporting will be required, additional fee arrangements may also need to be made.

In addition to the contractual obligations, funds should make periodic enquiries of their service providers. For administrators, such enquiries would include the mechanics of settlement, valuations, and currency redenomination. They should also be asked about the ability of their systems to handle an instantaneous redenomination in relation to trading, financial reporting and compliance, as well as issues that may arise in relation to settlement and clearing of trades.

In relation to custodians, enquiries may involve considerations of whether segregation/ring-fencing of assets is available in all countries in which the fund holds assets, the custodian's satisfaction with its sub-custody network and how cash held with a sub-custodian in a country exiting the euro-zone would be handled.

Any counterparty agreements entered into by funds should be reviewed and items of concern in such documents raised. In particular, credit exposure to counterparties and the quality of collateral must be reviewed at all times to ensure that the regulatory criteria are met.

For funds that have the euro as their base currency, the obvious concern is that countries might leave the euro, or that the currency will cease to exist and this will lead some funds to consider changing the base currency. Additionally, funds that do not have a euro base currency would likely have a euro share class and may need to consider how those classes would be treated in the event of a partial or total disintegration. Thi s may include redenominating the euro share class or dissolving it and switching investors into, say, a US dollar share class. Shareholder approval may be required in these instances, but this could be achieved at class rather than fund level.

Funds with a non-euro base currency may employ hedging. If currency hedging becomes more difficult, managers should consider whether hedging services should be removed from the fund offering.

Where accounts with placement agents, distributors or subscription and redemption accounts are located in a country exiting the euro, boards of directors should assess the impact of those accounts possibly being redenominated in the new local currency. In such circumstances, the redemptions are likely to be linked to the value of the underlying assets of the fund as stated in the new currency. This would mean the redemption would effectively be a currency conversion without necessarily resulting in a diminution in the value of the underlying investments. Additionally, consideration should be given to the impact any currency exchange controls instituted might have on getting redemption monies back out of an exiting country.

It is essential that communication plans be considered in any euro-crisis plan. Such considerations should include communications between the manager, board and service providers, particularly between regularly scheduled meetings. It should also include considerations of investor communications, and plans for investor mailings should be agreed with the administrator.

Although the future of the euro-zone is uncertain, the funds industry has the experience and the tools necessary to manage a euro event. While not everything can be planned for, it will be those funds that have considered and planned for a euro event that will be best placed to deal with a crisis, should one occur.

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