

LCP briefing note

LCP Eurozone debt crisis: This note considers the actions pension schemes could take to protect their scheme against the increasing crisis in the Eurozone.

DECEMBER 2011

Following the collapse of Lehman Brothers in September 2008, the global economy has entered a period of volatility that has led to fluctuating returns in the value of equities, divergence in the yield of Eurozone bond markets and increases in the value of pension scheme liabilities. As a result, Irish pension schemes have experienced increasing volatility in the funding levels over the past three years.

In this note we summarise:

- How the Eurozone crisis has evolved.
- Why the actions taken so far haven't resolved the crisis.
- The potential impact of the break-up of the Euro on Irish pension schemes.
- Options available to Irish pension schemes to reduce the risk of future volatility.

How has the growth level of the major global economies changed during the financial crisis?

Up until 2008, the real GDP of developed market economies was growing at a rate between 2% and 4%, while the emerging market economies' trend rate of growth was between 5% and 10%.

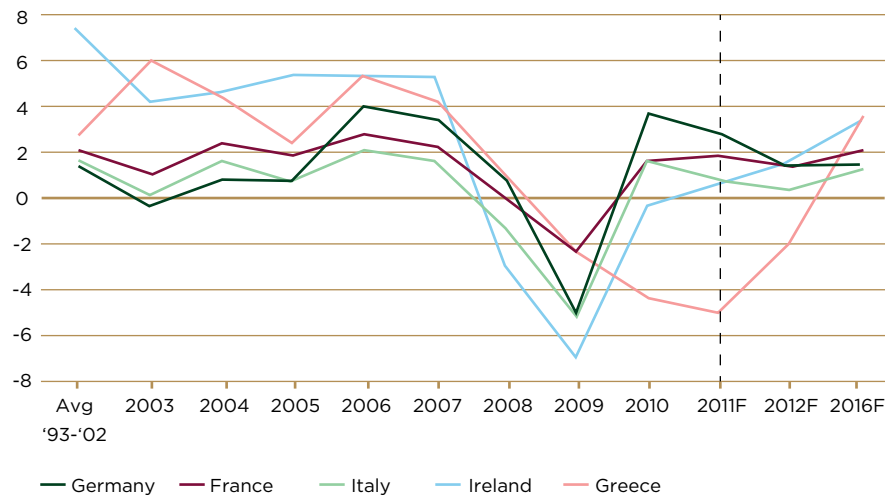
Following the collapse of Lehman Brothers in September 2008, economies went through a period of recession. The exceptions to this were the emerging market economies, such as China, whose growth moderated from 14.2% in 2007 to 9.2% in 2009.

After the setback over the last three years, most developed global economies are now growing again at a rate between 1% and 2%. However, this is still below the normal growth rate experienced through much of the last decade.

Developed market economies are growing again, but at lower than normal levels.

Focusing more specifically on the Eurozone, the graph below shows that growth rates of the Eurozone economies have varied widely.

Growth rates of the Eurozone



Source: IMF World Economic Outlook

Germany is now benefiting from tough labour market reforms implemented over the last decade.

When the Euro was introduced, Germany had one of the lowest growth rates in Europe resulting from the reunification of West Germany with the much poorer East Germany. Germany was nicknamed the “sick man of Europe” as the Germans struggled with inflexible labour laws, uncompetitive wages, and high rates of long-term unemployment. However, under the chancellorship of Gerhard Schröder, a series of tough labour market reforms were implemented through the last decade in an effort to regain competitiveness. Combined with the opening of the Eurozone export market this has resulted in Germany becoming the second largest exporter in the world (after China).

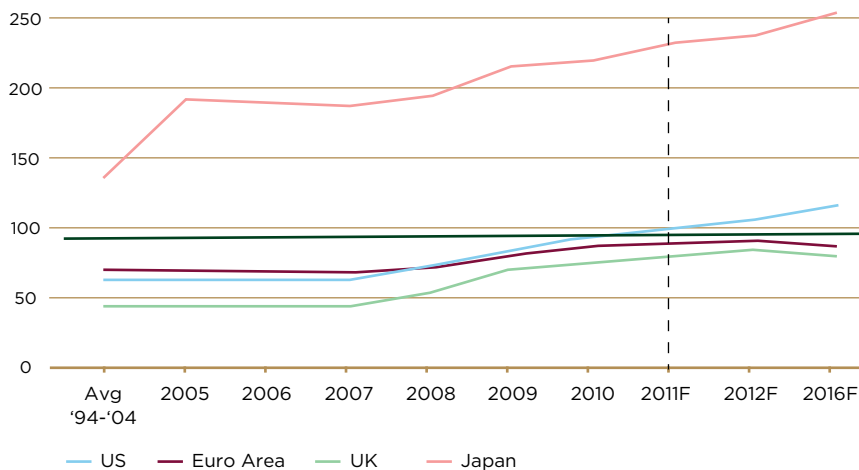
While the growth rates of France and Germany remained relatively stable through the first half of the last decade, growth rates in the peripheral countries such as Ireland and Greece increased to high levels. This was primarily due to the cheap credit that was available on the back of the strength of the Eurozone as a whole. However, the new found wealth in these countries was not used for productive investment. Ireland, for example, experienced a significant property market bubble. A similar situation was seen in Spain. This resulted in a property boom and crash in both countries (particularly Ireland where prices have fallen 50% from the peak in 2007). Other countries such as Greece missed the opportunity to use their new wealth to reform their financial, legal and tax collection system.

Is the slower growth a result of the cost of servicing the rising debt levels?

The debt levels of the developed global economies have been increasing steadily since the 1970's. The relatively stable economic environment over the last 40 years has brought with it lower unemployment rates, lower inflation rates, lower interest rates and less uncertainty. Believing the world to be a safer place, borrowers borrowed more and lenders lent more.

The graph below shows the historic debt levels (as a % of GDP) for the US, Eurozone, UK and Japan as well as debt level forecast for those countries (IMF forecasts).

Historic debt levels and forecasts



Source: IMF World Economic Outlook

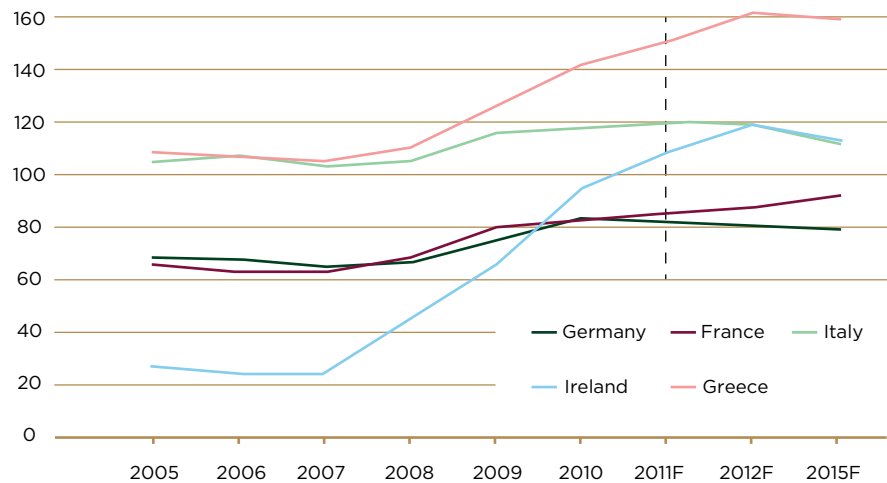
Research from the Bank for International Settlements has estimated that Government debt levels do not become troublesome for a country with a flexible exchange rate until it surpasses 85%. Above this level debt acts as a drag on economic growth. They estimate that for every 10% increase in the debt to GDP ratio, growth slows by more than 0.1%.

High levels of debt can result in reduced economic growth.

The graph above shows how debt levels have been much higher in Japan than elsewhere. In contrast the graph shows how Eurozone debt should not be any less manageable than debt in the USA and the UK.

However, if you look more closely within the Eurozone it is clear that not all countries have managed their debt prudently.

Debt rates of countries in the Eurozone



Source: ECB, Ernst & Young

Since the introduction of the Euro, the Government debt levels of the Eurozone as a whole looked reasonable. In addition, as the Eurozone was in a period of growth over the last 10 years there was little focus on the structural debt issues that plagued countries such as Italy and Greece. Throughout the Euro era, Italy and Greece have consistently had high levels of debt, while the property/banking crisis in Ireland has pushed Irish Government debt levels to harmful levels in recent times (private debt became public debt as banks were nationalised).

Recession has resulted in countries with high levels of debt coming under intense scrutiny.

However, once the recession hit the Eurozone in 2008/2009 the focus quickly shifted to the sustainability of debt levels for certain Eurozone countries. In particular, Greece came under intense scrutiny and it was discovered that successive Greek governments had consistently misrepresented the country's official economic statistics to keep within the monetary union guidelines. This had enabled Greek governments to spend beyond their means, while hiding the actual deficit from the EU regulators.

As a consequence, there was a crisis of confidence in Greece's ability to repay its sovereign debt. In order to avert a default, in May 2010, Greece requested emergency aid from the IMF, European Commission and ECB. In November 2010, Ireland was also forced to seek emergency capital and in April 2011, Portugal became the third country to receive external assistance.

So while there is no doubt that the high debt levels in Greece, Ireland, Portugal and Italy have impacted on their growth levels, the larger economies of France and Germany have remained less impacted so far. Germany and France have managed to consistently keep their debt at controllable levels and the IMF has forecast that this will continue to be the case.

However, whilst the debt levels of Germany and France look manageable at present it is important to take into account the exposure that these countries have to other members of the Eurozone. In particular, German and French banks have large exposure to the banking sector in Italy and Spain (which we will explore later). It is likely that both these countries will eventually be forced to use their lower debt levels to help support the weaker economies within the Eurozone.

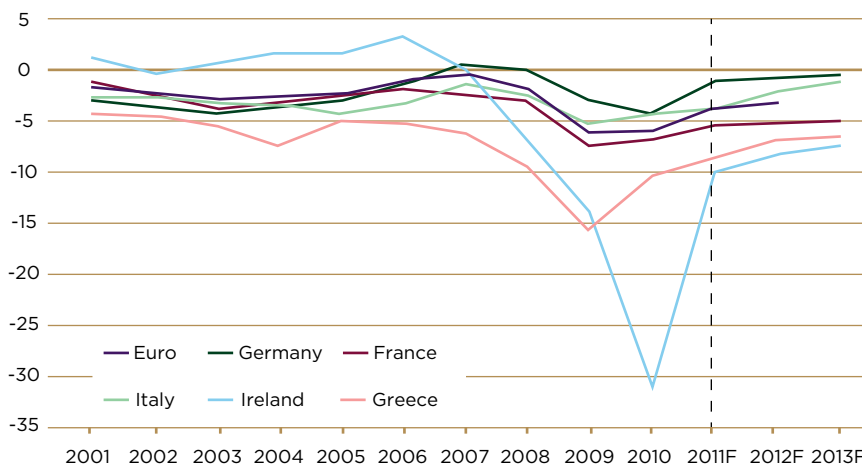
German and French debt levels could eventually increase.

Is the debt level of Eurozone countries continuing to increase?

One way of measuring the future levels of Government debt is to look at the revenue and expenditure of the country. When a government's total expenditure exceeds the revenue that it generates in that year the Government is said to be running a fiscal deficit. If a country runs a fiscal deficit it will lead to an increase in the debt level of that country. If the increase in debt is not offset by increasing growth in GDP, the country's debt to GDP level will increase.

The graph below shows the fiscal deficit/surplus (as a % of GDP) of Eurozone countries since 2001.

Fiscal deficit/surplus of Eurozone countries since 2001



Source: ECB, European Commission

The graph on the previous page shows that with the exception of Greece, Eurozone countries were generally keeping their fiscal deficits within the range agreed under the Maastricht Treaty (fiscal deficits less than 3%). However, by the end of 2010 all Eurozone countries were in breach of the Treaty (including Germany). Ireland in particular found its fiscal deficit increasing above 30% due to costs of turning private debt into public debt (ie nationalising banks).

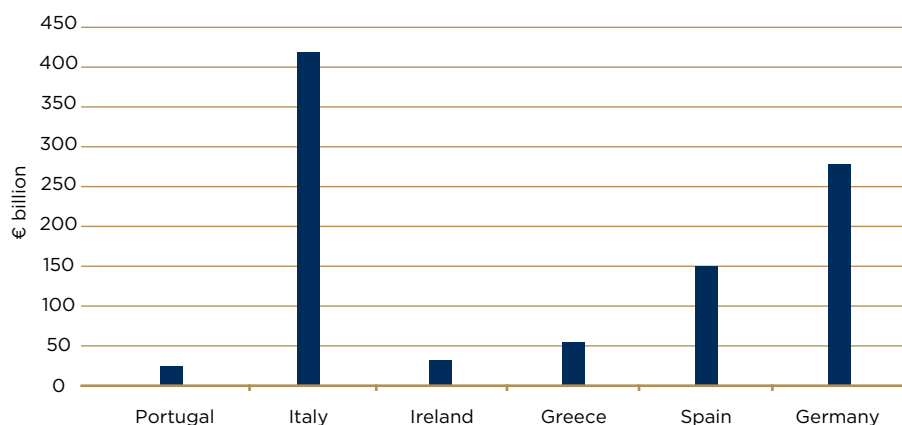
As a result of the increasing fiscal deficits and therefore increasing debt levels, certain Eurozone countries have been forced by their European counterparts to implement a range of austerity measures to get their fiscal deficits back to agreed levels. The austerity plans typically involve tax increases, spending cuts in the public sector, VAT increases and pensions reform. However, these measures will only help stabilise the level of debt within those countries. Economic growth is required for the debt (as a % of GDP) to decrease. Therefore, there is a difficult trade-off between forcing too much austerity over a short period on a country and fostering growth.

How exposed are the core Eurozone economies to peripheral economies?

Both France and Germany have large exposure to the peripheral economies of Greece, Ireland, Portugal, Spain and Italy.

The graph below shows that French banks have a particularly large exposure to Italian, German and Spanish banks.

French Bank Exposure



Source: Bank for International Settlements

French banks are particularly reliant on the health of the Italian and Spanish banks.

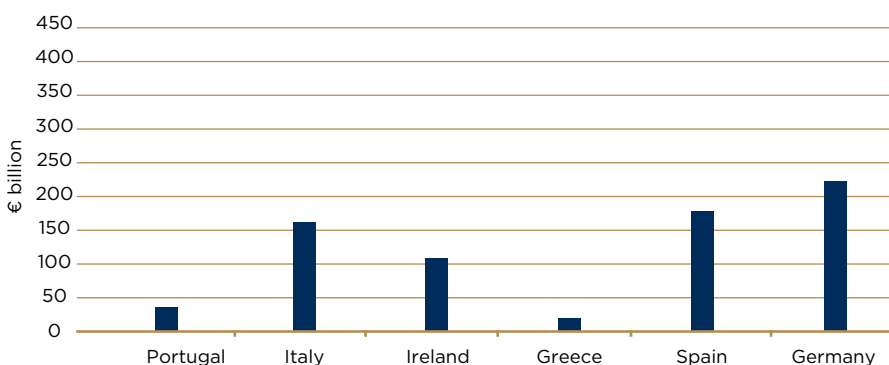
Each time a Eurozone bank gets into financial difficulty, the national Government has stepped in and provided support. French banks have recently got into difficulty due to their exposure to the Italian and Spanish banking sectors which are currently struggling. Consequently French banks have also come under pressure in recent weeks. Added to this, Eurozone banks are being forced to stress test their loan book and

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hold greater reserves to protect against losses from holding Eurozone Government bonds. All this is causing havoc in the banking sector across the Eurozone. As a result of the increasing likelihood that French banks will need financial assistance from the French Government, French bond yields have started to increase in recent weeks.

The graph below shows that German banks have a large exposure to Italian, Spanish and French banks.

German Bank Exposure



Source: Bank for International Settlements

With Italian, Spanish and now French banks under pressure, it is reasonable to assume that German banks may be forced to take losses on their exposures to these economies. This should negatively impact the German bond market and bond yields should rise. However, the German bond market has thus far been relatively immune to this and German bond yields have moved lower to Euro area record lows. This situation could reverse quite quickly once the bond market focuses on Germany's exposure to France, Spain and Italy.

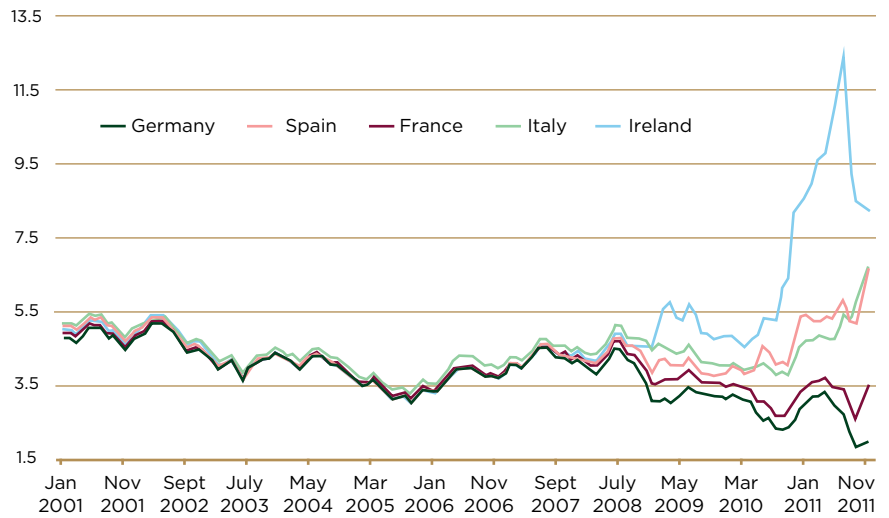
Germany has thus far remained relatively immune to the Eurozone crisis but this could change quickly.

As a result, while the public debt levels of France and Germany look manageable at present, there is increasing contagion risk. That is, if Italian banks get into financial difficulty, French banks will then get into further difficulty. If French banks start to struggle, German banks will also struggle due to the German bank exposure to Italy, Spain and France. A struggling banking sector may result in more financial aid from their national Governments. Given the already elevated levels of debt within the Eurozone, it is unlikely that the bond market will react favourably if individual countries need to issue more debt to protect their banking sector.

How is the bond market reacting to all this uncertainty?

The graph below show the bond yields in a selection of Eurozone countries.

Bond yields in the Eurozone



Source: ECB

German bond yields have remained at extremely low levels but have started to increase recently.

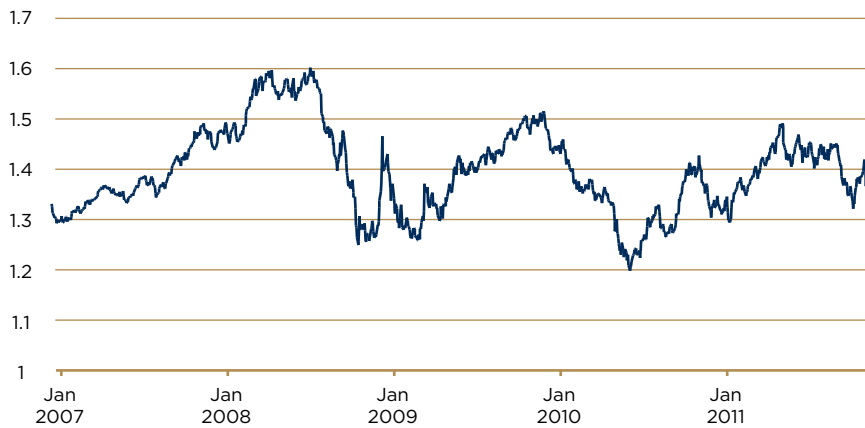
As the graph shows, the yields on most Eurozone countries have been increasing in recent times to reflect the uncertainty surrounding the ability of Governments to finance their debt. The exception to this is Germany whose yields have moved lower as the market currently regards German bonds as close to risk free. However, as we have explained in the section above, German bonds yields might not be so risk free and could reverse direction if the situation in France, Italy or Spain deteriorates further.

Is the Euro currency weakening as a result?

While Eurozone bond markets are pricing in the financial crisis, the Euro currency has thus far remained unusually resilient.

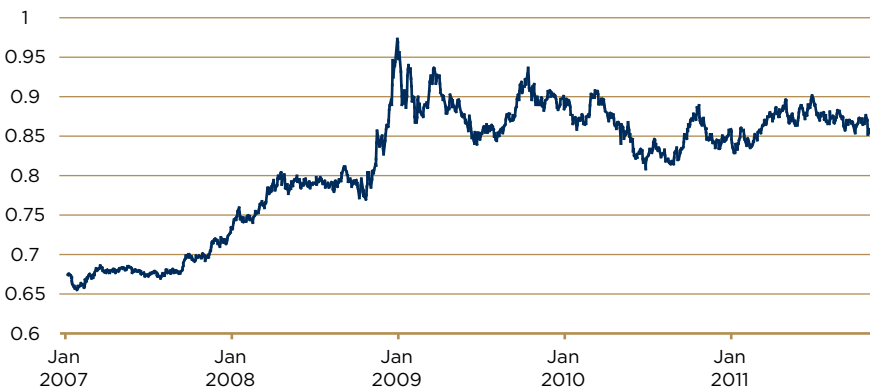
The following graphs illustrate this by showing the performance of the Euro against the US Dollar and Sterling.

Performance of the Euro against USD \$



Source: ECB

Performance of the Euro against GBP £



If the members of the Eurozone had their own free floating exchange rate, peripheral countries like Greece, Ireland and Portugal would have a significantly weaker currency and core countries like Germany would have a stronger currency.

However, given that the crisis is now spreading across all of the Eurozone, many analysts are questioning how the currency remains so resilient.

What are the policy makers in Europe doing to resolve the crisis?

To date, **three main initiatives** have been put forward to tackle the crisis. Ultimately these initiatives are steps towards fiscal integration in the Eurozone.

1. The European Financial Stability Facility (EFSF)

The EFSF's mandate is to safeguard financial stability in Europe by providing financial assistance to Euro area member states.

The EFSF is authorised to:

- Provide loans to countries in financial difficulties;
- Intervene in the bond market to stabilise volatility in bond yields;
- Recapitalise financial institutions through loans to governments.

To fulfill its mission, EFSF issues bonds or other debt instruments on the capital markets. This is somewhat similar to the creation of Eurozone bonds.

The EFSF is backed by guaranteed commitments from the Euro area Member States and has a lending capacity of €440 billion. It is envisaged that this will be increased to €1,000 billion but the mechanism for achieving this is still under negotiation with a resolution expected shortly. In addition, the lending capacity of the EFSF could be reduced if any of the main contributors to the fund (eg France) lose their AAA-rated status.

The EFSF is a temporary measure that is due to end in June 2013, at which point the ESM (below) would take over.

2. The European Stability Mechanism (ESM)

The ESM is a permanent rescue-funding program to succeed the temporary EFSF.

According to official EU documents, the ESM will have a lending capacity of €500 billion.

The ESM is structured as a three step system.

Step 1: Provide surveillance and monitoring mechanisms to avoid a repeat of the current crisis.

Step 2: If step 1 fails to prevent a crisis, the ESM will provide financial aid to the EU member state as long as an analysis by the European Commission shows the country will be able to repay that debt.

2. (cont'd)

Step 3: If the aid is not enough to prevent the crisis worsening and the problem is one of solvency rather than liquidity, a default mechanism will be put in place. For a country deemed insolvent, debt restructuring will be a precondition to access ESM aid.

The ESM will effectively act as a lender of last resort for illiquid but solvent countries and as a default resolution mechanism for insolvent countries.

3. The European semester

The European semester is a six-month period every year during which the member states' budgetary and structural policies will be reviewed to detect any inconsistencies and emerging imbalances. The aim is to reinforce coordination while major budgetary decisions are still under preparation.

One key issue to consider is that national law in a number of member states will have to be amended to make the increased level of surveillance possible.

So given that there is a plan in place, why is the market remaining so volatile?

The EFSF, ESM and European semester strategies are initiatives to deal with the crisis in the medium term. They will take time to implement in full. In addition, there remains a great deal of uncertainty as to who will fund these initiatives, as most Eurozone countries are trying to reduce their levels of borrowing and probably can't afford to contribute to the rescue fund at this time. As a result, some support from outside the European Union will likely be required. Some of the Asian and Latin American economies have been mentioned as providers of capital but so far nothing has been agreed.

Given the uncertainty as to where the funding for the initiative will come from, the market has become sceptical that a solution will be found. The delay in a concrete plan has resulted in the crisis spreading from Greece, Ireland and Portugal to Italy and Spain. If Italy and Spain need financial assistance, it is not clear that any of the initiatives announced so far are of a large enough scale to deal with the €2 trillion Italian debt market or the €600 billion Spanish debt market.

The initiatives proposed will take time to implement whereas the market is looking for an immediate solution.

What else can be done?

Urgent fiscal reform (and probably fiscal union within the Eurozone) and a growth strategy for weaker member states is required in order to prevent the level of debt increasing to levels that become unsustainable. However, this will take time to negotiate. Of more immediate importance is a credible short term solution to stop borrowing costs in Italy, Spain and more recently, France increasing further. This is of critical importance as these countries will have to borrow heavily in the bond market in early 2012.

In addition, European banks need increased capital in order to shelter them from the impact of losses they may be forced to realise on certain Eurozone Government bonds. However, up to this point, a large and credible short-term solution to providing this capital has not been found.

Many analysts now feel that the only way to restore confidence and stop borrowing costs rising in countries such as Italy and Spain is for the ECB to use its balance sheet to provide the necessary capital. The ECB would use its capital to recapitalise the banking sector and control borrowing costs for vulnerable member states (through the purchase of Government bonds).

Many analysts feel that increased action from ECB or Eurozone bonds are necessary to restore confidence.

However, thus far, both the ECB and Germany have resisted calls from the market to follow this approach to a meaningful extent. For example, the ECB has restrained its bond purchases to approximately €200 million and allowed borrowing costs in many countries to rise to Euro-era highs. By contrast, the Federal Reserve in the U.S. has bought trillions of dollars in bonds to keep U.S. interest rates down and support growth.

The current Eurozone crisis has resulted from excessive levels of debt and both the German politicians and the ECB argue, with reason, that issuing more debt will not solve the problem of too much debt. As a result, both parties are pushing Euro-area countries to stabilise their debt levels, and ultimately to cede some level of sovereignty to a new European authority that could prevent chronic spending. Once this happens, they will provide support. While this reform is necessary and crucial to the survival of the Euro, they are running the risk that their categorical refusal to backstop the debts of solvent governments until this reform is implemented will unnerve investors and create a market collapse that could be beyond the ECB's ability to control.

Germany and the ECB fear that increased issuance of debt will lead to much higher inflation.

The German and ECB's reluctance to step in further comes from the German Central Bank (The Bundesbank) who strongly believe that printing money to buy government debt is the first step down a road that ends in hyperinflation – an economic situation that led to the rise of Nazism in 1920's Germany and the subsequent World War. However, in this instance, they may be willing to eventually change their stance because the amount of capital that is printed will be controlled by the ECB.

The next few weeks and months will be critical to the future of the Eurozone. A major announcement that the markets view as credible and of a sufficient size is required to restore confidence and stabilise the markets. There is a Heads of State meeting of European members on 9 December. The market is hoping for such an announcement at this meeting. Otherwise the future of the Euro will be called into question.

What are the potential implications of the breakup of the Euro on Irish pension schemes?

The likelihood remains that the Euro does not break up and that some form of fiscal integration eventually takes place. However, given the speed at which the Eurozone crisis has deteriorated in recent weeks and the lack of a political consensus to deal with the problems, it is no longer inconceivable that the Euro currency could break up at some point in the medium term. For every week that goes by without significant and decisive action, the probability of such an event increases.

Without urgent action, the break up of the Eurozone becomes more likely.

There is no doubt that the breakup of the Euro would be an extremely difficult and expensive operation for all countries in the Eurozone, as the Eurozone countries are now so financially and economically interlinked.

Research by UBS has estimated that the cost of a weak Euro country, such as Ireland, leaving the Euro could be approximately €9,500 to €11,500 per person during the first year. The cost would then probably amount to €3,000 to €4,000 per person per year over subsequent years. That equates to between 40% and 50% of Irish GDP in the first year.

There are a number of possible implications for Irish based pension schemes. In the first instance, if Ireland was to return to the Irish Pound, the Irish currency would face a sharp devaluation against other financially stronger countries such as the UK, the US, Germany etc.

Consequently, any assets held in these stronger countries would immediately increase in value when converted back to the new Irish Pound.

Pension payments would most likely be payable in the new Irish Pound and thus the value of the liabilities should reduce relative to the assets.

As a result, you would expect an immediate increase in funding levels for those pension schemes that hold assets outside of the Irish State and in stronger currencies.

However, this doesn't take account of the undoubted drop in the standard of living that Irish residents would face, as inflation would increase due to the rise in cost of imported goods and services. This would occur as a result of the devaluation of the new Irish Pound.

It is also important to take into account the impact on the business of the pension's sponsor, whose business in Ireland will be impacted. The strength of the employer's covenant could be weaker or stronger depending on the nature of their business in Ireland.

What options are there for pension schemes to protect against continued volatility?

Given the increasing uncertainty in the Eurozone, there are a number of options that Irish pension schemes can take to deal with future volatility and potential Euro breakup.

A Euro breakup will provide risks and opportunities and those pension schemes that prepare in advance should perform best. There are various options that trustees should consider to help ensure that they are well equipped to deal with all eventualities.

Some of the options available are discussed briefly below:

- **Invest in global assets on an unhedged currency basis**

Many Irish pension schemes have a large exposure to Eurozone equities and Eurozone bonds markets.

For equities, most managers now have equity funds that are managed against a well-diversified global index, that has a lower exposure to Eurozone equities and a higher exposure to US, Japanese and emerging market equities. Given the potential for overseas currencies to strengthen against the Euro, leaving the currency unhedged may provide a further source of return/insurance.

Traditionally, Irish pension schemes invested in Eurozone bonds as a match for their pension scheme liabilities. However, given the unprecedented volatility in Eurozone bond markets some pension schemes are making a tactical decision to deviate from Eurozone bonds and make an allocation to a global bond portfolio. Many fund managers are offering the option of a global bond fund that has allocations to the US, UK, Scandinavia, Australia and Canada, for example.

- **Global corporate and emerging market bonds**

Rather than just investing in Government bonds, some pension schemes are looking for more security in a global corporate bond portfolio. Many large multi-national corporations are now viewed as a safer bet than some Government bond markets. Again, we are advising clients to invest globally where possible, as investing in the Eurozone corporate bond market is likely to result in a large exposure to the Eurozone financial sector.

Pension schemes can take action now to protect against future volatility.

Emerging market Government bonds also presents an interesting opportunity for pension schemes as the debt levels of emerging market economies are typically less than that of developed market economies. In addition, the growth rate of emerging market economies is superior to that of developed market economies.

- **Diversified growth funds**

Diversified growth funds contain a range of asset classes that the investment manager will invest in, depending on their view of the relative attractiveness of that asset class. Asset classes include global equities, global bonds, global property, currencies, commodities and hedge fund strategies. For example, if the investment manager views commodities as cheap, they will move into this asset class. They will then monitor this investment and sell the commodities when their views on this asset class changes. From a trustees point of view, the advantage of investing via a diversified growth fund is that the investment manager is continually monitoring the relative attractiveness of each asset class.

- **Emerging market multi asset funds**

Emerging market multi asset funds are similar to diversified growth funds but with a focus on emerging market equities, emerging market bonds and emerging market currencies. Emerging markets are an attractive investment opportunity as they represent a very significant proportion of the world's population, resources and economic output. By appointing an investment manager with a remit to invest across all emerging market asset classes, trustees will have exposure to a wide range of return opportunities.

- **Absolute return bond funds**

Absolute return bond funds provide a specialist bond manager the mandate to invest across the global bond market and even profit from falling bond prices. The bond manager will have the ability to move heavily into cash if they feel that is the safest place to be during extreme bond market turmoil. This is in contrast to a traditional bond mandate where the investment manager will remain heavily invested in bonds even if they feel that bond prices will fall substantially.

Contact us

If you would like any further information on the investment options available to Irish pension schemes, please contact Michael.

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