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Eurozone Crisis

Standfirst: Could problems in the Eurozone bring down a British bank and what can savers and businesses do to protect themselves? Stephen Watson from Watson French offers some advice.

Another day another adverse comment or article on the sovereign debt crisis in Europe. Last week Greece was the headline news, this week Italy.

At the time of writing, the equity markets have fallen owing to a new and rather alarming headline, news that Moody's Investors Service put the U.S. credit rating on review for possible downgrade.

Ben Bernanke, Federal Reserve chairman described a possible US default as a 'financial calamity' while Guilio Tremonti, Italy's Finance Minister compared the eurozone crisis to the Titanic, "where not even first class passengers can save themselves".

Justifiable sovereign debt fears in America and Europe could indicate that another phase of the economic crisis which started in 2007 is a real possibility. However this time governments are unlikely to have the resources to offset another private sector panic.

In June the Bank of England issued its First Financial Policy Committee Report as the new regulator of banks, awaiting a full hand over from the Financial Services Authority. Their first instruction to the FSA is to ensure that improved disclosure of sovereign and banking sector exposures by major UK banks becomes a permanent part of their reporting framework.

The explanation for this requirement is that “Sovereign and banking strains are the most material and immediate threat. Market concerns remain over fiscal positions in a number of euro area countries and the potential for contagion to banking systems. Any associated disruption to bank funding markets could spill over the UK banks.”

The Bank of England points out that the amount of dangerous government debt owned by the main UK banks is under control. Consequently it appears that the UK banking system is not excessively exposed to the euro debt crisis.

However, as we have already experienced with the credit crunch, a debt crises can seriously and very quickly spiral out of control. In September 2008 the failure of Lehman Brothers almost brought down the world’s banking system. Ten years before that, Russia’s default on its sovereign debt rocked the credit markets, causing the default of Long Term Capital Management, a profitable American hedge fund.

When the unthinkable suddenly becomes the inevitable, without pausing in the realm of the improbable, then you have contagion. Contagion can very quickly spread through a large number of routes.

Europe’s inter-bank market could seize up, unsure which banks would be hit by sovereign defaults. Banks then stop lending to one another, depositors take fright and we see another run on the UK banking system. This is all possible but according to the Bank of England it is unlikely.

One assumes that the UK banking system has avoided investment in assets that will result in losses in the event of a sovereign debt default. I hope so because given the scale of sovereign debt, in my opinion a default is inevitable. It is unlikely this will be America, possibly it will be Greece.

The Greek crisis began in October 2010 when the Greek government admitted that its predecessor had falsified the national accounts. It is struggling with a budget deficit of 13.6% combined with debt equal to 115% of GDP. It cannot devalue because it is in the eurozone and its people seem unwilling to tolerate the cuts in income and services needed to make their economy competitive. Greece looks bankrupt.

Other European countries have problems. Portugal has a high budget deficit and is seriously uncompetitive. Spain has a low stock of debt but it seems unable to restructure its economy. So too Italy, which is also heavily indebted.

In the event of a sovereign debt default could the unthinkable happen? Could a British High Street bank falter and if so would the government step in and act as saviour? Without wishing to be alarmist the answer to these hopefully hypothetical questions is yes and no. Yes a bank could fail, no, the government will not act as saviour.

Now is a good time to review bank deposit protection under the Financial Services Compensation Scheme (FSCS).

Most individuals have already worked out the level of their protection they have under FSCS. The compensation limit for retail deposits from 31st December 2010 is £85,000. I am occasionally asked if this includes deposits for a business. The answer is not always. FSCS was set up mainly to assist private individuals although some smaller businesses are also covered.

Larger businesses are generally excluded but there are some exceptions to this. Generally speaking the smaller companies are protected. A smaller company must meet two of the following criteria: turnover not more than £6.5 million; balance sheet total not more than £3.26 million; total number of employees not more than 50.

If your business does not meet these criteria or if you have more than £85,000 deposited with one deposit taker, now is a good time to review the management of your capital deposits and to measure your risk exposure if the unimaginable event occurs. Start by knowing what you are entitled to under FSCS. Details can be found on www.fscs.org.uk/what-we-cover

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