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Commentary

Eurozone Crisis
U.S. Investors Focused on Capital, Counterparty Risks

By: SEI Investment Management Unit

- As government debt problems intensify in the European Monetary Union (EMU), financial firms outside of Europe have come under increasing pressure.
- MF Global, a small U.S.-based broker-dealer, recently declared bankruptcy due to its exposure to EMU government debt; another, Jefferies, has come under intense investor scrutiny. These episodes illustrate the powerful effects that fear and uncertainty can have on investor behaviour and market volatility.
- The larger issue is not individual firms, but the risk of contagion from Europe to the global financial system and world economy.

Eurozone Contagion—MF Global

As noted in a recent SEI commentary on the latest bailout agreement for Greece ("Has Europe Finally Rescued Itself? Probably Not"), there is a meaningful risk that the eurozone's government debt crisis could eventually spill into the global financial system given its many interconnections with Europe. The recent bankruptcy filing by small-cap U.S. broker-dealer MF Global, which found itself over-exposed to EMU government debt, might prove to be the canary in the contagion coal mine. Then again, it's possible that MF Global simply made some poor decisions that landed it in trouble with both its regulators and its counterparties. If so, its bankruptcy would reflect company-specific errors rather than systemic contagion.

According to an article for Reuters by investigative journalist Bethany McLean,[1] MF Global's core business activity—primarily offering (and retaining a portion of) better-than-market yields on short-term investments to clients—had been struggling in the post-2006 declining-interest-rate environment. In early 2010, the firm hired former New Jersey Governor, U.S. Senator and Goldman Sachs Chairman John Corzine as its new CEO. Under his leadership, the firm significantly expanded its holdings of short-term, high-yielding eurozone government debt and financed a significant portion of those holdings through repurchase or repo agreements with various counter- parties. The repurchase agreements involved MF Global selling the securities to the counter-party and agreeing to repurchase them at maturity at a higher price (the higher repurchase price, known as the repo rate when expressed as a percentage, acts as compensation to the counter-party). During the life of the agreement, counter-parties require the repurchaser to maintain a margin balance (cash or other collateral representing a certain minimum percentage of the eventual repurchase price). As long as the underlying securities provided a greater return to MF Global at maturity than the repo rate it paid to its counter-parties, the agreement resulted in a profitable trade and helped provide the higher short-term yields that MF Global's clients expected.

In MF Global's public filings, it indicated that all of the securities in question would mature by December 2012 at the latest, and the company specifically referred to the planned expiration date of June 2013 for the European Financial Stability Fund (EFSF). In other words, MF Global placed large bets on eurozone government securities based on the assumption that the existence of the EFSF beyond December 2012 guaranteed the full return of principal and interest on them. While that assumption may have been reasonable, MF Global used off-balance-sheet treatment to account for some of the positions, which captured the attention of regulators in 2011. As regulators demanded more detailed disclosures from the company, credit-rating agencies began to downgrade the firm's debt. It's reasonable to presume that as these events unfolded, counter-parties would have become increasingly concerned about the firm's ability to fulfill on its repo commitments, and demanded ever-greater margin or

[1] Bethany McLean, "Did accounting help sink Corzine's MF Global?" *Reuters*, 11/1/2011, <http://blogs.reuters.com/bethany-mclean/2011/11/01/did-accounting-help-sink-corzines-mf-global/>, accessed on 11/8/2011.

collateral. From what is known at this time, it appears that margin calls from as-yet-unknown counter-parties (along with a lack of strategic buyers from whom additional capital could be raised) were indeed what eventually forced the company to file for bankruptcy protection.

Eurozone Contagion—Jefferies

In the wake of MF Global's surprise bankruptcy filing, investors began to scrutinize the European debt exposures of other U.S. financial firms. The market's sights soon settled on Jefferies, a small-to-mid-sized U.S.-based diversified financial services firm that had been downgraded by credit ratings agency Egan-Jones due to what appeared to be significant eurozone debt exposure in the company's public filings. From the October 27 intraday high through the November 3 intraday low, the price of the company's common stock declined by 36%.

Jefferies responded forcefully and proactively to market concerns in a series of highly publicized press releases indicating that its exposures to EMU government debt differ markedly from the type that MF Global carried. Its net exposure—the difference between its long holdings of EMU government debt and its short positions in EMU government debt—is reportedly a much smaller percentage of its equity capital than MF Global's long bets were. And its holdings reportedly are a function of its market-making activities for clients who wish to buy and sell EMU debt, which means that they are very short-term holdings that should offset to a significant extent while also providing trading revenue for the firm (as a market maker, Jefferies earns the spread between what buyers pay and sellers receive for a security).

Thus far, markets seem to have been reassured by these disclosures; at the close on November 4, the company's stock price had recovered by 23% from its November 3 intraday low.

Our View—Financials Attractive, But Uncertainty Rules the Day

By several measures, financial firms, especially banks, appear to be attractively positioned today. Valuations are attractive on a historical basis, and looming regulatory reforms should mean lower balance-sheet risk. Unfortunately, the uncertainty overhanging the financial sector worldwide is unlikely to dissipate any time soon.

We also find it very unlikely that the latest measures in Europe can permanently resolve its debt crisis, which means that the risk of global financial contagion remains elevated. Investors should remain attentive to events in Europe for this reason, as an episode of uncontrolled (or poorly controlled) contagion could potentially lead to a sharp slowdown in the world economy.

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