

TABLE OF CONTENTS

EU Public Debt and Deficit

- Deal on Greek debt in sight
- European Fiscal Compact is adopted
- European Parliament increases pressure for introduction of eurobonds
- European Stability Mechanism sign-off is accelerated
- Alert Mechanism Report on macroeconomic imbalances adopted
- Review Mission to Ireland concludes with mixed results

EU Financial Markets Regulation

- Agreement reached on OTC derivatives and markets infrastructure
- European Institutions continue to work on MiFID proposals
- New calls from Member States to accelerate work on an FTT

Coming up

EU Public debt and deficit

Deal on Greek debt in sight

The conclusion of a second bailout for Greece is imminent as an agreement seems likely to be signed off by EU finance ministers on 20 February at a meeting of the Eurogroup. Despite open criticism of the EU's capacity to rescue Greece, and outcry from the European Parliament insisting that austerity will send Greece into a negative debt and growth spiral, finance ministers look set to give the green light on funding. Some Member States had suggested postponing talks on some or all of the package until after Greek elections expected in April, but immediate action is necessary if Greece is to be able to meet its bond payment on March 20. Senior officials from eurozone finance ministries and the European Central Bank held a conference call on 19 February to go over the final details of the €130-billion programme, including a debt sustainability analysis critical to the IMF.

Considerable dissatisfaction among a number of Member States has seen a second bailout deal hang in the balance. Politicians from both Germany and the Netherlands have attacked policymakers in Greece, questioning their promise to implement reforms in return for a bail-out. Greece has until now consistently missed its deficit targets under its first bailout and has failed to kick-start a €50 billion privatisation programme. In the light of this, Greece will probably have to submit to a permanent troika presence in Athens and may have to set aside interest payments on its bailout loans in an escrow or trust account to reassure creditors that they will be paid back.

Greece will have approximately €100 billion of debt written off via a restructuring involving private-sector holders of Greek government bonds. Banks and insurers will swap bonds they hold for longer-dated securities that pay a lower coupon (3.6%) resulting in a real 70% reduction in the value of the assets. The bond exchange is expected to take place on 8 March and completed three days later. It is hoped that this will mean that the €14.5-billion-bond repayment due on 20 March would be restructured, allowing Greece to avoid default.

The vast majority of the funds in the €130-billion programme will be used to finance the bond swap and to ensure that Greece's banking system remains stable: €30 billion will go to "sweeteners" to get the private sector to sign up to the swap while €23 billion will go to recapitalise Greek banks. A further €35 billion will allow Greece to finance the buying back of the bonds, and €5.7 billion will go to paying off the interest accrued on the bonds being traded in. The overall objective is to reduce Greece's debts from 160% of GDP to around 120% by 2020 - the figure and timeframe that the IMF, ECB and the European Commission, together known as the troika, have established as sustainable.

Economic and Monetary Affairs Commissioner, Olli Rehn stated that 'Greek authorities and political forces should now take full ownership and make the case for the second programme and fully implement it, in order to ensure the return of the country to sustainable economic growth'. Members of the European Parliament have been particularly scathing about the manner in which the bailout was handled. Socialist leader Hannes Swoboda said the current plans are "endangering the progress in deficit reduction" and promised to send an 'alternative troika' to counteract the bailout mission of the European Commission, ECB and IMF officials who are currently negotiating with the Greek government.

European 'fiscal compact' is adopted

On 30 January, all EU Member States, with the exception of the UK and the Czech Republic, agreed to the adoption of the 'fiscal compact' or "Treaty on stability, coordination and governance in the Economic and Monetary Union". Five drafts of the treaty were needed before agreement could be reached as a number of issues remained contentious. These included:

- Writing spending breaks into national law and allowing the EU Court of Justice to impose sanctions if not applied
- Minimising opt outs to the debt rule

- Introduction of a new voting system for accepting Commission recommendations on deficit levels. The signature of the fiscal compact, which is to enter into force once 12 eurozone members have ratified it, is foreseen for the 01 March European Council.

Certain details concerning the procedure to enable the EU Court of Justice to assess the implementation of the balanced budget rule still need to be finalised. The latest draft of the intergovernmental treaty specified that the debt break must have “binding force and permanent character”, or else this could mean receiving “a lump sum or a penalty payment” by the European Court of Justice, which cannot exceed 0.1% of the country’s GDP.

As planned, the UK did not sign the fiscal compact. Despite having a number of legal concerns, British Prime Minister David Cameron stated that he did not wish to block the intergovernmental agreement. “We don’t want to hold up the eurozone doing what is necessary to solve the crisis as long as it does not damage our national interest,” he said after the summit.

The utility of the fiscal compact, requested by Angela Merkel and pushed for by the ECB, has been called into question by many. The leader of the socialist group in the European Parliament doubted the necessity of a new treaty saying it was an “irrelevance and distraction from the real problems facing the EU”.

Following the summit, French President Nicolas Sarkozy made reference to a three tiered European Union: one at 27 in the single market; one at 25 for the ‘euro pluses’; and one at 17 for the eurozone. European Council President Herman Van Rompuy sought on the other hand to dispel notions of division. “With this treaty we maintain as much as possible the unity of the Union, taking into account that those that have a common currency have the possibility to deal with the problems linked with their currency,” he said.

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European Parliament increases pressure for introduction of eurobonds

On 15 February, the European Parliament voted through a resolution with 515 votes in favour, 125 against and 52 abstentions calling for more action to be taken on the introduction of eurobonds. The Resolution welcomed the Commission's green paper published in November 2011, but calls on the Commission to ‘come forward rapidly with proposals to address decisively the current sovereign debt crisis, such as the European redemption pact proposed by the German Council of Economic Experts and/or the finalisation and ratification of an ESM treaty and/or eurobills, as well as joint management of sovereign debt issuance’. It also sets out a number of questions that need to be examined in more detail, for example:

- Specific ways of addressing potential moral hazard
- Making the system attractive for AAA countries as well as heavily indebted ones
- Increasing competitiveness
- Introducing enforceable debt reduction systems

Despite the clear message, the European Commission signaled the day before the vote in Parliament that it was in no rush to take extra steps toward introducing eurobonds, highlighting the political roadblock in Germany to such a move. Neelie Kroes, one of the vice presidents of the European Commission told the European Parliament that “The possible challenges remain daunting. There are many wide technical topics to be analysed before any definitive decisions are taken. And we must take the time to do so, as nothing should be left to chance.” Before the Parliament voted on the Resolution, Italy’s Prime Minister Mario Monti addressed MEPs saying that “joint bonds are a useful tool for greater financial market integration...they could deliver a contribution to ensure that financial markets are more disciplined”. He also urged Members to keep pushing EU member states to agree to create Eurobonds despite opposition from Germany.

The Resolution is qualified as a 'preliminary response'. The Economic and Monetary Affairs Committee is now preparing an own-initiative resolution, under the stewardship of Parliamentarian Sylvie Goulard (ALDE, FR), which will provide a more detailed reaction to the Commission's green paper.

European Stability Mechanism sign-off is accelerated

On 02 February, EU Member States signed a treaty setting up the European Stability Mechanism (ESM), the eurozone's permanent €500 billion safety net designed to fund future bailouts. The European Stability Mechanism (ESM), is a permanent fund written into EU law, which can raise money on financial markets to assist struggling Member States. The fund will also be allowed to purchase bonds from Member States who may be in financial difficulty on primary and secondary markets (direct from issuers or from traders) and lend money to governments for the specific purpose of recapitalising their banks.

It will also be able to offer IMF-style precautionary loans under less strict conditions than future bailouts. The fund was due to take over from the existing (and temporary) European Financial Stability Facility, but EU leaders will in March consider using the funds both to boost the total amount of money available to governments and dispel speculation that the EU could not afford the rescue of a larger country, such as Spain. The treaty was set to be signed by finance ministers in March but is being brought forward to meet the July deadline. Under pressure from other governments, Germany has agreed to look again at the fund's lending ceiling in March.

The lending ceiling is supported by a combination of €80 billion of paid-in capital (to be collected over five years) and capital of up to €620 billion, which is pledged by eurozone Member States and only paid in "if needed to avoid the ESM being in default of any scheduled or other payment obligation due to ESM creditors". The capital entitles ESM countries to shares in the fund. The ESM treaty guarantees:

- Precautionary financial assistance - an IMF-style credit line that will only charge interest or be drawn down when it is needed. Poland currently has a flexible credit line agreement with the Washington-based fund
- Loans for bank recapitalisation, which are made to governments
- Primary market purchases - where the ESM buys bonds direct from issuers in primary markets to support government debt prices
- Secondary markets purchases where the ESM buys bonds from traders for the same reasons, "to address contagion". This sort of purchase can only be made after an ECB analysis, which finds "the existence of exceptional financial market circumstances and risks to financial stability"
- ESM loans - a full EU-IMF programme equivalent to those agreed for Greece, Ireland or Portugal.

Until the EFSF is run down, in mid-2013, the consolidated ESM and EFSF lending shall not exceed €500,000 million. This is to be reviewed in March 2012. Eurozone contributions to the ESM will be based on their contributions to the European Central Bank.

Alert Mechanism Report on macroeconomic imbalances adopted

On 14 February, the European Commission adopted its first Alert Mechanism Report on macroeconomic imbalances in EU Member States. The Macroeconomic Imbalances Procedure is a new tool which was created under the six-pack set of legislation on economic governance that entered into force on 13 December 2011. The mechanism is intended to help the European Commission detect and correct risky economic developments in EU Member States.

Based on a scoreboard, the European Commission examined economic indicators to identify internal and external imbalances. There is no automatic interpretation of the results, but rather a qualitative assessment. The overall number of breaches of thresholds, the severity of individual breaches as well as the combination of breaches is taken into consideration. The assessment also takes into account other relevant information and economic indicators beyond the scoreboard with a view to getting a comprehensive picture.

The first report identified twelve Member States (Belgium, Bulgaria, Denmark, Spain, France, Italy, Cyprus, Hungary, Slovenia, Finland, Sweden and the UK) whose macroeconomic situation would need to be examined in more detail. The aim is that the mechanism will give the European Commission and the Council of Ministers the possibility to take action before the imbalances reach unstable levels.

The conclusions of the Alert Mechanism Report will be discussed in the Eurogroup of euro area Finance Ministers and in the EU's Council of Economic and Finance Ministers. Following this, the European Commission will prepare country-specific in-depth reviews. The reviews will provide the analytical basis for potential recommendations to be addressed to Member States under the preventive or corrective arm of the new procedure. However, an in-depth-review does not automatically lead to a recommendation.

Review Mission to Ireland concludes with mixed results

Between 10 and 19 January, teams from the European Commission, the European Central Bank and the International Monetary Fund visited Dublin on its regular quarterly review of the economic programme. The delegations concluded that although the programme was on track, challenges remain and strict policy implementation will be needed.

Front-loaded fiscal consolidation is on track and the 2011 deficit is lower than the programme targets. Budgetary measures of 3.5 % of GDP reduced the estimated general government deficit to approximately 10% which is comfortably within the programme target of 10.6%. The two pillar banks met the 2011 deleveraging targets with almost €15 billion of predominantly foreign assets sold at a better price than anticipated. Implementation of the strategy to restore the viability and solvency of the credit union sector is underway. More conservative provisioning and disclosure guidelines will enhance the transparency of the banks' 2011 financial statements. Asset disposal plans are being finalised in order to strengthen competition and efficiency in key sectors.

Looking ahead, Ireland continues to face considerable challenges. Domestic demand remains subdued and unemployment high. As a result, projected GDP growth for 2012 has been revised down to ½ percent. The authorities' priorities in first half of 2012 include publishing a fiscal responsibility bill to underpin budgetary consolidation. They are also working with lenders to promote efforts to address loan arrears. The authorities are also strengthening the effectiveness of activation and training policies to help job seekers get back to work.

The objectives of Ireland's EU-IMF supported programme are to address financial sector weaknesses and to put Ireland's economy on the path of sustainable growth, sound public finances, and job creation. The programme includes loans from the European Union and EU member states of €45.0 billion and a €22.5 billion Extended Fund Facility with the IMF. Ireland's contribution is €17.5 billion. Approval of the conclusion of this review will allow the disbursement of €3.2 billion by the IMF and €6.5 billion by the EU. The mission for the next programme review is scheduled for April.

EU Financial Markets Regulation

Agreement reached on OTC derivatives and market infrastructure

Informal negotiations, so-called 'trialogues', between the Council (represented by the new Danish Presidency), the MEPs and the European Commission on 'EMIR' (European Markets Infrastructure Regulation) were finally concluded on 09 February after more than a year of intense and often fraught discussions.

The text, which still needs final adoption by the European Parliament and the Council of Ministers has put to rest a number of contentious issues which were holding up agreement. The most problematic of all were the extent of powers that the newly created European Securities and Markets Authority (established in January 2011) would have in the authorisation of CCPs. The European Parliament was keen that ESMA have an increased role in this process, whereas a number of Member States (and the UK in particular) was adamant that national competent authorities should have the final say. Among a deal that was struck on this in the final triologue meeting between all three institutions which took place on 09 February, a new timetable was also decided for the second stage of the process.

In the original Commission proposal, ESMA would have until 30 June 2012 to draft its draft Level 2 technical standards to be submitted to the European Commission for approval. Given the substantial delay in agreeing the text, it was decided to grant ESMA 3 more months (until 30 September 2012) to draft its advice.

ESMA has already issued a first consultation which will look at a number of technical issues such as appropriate collateral for CCPs, thresholds for mandating central counterparty clearing and the types of derivatives that should be deemed eligible for clearing.

After agreement was reached, Commissioner for Internal Market and Services Michel Barnier commented "It is a key step in our effort to establish a safer and sounder regulatory framework for European financial markets. This matters because we need to restore trust in the financial sector, and because we need the financial sector to operate on a sound footing to ensure a return to sustainable growth of the real economy".

European Institutions continue to work on the MiFID proposals

Work on the MiFID proposals in the European Parliament has speeded up following the public hearing that took place in November 2011. Rapporteur for the proposal in the Parliament's Economic and Monetary Affairs Committee, Markus Ferber, issued a public consultation which closed on 13 January and which received almost 200 responses. The results are currently being analysed and will feed into his draft report which should be presented on 24 April (already a month later than originally scheduled).

On 13 February, the Economic and Monetary Affairs Committee held a first exchange of views on the proposal in which the rapporteur, shadow rapporteurs and other Members of the committee expressed their opinions on the proposal. The vast majority of comments related to provisions on investor protection and calibrated transparency for different asset classes. The question of high frequency trading seemed at some points to dominate discussions and many Parliamentarians said they were very sceptical as to the merits of such practices. Others remained unconvinced of either its merits or defects and remarked on the lack of reliable research and data in this area. The Commission's provisions on the creation of a new trading platform (Organised Trading Facility) seemed to garner little support, and the rapporteur himself proclaimed that he did not fully comprehend the necessity of its introduction.

Although the draft report has already been delayed, rapporteur Markus Ferber has expressed his wish that a text can be voted upon in the Economic and Monetary Affairs Committee before the Summer.

The Council has also begun its work, convening meetings with attaches and their respective experts from the national Treasuries via working groups. Although the Danish Presidency, which is leading the work on the proposal in the Council of Ministers is not aiming to finish negotiations on the text, working groups continue to take place with a further meeting scheduled for 09 March. The Presidency has little hope of concluding work on the proposals but has instead decided to tackle scope and definitions. The aim would be to ease the work of the Cypriot

Presidency which begins its work on 01 July 2012 and which has little experience in financial services and which will not have the same resources as some other larger Member States to tackle such a complex proposal.

New calls from Member States to accelerate work on an FTT

Work is slowly continuing on the European Commission's proposal for the introduction of a Financial Transaction Tax which was presented in October 2011. Although work in the Council is especially slow, there has been a flurry of movement both on an individual Member State basis as well as by the European Parliament.

Nine Member States signed a letter which was sent to the Danish finance minister and to the European Commission urging for the work on the proposal to be accelerated in the Council. It was felt that the Presidency may have been stalling its work and needed a high level push to reactivate discussions. It is no secret however that the Presidency has not put this high on its agenda and work has progressed slowly. There is another working group scheduled for 06 March although it is not expected that any substantive progress will be made.

Some have speculated that it is no surprise that it was 9 Member States that signed the letter, as this is exactly the minimum number of Member States needed to implement a tax under 'enhanced cooperation'. Following approval by the European Commission which would issue a new proposal for implementation of a tax in nine Member States only, the Council would need to vote on select Member State implementation and continue working groups will all 27 Member States providing their input. For some seen as an ideal solution, it may well prove that any move to enhanced cooperation may take even longer to implement. Only twice has a piece of legislation been adopted under this method, and never in relation to the internal market.

The European Parliament's Economic and Monetary Affairs Committee presented its draft report on the FTT which includes the following changes to the original Commission text:

- Failing agreement among all 27 Member States the Parliament encourages accelerated implementation via enhanced cooperation
- If implemented across all Member States, the EU should have a role in managing the FTT revenue for development and climate goals
- The tax would also be applicable when the transaction involves a financial instrument issued by legal entities registered in the Union
- The FTT should involve a system ensuring that if the tax is not paid, the contracts to buy or sell an instrument are ruled unenforceable. According to this system, an untaxed instrument would be ineligible for central clearing, which would cost the evader several times more than the tax
- A financial transaction in relation to which no FTT has been levied shall be deemed legally unenforceable and shall not result in the transfer of legal title of the underlying asset

It is worth bearing in mind however, that the European Parliament has no formal say on the adoption of the proposal but can merely perform an advisory role.

- COMING UP -

- **30 January 2012: ECOFIN Council** with likely adoption of the Greek bailout package
- **April 2012:** European Commission legislative proposal on **crisis management and bank resolution**
- **07 March 2012:** European Commission proposal for a **Central Securities Depositories Regulation**
- **1-2 March 2012:** Next regular **EU summit**. eurozone and other EU member states expected to sign a new intergovernmental treaty putting in place the so-called "fiscal compact".
- **July 2012:** Entry into force of the eurozone's permanent bailout fund, the **ESM**.
- **End of 2012:** Target date for **completing ratification process** of the new treaty.

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