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EU Public debt and deficit

Commission confirms that it may propose legislation on eurobonds and the eurozone's AAA rated countries strongly oppose

Commissioner for Economics and Finance Olli Rehn has confirmed that the Commission is undertaking a study on the feasibility of eurobonds and may propose legislation in the coming months. There is currently no set timeline and the outcome largely depends on the progress of the Growth and Stability Pact legislation in the Council and European Parliament. In a response to a [question](#) from a Member of the European Parliament, Commissioner Rehn stated that: "These euro securities would aim to strengthen fiscal discipline and increase stability in the euro area through markets." The aim of eurobonds is to allow cheaper borrowing for highly indebted countries thus the eurozone countries would borrow as one entity and would guarantee each other's debt.

The European Parliament and the indebted states largely support the use of eurobonds and the AAA rated countries, led by Germany, strongly oppose them. German Finance Minister Wolfgang Schäuble has re-emphasised the German position that there will be no eurobonds without fiscal union between the eurozone nations. Germany wants to see step-by-step political integration. The UK Finance Minister George Osborne has spoken out in support of further fiscal integration and the use of eurobonds in the eurozone as long as the UK does not have to take part in it.

France and Germany propose a eurozone economic governance body

In the midst of rumours of contagion in the eurozone and increased calls for eurobonds, France and Germany have put forward a proposal for a new eurozone institution of economic governance. The exact title of this institution is not set but in essence it would be a ministry at eurozone level. It would comprise of non-elected supervisors, would formalise meetings of the eurozone states and would be based on initiatives of the Member States and not of the Commission. Pre-existing suggestions of incorporating limiting deficits into national constitutions and a capped limit on the temporary European Financial Stability Fund (EFSF) were also present in the proposal.

This pact has been largely supported by the Commission President Barroso and Economics and Finance Commissioner Olli Rehn. It will be a subject for discussion at the EU summit of leaders in October in the wider context of the European Growth and Stability Pact.

EU agreement to grant a second bailout to Greece faces opposition at national levels

The EU leaders' July agreement to allow the European Financial Stability Fund (EFSF) to directly purchase national bonds and to grant Greece a second bailout is currently going through national adoption processes. Despite high level agreement between the Member State governments, disquiet nationally has led to many hurdles.

In order to address this implementation, the French and Belgian parliaments are to reconvene in September which is one month earlier than expected. Finland succeeded in concluding a collateral deal with Greece on its contribution to the second bailout. However, there are still unresolved issues concerning the guarantee which would comprise of Greek assets. Following the conclusion of this bilateral collateral deal, Austria, Slovenia and Slovakia have all called for similar deals regarding their contributions. In Slovakia in particular there has been disagreement in the national parliament on funding a second Greek bailout. Further to this, the Dutch parliament is questioning the legality of this bailout.

These national disputes have led to further uncertainty on the stability of the euro especially as any single Member State can veto the second bailout if national implementation cannot be attained.

Despite agreement on second bailout, markets still wary of Greece

Following the agreement of EU Member States on 21 July to grant Greece a second bailout with private sector involvement, yields on Greek bonds continued to rise. The involvement of private

sector participants is increasingly seen as a *de facto* default and has led to credit downgrades by Moody's and S&P to Ca and CC respectively. This places Greece in the category of in default and with little prospect of recovery.

Contagion rumours spread to Spain, Italy, France and Cyprus

Agreement on a second Greek bailout did not succeed in quelling fears of sovereign debt contagion to other eurozone countries. Italy and Spain faced rapidly increasing interest rates on the sovereign bond markets and have come dangerously close to the 7% interest rate which in the past has necessitated bail-outs for Portugal and Ireland. Economics and Finance Commissioner Olli Rehn has emphasised that this unrest is not justified and Spain and Italy have both denied that they are seeking a bailout.

In response to these market fears, Italy has passed controversial austerity legislation and Spain has called for a eurozone meeting in September. Spain's request for a meeting was denied by Finland which does not want any more meetings until the July agreement is implemented.

France also faced speculation in the last month because of the French banks' exposure to the Italian debt market. This led to a loss of 5% on the Paris stock exchange on 10 August and subsequent emergency meetings of French ministers. France's AAA credit rating is also under scrutiny as its bond yields and deficit levels are higher than expected for such a rating.

Cyprus also emerged as a possible future bailout state amidst national political turmoil and its high exposure to Greek debt. On 28 July the Cypriot cabinet resigned following an explosion at the island's main power plant which has had a significant economic impact. Moody's credit rating agency downgraded Cyprus by 2 notches to Baa1 which is only three notches above non-investment grade. The reasons cited for this downgrade were the explosion at the power plant and the government's failure to implement austerity measures. The borrowing rates for Cyprus have soared and now exceed the rates which forced Portugal and Ireland into a bailout.

EU Financial Markets Regulation

Short selling and CDS: negotiations to continue in September

Tough negotiations before the summer recess between Member States and the European Parliament on a Regulation on Short Selling and CDS have not been resolved. Against the political background of bans on short selling in four Member States at the beginning of August, negotiations will continue when the EU Institutions resume work in September.

The crucial issues of contention haven't changed: It is unsure whether a ban on naked short selling should also apply to sovereign debt, whether naked CDS contracts will be banned and what the powers of the EU Securities and Markets Authority's (ESMA) will be.

OTC derivatives and markets infrastructure: no deal yet, delay likely

The European Markets Infrastructure Regulation (EMIR) faces a similar situation: after MEPs decided their position on 4 July, Member States failed to come to an agreement before the summer recess. The Polish Presidency will come forward with a new compromise proposal which Member States will debate at the beginning of September.

The major issues dividing Member States are still the scope of the regulation (whether it will apply to OTC contracts or to all derivatives), the powers of ESMA in authorising and supervising CCPs and access to central bank liquidity for CCPs.

As reported before, we will not know what the final text will look like at least for another four months. A final text is not likely to be ready before January which would jeopardise the G20 deadline.

Sarkozy and Merkel put their weight behind Commission proposals on a Financial Transaction Tax

On 16 of August, as part of the outcome of their talks, French President Sarkozy and German Chancellor Merkel reiterated their support for a European financial transaction tax (FTT). Although markets strongly reacted to this, it did not constitute anything new in terms of planned initiatives.

As reported last month, the European Commission had, as part of its proposals for the EU budget, specifically proposed a financial transaction tax which would be imposed to fund the EU directly. An interesting difference is that Sarkozy and Merkel intend to use the funds to support indebted Eurozone Member States. Commission President Barroso moved quickly to welcome the Franco-German resolve and emphasised that the Commission continues to work on its proposal, planned for autumn.

The fate of that proposal, for the moment, is uncertain. Any fiscal policy at EU level is subject to unanimity decision-making and that therefore any Member State can block this proposal. UK Treasury officials have said that "it's not going to happen". Caution is warranted though: EU budget negotiations are very political and the FTT will be only one element in them, so it is too early to say whether the idea will survive.

Commission proposes CRD IV prudential rules for banks

On 20 July the European Commission published its long awaited proposals for a CRD IV Regulation and Directive, which aim to implement the Basel III rules.

The proposal contains a lot of contentious elements:

- Prudential requirements for credit institutions and investment firms on capital; liquidity; leverage ratios; counterparty credit risk; OTC derivatives
- Rules around corporate governance for banks, including risk oversight through boards with a more diversified composition
- Harmonised sanctioning powers for supervisors and stronger supervision
- Additional haircuts on minimum capital requirements
- Banks' investment decisions to be based also on their own internal credit assessments, also on portfolio level

The proposal will now face tough political negotiations between Member States and the European Parliament in autumn, which will take a half a year at least.

- COMING UP -

- **October 2011:** European Commission legislative proposal on **crisis management and bank resolution**
- **October 2011:** European Commission proposal for a revised **Market Abuse Directive**
- **October 2011:** European Commission proposal for a reviewed **MiFiD**
- **17 – 18 October 2011:** **EU summit** to take place in Brussels.

For further information, please contact:

Christiaan Smits christiaan.smits@freshfields.com
+32.2.504.76.28

Elaine O'Brien elaine.obrien@freshfields.com
+32.2.504.71.84