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### Coming up

## **EU Public debt and deficit**

### **Greece's financial future uncertain amid divergent political views across the eurozone**

Despite an agreement between the EU Member States on 21 July which provided for a second bailout for Greece, Member States have faced many hurdles with national implementation. As a result, the Member States as represented in Council have not decided on their solution to this deadlock. A meeting of eurozone finance ministers on 16 September failed to bring about any significant progress and they now plan to address the outstanding issues in early October. In the meanwhile, the continued transfer of funds to Greece is in limbo.

The two countries which have put up the greatest opposition within national governments are Slovakia and Finland. In Slovakia the opposition has materialised within the parliament. With regard to Finland, the Council is scrutinising the Finnish-Greek agreement whereby Finnish funds alone would be secured by Greek collateral. This bi-lateral agreement has created a stir as it would mean differential treatment of Finnish funds. The issues are rather technical and arise from the fact that if collateral is in place, then the interest rate on the Finnish loan to Greece would be lower and thus the return on loans to Greece would also be reduced.

In Germany the political situation also seems divided. Following months of speculation, the markets are pricing in a possible Greek default and it has been rumoured that Germany is also addressing this possibility. The Free Democratic Party, which is the junior coalition partner to Angela Merkel's Christian Democrat government, has publically stated that the possibility of Greece leaving the eurozone cannot be ruled out. Chancellor Merkel has ruled out this possibility but has called for an EU treaty change to tackle the problem of wayward economies. A positive step for eurozone bailouts this month in Germany was the judgment of the Constitutional Court which found that the first Greek bailout was legal but that future bailouts have to be subject to parliamentary approval through a fiscal committee.

Additionally, the Dutch have publically stated that they are preparing for all "conceivable and inconceivable scenarios". Furthermore, in a letter published in the Financial Times on 7 September, Dutch Finance Minister Jan Kees de Jager called for the instalment of a European Commissioner for budgetary discipline.

All indications show that Member States have not been able to draw conclusions on their next steps but have remained adamant that the second Greek bailout will be in place by the end of October. However, negotiations are ongoing.

### **Issues with Greek reforms lead to uncertainty for continued bailout instalments**

In early September the troika (European Commission, the International Monetary Fund (IMF) and the European Central Bank (ECB)) review mission to Greece was withdrawn due to disagreements concerning the means for tackling the shortfall of €2 billion in the 2011 budget. The official line was that the Greek government were being given time to implement the promised reforms. Independent of the second bailout to Greece, if these deficit reduction targets are not followed, the sixth instalment of capital to the amount of €8 billion will not be transferred at the start of October as was previously timetabled.

Following this withdrawal, the Greek government stepped up efforts to implement austerity and proposed an emergency property tax which would be collected via electricity bills, members of parliament agreed to forego a month's salary, the privatisation programme was advanced and a plan to reduce public sector jobs and benefits was reiterated. In light of this the troika mission will return to Greece at the end of September with a view to publishing its findings by mid-October. If promised reforms are on track, the next instalment of aid, which amounts to €8 billion, will be given and discussions on the second bailout should be advanced.

Amid this uncertainty, France and Germany have reiterated that Greece will stay within the eurozone, but markets still appear wary.

### **Greek task force starts work on coordinating Greek assistance efforts**

The 21 July Council agreement included the establishment of a task force for Greece which would be tasked with coordinating and identifying technical assistance to Greece in cooperation

with EU Member States and the Greek government. This group began work on 1 September and includes Commission officials and seconded national experts. The head of this task force is Horst Reichenbach who is the vice-president of the European Bank for Reconstruction and Development. The goals outlined by this task force are to boost tax collection, streamline the running of the Greek public health system and to improve government communication.

Further to this, it has been decided that Greece will receive €7.7 billion in structural funds in the coming months. These funds are being fast-tracked as they were scheduled for distribution over the next two years and are independent of the bailouts. Structural funds are normally directed towards projects for developing regions and tackling regional disparity.

### **Agreement reached on European Economic Governance Pact**

After nine months of negotiations between the Council, the European Parliament and the Commission, an agreement on the European framework for economic governance was finally reached on 14 September during informal negotiations in Strasbourg. This was finalised in a meeting of finance ministers on 16 September and will be subject to formal approval by the ECOFIN Council on 4 October and the European Parliament plenary on 28 September.

The economic governance pact, or as it is otherwise known the six-pack, is a package of six legislative texts which have the aim of strengthening stability and growth in Europe. The texts concern the following:

1. Surveillance of budgetary positions and the surveillance and coordination of economic policies.
2. Speeding up and clarifying the implementation of the excessive deficit procedure.
3. Budgetary surveillance in the euro area.
4. Enforcement measures to correct excessive macroeconomic imbalances in the euro area.
5. Prevention and correction of macro-economic imbalances.
6. Requirements for budgetary frameworks of the Member States.

The exact details of this agreement have not been made public but it is understood that there is the inclusion of a “cooling off” period for Member States that break the deficit limit. Within this period the Member States will have the opportunity to make appropriate fiscal reforms before sanctions are put in place. Furthermore, for a Commission sanction to be blocked there will need to be agreement by a simple majority of Member States. This is a change from the European Parliament’s original obligation of having a qualified majority.

### **Calls for eurobonds continue despite German reluctance**

In anticipation of upcoming proposals on eurobonds, discussions have continued across the EU institutions on the suitability of these measures. The head of the liberals’ political group (ALDE) in the European Parliament, Guy Verhofstadt, has been a continuous advocate for the use of eurobonds and this month he released a statement that eurobonds are needed as the ECB cannot continue to buy up the debts of all the countries in difficulty. During a conference on 5 September, he said that these bonds are inevitable since the July agreement of the Member States provided that the European Financial Stability Facility (EFSF) can lend the full €440 billion in its coffers and can purchase bonds on the open secondary market.

On the other side, Germany continues in its resistance to a pooling of eurozone bonds and on 15 September Chancellor Merkel stated that “eurobonds are an absolute mistake. To have common interest rates, you need similar levels of competitiveness and similar budgetary situations.” Germany’s reluctance is mirrored across the other financially strong eurozone nations which are reluctant to endanger their top credit ratings.

The European Commission has not released the details of its upcoming proposals on eurobonds, but Commissioner for Economics Olli Rehn has stated that eurobonds would have to be accompanied by deeper financial coordination. Furthermore, the Commission president Barroso has stated that these proposals may necessitate EU treaty changes.

## **Amid financial market turmoil, the ECB also faces internal crises**

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Amid growing speculation on the sustainability of the eurozone, the ECB doubled its bond purchases in the last month and now the exposure on its books amounts to approximately €142.9 billion. It is largely understood that this sudden increase in bond purchases consists of Italian sovereign bonds.

Following these increased moves to purchase ailing eurozone debt, the German ECB board member Jürgen Stark resigned. While his reasons for resigning were not outlined in detail, it is understood to be as a result of the ECB's position on bond purchasing. This is the second high-level German resignation this year as German Bundesbank president Axel Weber also resigned for similar reasons in February.

Another crisis which has materialised is the revelation that the UK government is taking legal action against the ECB for a paper which it released in July 2011 on oversight of the eurozone. In this paper the ECB calls for transactions in Euros to be incorporated in the euroarea if they account for more than 0.2% of the total daily average value of euro area transactions. The UK government has taken this as a direct attack on London's financial centre and argues that it is contrary to EU laws.

## **Systemic risk to the banking sector starts to materialise**

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The interdependence of the financial services sector and sovereign debt became increasingly obvious this month when two French banks were downgraded by Moody's credit rating agency. Société Générale and Crédit Agricole are both heavily exposed to Greek sovereign debt and increased speculation of a Greek default have created shock waves which have hit these two banks in particular.

## **Ireland and Portugal continue on track but fears of Greek contagion remain**

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On 2 September the Council decided to release the next instalments of bailout funds to Portugal and Ireland. This follows positive reports from the troika (European Commission, the IMF and the ECB) review missions to the two countries. The progress of these countries is judged to be well on track and it is in this context that the Commission has also suggested reducing interest rate margins and extending maturities for loans.

However despite these national advances, it is widely acknowledged that these would be two of the most vulnerable countries in the event of a Greek default.

## **Speculation continues regarding Italy's financial stability**

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Investors and the markets continued to focus on Italy's weaknesses and the high debt levels over the past month. The government debt currently stands at approximately €2 trillion which is 120% of national GDP. On 6 September moves by the Italian government to push for swift adoption of austerity were welcomed by the Commission. These austerity measures include an increase of VAT by 1% to 21%, an increase of 3% on income tax for those earning more than €500,000 per year and an increase in retirement ages.

In light of this, the German Commissioner Günther Oettinger has stated that Italy was run "appallingly badly" and that the ECB had been "cheated" into the purchase of its bonds. The ECB has doubled its exposure to the eurozone in the last month and it is largely suspected to be because of its purchase of Italian bonds.

Following this, on 20 September Standard & Poor's credit rating agency downgraded Italy's credit rating by one notch to A with a negative outlook.

## **Commission to tackle the sovereign debt crisis by addressing the role of credit rating agencies**

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In a speech given in Vilnius on 8 September, Commissioner for the Internal Market, Michel Barnier, spoke about the EU's approach to tackling the sovereign debt and financial services crises. In this speech Commissioner Barnier stated that "we will soon present new proposals to reduce our overreliance on credit rating agencies and new rules as regards sovereign debt ratings". The motivation behind this is partially because of the "...tendency of these agencies to get things wrong..."

The specifics of this upcoming legislative proposal are as yet unknown as it is still in the drafting stage. The proposal is expected to be published in the fourth quarter of 2011.

## **EU Financial Markets Regulation**

### **Short selling and CDS: deal envisioned in the coming weeks**

The last stage of negotiations between Member States (represented by the Polish Presidency of the Council) and the European Parliament on a Regulation on Short Selling and CDS has started again after the summer break.

In the coming weeks the key decision-makers will come together in so-called (non-public) 'trialogue' meetings to try and thrash out a compromise. Meanwhile in the background, bans on short selling in five Member States have been extended, with a coordinating role for the EU Securities and Markets Authority (ESMA).

The core issues of contention are still the same: MEPs, EU Member States and the European Commission are divided on 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 ESMA should be.

### **OTC derivatives and markets infrastructure: negotiations ongoing, but rules will be delayed**

With the Polish Presidency drafting possible new compromise proposals and informal negotiations between the EU institutions ongoing, it is difficult to see what the exact outcome will be on EMIR (the European Markets Infrastructure Regulation).

Member States are struggling to come to an agreement on a number of the big issues: 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.

The final outcome is still at least another three months off. The rules are not likely to be ready before January which jeopardises the G20 deadline for enforcement of the new regime by the end of 2012.

### **Commission proposals on a Financial Transaction Tax due at the beginning October, tough talks ahead**

The European Commission has announced its intention to propose a Financial Transaction Tax (FTT) at the beginning of October, even though talks between Finance Ministers in Poland last week showed strong disagreement between the EU Member States on the need for an FTT. Nevertheless, political heavyweights, including French President Sarkozy, German Chancellor Merkel and Commission President Barroso, have spoken out in favour of the proposal.

If the Commission follows the advice of the French and Germans, then the FTT would cover bonds, equity, currency transactions and all (OTC and on-exchange) derivative trades.

However, at least four Member States are strongly against a proposal: the UK, the Netherlands, Sweden and Malta. For an EU FTT to come into effect, unanimous agreement between Member States will be needed. Interestingly, Finance Ministers have now raised the prospect of introducing an FTT only for the Eurozone – which would take the biggest opponent, the UK, out of the debate.

A lot will still depend on the specific design of the FTT in the Commission's proposal, and the Commission sees the proposal as a first step in an open debate – and of course a political signal against the background of the crisis.

**- COMING UP -**

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

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