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Coming up

EU Public debt and deficit

The faith of Greece's economy continues to be debated while a second bailout is arranged

On 2 June the Economics and Finance Committee of deputy ministers and senior officials of the eurozone states met in Vienna and agreed, in principle, on a new international bailout for Greece. The issue which still remains is how this refinancing can be framed in a way which does not constitute a default. In reality €60 billion worth of Greek sovereign debt will mature in 2012 and 2013 and it has been acknowledged that Greece will not be able to return to the financial markets for financing in 2012. A leaked report from the EU and the International Monetary Fund (IMF) acknowledges this and the fact that shortfalls in financing will need to be bridged in the medium term.

The exact details of the second bailout are currently being discussed and will be part of the agenda at the meeting of EU Member State Finance Ministers (ECOFIN Council) on 20 June. Germany, Finland and the Netherlands are pushing for the condition that private government bondholders would have to agree to roll-over their exposures. This has however proven controversial as such an obligation could be considered as a de facto default and would lead to credit downgrades across the eurozone. On 14 June Standard & Poor's (S&P) credit rating agency downgraded Greece by 3 notches to CCC which is only 4 notches above default. This is the lowest existing national credit grade by S&P. Further to this, S&P has warned that any restructuring of Greece's existing debt will be considered as a default.

The European Central Bank (ECB) has suggested encouraging creditors to exchange their existing bonds for bonds which have longer maturities or requesting that government bondholders buy new bonds once their debt has expired. These options have been referred to by the ECB as "voluntary rescheduling or reprofiling". Reprofiling is a term which was coined by eurozone finance ministers and which refers to a lighter form of restructuring.

At a national level, the Commission, the ECB and the IMF concluded the fourth review mission to Greece on 3 June and outlined the economic and financial policies which are needed for financial stability. Following this, on 10 June the Greek government outlined a 3 year austerity plan which involves €6.4 billion in spending cuts and €50 billion in raised capital from privatisations. This plan is widely criticised at national level as it involves further reductions to public sector numbers, public sector benefits, social welfare, capital investments, spending on health care and increased taxes. Greece's government has been in a deadlock with opposition parties on this plan for several weeks and it will go to parliamentary vote at the end of June. Economics and Finance Commissioner Olli Rehn has called on "...all political forces in Greece to put aside their domestic disputes and endorse the main objectives and policies of the programme for the sake of the recovery of the country, for the sake of growth and employment."

Possible effects of a Greek default

Amid increased uncertainty regarding Greece's financial situation and the framing of further assistance in a way which is not considered as a default, discussions have intensified regarding the status of credit default swaps (CDS) in the event that Greece defaults on its debt.

CDS have been widely purchased by holders of Greek sovereign bonds as an insurance against default and in recent weeks the cost of such instruments has reached record highs. In the event that the treatment of Greece's debt problems is considered to be a de facto default, massive payouts will be possible for the holders of CDS. Further to this, in the event of a de facto default, the European Central Bank (ECB) will not be able to accept Greek government bonds as collateral. This would lead to a capital crisis for the Greek banks which are largely exposed to Greek sovereign bonds.

Uncertainty regarding the financial standing of Greece has led to increased fears of contagion across the Eurozone

On 24 May Moody's Credit Rating Agency issued a warning that a default in Greece would lead to contagion across the eurozone with wide sweeping credit downgrades. The systemic problems of the euro are largely due to financial and political linkages among eurozone countries. At the publication of the European Commission's country-specific reports for economic decision making, Economics and Finance Commissioner Olli Rehn said that "this is a crisis which has both country-specific and systemic features."

There are other reasons for such a contagion risk which stem from national financing problems. These include the possible hidden regional debt in Spain and the large size of Italy's debt. In the last 2 months Spain and Italy have both seen significant increases in the rates which they pay over Germany for borrowing. It is believed that France and Belgium would be likely to follow Italy if a liquidity problem arises due to their similar sovereign debt structures.

Even further afield, it was acknowledged by US President Obama when meeting with German Chancellor Angela Merkel that default in the EU would be "disastrous" for the USA.

The European Commission issues country-specific reports with economic advice

At the end of the first European semester (i.e. the 6 month fiscal planning period where EU Member States submit budgetary plans to the European Commission), the European Commission issued 27 [country-specific recommendations](#) for economic decision making at national levels. The goals of these recommendations are to prevent the next financial crisis rather than treating the existing one. This non-binding advice varies depending on the country and is specific to national economic, fiscal and social environments. The advice includes increasing retirement ages, reforming retirement schemes, removing early retirement possibilities, increasing spending cuts, imposing binding spending limits, reducing regulation on start ups and reducing labour taxation.

Discussions on the EU's Economic Governance scheme expected to conclude by the end of June

On 14 June the EU's Finance Ministers met in a last attempt to come to an agreement on economic governance before they meet to vote in the ECOFIN Council on 20 June. The Hungarian Presidency of the EU will come to an end on 30 June and it hopes to reach an agreement before this date.

The economic governance legislation was proposed by the European Commission in September 2010 and aims at curbing runaway spending and harmful economic policies. This proposed legislation would give the Commission the power to levy fines on countries which consistently break debt and deficit limits or on those countries which do not address their economic problems such as bulging public sectors and asset bubbles. The scope of such powers has been a point of contention between Member States. However the need for such legislation has been endorsed by Luxembourg Premier Jean-Claude Juncker who is also the President of the Eurogroup. When discussing this proposed legislation with regard to the eurozone countries he said that: "The 17 Member States haven't really understood fully what it means to belong to a monetary union. National economies don't really exist anymore."

On 17 May the Council issued its guidance on its position which was subsequently taken to the inter-institutional negotiations. These negotiations took place between the European Parliament, the Council and the Commission for three weeks from that date. The outstanding issues which were addressed in these meetings are the extent to which sanctions can be applied, the application of reverse qualified majority voting to block a Commission sanction, macroeconomic scoreboards, the European Parliament's role in the process through economic dialogue, medium-term crisis management and the legal basis for the European semester. The European Parliament would like to extend its powers so that it could hold hearings with the national

ministers of errant Member States. This has been an evident point of dissatisfaction among the Member States in Council.

The European Parliament will vote on its position in plenary on 22 or 23 June following the vote in Council on 20 June.

Rumours persist on a possible increase in the European Central Bank's interest rate

On 9 June a meeting of the governing council of the European Central Bank (ECB) took place in Frankfurt. It was decided at this meeting that the ECB's interest rate should remain at 1.25%. Nevertheless, due to volatility in the commodities markets and uncertainty regarding Greece, it is widely believed that an increase is likely in July. Since April the ECB has been working on tightening its monetary policy and outgoing President Jean-Claude Trichet has previously stated that he will give warning of an interest rate increase.

EU Financial Markets Regulation

Short selling and CDS: tough negotiations ongoing between Member States and MEPs

- Tough negotiations are ongoing between the EU Member States and the European Parliament on the European Commission's proposal for a Regulation on Short Selling and CDS. One of the crucial issues of disagreement between Member States and the European Parliament is still whether a ban on naked short selling should also apply to sovereign debt. The compromise Member States agreed on now allows national supervisors to (temporarily) ease restrictions on naked short selling when liquidity in sovereign bonds is critically low.
- On another point of contention, Ministers have not agreed to try to ban naked CDS contracts. However, Germany took exception and specifically stated it wanted a ban on naked CDS. However, in the negotiations MEPs are still firm on their demand to ban naked CDS.
- The limit of the EU Securities and Markets Authority's (ESMA) powers is the third big political issue, with Member States still pushing for ESMA to only be able to suspend or restrict short selling (in emergency cases only) after it has notified national supervisors. MEPs on the other hand want to increase ESMA's powers here.

The original European Commission proposal contained a number of significant changes:

- Trading venues must ensure that there are adequate arrangements in place for buy-in of shares or sovereign debt, as well as fines and a ban on short selling, where there is a settlement failure.
- With the proposal, the Commission further aims to enhance transparency by requiring that all orders on trading venues be market flagged as 'short' if they involve a short sale.
- Investors will have to disclose significant net short positions in shares to regulators if they hold more than 0.2% of issued share capital and to the market if they hold more than 0.5%.
- ESMA will coordinate supervisory action when necessary, amongst others to prevent market turmoil, by restricting or even banning short selling, in certain exceptional circumstances.
- The proposal aims to exclude market makers, the definition of which is still up for debate.

Going forward, the informal negotiations will continue and another 3 informal (trilogue) negotiation meetings between the Council, the European Parliament and the European Commission have been scheduled on 16, 23 and 28 June. If these negotiations fail to yield an

agreement, Parliament may choose to go to a 'second reading', which would postpone the final deal by at least 6 months.

OTC derivatives and markets infrastructure: new rules possibly delayed, Member States may strike initial deal this month

On 24 May, MEPs held their first vote in the Parliament's Economic and Monetary Committee, on the proposed Regulation for markets infrastructure ('EMIR', aimed at OTC derivatives and clearing houses). Crucially, the Parliament's draftsman, Werner Langen MEP (German Christian-Democrat) has indicated he wants to have a 'second reading' which would mean that MEPs will not seek a full agreement with the EU Member States but will revisit the text after Member States have come to their own initial agreement. This would prolong the decision-making by at least 6 months, which would endanger the EU's ability to meet the G20 deadline of the end of 2012 for these changes. Amongst others:

MEPs have voted to keep the scope of EMIR restricted to OTC derivatives, instead of applying it to all derivatives.

On authorisation and supervision of CCPs, MEPs have voted to give the home competent authority a lead role, though the EU Securities and Markets Authority (ESMA) and the college of supervisors of a CCP will have a role in the initial authorisation and extension and withdrawal of authorisation.

Though Werner Langen wanted to delete the title on interoperability between CCPs, this has now been retained for cash instruments only.

In the meantime, the Hungarian Presidency of the EU has published further compromise proposals and still aims to get an initial deal between the Member States in the ECOFIN Council of Ministers on 20 June. Ambassadors are to look at a proposal for the second time on 15 June.

Amongst the issues outstanding, the Hungarians have highlighted:

- The powers of ESMA in authorising and supervising CCPs;
- Extension of the scope to include all (and not only OTC) derivatives;
- "Whether and how pension schemes could be provisionally exempted";
- Provisions related to third country CCPs;
- Access to central bank liquidity for CCPs.

The initial European Commission text proposes the following:

- The Commission proposed that OTC trade data should be reported to trade repositories and be accessible to supervisory authorities. Trade repositories will be subject to oversight by ESMA. Trade repositories will have to publish aggregate positions by asset class.
- To deal with counterparty credit risk, the Commission also proposed that standard OTC derivatives should be cleared through central counterparties (CCPs). To standardize derivatives, they will have to meet predefined eligibility criteria (e.g. sufficient liquidity). If a contract is not eligible and therefore not cleared by a CCP, different risk management techniques must be applied. This will include requirements to hold more capital, which will be proposed around the summer as part of 4th Capital Requirements Directive.
- CCPs will be subject to business conduct rules and harmonised organisational and prudential requirements, including internal governance rules, audits and harmonized capital requirements (to be drafted by ESMA and decided by the Commission). They will demonstrate they have access to either central bank liquidity or "reliable" commercial bank liquidity.

European Parliament calls for stricter regime and more competition for Credit Rating Agencies

On 8 June, the European Parliament adopted a non-legislative resolution on Credit Rating Agencies. With the resolution, Parliament hopes to influence the European Commission's

writing of legislative proposals later this year. The aim of the Commission's proposal is to deal with certain issues around the functioning of CRAs that have come to the political forefront during the EURO debt crisis. Amongst others:

- MEPs are calling for obligations on CRAs to explain their methods in rating instruments and for civil liability for CRAs for their ratings.
- MEPs are also calling for more competition in the sector. The European Commission is invited to conduct an assessment of the feasibility of a 'European Credit Rating Foundation' which would provide independent analysis.
- In addition, MEPs want there to be less reliance on CRAs' ratings and want ESMA to annually review CRAs' performance.

- COMING UP -

- **20 June 2011:** European Council expected to adopt the **Economic Governance Package** and to discuss the **2nd Greek Bailout**
- **22-23 June 2011:** European Parliament to vote in plenary on the **Economic Governance Package**
- **29 June 2011:** European Commission proposal for **financial activities tax**
- **June 2011:** European Commission legislative proposal on **corporate governance** for banks and investment firms
- **13 July 2011:** European Commission proposal for **CRD4**
- **July 2011:** European Commission proposal for a CSD **Regulation for Central Securities Depositories**
- **September 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**

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