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Coming up

EU Public debt and deficit

European Council 30 January: New fiscal treaty progresses

Despite protests from the European Parliament, 26 of the 27 EU Member States are due to agree on a new fiscal treaty at the European Council summit on 30 January. Talks are currently ongoing in a number of Member States regarding sensitive issues, some of which are set to be discussed during the 24 January ECOFIN Council which brings together Finance Ministers of the Union. The proposed treaty is supposed to introduce further integration in two new areas:

- Eurozone governance (currently unaddressed in the recently agreed 'six pack')
- Budgetary discipline

The final decision will however be taken on 30 January when Union heads of state are due to meet. Regarding developments on wording of the treaty, it has been reported that:

- The link with the European Stability Mechanism (ESM) is clearly established
- Additional sanctions CAN be foreseeable if a dispute over transposition of this rule is brought before the EU Court
- The 'golden rule' ('debt brake rule') be subject to discussion and arbitration by the heads of state and government

As in previous cases, bilateral summits between heads of state are due to take place before that of the 30 January. Indeed, on 16 January, French President Nicolas Sarkozy was in Madrid for a meeting with Spain's Prime Minister Mariano Rajoy followed the next day with Rajoy meeting van Rompuy before visiting the German chancellor, on 26 January in Berlin. However, the mini-summit between Italian Prime Minister Mario Monti, Angela Merkel and Sarkozy, scheduled for 19 January in Rome, is rumoured to be postponed.

The European Parliament has been particularly critical of the proposed treaty. Several members of the Economic and Monetary Affairs Committee aired their reservations during a debate in Strasbourg on 16 January in which concerns regarding the conformity of the new treaty with EU law was cited as a major obstacle. This was backed up by a heavy majority at the European Parliament in a debate on 18 January in which 521 MEPs approved a resolution calling for the Treaty to comply with EU law and called into question the need for an inter-governmental agreement deemed as contrary to the "community method".

Deal on Greek debt close

The EU's competition chief, Joaquin Almunia, has said that an agreement must be reached on the scale of the losses that private banks, hedge funds and other investors should take as part of a second Greek bailout. EU leaders agreed in October that as part of a second €130 billion bailout of Greece, investors should write down their holdings of Greek sovereign debt by at least 50%, saving the state up to €100 billion. Greece has to secure the extra funding before 20 March, when it has to repay €14.4 billion worth of debt. Eurozone finance ministers are to meet on 23 January for talks that are expected to be dominated by the question of private sector involvement, while it will also feature heavily at a summit of EU leaders, on 30 January.

Following a break-down of talks between Greek debt negotiators and bondholders after eurozone officials called for a sizeable decrease of the coupon on new bonds, talks have resumed and a deal may be imminent. Talks between debt negotiators and the IMF ahead of the meeting with the Institute of International Finance which represents bondholders, appeared to be well received. Following the meeting, bankers and hedge fund officials pronounced their optimism at an agreement on writing down €100 billion debt as agreed at a European Union summit in October 2011.

Negotiators are considering offering bondholders warrants tied to the recovery of the Greek economy in an attempt to secure their support and avoid a deadlock that would further jeopardise Greece meeting its repayments. This option, previously called a GDP warrant had been written off in the past by a number of major eurozone countries including Germany but have been reconsidered as part of a potential deal. Observers do however remain sceptical that any deal will gain total support but are acutely aware that if debt negotiators are not able to

convince bondholders, Greece may find itself unable to make the \$14.5 billion debt repayment due on 20 March.

Future of EFSF questioned after Standard and Poor's cuts ratings

On 13 January, Standard & Poor's downgraded its assessment of nine out of seventeen euro countries leading to the eurozone's Financial Stability Facility losing its 'triple A' credit score. France, also incidentally the second largest contributor to the EFSF, lost its high rating and Cyprus, Italy, Portugal and Spain had their ratings lowered by two notches. Similarly, Austria, Malta, Slovakia and Slovenia all lost one.

The EFSF was downgraded from 'AAA' to 'AA+' but surprisingly had no difficulty on 17 January, raising €1.5 billion in six-month bonds. Three-month bonds were successfully auctioned at the end of 2011 and Christophe Frankel, deputy head of the EFSF, revealed new plans to auction three, six and twelve-month bonds regularly. In a statement, the EFSF said the downgrade would not have a significant impact on its lending capacity and underlined that its short-term rating continued to be at top level.

However, Standard & Poor's assessment of the euro countries mentioned above angered European leaders and officials as they saw the downgrade as unjustified in the light of the reforms being carried out across the eurozone. Economic and Monetary Affairs Commissioner Olli Rehn qualified the downgrade as "inconsistent" and Internal Market Commissioner Michel Barnier expressed his "surprise" at the timing of the report, claiming it does not take into account the progress made in recent weeks.

Commissioner Rehn made specific reference to fiscal consolidation and structural reform across the eurozone as well as the efforts being made to address vulnerabilities in the banking sector as well as reinforcement of financial backstops and strengthened economic governance. Given the negative assessment by Standard and Poor's the details of the European Stability Mechanism will need to be finalised as quickly as possible in order to guarantee its entry into force in July 2012.

Growing consensus for the introduction of eurobonds

Support for the introduction of eurobonds is growing in European circles. Commissioner for Economic and Monetary Affairs Olli Rehn recently endorsed a plan for temporary eurobonds. The plan was proposed by a group of German economists which advises German Chancellor Angela Merkel, and which concluded that a €2.3 trillion redemption fund should be created by issuing common bonds to finance the excess debt of struggling governments across the eurozone.

Commissioner Rehn, who spoke at a seminar organised by the Alliance of Liberals and Democrats for Europe (ALDE) group in the European Parliament on 10 January stated that this possibility should be looked into further as an additional measure to the European Commission's proposal for eurobonds published in November 2011. Commissioner Rehn advocated for the advantages of eurobonds which according to him would "act as a driver for integration and efficiency of European bond markets". He also added that any such introduction would go hand in hand with strict rules on deficit reduction in order to ensure prevention of free-riding and moral hazard by Member States involved. Guy Verhofstadt who hosted the seminar in his capacity as ALDE leader strongly supported the idea of eurobonds, stating that the creation of a sovereign bond market comparable to that of the United States would be most beneficial to the eurozone. Italy's Mario Monti is also a keen supporter of the initiative and is pushing for it to be introduced in some form at EU level in order to counteract some of the more negative effects caused by austerity in his country as well as others.

Nevertheless, despite enthusiasm for the initiative, a number of Member States remain sceptical with Germany in particular opposing the initiative. On 17 January, Governing Council Member of the ECB, Ewald Nowotny, stated that the timing for discussion on the introduction of eurobonds was misplaced whilst the new fiscal treaty is not yet agreed.

Approval by the Spanish Government of extraordinary fiscal measures and the fiscal slippage in Spain

It was announced by the Spanish Government that a far-reaching package of fiscal measures to be complemented by comprehensive structural reforms in early 2012 would be undertaken in response to the sizeable fiscal slippage expected for 2011. Commissioner Rehn welcomed the significant package of budgetary policy measures approved by the Spanish government on 30 December. Amounting to Euro 15 billion or 1.5% of GDP the consolidation package is an important step in shoring up public finances and reassuring financial markets.

The European Commission has undertaken to carry out a detailed assessment of the larger-than-expected slippage and the budgetary impact of the new package once it has received all the details. It is hoped that these measures give a signal underlining the new government's determination to bring back the correction of the excessive deficit to the envisaged path within the deadline of 2013.

30 year maturity bond issued by the EU in a bid to fund loans for Ireland and Portugal

On 09 January following demand from investors, the European Union placed a bond with a 30 year maturity under the European Financial Stabilisation Mechanism (EFSM). The proceeds of the venture will contribute towards financial assistance packages for Ireland and Portugal who are set to receive € 1.5 billion each. This is the first time an EU issuance bond has held such a long maturity, but it is hoped that it will improve debt sustainability in both countries concerned. The bonds will mature on 04 April 2042. Unsurprisingly, demand from investors came predominantly from the EU, with Germany at 70 per cent and the UK at 13 per cent. Ireland and Portugal receive loans from financial assistance packages, jointly provided by the EU (EFSM), the European Financial Stability Facility (EFSF) and the International Monetary Fund (IMF).

The agreed external assistance for Ireland amounts to up to € 67.5 billion over 3 years, where the EFSM will contribute with € 22.5 billion. The agreed assistance for Portugal totals to up to € 78 billion with an EFSM share of € 26 billion. In 2012, under EFSM, the EU intends at this moment to issue bonds for a total amount of about € 12.5 billion, to be used for loans to Ireland and Portugal. Additional smaller amounts might be placed under the Macro-Financial Assistance (MFA) and BoP programmes.

Portugal dogged by default possibility

Portuguese bond prices have slumped into territory deemed by many investors as likely to default. Investors continue to offload Portuguese bonds as fears of contagion continue to rise which proved negative for the government's debt auction this month. Portugal does not have a bond maturing before June which is when €10 billion is due for repayment. Although the country's borrowing needs are fairly low at €17.5 billion, it is feared that the country's virtually stagnant growth could have a harmful effect on its ability to properly manage its debts.

Portugal was downgraded to junk by Standard and Poor's on 13 January which forced investors to sell Portuguese bonds. Further Portuguese debt was sold following Lisbon's removal from Citigroup's European Bond Index which investors track. There is a growing concern that the possibility of Greece defaulting may cause contagion and provoke Portugal to do the same. Following the downgrade, Fitch stated that it was probable that it would need to downgrade Spain, Italy, Ireland, Cyprus, Belgium and Slovenia who were all put on review in December 2011.

EU Financial Markets Regulation

Still no agreement 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) are set to continue in the new year with another discussion scheduled for 23 January.

Council Working Groups have continued to take place in January in a bid to allow the Danish presidency to agree on a mandate for negotiation with the European Parliament. The Presidency has already published a new compromise text and the European Commission has circulated some drafting.

As outlined previously, the treatment of third countries is proving particularly delicate, with EU Member States disagreeing between themselves and with the European Parliament. It has been rumoured that the European Commission may present an 'Omnibus Directive' proposal this year that would attempt to detail third country provisions that would be applicable across multiple pieces of legislation. The European Parliament and Council are still in disagreement on the powers of ESMA (European Securities and Markets Authority established in January 2011) to authorise and supervise CCPs.

The ECOFIN meeting of 24 January which brings together all the Finance Ministers of the Union is set to discuss progress on the proposal. This indicates that negotiations are likely to continue and that the G20 deadline for enforcement of the new regime by the end of 2012 will almost certainly slip.

European Institutions continue work on MiFID proposals

Following the public hearing on MiFID that took place in the European Parliament in November 2011, work has gradually continued on the proposal. The Council has begun its Working Groups which at this stage are attended by both attaches and their national experts from the national Treasuries. The Danish Presidency, which is now leading negotiations, has expressed that although the proposal is of great importance, it is aware that it will not be able to conclude negotiations under its mandate. Denmark is hoping to at least be able to agree on the scope and definitions of the proposal. Any possible deal is therefore not to be expected before the end of the Cypriot Presidency which runs from 01 July 2012 until 31 December 2012. The next meeting of the Council is scheduled for 15 February.

The deadline for responses to the questionnaire issued by rapporteur Markus Ferber MEP (DE, EPP) lapsed on 13 January 2012. The next step in Parliament is foreseen for 13 February in which an exchange of views between Parliamentarians is expected. This will be the first indication of positions of individual MEPs on specific provisions. Ferber's draft report is expected in March.

To recap, the Commission's text contains a large number of politically sensitive items:

- Access provisions underscore the Commission's commitment to fair competition in trading and post-trading: this includes mandating access to indexes through licenses and access to CCPs and trade feeds;
- In trying to regulate High Frequency Trading, the Commission has proposed a number of measures, including circuit breakers, systems and controls, and principles for trading venues in controlling HFT, but also order-to-trade ratios and a market making requirement for algorithmic traders;
- The Commission proposes a specific SME growth market regime;
- For data, the Commission proposes measures to improve the quality and to harmonise requirements and multiple consolidated tape providers;
- Transparency requirements under the Commission's text will now be extended to all asset classes and all venues;
- Proposals for trading venues (Regulated Markets, MTFs and the new category, Organised Trading Facilities) are meant to capture all trading (including prop trading)

and deal with all venues in the same way as regards systems and controls and transparency requirements.

Multiple possibilities emerge on the introduction of an FTT

Talks continue on the introduction of a Financial Transactions Tax although no agreement by all Member States seems possible. The Council has held only one working group on the Commission's proposal under the Danish Presidency which does not support the proposal and which will lead negotiations until mid 2012. The Presidency has openly declared that it will be approaching the proposal from a purely technical perspective, and not from a political one. No more Council Working Groups have been scheduled for the time being although a discussion is foreseen in the 22 June ECOFIN Council of Ministers.

Attention has been increasingly focussed on the possibility that individual Member States may decide to implement a tax if not enough support is garnered on an EU-wide or even eurozone-wide basis. Germany and France are the main supporters of a tax and are due to present a paper on a possible joint initiative in the coming weeks with the involvement of Italy.

The Commission continues to defend its proposal and will be publishing a note based on revised estimates to those which had been previously laid out the Impact Assessment accompanying the proposal. The note is expected in late January and will likely state that the impact of the tax would not be as harmful as commonly estimated. Given the lack of agreement amongst Member States on its introduction (the UK and Sweden are particularly sceptical) the possibility for implementation via enhanced cooperation is looking more likely. This would entail nine Member States agreeing on joint implementation, although this would still need agreement from those Member States not involved.

The European Parliament in a recent exchange of views broadly supported the proposal and advocated implementation at euro-zone level as a minimum failing full implementation across all EU Member States. Despite their enthusiasm, it is worth bearing in mind that the Parliament's opinion is only an advisory one and is in no way binding.

- COMING UP -

- **08/09 February 2012:** European Commission proposal for a **Central Securities Depositories Regulation**
- **February 2012:** European Commission legislative proposal on **crisis management and bank resolution**
- **24 January 2012: ECOFIN Council** with a discussion on progress of EMIR
- **30 January 2012:** Next **informal European Council** focussing on the new fiscal treaty
- **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**.

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