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Coming up

EU Public debt and deficit

Political changes and increased volatility in Greece

Following a deal between EU member states in late October to provide additional funds to Greece, markets went into turmoil after a declaration on 3 November by the former Greek Prime Minister, George Papandreaou, that he would hold a referendum on the bailouts and on Greece's eurozone membership. This led to a sharp depreciation in the value of the euro following a spike after the October agreement. This call for a referendum was in response to increased criticism nationally and led to emergency meetings with German Chancellor Angela Merkel and French President Nicolas Sarkozy.

The call for a referendum was withdrawn and Papandreaou agreed to resign on 7 November. He was swiftly replaced by Lucas Papandemos who is an economist and who was second in command in the ECB until 2010. Since his appointment he has made firm assertions that Greece will sign a letter stating that it will abide by the terms of its bailouts. The importance of this deficit reduction plan is of upmost importance and on 23 November the Greek Central Bank even stated that this is "probably the last chance" for the Greek economy to be rebuilt.

Greece takes steps to address outstanding tax payments

Alongside political turmoil and uncertainty this month, Greece tried to find ways of progressing on their bailout commitments. Discussions on a tax agreement have been opened with Switzerland as it is estimated that €100 billion in Greek wealth is located therein and a large quantity is believed to be due to the Greek tax authorities. The Commission's special task force to Greece has identified tax collection as the most urgent issue. Their first report found that there is approximately €60 billion in outstanding taxes and that between €6 billion and €8 billion of this is collectable because of changes to the tax dispute system and targeted action at large corporations. In an attempt to improve tax collection, the Greek Finance Minister will publish the names of 14,000 people who are evading taxes. However the situation is not that simply as many of these tax evaders are due money from the Greek government and approximately €30 billion is currently tied up in ongoing court cases.

Commission proposes additional economic governance legislation as the "Six Pack" is published in the Official Journal

The 23 November was the same day that the recently adopted "six pack" on economic governance was published in the Official Journal of the EU and that Commission President Barroso proposed two new EU Regulations on economic governance, the key messages for the 2012 Annual Growth Survey and a Green Paper on eurobonds. In the words of the Commissioner, these proposals are with a view to "...deeper integration for the euro area".

The first proposal for a Regulation is on strengthening surveillance of budgetary policies in the euro area. This would essentially give the Commission more power over the national budgets of member states as it would give it the right to assess these budgets on an annual basis. In the event that the Commission finds the budget to be non-compliant with the Stability and Growth Pact, which was the basis of the agreement on the European Monetary Union in 1997, the Commission could request revision of the budget. These Commission powers would be further enhanced for countries with excessive deficits which at the moment includes the majority of the seventeen eurozone states.

The second proposed Regulation is on strengthening economic and fiscal surveillance of euro area countries. This proposed regulation would give the Commission power to decide whether a member state is experiencing severe difficulties and if so, this would enable them to implement a system of enhanced surveillance. The Council, made up of the representatives of the Member States, would have the power to recommend that the concerned Member State seek financial assistance.

Commission publishes highly anticipated policy paper on eurobonds

On 23 November the European Commission published a Green Paper which outlined its policy position on the introduction of eurobonds. This is the first official step and as it is just a policy orientation paper, it is open to debate and will have to be formulated into a legislative proposal.

This debate is due to last for several months or even years. There are three options outlined for the eurobonds, or 'stability bonds' as the Commission is now calling them.

The first option would be a complete substitution of national bonds for eurobonds. This option would require a change to the Lisbon Treaty as it is specified therein that EU member states are responsible for their own debt. Changing the treaty, even by simplified procedure, is extremely sensitive and time consuming and could take several years to happen. Currently the EU president Herman Van Rompuy is drafting possible treaty changes which will be discussed by EU heads of state in March 2012. Additionally, it was announced on 24 November that France and Germany are also drafting treaty changes which are likely to be discussed in the upcoming meetings.

The second option is to partially mix national debt with eurobonds and to have joint guarantees. Like with the first option, this would also require a treaty change. A possible flaw to this option is that it could lead to default by heavily indebted states because of the burdensome nature of the guarantees and the need for payments to be maintained on both types of bonds.

The third option would be for eurobonds to partially finance a country's debt but for guarantees to be held separately by the member states. This would avoid the situation whereby states would guarantee each other's debt, thus avoiding the necessity for a treaty change. While this is the quickest option to implement, it is the least useful for the most indebted states as it would do little to tackle their high interest rates.

Eurobonds are highly politically sensitive and are firmly opposed to by Germany and the other AAA rated EU member states. However there is wide support by Luxembourg, Italy, Belgium, all major political groups in the European Parliament and in academic circles.

Commission publishes 2012 Annual Growth Survey in advance of expected publication date

On 23 November the Commission published the 2012 Annual Growth Survey which was two months in advance of schedule. This is not legislative and outlines the economic and budgetary priorities for the coming year. The Member States were asked to improve their economic reforms and key focus was placed on fiscal consolidation, bank lending, structural reforms, unemployment and the public sector. This is the first time that taxation is of specific focus and this is likely to be as a concession to Germany which is strongly opposed to eurobonds.

These recommendations will feed into the next stage of the European Semester which involves country specific recommendations concerning fiscal policy and the labour markets. These documents only constitute recommendations and do not have to be enforced by the Member States.

Disagreements between EU member states persist as further economic governance is considered

Following the publication of further proposed legislation on EU economic governance and continuing market turmoil in the eurozone, the EU Member States are to extend their scheduled summit on 9 December from one day to two days. It is also expected that the eurozone heads of state will have a separate meeting in the wings of this European Council summit.

The policy agreements from 27 October are expected to be discussed and further to this, there have been divergent positions on the extent to which the ECB should continue to intervene in the bond markets. This issue is particularly sensitive given the heavy debt burdens currently experienced by Spain and Italy. Germany and the ECB are adamantly opposed to continued intervention while France is calling for the ECB's continued purchase of these sovereign bonds. It has been argued that large purchases of bonds by the ECB could have the effect of 'quantitative easing' which is a practice often used by the central banks in the UK and the USA.

This political divide was summarised by the Estonian president this month when he blamed the eurozone members for the current crisis. Estonia is the newest member state to join the euro and is one of the only eurozone nations within the 3% deficit limit.

Changes to the eurozone bailout fund still under discussion

On 27 October the eurozone heads of state agreed to reinforce the European Financial Stability Fund (EFSF) by increasing it to €1 trillion. Further to this, it was decided that the operations of the bailout would be increased to include buying up sovereign bonds and setting up Special Purpose Vehicles (SPVs) which would finance operations and isolate financial risk. Following affirmative policy decisions to take these actions, Commission and national government staff have been working to put the technical details together. In a meeting of eurozone finance ministers on 7 November, it was announced that the details will take several more weeks to sort out.

Turbulent month economically and politically for Italy

Amid continued turbulence economically and politically, former Italian Prime Minister Silvio Berlusconi resigned on 12 November and his role was taken over by former European Commissioner for the Internal Market, Mario Monti. Despite this change and Monti's adamant stance that austerity would be implemented and Italy would stabilise its economy, on 15 November Italian bonds breached the 7% interest mark, a point at which Portugal, Greece and Ireland have previously been forced to receive bail outs. Uncertainty still prevails because of the general economic slowdown of the country's economy. Italy has the second highest debt mountain in the EU after Greece and its banks are largely exposed to the debt markets across Europe.

Spain's borrowing costs soar as ruling national government changes

On 17 November the cost of Spain's 10 year bonds came perilously close to 7%. As it currently stands, the costs of borrowing for Spain have soared above those of Greece. The high bond yields were largely based on persisting uncertainty regarding the continued economic woes of Spain and anticipation about the general election which took place on 20 November. In this election the main right wing opposite party (PP) won with 44% of the total vote. This effectively ousted the ruling left-wing party (PSOE) which had been in power since 2004.

Second review mission to Portugal a success but economic worries persist

Following the adoption of a draconian 2012 budget at first reading in the Portuguese parliament on 11 November, the second review mission of the troika (European Commission, ECB and IMF) found that Portugal was on track and the next tranche of aid to the value of €8 billion was granted on 16 November. However, on 21 November the Portuguese Finance Minister, Victor Gaspar, announced that the recession in Portugal was expected to worsen in 2012 because of a greater than expected decrease in GDP.

ECB lowers interest rate in an attempt to ease economic pressure

On 3 November the ECB lowered its interest rate by 25 basis points to 1.25% due to faltering economic growth. Further to this, both the lending and deposit rates were lowered by 25 basis points to 2% and 0.5% respectively. While this temporarily sent stock markets soaring, it was not sufficient to shield off further speculation and uncertainty in the following weeks.

EU Financial Markets Regulation

Credit Rating Agencies: Commission proposes far reaching new rules

On 15 November, the European Commission published a legislative proposal that will further regulate credit rating agencies. The Commission aims to "reduce over-reliance on ratings" and "improve the quality of the rating process". European Commissioner Barnier also wants to see more competition in the sector.

- Financial institutions will be required to do their own due diligence and make their own credit risk assessments.
- CRAs need to disclose more information underlying their ratings and consult issuers and investors on any changes to their rating methodologies.

- As regards sovereign debt, Member States will be rated more frequently (every 6 months) and sovereign ratings can only be published when markets are closed.
- Issuers will have to rotate their CRA every 3 years and for complex products multiple ratings will be required.

The proposal will now go to the European Parliament and to the Council of Ministers for political negotiations. These are likely to last well into 2012.

OTC derivatives and markets infrastructure: negotiations still ongoing

Informal negotiations between the Council (represented by the Polish Presidency), the MEPs and the European Commission on 'EMIR' (the upcoming European Markets Infrastructure Regulation) continue.

The final outcome is still at least a few months off. Especially treatment of third countries proves difficult, with EU Member States disagreeing between themselves and with the European Parliament. The Commission will now come forward with a new, targeted proposal for dealing with third countries. As mentioned, the rules are unlikely to be ready before January. This jeopardises the G20 deadline for enforcement of the new regime by the end of 2012.

European Parliament and Council commence work on MiFID review

Much of the political negotiations on the Commission's MiFID proposals will last well into 2012 and possibly beyond, but Parliament and Council have commenced their treatment of the proposals. First meetings of the working group of civil servants of the Member State treasuries have been held, though no positions on any of the sensitive issues have been taken yet. Parliament 'Rapporteur' Markus Ferber has issued a questionnaire to all stakeholders to inform his work. He intends to publish a working document in the coming weeks and the Parliament's Economic Committee will hold first public hearing on 5 December.

As mentioned before, 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 will under the Commission's text 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.

- COMING UP -

- **30 November 2011:** Meeting of EU Finance Ministers
- **December 2011:** European Commission legislative proposal on **crisis management and bank resolution**
- **December 2011:** European Commission proposal for a **Central Securities Depositories Regulation**
- **8 - 9 December 2011:** European Council - Summit of EU leaders and possible Eurozone summit
- **January/February 2012:** European Commission proposal for a reviewed **Securities Law Directive**
- **March 2012:** Expected proposals for EU Treaty changes

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