REPORTER

ECEFIL
European Center of Economic and Financial Law
ΕΥΡΩΠΑΪΚΟ ΚΕΝΤΡΟ ΟΙΚΟΝΟΜΙΚΟΥ ΚΑΙ ΧΡΗΜΑΤΟΟΙΚΟΝΟΜΙΚΟΥ ΔΙΚΑΙΟΥ

## Editorial

The euro area institutions have been running behind the markets - and democratically elected Parliaments and Governments have been held at hostage. The precautionary approach embodied in the EFSF following the July 21 Euro summit and the decision to leverage its resources reached at the October 26/27 summit were rightly perceived by the press as representing too little and coming too late to deal with the sovereign debt problem. In December, the ECB stepped in to help the Italian government refinance its debt by extending an unprecedented amount of approximately 500 billion euros, in the form of 3 year loans carrying a 1% interest rate, to encourage banks to purchase Italian government bonds.

For how long, however, will the limited "firepower" of the EFSF be compensated by ECB intervention? A downgrading of France from its triple A rating will soon be followed by the downgrading of the EFSF which will then be unable to perform its task as financial intermediary. In such a case the euro area members, including Germany for that matter, may decide to break up with the Maastricht heritage and accept treaty amendments allowing the ECB to perform the duty of a lender of last resort and/or some form of "mutualisation" of the debt of euro area members. The price to pay for such reforms - and concessions on behalf of Germany - is the strengthening of fiscal discipline; the recent adoption of the package of six proposals on economic governance and the forthcoming adoption of a fiscal stability pact provide adequate evidence to this effect.

## Dealing with bail-outs: Moral hazard versus risk of contagion

The moral hazard argument is central in dealing with bail-outs; bearing in mind moral hazard the G-10 Rey Commission report argued in 1996 that "neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large-scale official financing in the event of crisis". The no bail-out provisions in the Treaty on the Functioning of the EU aim at deterring euro area members and their creditors from irresponsible behaviour. Private sector involvement (PSI) in bail-outs aims at deterring and punishing the same creditors, although the idea of punishment, central in the moral hazard argument may not always be applicable. Thus for example, from the beginning of the crisis, Greek banks with impeccable international credentials were pressured to purchase governments' bonds.

The decisions regarding the second Greek bail-out may have been declared "unique and exceptional" at the Euro summit or 8/9 December 2011 but the success or failure of private sector involvement (PSI) embodied in these decisions may lead to a reconsideration of the whole idea and its grounding in the ESM Treaty. Nevertheless, in the ESM context, PSI is based on the premise that the bonds issued by the member State seeking ESM assistance embody Collective Action Clauses (CACs), allowing majority decision-making and binding decisions on haircuts whereas, in the context of the Greek bail-out, the exchange offer could be made compulsory for dissident bondholders only by legislation; although such legislation could receive the "sanction" of the IMF and the governments of the euro area, it would constitute an event of default triggering the relevant credit default swaps.

Arguably, any bail-out mechanism creates moral hazard. Nevertheless, the counter-argument regarding the risk of contagion has weighed heavily in the shaping of public policy. A prime example is that of the recapitalization of banks which have invested in government bonds; if these banks are systemically important they will not be punished for their irresponsible behaviour, in order to avoid contagion. A related argument is about the contagion effect that would result if a euro area member was allowed to fail. Should it be allowed or even encouraged to leave the euro area? The current policy dilemmas raise existential questions for the euro area and, potentially, for the international community as a whole.

Professor Constantine Stephanou

# The recent "six-pack" on the European Economic Union

In November 2011, six (6) sources of secondary European law were adopted with regard to a comprehensive reinforcement of economic governance in the EU and the euro area. This legislative package contains:

- three Regulations and one Council Directive dealing with fiscal issues, including a wide-ranging reform of the Stability and Growth Pact (see below under (a) – (d), and
- two Regulations aiming at effectively preventing and correcting emerging macroeconomic imbalances within the EU and the euro area (under (e) – (f)).

(a) According to the provisions of the Regulation amending the legislative underpinning of the preventive part of the Stability and Growth Pact (amendment of Council Regulation 1466/97), EU member-states will have to adopt prudent fiscal policies in 'good times' (i.e., during economic growth) in order to build up the necessary buffer for 'bad times' (i.e., during a recession). The monitoring of public finances will be based on the new concept of 'prudent fiscal policy-making', which should ensure convergence towards the 'medium-term objective'.

(b) According to the provisions of the Regulation amending the legislative underpinning of the corrective part of the Stability and Growth Pact (amendment of Council Regulation 1467/97), debt developments will be followed more closely and put on an equal footing with deficit developments as regards decisions linked to the excessive deficit procedure (article 126 TFEU). Accordingly, the decision to open an excessive deficit procedure will be based on a wider range of criteria. Member-states will be benchmarked as to whether they can sufficiently reduce their debt. Those whose debt exceeds 60% of their GDP should take steps to reduce it at a satisfactory pace, defined as a reduction of 1/20th of the difference with the 60% threshold over the last three (3) years.

(c) The abovementioned modifications of the SGP are backed up, through the provisions of the Regulation on the effective enforcement of budgetary surveillance in the euro area, by a new set of gradual financial sanctions for euro area member-states. In particular:

- as to the preventive part, an interest-bearing deposit should be the consequence of significant deviations from 'prudent fiscal policy making';

- as to the corrective part, a non-interest bearing deposit, amounting to 0.2% of GDP, should apply upon a decision to place a member-state in excessive deficit; this would be converted into a fine in the event of non-compliance with the recommendation to correct the excessive deficit.

*Accordingly, the SGP will become more 'ruled-based' and sanctions will be the normal consequence for euro area member-states breaching their commitments.*

To ensure enforcement, a 'reverse voting mechanism' is envisaged when imposing these sanctions. Accordingly, the Commission's proposal for a sanction will be considered adopted, unless the Council overturns it by qualified majority.

(d) According to the Directive on requirements for the budgetary frameworks of the member-states, minimum requirements must be followed by member-states in order to ensure that these frameworks should be strengthened and be fully aligned with the new European economic governance rules.

(e) The Regulation on the prevention and correction of macroeconomic imbalances introduces a new element of the EU's 'economic surveillance framework': the 'excessive imbalance procedure' (hereinafter the "EIP"). This procedure comprises a regular assessment of the risks of imbalances in a member-state based on a 'scoreboard' composed of economic indicators. According to the provisions of this Regulation:

- once an alert has been triggered for a member-state, the Commission will launch a country-specific, in-depth review in order to identify the underlying problems and submit recommendations to the Council on how to deal with the imbalances;
- for member-states with severe imbalances or imbalances that put at risk the functioning of the EMU, the Council may open the EIP and place the member-state in an 'excessive imbalances position';
- a member-state under EIP would have to present a 'corrective action plan' to the Council, which will set deadlines for corrective action;
- repeated failure to take corrective action will expose the euro area member-state concerned to sanctions.

(f) Finally, according to the Regulation on enforcement measures to correct excessive macroeconomic imbalances in the euro area, if a euro area member-state repeatedly fails to act on Council EIP recommendations to address excessive imbalances, it will have to pay, according to the provisions of this Regulation, a yearly fine equal to 0.1% of its GDP. The fine can only be stopped by a qualified majority vote, with only euro area member-states having the right to vote.

Professor Christos Gortsos

# A first Assessment of the Excessive Deficit Procedure

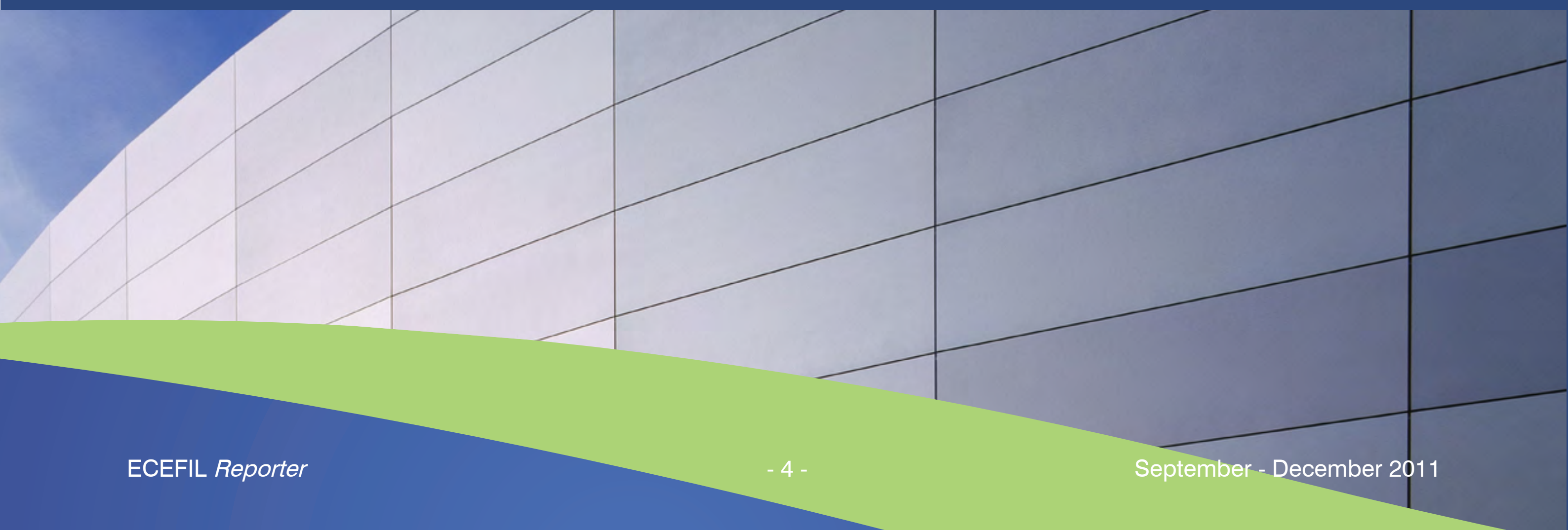
The current crisis faced, not only at national (Greek) level, but also at EU level shows that a reinforced commitment among member States to restore and reinforce public debt sustainability need to be made. The appropriate solution lies in the proper combination of budgetary consolidation and growth-enhancing structural reforms. The European Semester provided a first EU economic governance framework while the new “six-pack” legislation (mentioned in Professor Gortsos article), which entered into force on 13 December 2011, strengthened the preventive arm of the Stability and Growth pact (SGP) –the procedure to promote surveillance and coordination of economic policies and ensure that excessive deficits are avoided– and the corrective arm of the SGP – the Excessive Deficit Procedure (EDP), which includes financial disincentives and fines or sanctions for non-compliant euro-area member States, and suspension of Cohesion Fund commitments for EU member states that are not part of the euro area.

According to the Commission services’ 2011 Autumn Forecast, published on 10.11.2011, 23 out of the 27 member States are subject to an EDP – except Estonia, Finland, Luxemburg and Sweden. Moreover five out of the 23 member States –Greece, Ireland, Portugal, Romania and Latvia– are benefiting from a financial assistance programme. For Latvia the Balance of Payment programme expired on the 20th of January 2012. The assessment programme showed that the majority of countries adopted Council recommendations, under Article 126 (7) of the Treaty for the Functioning of the European Union, for the correction of their excessive government deficits, but for Belgium, Cyprus, Hungary, Malta and Poland the assessment indicated that a timely and sustainable correction of their excessive deficit was clearly at risk, as the deadline for correction was imminent or close, that is 2011 or 2012.

In response to the assessment and the imminent entry into force of the “six-pack”, Vice-President Olli Rhen addressed letters, 11.11.11, to the Member States concerned to treat as a matter of urgency the adoption of a 2012 budget taking into consideration any additional measures so as to ensure a timely and sustainable correction of their excessive deficit. In order to avoid the imposition of sanctions, the aforementioned member States, adopted or announced additional measures, which in most cases –for Belgium, Cyprus, Malta and Poland– were considered sufficient enough. However, in the case of Hungary, the Commission recommended on 11.1.2012 to the Council to activate the EDP, and adopt a Council Decision under Article 126 (8) of the Treaty establishing that no effective action has been taken in order to bring an end to the situation of an excessive government deficit, and in a later stage if no measures have been adopted the Commission may, in consistency with Council Regulation (EC) No 1084/2006, consider issuing a proposal to the Council on the suspension of Cohesion fund commitments to Hungary.

The next assessment of the Commission is expected to be published in May 2012. Until then, the Commission will keep monitoring the budgetary implementation of all member States currently in the EDP. Thus, the following months are considered crucial for the success of the first EU attempt to coordinate and monitor national budgetary policies in order to enhance European economic integration.

Dr. Sophia Ziakou



# The birth of the intergovernmental treaty on fiscal discipline

The sovereign debt crisis has undermined confidence in the single European currency. After setting-up bail-out mechanisms the euro area members have decided, under German guidance, to adopt far-reaching reforms aimed at boosting fiscal discipline. These reforms bring the euro area very close to a fiscal union, although they leave aside the issue of the euro bond. The proposed treaty, currently being drafted among the Member States, aims especially at those of the euro area. Some of its provisions correspond to the recently revised legislation on the Stability and Growth Pact (see preceding article by Professor Gortsos). Thus, for example, the required speed in the revised draft treaty for reducing government debt (by a twentieth a year of the portion of the debt exceeding 60% of GDP) is exactly the same as the speed required under the revised pact, which came into force last month. On the other hand, the provision on “automatic” fines for fiscal deficits exceeding 3% of GDP go beyond the pact and the corresponding provision of the TFEU.

The nature of the treaty remains fuzzy. Analysts, commenting on the first drafts, pointed out that the treaty will not be part of the Community *acquis* and will necessarily deviate from the Community method. The big question mark relates to the enforcement mechanisms and in particular the role of the European Commission and that of the European Court of Justice. The legal basis of its involvement is found in the article 273 of the Treaty on the Functioning of the European Union (TFEU). In a revised draft it was provided that only countries that have signed up to the deal may take other member States to the European Court of Justice for failing to properly introduce the golden rule on deficits in their primary legislation. Countries wishing to institute infringement proceedings would be required to ask the European Commission to draw up a report on the country in question and if the report confirmed their view, then proceedings would automatically be instituted against this country before the Court of Justice. In the most recent draft, it is provided that a contracting party may irrespective of the European Commission’s report bring the matter to the ECJ, if it believes that another contracting party has failed to comply with the treaty rules. Other issues requiring clarification include the attendance of non-euro area countries at euro area summits and the possibility of attendance at the same summits of the President of the European Parliament; the most recent draft provides that the EP President may be asked to join. As far as the ratification process is concerned, the new treaty will enter into force when a minimum number of Member States of the euro area (originally fixed at nine and subsequently at twelve) ratify it. The new treaty is expected to enter into force on 1 January 2013 and provides for a 5-year transitional period for its incorporation into the EU legal order.

Dr. Marina Stefou

## AIFM rules: a European compromise to be fleshed out with implementing measures

The Alternative Investment Fund Managers Directive (AIFMD), which entered into force on 21 July 2011, creates a 'harmonised and stringent' regulatory and supervisory framework for the 'shadow banking' industry.

It introduces a common set of rules in terms of licensing and supervision for nearly all non-UCITS funds, spanning sectors as disparate as hedge funds, private equity, real estate, venture capital and other non-regulated collective investments. Passports giving marketing rights throughout the EU will be made available to EU AIFMs from 2013, whereas non-EU domiciled managers and funds will be able to receive such passports from 2015. A dual marketing system will be in place until 2018 whereby existing national private placement regimes for non-EU funds will apply alongside the EU passporting regime.

The initial draft was radically altered since the rushed submission of overly severe rules in the immediate aftermath of the 2008 financial crisis. AIFMD aims at financial stability and investor protection and includes detailed provisions on authorisation, conduct of business, risk management, conflicts of interest, liquidity, valuation, and manager remuneration.

The main AIFM obligations having been set out in the Directive, the finer points are being hammered out as part of the Level 2 exercise currently underway. Following consultation with stakeholders, ESMA delivered its final guidance to the European Commission on 16 November 2011. The 500-page text addresses issues such as thresholds determining who is an AIFM, criteria for assessing whether the prudential regulation and supervision applicable to third-country depositaries have the same effect as AIFMD provisions, but also proposes a definition and calculation methodologies for leverage and clarifies the highly controversial issue of depositary liability for losses incurred. It is now for the Commission to prepare the implementing measures on the basis of this advice.

Lagaria Katerina, Ph.D Candidate

## EU and Euro Area Representation in the IMF: A non-issue?

The new provisions of article 138 TFEU differ considerably from the previous provision of article 111(4) TEC. The new par. 1 refers to the adoption of "common positions on matters of particular interest for economic and monetary union" rather than "the position of the Community" on these matters. Paragraph 2 refers to the adoption of "appropriate measures to ensure a unified representation in international financial institutions and conferences". The aforementioned framework takes into account the fact that the EC, and now the EU, lacks core competences on matters dealt with by the IMF: EU member States have retained their competence in the field of economic and fiscal policy, while euro area members have transferred their competence in the field of monetary policy to the ECB. Clearly, under the new provisions euro area members, including those participating in the IMF Executive Board, may be bound by common positions reached by qualified majority decisions of the Council; on the other hand, they have to accept a "unified representation" reflecting the allocation of competences between themselves and the ECB. Nevertheless, the Commission's efforts in this direction have failed and previous *ad hoc* arrangements on the coordination among EU members remain in force.

The implications of the failure to ensure a "unified representation" should not be overstated. EU influence on IMF decision-making has varied. Common positions played a key role in the IMF bail-outs of Hungary, Latvia and Estonia, which were non-members of the euro area. On the other hand, Germany and France played a key role in organizing the first Greek bail-out which involved 80 billion of pooled bilateral loan facilities by euro area members and a 30 billion euro loan facility by the IMF which was out of proportion with previous loans. The EU, by means of the EFSM, and the euro area, by means of the EFSF, provided most of the financing in the Irish and Portuguese bail-outs. Nevertheless, Germany and France, as major contributors to these mechanisms and to the IMF, as well as the UK which contributed additional financing to Ireland, played a key role in the decisions regarding the involvement of the IMF. The fact that these decisions were influenced by the larger EU / Euro Area members made the corresponding bodies largely irrelevant in the IMF decision-making process – and, arguably, less urgent the upgrading of their presence in the IMF.

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