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EU Agrees Stability Mechanism and Fiscal Compact

On February 2, 2012, the eurozone Member States signed the treaty establishing the European Stability Mechanism (the "ESM"),[1] and on January 30, 2012, participating Member States agreed on the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, better known as the "fiscal compact."[2] This memorandum provides an overview of the ESM and the fiscal compact, as well as related emergency measures taken by European Union ("EU") institutions and Member States in response to the eurozone's sovereign debt crisis, (i) the bundle of five regulations and a directive commonly referred to as the "Six Pack" and (ii) the European Financial Stabilization Mechanism (the "EFSM") and the European Financial Stability Facility (the "EFSF").

I. The European Stability Mechanism

The ESM aims to safeguard financial stability in the eurozone by providing assistance to eligible Member States experiencing or threatened with severe financing problems. The ESM will be an international financial institution based in Luxembourg with an initial maximum effective lending capacity of €500 billon and €700 billion of subscribed capital (€80 billion in paid-in shares and €620 billion in callable shares).

The eurozone Member States' financial contribution will be based on the European Central Bank's ("ECB's") capital contribution key. Member States joining the eurozone will automatically become members of the ESM. The ECB and national central banks will be permitted to lend directly to the ESM to add to the available funds. The mechanism is intended to replace the EFSF and EFSM, although these facilities may be maintained to increase overall lending capacity.

Because the ESM is arguably inconsistent with the "no-bailout clause" in the Treaty on the Functioning of the European Union ("TFEU"), Article 125(1) TFEU, its

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[1] A previous version of the treaty was agreed on October 26, 2010, and signed on July 11, 2011. The revised and newly signed treaty has been modified to incorporate decisions taken by the heads of state and government of the eurozone on July 21 and December 9, 2011, aimed at improving the effectiveness of the mechanism. The treaty is available at: http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf.

[2] The treaty is available at: http://www.european-council.europa.eu/media/579087/treaty.pdf.

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adoption requires a Treaty amendment. Thus, Decision 2011/199/EU adds the following paragraph to Article 136 TFEU:

> *"The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."*[3]

The ESM can only become operational once Member States have ratified this amendment, as well as the ESM treaty, according to their national constitutional requirements, which may include referenda. Ratification is expected to occur no later than January 1, 2013, but preferably before July 2012.

The ESM will be able to use a wide range of instruments to provide financial assistance to Member States, including precautionary credit lines and loans to Member States to recapitalize financial institutions. The ESM will also be permitted to purchase sovereign bonds directly from issuing Member States and is therefore not restricted, as is the ECB, to interventions on secondary debt markets.[4]

The most important decisions under the ESM will be taken by its board of governors – composed of Member States' finance ministers – by unanimous agreement. The ESM treaty provides for an emergency procedure whereby a decision to grant financial assistance can be taken by qualified majority of 85% of votes cast. This procedure can be used where the European Commission (the "Commission") and the ECB both conclude that a failure to urgently adopt a decision to grant or implement financial assistance would threaten the economic and financial sustainability of the eurozone.

The ESM's operating policies are similar to those of the EFSF (discussed below). The procedure for obtaining ESM support begins with a request from a Member State. A memorandum of understanding ("MoU") will be negotiated following a Commission analysis of the country's finances. This MoU will impose detailed economic policy measures to be implemented by the Member State. The monitoring of a State's

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[3] The Decision was taken according to the so-called simplified treaty revision procedure under Article 48 (6) TEU. The decision is available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:091:0001:0002:EN:PDF.

[4] The ECB's limitation stems from Article 123 (1) TFEU, which prohibits "*the purchase directly from [Member States] by the European Central Bank (…) of debt instruments*" to prevent the ECB from financing of Member States' budget deficits. Pursuant to Article 18 (1) of the ECB's Statute, however, the ECB may "*operate by buying and selling Member States' debt instruments in the financial markets*" (*i.e.*, on the secondary markets, not directly from the issuing Member State).

compliance with the policy conditions – a prerequisite for continued access to ESM funds – will be conducted primarily by the Commission, together with the ECB. The ESM will cooperate closely with the International Monetary Fund ("IMF") in executing financial support measures. In addition, the ESM requires inclusion of so-called collective action clauses in all new eurozone government securities with maturity above one year. If needed, these clauses would facilitate agreement with private bondholders on haircuts potentially required in future sovereign debt restructurings.

II. The Fiscal Compact

The fiscal compact agreed on January 30, 2012, is currently being finalized and is scheduled to be signed in March 2012. It will enter into force following ratification by at least twelve eurozone Member States. It is also open to EU Member States that are currently not members of the eurozone. Except for the UK and the Czech Republic, all Member States have stated their intention to sign and ratify the compact.

The compact will impose more stringent EU-level oversight of government spending and heightened coordination of Member States' budgets. The core provisions of the fiscal compact include:

- Primary national deficits (excluding the cost of debt financing) must not exceed 0.5% of GDP of the participating Member States. This is commonly referred to as the "Golden Rule". Governments may only ignore budget deficit limits in the case of "*exceptional circumstances*", defined as "*unusual event*" or "*severe economic downturn*".

- This rule must be anchored in participating Member States' national legal systems, preferably at constitutional or equivalent level.

- Decisions to place a country into the excessive deficit procedure provided for by the Six Pack (as discussed below) and to impose sanctions will be subject to reverse qualified majority voting.

- In case of breach of deficit ceilings, the compact foresees referral to the Court of Justice of the European Union ("CJEU"), including the possibility of financial sanctions of up to 0.1% of the Member State's GDP. Any financial sanctions imposed would be paid to the ESM.

- Only Member States that have ratified the fiscal compact will be eligible for assistance under the ESM.

Many of the compact's most notable elements have already been implemented as part of the "Six Pack," which is discussed below. The fiscal compact goes beyond the

Six Pack in some respects, however, in particular by introducing the Golden Rule cap on primary national deficits, conditioning ESM access on compact membership, and earmarking any fines imposed under the compact for the ESM.

III. Six Pack

On December 13, 2011, several new EU law instruments aimed at reforming the Stability and Growth Pact ("SGP") entered into force.[5] These new measures, the so-called "Six Pack," consist of five regulations and one directive.[6]

The SGP, which was agreed in 1997, provided that Member States would maintain an annual budget deficit not surpassing 3% of GDP and a national debt ratio of below 60% of GDP. The adoption of the SGP was driven by Germany, which wanted to ensure low inflation after the establishment of the Economic and Monetary Union.[7] The SGP lacked effective enforcement mechanisms and was repeatedly violated, including by Germany. While 23 out of 27 Member States have been in the so-called excessive deficit procedure for years, no fines or other sanctions have been imposed.

The Six Pack significantly revises the rules on EU-level oversight of eurozone Member States' budgets, in particular by improving the SGP's enforcement regime:

- Under the new rules, the Commission and the Council can now adopt preventive recommendations that stipulate, before budget deficits and macro-economic imbalances become too large, how a Member State should best consolidate its public finances. These recommendations can be made binding and entitle the EU institutions to impose detailed economic policy measures on a Member State whose budget deficit is to be curtailed. The Commission equally benefits from more power to ask for budget information from Member States and can conduct spot checks at national level.

- The SGP's enforcement regime is improved by the introduction of a two-step approach. If a Member State fails to comply with an EU-sanctioned corrective action to address excessive public deficits, an interest-bearing deposit can be imposed. After a second compliance failure, this interest-

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[5] More detailed information available at: http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/898.

[6] The legislative package is available at: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm.

[7] The euro had already been introduced as an accounting currency in 1999 and was preceded by fixed currency exchange rates of Member States participating in the European Currency Unit (ECU) system.

bearing deposit is converted into a fine of up to 0.1% of a Member State's GDP. Importantly, fines are automatic unless a qualified majority of Member States votes against. Previously, a fine could only be imposed if a qualified majority voted in favor.

- The SGP is also bolstered by the introduction of a new fine of up to 0.2% of GDP for fraudulent statistics on deficit and debt, a response to past inaccurate bookkeeping.

The Commission can refer Member States to the CJEU in case of failure to comply with one of its economic policy decisions taken pursuant to any of the Six Pack's instruments, including those on fining.

IV. The EFSM and EFSF

In May 2010, the Council adopted Regulation 407/2010 establishing the € 60 billion EFSM[8] and the eurozone Member States established the EFSF to make available an additional €440 billion crisis fund.[9] The EFSM regulation is based on Article 122 (2) TFEU, which provides that the Council may grant financial assistance where "*a Member State is in difficulties or is seriously threatened with severe difficulties caused by (…) exceptional occurrences beyond its control*". Since Article 122(2) provides only for direct financial assistance by EU institutions, the EFSF was established by intergovernmental agreement among the eurozone Member States to provide for assistance directly by Member States.[10]

1. The EFSM

The regulation establishing the EFSM empowers the Commission to borrow up to € 60 billion under an implicit EU budget guarantee to be on-lent to Member States experiencing, or seriously threatened with, severe financial disturbance where the financial disturbance or threat of financial disturbance is due to events beyond the control of the Member State concerned. The decision to grant financial assistance rests with the Council, acting by qualified majority on a proposal from the Commission.

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[8] Council Regulation (EU) No 407/2010 of May 11, 2010, establishing a European financial stabilization mechanism. Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:118:0001:0001:EN:PDF.

[9] The EFSF's website is available at: http://www.efsf.europa.eu/about/index.htm.

[10] The Framework Agreement is available at: http://www.efsf.europa.eu/attachments/20111019_efsf_framework_agreement_en.pdf.

2. The EFSF

The EFSF is a Luxembourg-registered limited liability company.[11] While the EFSF was originally intended as a temporary measure until creation of the ESM, it is currently contemplated to maintain the EFSF in parallel to the ESM to boost overall available EU lending capacity.

Similar to the EFSM, the EFSF provides economic assistance to financially distressed Member States, in particular by supporting eurozone Member State governments' ability to access debt markets at sustainable funding costs. For this purpose, the EFSF borrows funds on capital markets backed by eurozone countries' guarantees and provides the proceeds to Member States that otherwise could not borrow at sustainable interest rates.

The EFSF may:

- Issue bonds or other debt instruments to raise the funds needed to provide loans to countries in financial difficulties;
- Intervene in the sovereign debt primary and secondary markets; and
- Finance recapitalizations of financial institutions through loans to governments, including in non-program countries.

The EFSF's lending capacity is deemed by many to be too small. Despite its nominal lending capacity of €440 billion, the EFSF has an effective lending capacity of less than € 250 billion, because the credit enhancement structure includes an overguarantee of up to 165% to ensure the EFSF's best possible credit rating. Measures proposed to bolster the EFSF's funds available for lending include increasing guarantee contributions from eurozone Member States from € 780 billion up to € 1 trillion and enhancing the effectiveness of funds backed by Member States rated *AA+* or less.

3. Policy Conditions under the EFSM and the EFSF

To commence an EFSM or EFSF lending program, a Member State must submit a support request to the EFSM/ EFSF. A country program is then negotiated with the Commission and the Council. Once the program has been approved by eurozone finance ministers, a MoU between the EFSM/ EFSF, represented by the Commission, and the Member State in question is signed. Similar to IMF assistance, all but the first loan

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[11] The Articles of Incorporation are available at: http://www.efsf.europa.eu/attachments/efsf_articles_of_incorporation_en.pdf.

installments under EFSM and EFSF programs are contingent on continued compliance with the MoU's binding policy conditions.

Past MoUs for Ireland, Portugal, and Greece have imposed a quarter-by-quarter plan for deficit reducing measures intended to restore long-term economic stability in the Member State concerned. The measures address both high level policy considerations, as well as detailed sector specific reform conditions upon which loan disbursement will depend. Such conditions typically comprise (i) overall fiscal adjustment ratios, (ii) specific savings obligations in areas of major government expenditure, such as social security spending, and (iii) measures for overhauling key sectors of the economy, typically including financial and public services.[12] For instance, the MoU negotiated with Ireland required an increase of at least €1.4 billion in annual State revenues for 2011, accompanied by expenditure reductions of at least €2 billion.

The Commission, in collaboration with the ECB, examines compliance with these conditions on a regularly basis, which may lead to adjustments of the relevant Member State's program.

4. Current Assistance Programs

Currently, the EFSM and the EFSF have assistance programs in place with the following Member States:

- **Ireland** was granted a € 17.7 billion loan from the EFSF in addition to bilateral loans from non-eurozone Member States (the United Kingdom (€3.8 billion), Denmark (€0.4 billion), and Sweden (€0.6 billion)), as well as the EFSM (€22.5 billion) and the IMF (€22.5 billion).

- The financial assistance package offered to **Portugal** is valued at up to €78 billion, with equal €26 billion shares financed by the EFSM, the EFSF, and the IMF.

- With regard to **Greece**, a package of pooled bilateral loans from eurozone Member States initially amounting to €80 billion, to be disbursed between May 2010 and June 2013, was offered outside the EFSM and EFSF structures. The IMF provided additional financing of €30 billion under a stand-by arrangement.[13] On July 21, 2011, another three-year €109 billion

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[12] EFSF, "Frequently Asked Questions," C3-4. Available at: http://www.efsf.europa.eu/attachments/faq_en.pdf.

[13] An overview of disbursements made is available at: http://ec.europa.eu/economy_finance/eu_borrower/greek_loan_facility/index_en.htm.

package was agreed to be co-sponsored by the EFSF, eurozone Member States, and the IMF. This was enhanced up to €130 billion in October 2011. Disbursement of the package was approved on February 21, 2012.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel on our website at http://www.clearygottlieb.com.

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