HOUSE OF FINANCE
Goethe-Universität Frankfurt

POLICY PLATFORM | Policy Letter

Support Mechanisms Pose Fundamental Legal Questions

Helmut Siekmann
Institute for Monetary and Financial Stability

February 2012

The article will appear in the Frankfurt Main Finance Yearbook 2012

Support mechanisms pose fundamental legal questions

Helmut Siekmann

The crisis in the financial markets has led to a sovereign debt crisis. Public sector budget deficits in many countries have increased dramatically, as have their national debts. This was the result of the economic collapse and the methods used in handling it – in addition to extremely costly bank bail-outs. Several member states of the European Union ran into difficulties in assuming the loans needed. Eurozone member states ran the risk of insolvency. These developments were misleadingly termed the "euro crisis". Extensive countermeasures ensued.

Particularly precarious was the performance of Greece, whose government had not only provided false statistics at the time the euro was introduced, but, within a short space of time in the autumn of 2009, repeatedly had to revise its actual public sector deficit upwards. This lead to a drastic rise in interest rates. In some cases, funding in the capital markets was not possible at all, even though the capital markets and credit rating agencies had rated all the debt of countries in the European economic area as risk-free only a short time previously. They had possibly allowed themselves to sway to this erroneous assessment by legislation according to which these securities are to be rated like central bank money. European and national bank supervisory legislation is a particularly problematic area. It allows for capital requirements to be calculated by assigning an indiscriminate zero-risk weight to these securities, which means that in the financial statements they do not have to be backed by shareholder equity.

The temporary measures

On March 25, 2010, the heads of state of the eurozone member states initially declared themselves willing to support Greece with bilateral loans in addition to assistance from the International Monetary Fund (IMF). On April 23, 2010, Greece applied for the financial assistance offered by member states and the IMF. In its meeting of May 2, 2010, member states of the euro group approved loans of up to EUR 110 bn. Individual countries sought to provide a total of EUR 80 bn under strict lending terms, while the IMF was to take over a share of EUR 30 bn.

The general support program

On May 7, 2010, the heads of state of the euro group convened once more and agreed to a "euro rescue parachute" of a much broader European scope. The details were further developed by the ministers of finance and economic affairs on May 9, 2010, and consisted of two main components: The European Financial Stabilization Mechanism (EFSM), which provides EU funds, and the European Financial Stability Facility (EFSF), a special purpose vehicle meant to provide assistance to member states of the euro group. As a third component, loans from the IMF were added. The measures were limited to two years. In addition, the European Central Bank (ECB) became involved in this assistance program. The ECB board introduced a program aimed at the securities markets that authorizes national central banks to make secondary-market purchases of exchange-listed debt securities issued by central governments or public entities of member states. Debt securities issued by private legal entities, on the other hand, may be purchased in the primary market as well as in the secondary market, as long as they meet certain eligibility criteria. In addition to these measures there were two programs for purchasing covered bonds. The volume of the "rescue parachute" was set at EUR 750 bn. The distribution is as follows:

- Up to EUR 60 bn can be granted by the EU in the form of a loan or line of credit. (1)
- Up to EUR 440 bn can be made available to member states of the euro group via the EFSF. (2)
- Up to EUR 250 bn in support is to be contributed by the International Monetary Fund. (3)

(1) The act passed to introduce the EFSM authorizes the Commission to take out loans on behalf of the European Union. The act is expressly based on Art. 122 Section 2 TFEU, which allows for EU assistance in the event of natural disasters and other extraordinary emergencies beyond the control of the receiving country. Whether these conditions are actually present is not certain. By virtue of authorizing this borrowing, the highly controversial eurobonds have essentially already been created, just not as a direct obligation of the member states, but as an obligation of the EU. Not only member states of the eurozone would have to vouch for payment of these loans, but ultimately also those member states who have not (or not yet) introduced the euro.

2) The EFSF was incorporated on June 7, 2010, as a joint-stock company, the shares of which were transferred to the member states of the euro group on a pro-rata basis, corresponding to the capital shares each national central bank holds in the ECB. Further details are set forth in a framework agreement, in which the contractual partners committed to dissolve the company on June 30, 2013. This was meant to ensure that the EFSF is not an institution of the EU. It is nonetheless still not certain whether its incorporation is compatible with the provisions of European law. While it does serve the requirement of keeping the EU together, the assistance could still be in violation of a "no bail out"

clause in European Union primary law. An argument in favor of the latter contention is that the creators of the Maastricht Treaty intended for each state to bear the consequences of its own fiscal policies. If assistance can be expected as soon as the markets' own sanctioning mechanisms begin to kick in – higher interest rates, for instance – there would be little incentive to actually adhere to the required sound budgetary policy. The consequences might threaten the coherence of the monetary union, but also that of the EU as a whole. The example of the US, where there is a unified currency for an economic area that is hardly more homogenous than the eurozone, shows that the monetary union's continuation can only be ensured by strict refusal of general budgetary assistance when the states of the union experience financial distress. The legal concerns were taken so seriously that not even a year later the primary laws of the European Union were amended. The new Art. 136 Section 3 TFEU was created, which now allows for financial support – under very strict conditions – from member states whose currency is the euro. The important aspect to bear in mind is that this permission was not granted to the EU but to member states. Even if this clause can either be interpreted a mere clarification or as a constitutive regulation, it still limits the freedom of member states to provide assistance. Otherwise its narrow wording would not make sense. Bilateral assistance to Greece and the EFSF was determined to be compatible with German constitutional law by the German Federal Constitutional Court in its ruling of September 7, 2011, with certain reservations. The court made no pronouncement on compatibility with European Union law, although there would have been reasons for doing so. Above all, the court underscored observance of the budget autonomy of the German Bundestag. In very general terms, the court considers it to be impermissible for the parliament to transfer its "budgetary responsibility" by means of the "undefined budgetary policy authorizations of other agents". In particular, "nor is the law to give rise to mechanisms of a financial nature that […] could lead to unmanageable charges affecting the budget in a significant way in the absence of prior constitutive agreement, whether through expenditures or loss of revenues". Budgetary authorities have to make their decisions "free of external decisions on the part of the bodies of the EU and other member states of the European Union" and had to remain "masters of their own decisions". For this reason, no "permanent mechanisms of international law may be established that might in practice amount to liability for the free decisions of other nations." Yet the court demanded only individual authorization where measures of "great significance in the international or federal context are concerned". Insofar as "supranational agreements are made", which could be of "structural significance" to German budget laws, not only would each individual disposition require approval by the German Parliament, but the existence of adequate parliamentary influence over the manner in which available funds are treated would also have to be ensured. This requirement may only be met by means of a very precise and detailed control of how receiver states manage their budgets on the part of the Federal Republic of Germany, as the provider of financial assistance, including the involvement of the German Federal Court of Audit. This explains the current debate over control of the use of funds.

(3) The involvement of the International Monetary Fund in the support program gives rise to several legal questions. The fund was founded for the purpose of avoiding and rectifying imbalances in balance of payments accounts. However, that the financial support of member states of the eurozone is primarily aimed at correcting balance of payments divergences is by no means certain. Far more, it is the preservation of the solvency of public authorities that is the main issue. The designated receivers of this assistance share the same currency and have transferred their monetary sovereignty to the EU and its institutions. Yet the IMF is aimed at balancing out divergences between states with different currencies.

Purchase of debt instruments by the ESCB

The conduct of the European System of Central Banks (ESCB) has given rise to considerable concern. The tasks of the ESCB do not include rescuing insolvent banks, banking systems or sovereign public authorities by direct or indirect means. No independent economic or financial policy responsibilities were transferred to it. It would make little sense to enumerate the "ESCB's fundamental purposes", were it able to assume further tasks in the absence of express authorization. The transfer of further responsibilities to it was rejected when the Maastricht Treaty was drawn up. The only item permitted was a contribution on the part of the "competent authorities" towards the "smooth implementation" of measures taken in the area of "supervision of credit institutions" and "the stability of the financial system". Nor would a sweeping prohibition on financing the loans of sovereign public authorities make any sense, if bonds can be purchased on the secondary market virtually at whim. The short-term acquisition of debt instruments on the secondary market may be a further monetary policy measure within the permitted open market policy (Art. 18.1. of the ESCB and ECB Statute).

The purchase of government bonds with horizons of over one year can no longer be justified in terms of the requirements of a "monetary policy transmission mechanism" that is allegedly malfunctioning. This applies particularly to cases where bonds are held long-term. Purchasing programs used to subsidize the interest rates the market is demanding of solvent member states down to manageable levels are no longer monetary policy measures but belong to the realm of fiscal policy. This must be clearly distinguished from monetary policy. The primary laws of the EU unequivocally did not assign the ESCB competence over fiscal and growth policies. Directly or indirectly financing member states of the EU on the part of the ESCB is in any event strictly prohibited.

Expanding the competencies of the EFSF

On July 21, 2011, the heads of state of the eurozone announced that they sought to improve the effectiveness of the EFSF and increase its flexibility. While financial support was originally only supposed to be granted in the form of loan and loan facility agreements, support could now be provided in the form of inventory financing loans, lines of credit, loan commitments for recapitalizing financial institutions on the part of the member states in question and, in particular, by purchasing bonds on the primary and secondary markets. Interventions in the secondary market were only supposed to be carried out on the basis of ECB analysis, which was to previously confirm the existence of extraordinary market conditions and risks to financial stability. The scope of guarantees was at the same time raised to EUR 780 bn. This was intended to bring the amount actually available to EUR 440 bn. At the same time, interest rates were lowered for receiver countries and the assistances' terms to maturity were extended.

Permanent support mechanism

In the course of 2011, work was initiated to create a permanent European Stabilizing Mechanism (ESM). In July of 2011, the Council of economics and finance ministers of the eurozone signed a framework agreement for a new, permanent stabilizing mechanism meant to succeed both the EFSM and the EFSF. It was intended to enter into effect in mid-2013, upon expiry of the temporary assistance mechanisms. At a meeting of the European Council on December 9, 2011, it was decided that the initiative would enter into force earlier, in July of 2012. At the same time, mainly at the request of Germany, an attempt was made towards adopting more effective regulation for imposing permanently sound financial policies among member states in EU primary laws. This attempt failed since the United Kingdom refused to go along with the required amendments to EU treaties. Instead, the heads of state of the eurozone agreed at the meeting of the European Council on December 9, 2011, to establish regulations along those lines in a separate, international treaty. Currently two treaties on the provision of assistance to member states of the EU are in the final stages of consultation and implementation in the wake of that meeting:

- a treaty to create a European Stabilizing Mechanism (ESM) for coping with crises, and
- a fiscal policy treaty (the "new fiscal compact"), primarily for prevention of crises

A permanent European Stabilizing Mechanism (ESM)

The German Bundestag has already approved the framework agreement of July 11, 2011, by means of the "Act Concerning the Giving of Guarantees within the Framework of a European Stabilization Mechanism."

Most important components of the regulations:

- A permanent stability mechanism, the ESM, is set up as an international financial institution.
- It is headed by a Board of Governors consisting of the finance ministers of the euro group and/or members of national governments of member states in charge of the finances.

- Unanimous agreement is required for assistance to be granted.
- The ESM has EUR 700 bn at its disposal. Of the latter amount EUR 80 bn are to be paid in immediately.
- The respective shares of the member states are once again a function of the capital share of the central banks of those states in the ECB. There is a special provision for member states with below-average economic capabilities. This means that, unlike the EFSF, the institution will be able to dispose of its own capital.
- The Board of Governors may decide on a capital increase at any time, but only on the condition of mutual agreement. According to IMF procedure, the interest rate is to be one percentage point higher than the funding costs of the ESM, after three years it will be raised to two percentage points. The ESM is to enjoy seniority status over other creditors, subordinate only to the IMF.
- Identically worded collective action clauses (rules for adapting bonds with a supermajority of bond holders) are to be added to the terms and conditions of all bonds of eurozone states with terms to maturity of over three years. This is intended to garner the participation of private creditors in the burdens of debt restructuring.
- Assistance is only to be granted under strict conditions.
- The ESM should be able to take on bonds.
- The ESM should be allowed to acquire the bonds of member states in the primary markets.
- Losses on the part of the ESM are initially to be borne by the institution itself, first from the capital paid in and then later by participating member states on a pro-rata basis according to their shares.

The German Bundesbank welcomed the establishment of a mechanism as a last resort for warding off existential financial crises. However, three points must be observed: First, the assistance payments must be bound to strict economic and financial policy restrictions; second, interest rates must be reasonable; and third, the involvement of credible private creditors in the event of a state bankruptcy or default. The decisions of July21, 2011, however, are in violation of these requirements. They imply another important step towards joint liability and less disciplining on the part of the capital markets, without noticeably enhancing options for control and influence on national financial policy by contrast.

On December 9, 2011, eurozone heads of state agreed to make the following amendments:

- Participation of the private sector, by means of inserting standardized and identical collective action clauses in the terms and conditions of government bonds

- Amendment of voting rights to include an emergency procedure.

There is also a general consensus to incorporate control on the part of courts of audit, an aspect that was not previously included in the wording of the contract. Unanimity concerning the ESM was attained at the summit meeting of all 27 member states on January 23, 2012. In an emergency, the ESM may step in and make use of all the principal instruments at its disposal: bond purchases in the primary market, interventions in the secondary market, recapitalizing financial institutions and pension schemes. For the time being, a limit of EUR 500 bn in loan capacity has been set. The heads of state are nonetheless to perform a review at the start of March. The agreement is to be signed in February and will enter into effect in July of 2012, following its ratification by the member states, i.e. one year earlier than originally planned.

The new fiscal compact

According to the agreement reached by the heads of state on December 9, 2011, the fiscal agreement is meant to contain the following elements:

- Provisions on a balanced budget in national constitutional laws or equivalents
- Limitation of annual structural deficits to a maximum of 0.5% of a country's nominal GDP
- Introduction of mechanisms to correct aberrations automatically
- Comprehensive reporting obligations
- Involvement of the European Court of Justice in implementing the above.

The agreement is to be concluded by February 2012 and to enter into effect by March 2012. In an initial draft of the treaty, a requirement for a constitutional basis for the obligation to balance public sector budgets was already made less stringent, an alternative option for states of emergencies was inserted, the permitted structural deficits were raised to 1% of GDP and control on the part of the European Court of Justice was restricted. The adequacy and usefulness of this kind of agreement is dubious. Even in Germany, regulations on financing public sector deficits on credit have often been violated. Granting budgetary assistance has only rarely improved the fiscal situation of receiving countries. While instruments for imposing the regulations are necessary, they hit upon serious constitutional difficulties. The same applies to an insolvency act for sovereigns that can only function if receivers in insolvency are equipped with sovereign authority and may intervene in the core responsibilities of a state. All told, setting up a parallel structure to the primary laws of the EU in key areas of the economic and monetary union is not without its problems.