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“Oh, the times they are a-changin’ ”

Karlsruhe rules on OMT... and nobody cares

If anyone still needed to be convinced that the systemic crisis is behind us, the *Bundeverfassungsgericht's* (BVG, German Constitutional Court) ruling on the ECB's OMT program is probably going to do the job.

Eighteen months ago, the Eurozone crisis was reaching a new peak: yields on Italian and Spanish debts were at unsustainable levels and Target 2 balances (or rather imbalances) were at their historical highs, with a 750bn€ exposure for Germany alone. This is when the ECB decided to come out of the woods with a new concept: it would do "*whatever it takes*" to stabilize the Eurozone. And "*what it took*" at that time was the OMT program: unlimited, *pari passu*, purchases of sovereign bonds in the secondary market, provided "Troïka conditionality" was applied and the sovereign still had market access.

Of course, it was a pure Jedi trick: distressed Eurozone sovereigns now have a market access because the ECB is backing them and the ECB is backing them because they have a market access. The ECB invented the virtual QE, almost as effective as the real one.

But there was a glitch: ze Germans and their history-driven hatred of monetary financing. If Germany was to participate, its powerful constitutional court needed to approve the scheme. When a first ruling on Eurozone firewalls was issued a year ago (September 2012, on the EFSF), most analysts - including us - believed that the OMT ruling would also be an easy pass.

And indeed, when last Friday the BVG issued its ruling on the OMT, nobody cared. Whereas the EFSF ruling was broadcasted live throughout Europe and made the front page of every single economic or mainstream newspaper, the OMT ruling went almost unnoticed. This is probably the best proof that the market has completely changed its mind on the Eurozone.

Still, the Eurozone is not completely cured and, considering the importance of the OMT in 2012, we believe it is the duty of any investor to carefully analyze the decision and its technicalities. It turns out to be more challenging and complex than expected and has already been interpreted in many different ways by various parties involved, including the ECB itself.

Here is our take on that ruling.

Firstly, it should be stressed that Germany is the only major country in Europe that still considers that its constitution prevails over EU treaties. Even France and the UK accepted to lose that battle a few years ago. This is of utmost importance, because it means that, in Germany, and only in Germany, a law, regulation, directive, whatever, coming from an EU body cannot be imposed if it is not compliant with the German constitution.

Keeping that in mind, we turn to the actual decision of the BVG. In a nutshell, the Court referred the case to the European Court of Justice to ask if and how the OMT program is complying with EU law.



It is the first time in the Court's history that it refers a case to the ECJ, clearly a sign that the decision is of utmost importance.

The bulls and the ECB have a very simple interpretation of the decision: if the ECJ approves the OMT, it will be a done deal. Indeed, if the EU's Supreme Court validates the scheme, no one can prevent the ECB from implementing it, as the ECB has full immunity in such matters and can only be challenged before the ECJ. Everyone expects the ECJ to approve the OMT.

The bears have a very different analysis, not without merits. Their argument has two different points. First, they claim that, even with a positive ECJ decision, the BVG could decide that the OMT is illegal in Germany. Clearly, this would not prevent the ECB from implementing the scheme, but it would be illegal for the Bundesbank ("BuBa") to participate – at least under German law (under EU law it could actually be illegal for the Bundesbank NOT to participate, more on that below.) This is not a minor issue, as one has to remember that the Securities Market Program (very similar to the OMT) is implemented by the national central banks, not by the ECB itself. The national central banks are the ones that are buying the paper, so the BVG could forbid any purchase by the BuBa. Of course, all the other central banks could purchase unlimited amounts, but the political strength of the program would be undermined.

But then you might ask: why on earth would the BVG ask the ECJ for its opinion if they intend to discard the OMT in any case? That's where the argument of the Eurosceptics gets more subtle. The BVG did not simply ask for a legal opinion on the OMT's compliance with EU law. The constitutional judges stated that, in their opinion, the OMT is most probably illegal under German and EU law, but that the OMT program could be interpreted as being compliant with both laws if some restrictions were attached to it, the most important ones being that the amounts are limited and that the *pari passu* treatment is not applicable (i.e. the ECB should not accept any haircut even if other creditors do). Of course, these are the two key characteristics of the OMT program. So the true question of the BVG to the ECJ is the following: *"I believe that the OMT is compliant with EU and German law if and only if it follows these rules that I just defined. Can you confirm that you have the same view and that the ECB cannot act differently?"*

This is a very smart trap. If the ECJ agrees with the BVG, then the OMT program will lose most of its effectiveness. If the ECJ disagrees and says *"an unlimited and pari passu OMT program is compliant with EU law"* then the BVG will say *"Ok, then my understanding of EU law was wrong and the OMT is illegal under German law. Hey, I warned you."*

Hence, the true meaning of the decision is that the BVG is putting an enormous amount of pressure on the ECJ.

From there, what are the possible scenarios?

The first one, generally overlooked by commentators, but not that unlikely, would be that the ECJ deems the referral not admissible on the ground that the ECB never took an actual decision on the OMT. Whereas there is an actual decision on the SMP (ECB 2010/5) there is none on the OMT! The ECJ could argue that the press release mentioned in the BVG's referral is not an actual *"act"* made by an EU entity as defined in article 267 of the Treaty on the Functioning of the European Union (TFUE). The BVG is aware of that risk and asked a second question to the ECJ which is, in essence, saying: *"even if the ECB did not make an actual decision, what would be your view if they made one someday"*. Again, this is a very smart move from the German judges, but there is no guarantee that the ECJ will fall into the trap and accept the question, especially considering the very delicate situation that it will be facing.

If the ECJ does not answer, then the BVG will probably take its responsibilities and maintain its views that the OMT must meet certain criteria. In practice, the ECB would be free to act and the BuBa would have to pretend that it acts in accordance with the BVG's decision. So the BuBa would have to set a limit to its purchases – not that difficult – and, in theory, would have to refuse haircuts. Of course, no one expects any actual haircut to happen, so this might not be such a big deal as it would leave the legal mess to be sorted out in some hypothetical future scenario.

Assuming now that the ECJ does make an answer, what could happen? There are three scenarios.

1. The ECJ says the OMT is illegal. Quite unlikely, but this would obviously kill the OMT.
2. The ECJ (and the ECB) addresses some of the concerns of the BVG. In particular, the ECB could say that the program is limited in amount but set a very high limit (e.g. exceeding the size of the Italian sovereign bond market), that ratings will need to be above some limit, e.g. a D rating (as in the SMP/MRO programs), that bonds do not have to be held until maturity, *etc.* The issue of the *pari passu* treatment is the most complicated one, but the BVG mentioned that it was concerned not only by the various items detailed in the decision but also by the fact that *"the following aspects – at least when taken together – also indicate that the OMT Decision aims at a circumvention of Art. 123 TFEU"*. The keywords here are *« at least when taken together »*: the BVG is not asking for a full overhaul of the OMT, but at least for some kind of effort to show that it did its job to protect German voters. This clearly opens the door for a compromise between the ECJ, the ECB and the BVG to put the program back on track.
3. The ECJ declares the OMT program compatible with EU law, with no substantial change. This would be a slap in the face of the BVG, but the German judges would probably stick to their analysis and declare the OMT illegal in Germany. The political ramifications would be huge as the prohibition of monetary financing was the key section of the EU Treaty that made it compliant with the German constitution when the Maastricht treaty was ratified. The legal consequences would also be incredibly complex. The Bundesbank would be bound by the BVG's decision and would be prohibited from buying sovereign bonds – at least under the same terms as the other central banks (haircut and unlimited potential). This would not, however, prevent all the other national central banks from buying these bonds in the market. One might think that the BuBa would not benefit from the carry trade and would not take the default risk, but actually it is far from being clear. Indeed, article 32.5. of the ESCB Statute states the global monetary income of the Eurozone is split between the central banks according to a capital key and article 32.4. allows for a sharing of losses following the same key¹. So, even without taking a haircut, the BuBa might still take an indirect loss in case of default. Still, having the largest central bank in the Eurozone not fully on board for one of the most important ECB policy would obviously be a political nightmare and would threaten the credibility of the ECB. The ECB could be tempted to twist the BuBa's arm into buying bonds, as article 14.3. of the Protocol on the ESCB states that *"national central banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB."* However, the ECB might find it difficult to actually enforce its decision... This is where the European Commission could step-in and make things even more complex. Technically, the EC could start an infringement procedure on Germany and ask for a modification of German law in order to make the BuBa comply with EU law, and not the German Constitution. This could be the end of the German exception on

¹ This is how losses were split on the MRO when the European subsidiaries of Icelandic banks went bankrupt.

the respective forces of the Constitution and EU Treaties. Needless to say, this would have enormous consequences in Germany and would be viewed as a huge loss of sovereignty, something nobody wants in the current context.

Whatever the final decisions of the ECJ and the BVG, the issues at stake are of outmost importance. So why didn't the market react, in one way or another? We believe there are four possible reasons.

The first one is that the decision is complex and the market needs time to digest it. There is some truth in this point of view, but in the past the market has had a tendency to analyze complex decision very quickly as being negative decisions (*"if they don't say it clearly, then it must be bad"*). This is not the case anymore.

The second possibility is that the market accepts the bullish view that the ECJ will validate the OMT and will end the debate. We do not think this is a realistic interpretation both of the decision and of the market's reaction. Some commentators have already pointed out that there is more than a simple referral to the ECJ in the BVG's analysis.

The third one is that the market has already made up "its mind": the BVG, the ECB and the ECJ will reach a compromise, with a few tweaks to the OMT, but keeping its essential characteristics. This is probably putting too much faith in the market's capacity to assess intricate legal wordings in a few hours' time.

So we are left with the most realistic option: that the market doesn't care about the OMT anymore. The OMT was a psychological masterpiece. It has never been put into effect (there is no actual ECB decision, not to mention bonds purchase!) and, most probably, it will never be. So who cares if it's legal? The most important message from the ECB was not the OMT, it was the *"whatever it takes"* statement. If after three years of complex legal proceedings the BVG finally manages to stop the BuBa's participation to the OMT, the ECB will simply come up with something else to save the Euro (if it still needs to) or will act without the BuBa being directly involved. Judges and central banks do not act with the same timing, and this is why, at the end of the day, the ECB will always prevail.