

ALLEN & OVERY

German Federal Constitutional Court ./ . ECB and CJEU

German court rulings rarely find their way into international newspapers – but this one is different: In times of "corona bond"-discussions and further increased bond acquisition programmes of the European Central Bank (**ECB**), the German Federal Constitutional Court (*Bundesverfassungsgericht* – **BVerfG**), in its ruling of 5 May 2020, had to decide about constitutional claims arguing against the lawfulness of bond acquisition programmes of the ECB. And indeed, the BVerfG decided that, in its view, the ECB had exceeded the powers conferred to it by the Treaties of the European Union when adopting the Public Sector Asset Purchase Programme (**PSPP**) by ignoring the economic consequences of the programme and had therefore not sufficiently examined its proportionality. In light of this assessment, the German Federal Government and the German Parliament (**Bundestag**), in the view of the BVerfG, would have needed to take action against the PSPP; by not doing so, they have violated fundamental rights. According to the BVerfG, the ruling of the Court of Justice of the European Union (**CJEU**) previously handed down on the same matter which confirmed the lawfulness of the PSPP does not stand in the way of the BVerfG's decision, as it was not comprehensible with regard to the proportionality test and had thus been itself *ultra vires*. In light of the relevance of the ruling for the asset purchase programmes of the ECB and, hence, the market developments and the potential wider consequences for the EU as such, this bulletin outlines the background of the ruling, summarises key statements and tries to identify consequences and potential developments.

1. Background of the BVerfG's ruling

a) *The PSPP*

The PSPP is part of the Expanded Asset Purchase Programme (**EAPP**), a framework programme of the European System of Central Banks (**ESCB**) for the purchase of assets. According to its official reasoning, the EAPP aims to expand the money supply in the euro area to stimulate consumption and investment and to raise the inflation rate to just below 2 per cent. PSPP is used to purchase government bonds and similar marketable debt instruments issued by the central government of a member state of the euro area, "recognised institutions", international organisations and multilateral development banks domiciled in the euro area. The PSPP represents by far the largest part of the EAPP. As at 8 November

2019, the ESCB had acquired securities totalling approx. EUR 2,5 trillion under the EAPP, of which more than EUR 2 trillion were attributable to the PSPP.

b) The German system of protection of fundamental rights and the course of proceedings

Under German constitutional law, any person may bring a claim before the BVerfG claiming a breach of their fundamental rights. Such rights can, technically speaking, only be breached by an act or omission of a German state entity, not by an EU entity. However, the BVerfG takes the view that the German Basic Law (*Grundgesetz*) grants German citizens a right to enjoin German state entities from participating in – and taking sufficient measures to avoid – actions of EU entities which, by acting beyond the authority which Germany has conferred to the EU, in a qualified manner act "ultra vires", i.e. beyond their legal power and authority. Finally, while the BVerfG has stated that it will in principle grant the CJEU the prerogative to control whether EU entities breach EU law, it reserves for itself the right of a "super-control" if the CJEU does not, in an obvious manner, fulfil its function properly to assess compliance with EU law. In essence, that reflects the current concept that the EU is not a federal state, but that its competence is "only" derived from the competences of its member states – and therefore limited to what is transferred; put differently, the EU does not have the "competence competence", i.e. the competence to determine the scope of its own competences.

In the case at hand, the complainants – private German citizens – argued that the PSPP breaches (i) the prohibition of monetary public sector financing in Article 123 of the Treaty on the Functioning of the European Union (TFEU) and (ii) the principle that the EU has only the limited powers conferred to it (principle of conferral) in Article 5(1) of the Treaty of the European Union (TEU).

The BVerfG had suspended the case at hand with decision of 18 July 2018 and referred several questions to the CJEU for a preliminary ruling. These concerned the prohibition of monetary public sector financing, the scope of the ECB's mandate for monetary policy and a potential encroachment on the budgetary sovereignty of the EU Member States. In its ruling of 11 December 2018 – case C-493/17 –, the CJEU ruled that the PSPP did not go beyond the ECB's mandate and did not violate the prohibition of monetary public sector financing.

2. The BVerfG's Ruling in a Nutshell

The ruling of the BVerfG from 5 May 2020 – case 2 BvR 859/15 et al. – is very complex and more than one hundred pages long. It is therefore not possible to reflect in this bulletin all aspects that the BVerfG has considered with regard to the PSPP. The following is therefore limited to the key findings in the BVerfG's ruling.

a) The PSPP is not covered by the ECB's monetary policy mandate

The BVerfG concludes that the decisions of the ECB on the establishment and implementation of the PSPP are no longer covered by the powers conferred on it: The ECB has been granted power to take measures in the area of monetary policy. By contrast, economic policy largely remains the prerogative of the Member States. The EU Treaties do not clarify the delineation. In light of the principle of conferral, the ECB, in order not to exceed its monetary policy competence and encroach upon the economic policy competence of the Member States, must observe the principle of proportionality when taking measures aimed at monetary policy purposes, but with consequences for the economic policy. According to the BVerfG, a programme for the purchase of government bonds such as the PSPP, which has considerable economic policy implications (such as its economic and social impact on almost all citizens who are affected, for example, as shareholders, tenants, property owners, savers and policyholders), required that the monetary policy objective and the economic policy implications be identified, weighted and weighed against each other. The ECB's decisions on the adoption of the PSPP, however, do not take into account the economic policy implications of the PSPP, but merely assert that the inflation target has not been achieved and that measures less extensive than the PSPP are not available to it. The BVerfG therefore concludes that these assertions are made in breach of proportionality. As such they are not covered by the ECB's monetary policy mandate and, are, hence, ultra vires. Importantly, however, the BVerfG does not conclude that the PSPP itself is *per*

se and in an absolute manner an ultra vires act of the ECB, but only as long as it is not supported by a reasoning evidencing that it respects the principle of proportionality.

The BVerfG recognises that its conclusions are in explicit contrast to the CJEU ruling on that point. The BVerfG first reiterates its general statement that it generally follows the CJEU interpretation of EU law. However, at the same time it explicitly states that, in its view, the specific CJEU decision is not binding on the BVerfG since it fails in an obvious manner to recognise the significance and scope of the principle of proportionality (which under EU and German law is not only a policy concept, but subject to full scrutiny of the courts). As such the CJEU decision is itself inadequate and, hence, ultra vires.

b) The PSPP does not breach the prohibition of monetary public sector financing

The BVerfG does – "not yet" – consider that the PSPP breaches the prohibition of monetary budget financing for the following reasons:

- (i) the volume of bond purchases by the ESCB is limited in advance;
- (ii) the purchases are only announced in aggregated form;
- (iii) there is a limit of 33 per cent per bond issue (by reference to its ISIN);
- (iv) the purchases are made according to the "capital key" of the euro area's national central banks (the **National Central Banks**);
- (v) only bonds issued by entities which have access to the bond market on the basis of a minimum rating eligible for the programme;
- (vi) when continued intervention is no longer necessary to achieve the inflation target, purchases are to be limited or suspended and purchased bonds resold to the market.

However, the BVerfG implicitly indicates that it could come to a different conclusion if any of the above criteria are no longer met.

c) The PSPP does not violate the budgetary responsibility of the Bundestag

Furthermore, the BVerfG did not find that there was any breach of the Bundestag's budgetary responsibility. According to the BVerfG a subsequent change in the risk allocation between the ECB and the National Central Banks in respect of the PSPP's size of more than EUR 2 trillion may affect the limits of the Bundestag's budgetary responsibility, as developed by the BVerfG in its case law. However, the PSPP does not currently contemplate any risk sharing on government bonds of euro area member states acquired by National Central Banks pursuant to the PSPP, a risk sharing which, the BVerfG notes, is prohibited by the EU Treaties.

3. Immediate Consequences – Obligation to work towards a proportionality assessment by the ECB

The BVerfG stresses that the Federal Government and the Bundestag are obliged to oppose the way the PSPP has been implemented so far, given that the PSPP is an ultra vires act of the ECB. That said, the BVerfG grants a transition phase of three months, which presumably started to run with the delivery of the ruling on 5 May 2020, during which the ESCB has the ability to develop a reasoning which properly justifies that the PSPP is in compliance with the principle of proportionality. If no such decision is taken by the end of that period, the German Central Bank (**Bundesbank**) may no longer participate in the PSPP.

The BVerfG does not explicitly state who will decide whether a new decision of the ESCB satisfies the principle of proportionality. Our view is that this is, at first instance, the responsibility of the Bundesbank and the German government. Any determination they make will of course be capable of review by the BVerfG.

4. Additional consequences

a) No consequences for ECB's supervisory function

The ruling of the BVerfG has no immediate implication for the ECB in its function as bank supervisor; it is limited to the ECB's role in the context of monetary policy and in particular on the design of the PSPP in furthering monetary policy within the boundaries of the ECB's powers and mandate.

b) Intensification of the political discussion on the PSPP

Formally, the ESCB has, in BVerfG's view, breached EU law by not providing a proper reasoning of the PSPP's consistency with the principle of proportionality. It is open whether this "breach" can be simply cured by providing a new and appropriate reasoning or whether the PSPP needs to be amended and if so how. Given that decisions of the BVerfG normally take years (unless the BVerfG would feel comfortable to decide by way of a preliminary judgement), it seems that in the near-term to mid-term future the discussion will principally be political rather than legal in nature. Looking at the reaction of the capital and currency markets, an immediate shock following the ruling was relatively quickly overcome reflecting a market perception that the ruling will not be a "show stopper" for continued quantitative easing in the euro area.

c) Potential consequences for the PEPP

The BVerfG did not rule on the ECB's new Pandemic Emergency Purchase Programme (**PEPP**), which was adopted to ease the consequences of the Covid-19 pandemic. Nonetheless, it is likely that the BVerfG would expect the Federal Government and the Bundestag to work towards a proportionality assessment by the ECB also with regard to the PEPP. As with the PSPP, it is not clear whether a proper proportionality-consistent reasoning will be sufficient or whether a substantive amendment of the PEPP itself will be required. Crucially, the PEPP appears to be in breach of criteria 2(b) (iii), (iv) and (v) above and imposition of any of these criteria will have immediate consequences on the bond prices of some euro area member states. If therefore a substantive change is required, the highly relevant question is whether the ESCB would need to reduce its "fire power" and, if so how. It remains to be seen if, in such a scenario, EU politicians would then feel forced to step in and replace the firefighting power of the ECB by other support measures.

d) Escalation in the relationship with the CJEU

The ruling marks a new escalation in the never easy relationship between the BVerfG and the CJEU. If it heralds the beginning of a series of attacks by national courts on the "supremacy" of the CJEU, the long-term consequences of the decision for the success of the EU as a project could go well beyond its impact on the ECB monetary policy actions.

5. What happens next – Two scenarios

After a briefing on the German ruling, the ECB stated it had "taken notice" of the decision and went on to emphasise its determination to carry on with its stimulus efforts. The ECB remains "fully committed to doing everything necessary" to ensure its policies are effective within the whole of the euro area economy. At the same time, the German Federal Government now intends to approach the ECB for the requested thorough examination of the asset purchase programme's proportionality, anticipating the ECB's co-operation.

As regards mid-term perspectives, two scenarios seem possible:

a) "Compromise scenario"

In a "compromise scenario", the ECB will dedicate all efforts to preparing a detailed reasoning of the PSPP and, quite likely, also of the PEPP; the Bundesbank and other German bodies will review it and come, after "careful consideration", to the conclusion that PSPP and PEPP meet the proportionality test as required by the BVerfG's decision. Quantitative easing will continue, maybe with some more caveats. The claimants will, very likely, file another law suit with the BVerfG which will not be prepared to release an preliminary decision, but will instead decide in a separate case in some years. In our view, that is the more likely scenario: Generally, but in particular in times of the Covid-19 crisis, none of the stakeholders can have an interest in a "blow-up" at this stage. Moreover, the justification of the ECB's measures should be even easier against the backdrop of the current crisis. Although the ECB might be reluctant to comply with the demand of a national court, it is likely to provide the requested assessment as the Bundesbank is the ECB's largest shareholder with about 26 percent. Its share percentage corresponds with the Bundesbank's large purchase volume. Thus, the continuing of the participation of the Bundesbank in the ECB's bond acquisition programmes is crucial for their effectiveness. On balance, the immediate effects on the markets in this scenario will be limited. The long term effects, in particular the risk that the ruling marks the beginning of a series of attacks by national courts on the "supremacy" of the CJEU thus jeopardising the success of the EU as a project, are much more difficult to assess, but could nevertheless be massive.

b) "Conflict scenario"

However, a number of things could instead result in a "conflict scenario": The ECB decides, as a matter of principle, that it should not "abide" by a ruling of a national court as such courts do not have any jurisdiction over it. In this case, the Bundesbank will hardly be able to continue participating in the bond acquisition programmes. However, it nevertheless seems likely that a political compromise can be found to fudge things. If that is not possible and the Bundesbank needs to stop its participation in these programmes, there are two sub-scenarios: Either the lack of fire-power of the ECB is compensated by an even bigger stimulus programme set-up on the level of the EU, resulting in more cohesion. Or, and that is probably the scenario with the highest market impact, the ECB's power is heavily crippled, but not compensated by alternative support. Ultimately, this scenario would likely result in the biggest challenge of the euro area since its beginning.

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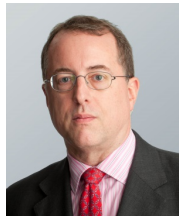
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