RegCORE Client Alert

Financial Services: Taking stock of the European Central Bank's (ECB) new Transmission Protection Instrument (TPI)

July 2022

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QuickTake

The ECB's newest instrument, the TPI aims to:

- counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area;
- purchase " in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals"; and
- buy eligible securities with maturities of 1 to 10 years.

The TPI does not have a maximum amount to its purchases. It does however have a number of preconditions that an EU Member State, wishing to avail of the benefits of the TPI, will need to satisfy prior to the TPI being activated.

A decision by the ECB's Governing Council to activate the TPI will be based on a comprehensive assessment of market and transmission indicators. Purchases would be terminated either upon a durable improvement in transmission, or based on an assessment that persistent tensions are due to country fundamentals. A key component is that the jurisdictions in question are compliant with the EU fiscal framework, inter alia:

- not being subject to an excessive deficit procedure;
- absence of severe macroeconomic imbalances;
- evidencing fiscal sustainability; and
- maintaining sound and sustainable macroeconomic polices, which must comply with the commitments submitted in the plans submitted under the EU's Recovery and Resilience Facility as well as the European Commission's country specific recommendations under the fiscal components of the "European Semester".

It remains to be seen whether legal challenges will be commenced against the ECB, as has been the case in the case of other monetary policy activity that claimants have attempted to argue go beyond the ECB's mandate and/or judgement or the controversial discussion around the establishment of a (much needed) fiscal union. Much of that may turn on the point as to whether too much discretion and power is placed in the Governing Council's hands. The ECB may well, given previous experiences in front of various courts, put in place further safeguards through increased transparency to ensure the TPI can, if activated deliver what it aims to do, namely, to prevent further fragmentation in the euro area by smoothing monetary policy transmission. This Client Alert assesses some of these considerations from a legal perspective.

What the ECB has announced and why it matters

As most of Europe was grappling with a heatwave and readying themselves to head off to the summer holidays, the ECB, in the wake of worsening capital market trends, rising energy and food prices and conflict at the doorstep of the EU, published on 21 July 2022 its announcement of the long-awaited TPI. The TPI as the newest addition to the monetary policy toolkit but also marks a careful balancing act in regaining monetary and fiscal space without adversely impacting the EU's fragile economic recovery prospects following the COVID-19 pandemic.[1]

ECB President Lagarde concluded her statements ahead of the questions on the monetary policy decisions and TPI announcement by stating[2] "We now stand ready to adjust all of our instruments within our mandate to ensure inflation stabilises at two percent over the median term. Our new transmission protection instrument will safeguard the smooth transmission of our monetary policy stance throughout the euro area as we continue adjusting the stance to address high-inflation."

While announced, the TPI has yet to be activated. If activated it aims to "…counter unwarranted, disorderly market dynamics that post a serious threat to the transmission of monetary policy across the euro area." The ECB goes on further to state that "as the Governing Council continues normalising monetary policy, the TPI aims to ensure that the monetary policy stance is transmitted smoothly across all euro area countries. The singleness of the Governing Council's monetary policy is a precondition for the ECB to be able to deliver on its price stability mandate."

The ECB's Governing Council is the body that decides whether to activate the TPI and will only do so following a comprehensive assessment of the market and transmission indicators, an evaluation of the eligibility criteria and the purchase parameters and ultimately whether such purchases are proportion to the achievement of the ECB's primary monetary policy objectives. Any termination of the TPI will occur either upon a "durable improvement in transmission" or based on an assessment that persistent tensions are due to country fundamentals as opposed to tensions or threats to the efficacy of monetary policy transmission.

Purchase parameters of the TPI

The TPI will, if certain established criteria are fulfilled, will allow the ECB along with the Eurosystem of central banks to conduct secondary market purchases of securities issued in jurisdictions that are "…experiencing a deterioration in financing conditions not warranted by country-specific fundamentals, to counter risks to the transmission mechanism to the extent necessary." TPI purchases are specified as focusing on public sector securities that are, in accordance with the Eurosystem's General Documentation[3], categorised as "marketable debt securities" i.e., those issued by central and regional governments as well as by authorities and agencies, that have a remaining maturity of between one and ten years. The ECB also, in setting the initial purchase parameters have reserved their policy option by stating "purchases of private sector securities could be considered, if appropriate."

Crucially, the ECB has confirmed in its statement that the Eurosystem accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area governments and purchased under the TPI in accordance with the terms of such bond.

In addition to this broad discretionary power to decide what to buy where and when, the ECB states that "The scale of TPI purchases would depend on the severity of the risks facing monetary policy transmission. Purchases are not restricted ex ante." As evidenced in other instances of the ECB having to extend the instruments to make sure its toolkit can be put to effective work for extraordinary monetary policy, a lot of detail remains to be published and future amendments can ensure the TPI can be tailored to needs as these may change or indeed to support the efficacy of other existing extraordinary asset purchase programmes.

[1] Details available here and in the combined monetary policy decisions and statement available here.

[2] See press conference statements and Q&A session available inter alia here.

[3] The 'Eurosystem' comprises the European Central Bank (ECB) and the national central banks (NCBs) in those EU Member States that have adopted the euro. The General Documentation refers to the various rulemaking instruments making up the framework fully referred to as the "Single monetary policy in the euro area: General Documentation on the Instruments and Procedures of the Eurosystem Monetary Policy"

Jurisdictions and their eligibility for TPI purchases

In its statement on 21 July 2022, the ECB set out that the Governing Council will consider a "cumulative list of criteria", that may be "dynamically adjusted" to reflect the unfolding risks and conditions that the TPI aims to address, when assessing in which jurisdictions the Eurosystem may conduct purchases under the TPI. Specifically, these jurisdictions will only be eligible where they pursue sound and sustainable fiscal and macroeconomic polices. This includes (but is not limited to) the following headline items:

1. **Compliance with the EU fiscal framework:** not being subject to an excessive deficit procedure (EDP), or not being assessed as having failed to take effective action in response to an EU Council recommendation under Article 126(7) of the Treaty on the Functioning of the European Union (TFEU);
2. **Absence of severe macroeconomic imbalances**: not being subject to an excessive imbalance procedure (EIP) or not being assessed as having failed to take the recommended corrective action related to an EU Council recommendation under Article 121(4) TFEU;
3. **Fiscal sustainability**: in ascertaining that the trajectory of public debt is sustainable, the Governing Council will take into account, where available, the debt sustainability analyses by the European Commission, the European Stability Mechanism, the International Monetary Fund and other institutions, together with the ECB's internal analysis; and
4. **Sound and sustainable macroeconomic policies**: complying with the commitments submitted in the recovery and resilience plans for the Recovery and Resilience Facility and with the European Commission's country-specific recommendations in the fiscal sphere under the European Semester. Both of these conditions are not in themselves a cyclical fiscal stabilisation nor a shock absorption tool.[4]

The EU's fiscal rules and the question of a (much needed) fiscal union have long been a contentious issue for national governments leaving it up to the ECB to hold the Economic and Monetary Union and thus the euro area together during previous crisis. This often put the ECB in a difficult position, as it is supposed to be politically neutral and not take on the role of, what many commentators have called for as a new institution, to act as a European Debt Agency.[5]

Outlook

The TPI marks a bold if not much needed step forward as the ECB and indeed the EU's economy faces new challenges. It certainly widens the toolbox with a big gun that goes hand with forward guidance that suggests higher interest rate hikes in September 2022 i.e., after the summer break and possibly after the Italian elections. What it does not however do is fix the differences between economic and financial structures which vary between euro area economies thus meaning that transmission (and its strength) of monetary policy invariably may differ. Fiscal and wider-spread reform in the euro area remains a (longer-term) priority of the ECB but one which the TPI will not likely resolve as it requires political driven reform in individual Member States of the euro area but the EU as a whole.

A more immediate challenge to the TPI and the ECB's efforts may well be whether, as indicated in the QuickTake, legal challenges are commenced against the ECB. Some well-known critics have already been quick to announce they are considering their options. This may in turn also further affect how the TPI is received amongst institutional and professional market participants, perhaps the true judges of the TPI, and

[4] Importantly, the EU Recovery and Resilience Facility funds are financed by the European Commission's issuance of new EU debt as Next Generation EU bonds, which established, for the first time a large-scale joint funding model. Funds raised are then transferred as grants and concessional loans to finance ministries at the national government level. The Commission has had a very successful issuance journey to date, having raised EUR 121 billion in long term funding over ten syndicated transactions and eight bond auctions as well as EUR 58 billion in short term funding via the EU Bills programme. These, together, have enabled the disbursement of EUR 67 billion in grants and EUR 33 billion in loans to EU Member States under the Recovery and Resilience Facility. Strong investor interest has followed as the issuance as Next Generation EU bonds provides an opportunity to buy into a 'safe-haven' while receiving a marginal return over the German Bunds. Moreover, as more than 30% of Next Generation EU bonds are planned as green bonds is also expected to attract ESG driven investors and could lead to considerable savings for the EU due to the lower spread over the benchmark. Nevertheless, according to early ECB estimates, Next Generation EU issuances will raise the EU's debt by a factor of roughly 15, making it the largest ever experiment in supranational euro-denominated debt sharing.

[5] See inter alia, contribution published at the CEPR available here.

its appeal (or potential lack thereof) to achieve its aims for the euro area more broadly and individual Member States specifically.

If the TPI (or the promise of its activation) fails to deliver, then one would (possibly) need to return to the drawing board or the ultimate fallback of the Outright Monetary Transactions (**OMT**) program. The OMT was prepared by President Lagarde's predecessor, Mario Draghi in 2012, i.e., at the height of the euro area debt crisis. While never used, OMT remains operational and involves the use of the European Stability Mechanism (**ESM**) but that also has its own drawbacks. Some of these OMT barriers included conditionality of having to negotiate a programme of reforms with the ESM, thereby presenting the risk of being politically sufficiently onerous and difficult for any EU Member State in requesting it. In contrast, other instruments such as the European Commission's SURE as well as the relatively new ESM Pandemic Crisis Support instrument were agreed with fairly limited conditionality, yet they are both very narrow in scope and duration. SURE proved successful in deploying resources to protect jobs and incomes affected by the pandemic, however, the ESM initiative had little success given that the stigma around conditionality appears to have extend to that new instrument as well.

Given the above, it remains to be seen what further details the ECB will release in relation to the TPI, its potential use and any other adjustments to the monetary policy toolkit. In any event TPI is but one of many tools that the ECB will continue to deploy to do "whatever it takes" in achieving its mandate. That being said it remains, in many ways, still very much up to the European Commission to focus on how to drive economic growth and recovery in setting its immediate aims in September and ultimately its 2023 work programme's priorities ultimately in the fourth quarter of 2022.

About us

PwC Legal is assisting a number of financial services firms and market participants in forward planning for changes stemming from these proposals.

If you would like to discuss any of the developments mentioned above, or how they may affect your business more generally, please contact any of our key contacts or PwC Legal's RegCORE Team via de_regcore@pwc.com or our website.

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