DG Economic and Financial Affairs
European Commission
Brussels

06 January 2012

Dear Sirs,

Response submission from the International Capital Market Association (ICMA)
Re: European Commission Green Paper on the feasibility of introducing Stability Bonds

This response submission addresses the Green Paper, launched by the European Commission under cover of a press release dated 23 November, on the feasibility of introducing Stability Bonds. In responding we focus our comments on technical aspects of Stability Bonds' issuance, leaving aside questions regarding whether such issuance is, or is not, desirable. We also note that in commenting we have not considered Treaty change implications.

The response comprises three integral parts. Part I presents a synthesised view informed by thinking from all parts of the value chain, drawing together a range of inputs provided by ICMA's member firms which thus encompasses issuer, intermediary and investor perspectives. Part II has been prepared specifically by the buy-side ICMA Asset Management and Investors Council (AMIC). Given that the achievement of investor acceptance will be a crucial factor in the actual feasibility of any Stability Bond issuance proposal, we considered it valuable to include this more focussed segment providing the European Commission with tangible advice concerning these important buy-side specific viewpoints. Finally Part III offers a few more detailed thoughts on some of the many legal questions which will demand thorough scrutiny in case there is to be adoption of any scheme for the issuance of Stability Bonds.

The ICMA appreciates the valuable contribution made by the European Commission's examination of the issues articulated in this Green Paper and would like to thank the European Commission for its careful consideration of all of the points made in this response. The ICMA remains at your disposal to discuss any of the above points.

Yours faithfully,

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Part I

Synthesised ICMA Views

Introductory comments regarding ICMA:

ICMA[1] is a pan-European self regulatory organisation and an influential voice for the global capital market, of over 40 years standing. It has a membership of well in excess of 400 firms, representing a broad range of capital market interests including global investment banks and smaller regional banks, as well as asset managers, exchanges and other venues, central banks, law firms and other professional advisers. Our main role is to set industry standards to help create and maintain orderly and well-functioning capital markets. As an organisation based in Europe, we are keen to work collaboratively with the European authorities in furtherance of their and our objectives.

The views expressed in this response are the carefully reflected current outcome of continuing discussions with our members, but, given the diversity of our membership, should not be read as having specific endorsement from any individual ICMA member firm.

Overall ICMA commentary on the Green Paper's three proposed approaches:

The European Commission's Green Paper on the feasibility of introducing Stability Bonds considers three approaches:

(1) the full substitution of Stability Bond issuance for national issuance, with joint and several guarantees;

(2) the partial substitution of Stability Bond issuance for national issuance, with joint and several guarantees; and

(3) the partial substitution of Stability Bond issuance for national issuance, with several but not joint guarantees.

In evaluating the respective feasibility of these three options a rational starting point is to focus on the differences which exist between them. On this basis we consider that there are in fact just two major features to examine. These are:

- "Full" versus "Partial" substitution – being the difference between the approaches (1) and (2); and
- "Joint and several" versus "Several but not joint" guarantees – being the difference between the approaches (2) and (3).

We note that these are indeed identified as the "Main features" in Table 1 within the Green Paper, which goes on to explore that they have different effects upon a number of important considerations.

One element which makes the assessment of these effects particularly tricky is the fact that they will vary over time. In illustration of this point we note our experience that the same commentator can change his perspective, depending if the question being asked involves immediate adoption of one of these options; adoption only after a couple of years in which good progress has been made in easing tensions currently experienced in European Sovereign markets; or adoption following many further years of fiscal integration amongst the euro-area Member States.

We believe that credibility, simplicity and certainty should be guiding principles in all cases.

[1] For more information regarding ICMA please go to https://www.icmagroup.org/home.aspx

“Full” versus “Partial” substitution:

In assessing whether to pursue the path of full or partial substitution, we consider that it is vital to give detailed consideration not just to the Stability Bonds but also to the remaining national bonds that must be anticipated in the partial approach. It should be possible to design an effective scheme accommodative of both, but this does require that the design of the Stability Bonds be tuned in a way which leaves appropriate space for any ongoing national bond requirements, which will themselves need to achieve adequate liquidity levels and be capable of being predictably funded. We note that it took many years for the US market to evolve its matrix of federal, state and local bond issuances.

A crucial question embedded in the consideration of this element is how the split would be determined in case a partial substitution scheme is to be adopted. A generous threshold for a partial scheme might mean that there was little difference compared to full substitution; whilst, on the contrary, a very tight threshold would inevitably exacerbate concerns over the financing of the remaining national bonds. Whilst a threshold equivalent to 60% of GDP is aired as one alternative, there is no doubt that rational arguments can be made for other figures or indeed for some more flexible approach (which might attractively ease any cliff effects associated with the application of a rigidly set limit). Equally there may be other credit metrics or economic characteristics, such as original maturity, which could be used, either individually or in some combination, to establish a suitable split. Whichever approach might be adopted, we see that there would need to be sufficiently robust mechanisms in place objectively to control its application.

One obvious point argued in favour of full substitution is that it creates the largest potential pool of obligations, which should in principle attract the greatest liquidity and create the most attractive benchmark. The better the benchmark the more useful role it can play in support of other markets, such as corporate bonds and derivatives, which can be priced off of it. Nevertheless we recognise that beyond a certain point the incremental benefit of further increasing the size of the pool will become somewhat marginal. It may well be that the pool of Stability Bond obligations which would arise under a partial substitution approach would in itself prove to be quite large enough.

“Joint and several” versus “Several but not joint” guarantees:

On the question of which guarantee structure to adopt we perceive that a key consideration is credibility. This needs to be considered not just at the moment of issuance but throughout the life of the guaranteed obligations, which may of course stretch across periods of economic fluctuation. Accordingly the design of Stability Bonds should factor in an element of stress, to generate confidence that it will be robust enough to persist. Relevant stresses to consider should encompass a range of economic scenarios, which should certainly include (but not be limited to) circumstances of rapid deterioration in the fiscal position of multiple Member States – much as has been witnessed over the course of the last couple of years.

So long as there is credibility, the simple starting point would appear to be that joint and several guarantees offer a greater degree of credit enhancement for investors than they would enjoy with several but not joint guarantees. And it is rational to assume that the stronger the credit the lower the rate that will need to be paid for the same volume of investment. Nevertheless it is of course also necessary to consider other elements which will impinge upon the credit analysis of the Stability Bonds. This will particularly include the issuance structure, including the detailed construct of both its capital and its asset base.

Practical questions:

In case Stability Bonds are to be issued there are many practical details which will need to be fully assessed and suitably addressed. Whilst these do not for the most part affect the balance of advantage between the three options under consideration, we note that these will include:

- Who issues – a new authority or an existing one? How will any guarantees be attached?
- Euro-area only, or can other EU Member States also raise euros through this channel?
- What is the relationship of Stability Bond obligations, including those of guarantors, to existing obligations, particularly considering any legal or structural subordination?
- How will admission of new euro-area (or EU) members impact the arrangements?
- Will there be a single debt management office, continued national ones, or some combination of a new central one and the existing national ones?
- Will issues be through auctions and, if so, who will be admitted as primary dealers, or through syndication managed by appointed lead arrangers, or both? What market-making arrangements are envisioned?
- Will settlement be within a CSD, the ICSDs, or some combination?
- Will the Stability Bonds attract the highest credit ratings, ECB collateral eligibility and admission to sovereign bond indices?
- Will full terms and conditions be prepared in a form consistent with market standards? Including collective action clauses akin to those currently being prepared for euro-area adoption?
- Will terms and conditions be published and readily available? In English, for the benefits of international investors? Already our members firmly favour seeing such transparency consistently delivered and they would certainly expect it to also apply to any future Stability Bond issues.
- Which governing law and place of jurisdiction will be adopted?

Also included in Part III of this response are a few more detailed thoughts on some of the many legal questions which will demand thorough scrutiny in case there is to be adoption of any scheme for the issuance of Stability Bonds.

Other approaches:

We also observe that, whilst the Green Paper has focussed on three specific options, there are quite a number of other related proposals which have been made. As work progresses these should continue to be borne in mind, as each of their promoters may indeed have good insights which should be factored into the design of any proposal which may subsequently be selected for actual adoption.

Part II

Views from the ICMA Asset Management and Investors Council (AMIC)

Introductory comments from ICMA AMIC:

The ICMA AMIC was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation. Taking into consideration the changes that have occurred in the industry, the AMIC composition embraces the diversification and the current dynamics of the industry – taking the asset management representation to a broader and global level.

The AMIC welcomes the opportunity to respond to the European Commission Green Paper on the feasibility of introducing Stability Bonds. The AMIC response summarises the changes in investors' behaviour in the face of the current crisis, followed by some views on points investors would want to clarify regarding the possible issuance of Stability Bonds and finally reviews the different options proposed in the Green Paper.

Faced with the eurozone crisis investors are changing their behaviour:

The sovereign debt crisis and persistence of low interest rates in advanced economies has fundamentally altered global asset allocation and associated investment decisions of long-term unleveraged investors and the behaviour of those investors.

Indeed capital flows that have been triggered by the crisis, and which have been very disruptive, have mainly occurred within the borders of the eurozone. Indeed the capital flight has involved a repatriation of holdings of peripheral bond markets back to domestic debt and also some shift of bank deposits into the core. Banks, insurance companies and pension funds in Northern Europe have reduced their lending to overextended countries to safeguard their money. Many now are only comfortable investing at home or in the safest markets such as Germany, threatening a complete fracturing of the eurozone financial markets along national lines. Stability Bonds could therefore draw investors out of their national markets into the broader eurozone market, while also attracting greater investment from non-eurozone asset managers.

One highly significant consequence that AMIC members have noted is that investors are changing their behaviour towards benchmarks. Mandates – stating investor aims, limits within which to invest, and the investment policy to follow – are moving away from eurozone aggregate benchmarks to just using the Bund market as a benchmark, leading directly to revised portfolio allocations.

Investors with a longer horizon appear much more sensitive to liquidity risk and are less willing to provide market liquidity. Having suffered losses from forced sales during the crisis, many managers of retail mutual funds have increased liquidity to guard against fire sales. Even long-term real-money investors, who should be able to capture a significant liquidity premium, are hesitant to hold such assets – a tendency aggravated by solvency regulations and a preference for mark-to-market rather than the buy-and-hold view of investment risk. The disruption of liquidity during the crisis and the recent sovereign risk concerns have made investors especially mindful of market liquidity risks and the importance of credit risk in sovereign bond markets – even in the most developed countries. There is strong anecdotal evidence that these events have altered asset allocation frameworks in a structural and lasting way.

These modifications of investor behaviour are reflected below in the features that investors would like to see addressed should Stability Bonds be adopted.

Assessment of the creation of a eurozone Stability Bond market:

AMIC members believe that a new market, with deep liquidity and of unchallenged credit quality, which could compete with the US Treasury market, would be very positive for investors. However members have listed a number of features that they would like to see if there is to be such a market and have raised questions regarding certain aspects of the issuance of these bonds. While it is acknowledged that the Green Paper merely outlines a range of possible options, members would appreciate some further clarity regarding how these options might be implemented.

Firstly, as mentioned above, market liquidity is a major concern. AMIC members are interested to know who would be responsible for making a market for these instruments, and how market liquidity can be assured. There are also underlying questions regarding the size of issuance, and whether investors might be swamped by the aggregate volume of paper being issued. More clarity on what institution would issue the Stability Bonds would also be helpful.

As explained in the Green Paper Stability Bonds would be, in effect, a mechanism of credit risk transfer from weaker countries to stronger countries. Investors would need to be reassured regarding the risks involved in common issuance, the impact on the liquidity of the instrument, and its rating. With a number of AAA ratings currently looking fragile, there is a risk of downgrades and members need to understand how the collective rating of the Stability Bonds would be affected by potential national rating downgrades.

Other areas where investors would need reassurance relate to credit risk, legal risk and the underlying legal structures. The Green Paper does not provide any indication regarding the jurisdiction under which Stability Bonds would be issued. Other questions from AMIC members relate to the creation of a CDS market to accompany the new bonds.

The issue of moral hazard, as discussed by the Green Paper, has also been mentioned as a major issue and will need careful consideration. It is clear for AMIC members that the issuance of Stability Bonds is a long-term development given that many current sovereign bonds have maturities of more than 30 years. Some members have queried whether these bonds would be allowed to roll off naturally or whether there would be some sort of clean-up operation at some point.

Ultimately what investors would like to see is a modern, deeply liquid, homogenous market of stable and predictable credit quality. The advantages that such a market could offer are clear, but many questions remain, regarding both when such a position might actually be achieved and also as to what institutional structures would be necessary to achieve broad acceptance of the concept. Without some form of credit homogeneity, the current fractured issuance market continues to risk seeing borrowers being sequentially picked off and shut out of the market.

The different options proposed by the Green Paper:

The Green Paper makes the case that Stability Bonds could come in many shapes and sizes and that it may be possible to customise them to perform both the role of crisis bonds and a deeper role as precursors to a closer fiscal union.

Turning to the specific options outlined in the Green Paper, the paper itself alludes to the desirability of the first option, the variant that reflects the closest form of fiscal coordination.

Options (2) and (3) meanwhile represent pragmatic alternatives, reflecting ways to handle administrative issues such as the need to try to avoid requiring Treaty changes or an attempt to mitigate moral hazard.

The key virtue of option (3) is that it should be relatively quick to implement, as it is hoped that it would require no Treaty changes and it has none of the political complications associated with joint guarantees.

However, rating agencies have already made it clear that they would rate common issuance under a several guarantee in line with the rating of the weakest member. The issue here is the probability of default rather than its severity, so in effect the rating reflects the probability of the first loss.

Had this option been introduced prior to proposals to haircut Greek debt held by the private sector, it is conceivable that it might have been positively perceived. However, now that the possibility of losses on even the highest rated eurozone sovereigns has been acknowledged in the EBA stress tests, it is unlikely that a structure that involves no credit uplift would prove a viable solution. What investors need is as high a degree of credit certainty as it is possible to achieve and for that credit quality to be easily demonstrable.

Option (2), the “Bruegel” option, introduces joint liability, but maintains the market discipline of continuing national bond issuance. While the concept of issuing subordinated debt to impose market discipline has been much discussed in academic circles, the reality has proved less satisfactory. Subordinated debt has been a source of extreme uncertainty and investor resentment: illustrated in high profile cases such as the counter-intuitive recoveries on the subordinated credit derivatives of Fannie Mae and Freddie Mac in 2008; and Ireland’s bank bond exchanges earlier this year.

The key issue with subordinated debt as a means of imposing market discipline is that it has to be capable of absorbing losses without the liquidation of the entity concerned. Generally though, market discipline imposed by subordinated debt is delivered too late and is too stringent to promote anything other than additional stress. As they are currently drafted, existing sovereign bonds can only absorb losses in the event of a default, which would exacerbate market instability at the time of greatest stress.

Moving to option (1), the real question is whether the intention is to find a quick fix, or to transition towards a deeply liquid, modern market. The political sensitivities regarding moral hazard must clearly be addressed by a sufficiently robust fiscal structure and the Green Paper acknowledges this without necessarily making recommendations about its form. However, a sufficiently rigorous fiscal framework is equally necessary for either option (2) or (3) to succeed.

To that end, AMIC members consider it is too simplistic to state that the current crisis has resulted in a flight to quality benefiting German assets at the expense of the more “peripheral” sovereigns. There is a fine distinction between an intra-eurozone flight to safety and a more general flight from the euro. At times it has not been entirely clear that even the Bund market has been immune to the flight from euro assets. Longer-dated Bunds have, on occasion, yielded more than dollar LIBOR on an asset swapped basis. This rather suggests that all parties to common, joint and several issuance could stand to benefit going forward.

Part III

Certain legal questions pertinent to the evaluation of the feasibility of Stability Bonds

Introductory comments:

There are many legal questions which will demand thorough scrutiny in case there is to be adoption of any scheme for the issuance of Stability Bonds. In its discussions regarding the Green Paper ICMA has identified a few of these, as elaborated in this part of the response. These points are included as a prompt for further thinking and are not intended to be comprehensive catalogue or examination of all such matters.

Through its membership and its own long standing in the market, ICMA has strong contacts with highly experienced legal professionals. As such, to the extent that work on the feasibility of Stability Bonds should continue to be progressed, ICMA would be happy to further elaborate on the questions raised herein or indeed on other pertinent legal questions.

Initial issuance:

The fact that there will be so many guarantors (whether joint and several or several) raises considerable practical problems. Lead managers of syndicated deals will not want to have to check on a deal by deal basis that all guarantors have validly granted their guarantee.

We would therefore think that some kind of agency vehicle as issuer would be sensible. With such a vehicle, the guarantee arrangements could take the form of an obligation (for example, in the constitution of the issuer) requiring the guarantors to ensure that the issuer always has sufficient funds to service its debt obligations. Thought should also be given to making the obligations of the guarantors to the issuer actionable by investors, enabling them to recover directly from the guarantors should they fail to perform their obligations to the issuer. With such a model, the lead manager of a syndicated issue would not need to check, on a case by case basis, whether the multiple guarantees have been given (because all issues by the issuer are covered under its constitution).

By contrast, if the obligations of the state are to be guaranteed on a case by case basis, the arrangements become much more difficult to operate in practice, although we suppose that a mechanism for attaching the guarantee could be developed. For example, it may be that each guarantor could agree that an agent, common to all guarantors, could issue a certificate that acts as a trigger to attach a pro forma guarantee to a particular issue. But that is not as convenient, we suspect, as the agency issuer option. And it may be less secure, from a legal perspective – for example, investors will not want to become involved in disputes between guarantor and agent as to whether a particular certificate was validly given.

Payments on default:

In case there is ever a default by the issuer, investors are going to want to be able to recover their money fast, which we note that the Green Paper acknowledges in the last paragraph on page 24. Investors will not want to have to make multiple demands on numerous guarantors. And, if there is any delay in payment by guarantors, investors will expect accrued interest on the defaulted amount (no doubt at default rates).

“Joint and several”, in its proper legal sense, would help here in that it would entitle the investor to demand the full defaulted amount from any of the guarantors (or any combination thereof) leaving the paying guarantor to demand contributions after payment from the other guarantors. But we perceive that the Green Paper is using “joint and several” in another sense – namely that, if one guarantor defaults, the others will pick up that defaulted amount. This is much less effective as it necessarily involves delay (while the demand on the defaulter is made, grace periods run and no doubt legal quibbles intervene), only after which a new demand can be made on the remaining guarantors.

An example of the sort of complexity which we consider would prove unappealing is an arrangement where in the case of a default each investor has to claim directly against each state for its pro rata share and no guarantee claim will be accepted if the investor has not simultaneously claimed against all guarantors. That would obviously be a significant problem in this context, given the number of guarantors. In short, what the market needs is a very speedy claim and repayment mechanism, and this again might be best achieved by an agency issuer with a requirement on the guarantors to ensure it is put in funds for each payment.

Structure:

Whatever structure is adopted, it will be very important that it avoids complexity. Recent experience has shown that complexity confuses markets. Investor confidence, particularly in current market conditions, is closely linked to the investor’s ability to understand the product and, thus, to evaluate the risk.

Subrogation:

Some thought needs to be given to what happens when the guarantors pay. Presumably they will want to be subrogated to the claims of the investors. How will that be achieved? How will the subrogated claims rank against the issuer? Will the guarantors be entitled to a payment as compensation for having met the defaulter’s obligations? If so, how will that payment rank as against other market obligations of the defaulter?

Defences:

We do not understand the statement in paragraph 4.1.3 that “there may be a problem if all government debt was covered by UK or US law, because the Anglo-Saxon case-law approach is different from the legal system in many Member States”, as we cannot see why English case law presents a problem. Many billions of dollars worth of guarantees in the bond markets are subject to English law; and legal opinions say, in each case, that the guarantee works. It is true that there are cases in English law that call particular guarantees into question; but the cases have helped lawyers over the centuries to draft guarantees that are legally water-tight. The assertion that English law relating to guarantees may be problematic is therefore incorrect and it is important that those benefitting from numerous such guarantees in the financial markets should understand that fact.

Having said that, many other systems of law no doubt also provide the requisite legal certainty and would be a suitable choice as governing law for the guarantee arrangements contemplated by the Green Paper. Most legal systems will have developed defences for guarantors against unwarranted or unfair claims though and whichever legal system is chosen, there needs to be legal certainty that those defences will not prevail against those claiming under the guarantees. In particular, the market will need to be convinced that the question of sovereign immunity is properly covered (both as to suit and execution of judgements).

Form of guarantees and governing law:

If separate guarantees are used (rather than a single agency structure) it will be very important that each is in identical form and is subject to the same governing law. Investors will not want to follow different legal procedures when they make their claims or, in the event of non-payment, to take proceedings in many different courts. Equally, each guarantor will be concerned to ensure that the other guarantors are subject to the same contractual texts and legal rules to avoid the risk of one of their number escaping from liability due to a loophole in the language of the guarantee or in the law governing its guarantee, with the resulting shortfall having to be met by the other guarantors.