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Response to the European Commission's Consultation on the Feasibility of Stability Bonds

Global Public Finance Unit

January, 2012

Identification of the respondent

The response below is given by Daniel Navia, Global Head of Relationship Management for Central Banks and Sovereign Wealth Funds, on representation of the Global Public Finance Unit of Banco Bilbao Vizcaya Argentaria S.A. (BBVA GPF), a registered financial institution.

Response

1. BBVA GPF welcomes the opportunity to express its views on the prospects for Stability Bonds. The EC has shown decisive vision and leadership in producing this paper, and has put forward with great clarity the main vectors of the debate.
2. A reform of Euro area debt issuance procedures is desirable regardless of ongoing pressures in sovereign debt markets. In the same vein, a strengthening of the fiscal framework in the European Union is also a positive goal, regardless on the current crisis and regardless of the introduction of Stability bonds.
3. BBVA GPF shares all the arguments in favour of Stability Bonds put forward by the EC, particularly those relating to medium term benefits in financial stability, liquidity, the international status of the Euro and the transmission of monetary policy. Stability Bonds are a worthy instrument even if they cannot solve the debt crisis.
4. Timing and ownership of any decision regarding Stability Bonds is crucial. Most ambitious forms of Stability Bonds (options 1 and 2 in the Green Paper) cannot be accomplished in the short term without risking a lack of popular support. Several liability bonds (option 3 in the Green Paper) would be feasible in the short-term, as they do not imply a mutualisation of debt, and still provide a sensible first step in a gradual approach to deeper integration.
5. As in practice the choice at this stage seems to be between Option 3 and no action in this matter at all, BBVA GPF would support the introduction of several liability bonds (as in option 3). In fact, BBVA GPF has produced a first analysis of how this bond might work in practice, with its report on basket bonds.
6. In order to limit moral hazard, the use of an internal calculation (as in Box 2) to distribute the costs of Stability Bonds deserves consideration as it would avoid moral hazard and mitigate the risk of self-fulfilling spirals in funding costs.
7. Stability Bonds should be designed to be the risk free asset used by Euro area investors, particularly Euro area financial institutions. The design of Stability Bonds should not put too much weight on capturing non-Euro area demand.
8. The importance of achieving a high credit quality is probably overstated in the Green Paper. As shown by Japan or more recently the US, an AAA rating is not a precondition for international investors outside the Euro area.
9. In view of this, it is not clear why a several liability Stability Bond would require overcollateralization or seniority, as proposed in the Green Paper. These design features could in fact be counterproductive because they increase the complexity of the product (whereas investors in sovereign debt are looking for simplicity).

10. The importance of liquidity and primary markets may be underestimated in the Green Paper. The perverse dynamics created by having each Euro area member tapping markets on their own at times of stress should be tackled. Escalating bond yields because of illiquidity is the main threat to debt sustainability and hence dealing with the liquidity mayhem would alleviate solvency concerns shown by market participants. A several liability bond would coordinate national issuance policies and improve market liquidity for all members.
11. If the priority is using Stability Bonds to mitigate the ongoing debt crisis, two (non-exclusive) options could be considered to achieve this with a several liability bond:
    - It would have to completely substitute domestic issuance by national governments. This would starve investors of supposedly less risky assets, facilitate the adoption of the Stability Bond as the Euro benchmark and show a strong commitment from member countries towards the Euro project.
    - It would have to be adopted as the first step in a strategy leading to more ambitious options (ie.joint and several bonds). In this regard, BBVA GPF would welcome the adoption of a roadmap for the creation of Stability Bonds, a possibility that according to press reports is apparently being considered.
12. Regulatory treatment of the Stability Bond is a very important concern. Three key conditions should be guaranteed to ensure the demand for a several liability Stability Bond:
    - A fair treatment in terms of capital requirements, either in Basel regulation or in stress testing. The recent EBA exercise was very damaging in this regard.
    - Its eligibility as collateral for ECB lending. As emphasized above, this point is critical for the main group of buyers, Euro area financial institutions.
    - It must not be considered an ABS: a several liability bond does not involve tranching or structuring of credit risk, there would be no argument for treating it as an ABS.
13. In terms of next steps, a realistic estimate of how long it would take to create a several liability bond in the Euro area could be around 6 months, with risks tilted to the whole process taking longer.

About BBVA GPF and the basket bond proposal

The Global Public Finance Unit at BBVA is responsible for business with public sector clients of all kind: from debt management offices to central banks to regional government. Members of the GPF team have backgrounds as public sector officials and/or in research departments, providing them with a broad range of skills to advice on policy.

The Global Public Finance Unit has produced a policy report entitled “A unified sovereign debt issuance procedure in the Euro area with a basket bond”. The views expressed in this response are in line with those expressed in the aforementioned policy report. The authors are available to provide further clarifications at the EC request. The authors can be reached using the following email: daniel.navia@grupobbva.com.