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EUROPEAN COMMISSION CONSULTATION ON STABILITY BONDS

EFRP RESPONSE

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IDENTIFICATION OF RESPONDENT

The **European Federation for Retirement Provision (EFRP)** represents national associations of pension funds and similar institutions for supplementary/occupational pension provision. Its membership consists of institutions for work-related (2nd pillar) retirement. Some of them are also operating purely individual pension schemes (3rd pillar).

The EFRP has **22 members associations** in most EU-15 Member States and other European countries that have a significant – in size and relevance – workplace pension system[1].

In October 2006 the EFRP established the **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

83 million EU citizens are covered for their workplace pension plan by EFRP members. Through its Member Associations the EFRP represents approximately € **3.5 trillion of assets (2009) managed** for future occupational pension payments.

EFRP Members are large institutional investors representing the **buy-side** on the financial markets. They are specialised institutions solely dedicated to the accumulation and decumulation of assets to provide a supplement to the State pension to avoid old-age poverty.

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[1] EU Member States: Austria, Belgium, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Croatia, Guernsey, Iceland, Norway, Switzerland.

GENERAL COMMENTS

The European Federation for Retirement Provision (EFRP) welcomes the European Commission Green Paper on the feasibility of introducing Stability Bonds.

The EFRP expresses its support for the idea of introducing stability bonds and considers that Institutions for Occupational Retirement Provision (IORPs) might be interested in investing in them, particularly with reference to their low risk. Therefore, substantial financial guarantees and detailed legal provisions should be set when designing these bonds.

We warn that the introduction of stability bonds may have significant economic, political and financial consequences. Therefore, we call for a meticulous and exhaustive evaluation of such impact.

We agree with the Commission that the success of stability bonds would be strongly related to fiscal integration, budgetary discipline and policy coordination. Hence, we would like to stress that stability bonds could be a significant step, on top of a strengthened fiscal surveillance and a coordinated definition of macro-economic policies at EU level.

We highlight that stability bonds should be rather seen as a medium and long term instrument to help prevent the emergence of unsustainable fiscal positions than as an immediate response to the present sovereign debt crisis. Therefore, alternative solutions - and the relation between different solutions - to the problems facing the sovereign bond market should be discussed, including the role of the ECB and the debt redemption fund proposal.

We offer our availability and expertise to support the Commission in further exploring the feasibility of this initiative.

STABILITY BONDS' POTENTIAL BENEFITS AND SHORTCOMINGS

The EFRP agrees that stability bond issuance would offer the possibility of a large and highly liquid market for safe assets, with a single benchmark yield in contrast to the current situation of many country-specific benchmarks. Furthermore, the introduction of stability bonds could lead to lower financing costs for both the public sector and the private sector in the euro area and thereby reinforce the longer-term growth potential of the economy.

In the short term, stability bonds could cut the positive feedback loop when a Member State loses market trust. This could result in more financial stability, lower interest rates in Member States without an AAA-rating but also in a decrease of the interest rates of “safe havens”.

In the medium and long term, stability bonds can foster stability in the euro area and be a part of a solution to help prevent the emergence of unsustainable fiscal positions. However, stability bonds are not suited as an immediate response to the present sovereign debt crisis.

Liquid, safe and stable bonds could be useful instruments for IORPs, also in order to diversify the asset mix. In addition, pension funds would benefit from higher economic growth due to the lower financing costs. However, lower interest rates will imply lower returns for pension funds and could have a negative impact on pension funds when they have to discount their liabilities with this interest rate.

The EFRP welcomes the fact that the Commission warns about the moral hazard risk. The EFRP's position is that common issuance of bond and the mutualisation of public debt can only be part of an enhanced economic governance in the euro area aiming at strengthening fiscal discipline and safeguarding a sustainable growth.

IMPLEMENTATION IS COMPLEX AND CRUCIAL

The answer to the question *whether* stability bonds would provide financial stability and economic efficiency fully depends on *how* these stability bonds will be introduced. As the European Commission mentioned, a sufficiently robust framework for budgetary discipline and economic competitiveness at national level and a more intrusive control of national budgetary policies by the EU would be required. Without these commitments, the loosening of incentives caused by stability bonds will undermine the confidence in repayment, thus the liquidity and stability of the market. We are pleased that the European Commission acknowledges that an appropriate implementation will be crucial. The Green Paper goes into detail on implementation issues like the organisational set-up, the legal regime, market conventions and accounting issues. The EFRP is of the opinion that it is very important that *all* implementation details are accomplished and agreed upon by the time the scheme gets proposed.

As a potential buyer of stability bonds, the pension sector wants to point out that financial markets expect a transparent relation between risk and return. With their long history of trading sovereign bonds, markets are used to (and have ways to) assess the risk of national bonds. With the introduction of stability bonds, markets would have to assess the risk inherent in a joint bond. That is the stacked risk of many things: the collective holding together, and all the cases in which a single Member State would become delinquent and what that would mean for the common bond. The relation between risk and return becomes less transparent, especially with joint and several guarantees (Approach 1). This argues for maximum simplicity and transparency in the design of the bonds:

- First of all, the default mechanism should be clear, both for debt that falls outside the main, jointly guaranteed supply and for the stability bonds themselves.

- Another essential element for institutional investors is predictability. When political decisions can change the conditions of the stability bonds along the way, this will reduce the willingness to invest in the new bonds. The European Commission should take this into account and rule out political interference from the start.

IMPACT ASSESSMENTS REQUIRED

Currently, institutional investors have the option of diversifying their investments among different European Member States. Pension funds are traditionally looking for opportunities to diversify in order to reduce their risks. With stability bonds Approach 1, the option to diversify disappears and the whole financial sector in Europe is exposed to one instrument. This concentration of risk in a very systemically important asset means that it is crucial that all the details and implications have been worked out thoroughly in advance. In the opinion of the EFRP, it is of the utmost importance that the in-depth impact analyses of the introduction of stability bonds include the potential consequences on the European economy and the financial sector.

Another important question is what the status of the outstanding bonds will be relative to stability bonds. If the currently outstanding bonds become junior to the jointly issued bonds, this will increase their risk and the yields on the outstanding bonds will increase. This means that the current holders, for example pension funds and their members and beneficiaries, will pay the price of the introduction of stability bonds. On the other hand, the odds of a default go down if this plan is accepted, as it would likely calm markets and give countries a source of financing to pay off the old bonds. An impact assessment is needed to quantify these effects.

As some credit rating agencies recently stated, the stability bonds, if jointly introduced, would be given the rating of the lowest Member State participating.

Such a result would completely undermine the potential benefits of the introduction of stability bonds. Therefore, the question of the future rating of the stability bonds is also crucial and need to be assessed according to the different options.

OTHER INSTRUMENTS

The Green Paper recalls the potential beneficial effect of stability bonds in alleviating tensions in the sovereign debt market. Nonetheless, as recently highlighted by the European Parliament in its draft motion for a resolution[2], stability bonds should be rather seen as a medium and long term instrument to help prevent the emergence of unsustainable fiscal positions than as an immediate response to the present sovereign debt crisis. Design and proper implementation of a new financial instrument, such as stability bonds, would require detailed provisions and, therefore, a relatively long time.

On the contrary, solutions to the sovereign debt crisis should be put in place rapidly and, therefore, they should be rather defined within the existing structures. Alternative solutions - and the relation between different solutions - to the problems affecting the sovereign bond market should be assessed. In particular, emphasis should be put on the role of the ECB and the debt redemption fund proposal.

Moreover, stability bonds may not be sufficient to solve debt problems of some Member States. These may need to restructure their debt anyway. Such eventuality should be dealt with before any joint issuance.

[2] European Parliament, Draft Motion for a Resolution on the feasibility of introducing stability bonds (2011/2959(RSP)), B7-00/2011

THE WAY FORWARD

Stability bonds could represent a significant contribution to the improvement of long-term sustainability of the European economy. However, the introduction of these bonds would require binding political decisions, a detailed organisational and legal groundwork and the definition of a new set of market conventions. Moreover, full commitment from Member States and clear communication of all the implementation details to potential investors are inescapable conditions. Otherwise, the introduction of these bonds might seriously hamper the European economy. Very extensive and detailed assessment is therefore required. Notwithstanding interest of IORPs as potential investors in stability bonds, the EFRP is supportive of the Commission carrying out further analysis of feasibility and offers its availability and expertise to contribute to the assessment of all possible consequences of the introduction of stability bonds.