Introduction

On 23 November 2011 the European Commission issued the green paper "On the Feasibility of Introducing Stability Bonds". The purpose of this Green Paper was to launch a broad public consultation on the concept of Stability Bonds with all relevant stakeholders. ING welcomes this initiative by the EC, and is in principle supportive of the introduction of such bonds, subject to certain conditions.

This document presents ING's comments to the Green Paper. The aim of this document is to express ING's general opinion on a way forward for a sustainable introduction for a common debt issuance by sovereigns in the Euro area which contributes to enhancing the credibility of the Eurozone. This document provides a high level overview of a framework of the Stability Bonds that ING sees as most effective. It also describes the general preconditions necessary to come to a viable and sustainable situation. It does not contain a comprehensive overview of technicalities nor comments on the various alternatives. In our view the core principles should be agreed upon first, after which further details can be worked out, preferably by a working group consisting of members of both the public and the private sector.

This document will first elaborate on the general economic and political preconditions necessary for the introduction of the stability bonds. After this, suggestions for the financial terms and conditions of the Stability Bonds are presented.

Economic Preconditions

Stability Bonds are effectively an implicit fiscal transfer from the core to the periphery, which may be more acceptable and create less political opposition in the Euro countries. However, Stability Bonds in itself are not a solution for the current crisis, which is mainly driven by a lack of convergence and the failure of the Excessive Deficit procedure and the Stability and Growth Pact. Stability Bonds could even make matters worse, as they entail the risk of undermining fiscal discipline.

To reap the full benefits from a commonly issued Eurobond and to make it an effective instrument for crisis prevention, some conditions need to be met before Stability Bonds can be introduced successfully. To address the issue of lack of convergence, we propose that the economies of the various countries in the Euro area should all ultimately reach a sustainable Debt to GDP level, which is widely believed to be a maximum of 60% in the long run. For this convergence structural reforms in both peripheral countries, but also in the core countries are a necessity. These structural reforms should not only focus on austerity measures, as is currently the case, but they should also be aimed at improved competitiveness and growth of GDP. We envisage that for a successful introduction of Stability Bonds the maximum Debt to GDP ratio for any of the participating countries amounts to 80% ideally. However, under current circumstances it would have to cater for all debt, with a rigidly strict objective to converge towards 80% in the medium-term and towards 60% on the longer term.

We recognise that such a situation will not be achievable overnight, but we deem that concrete resolutions for such a recovery path are not within the scope of the Green Paper and this consultation.

For that reason we also put to one side merit in considering other solutions aimed at soothing the debt crisis, such as a limited-term stability joint and several liability bond that funds all Eurozone bond redemptions for a specific period (say for 5 years), or a variation of the blue/red bond approach where the blue bond is funded at market levels but disbursements to national exchequers could be done at different rates depending on an agreed pricing matrix that reflects selected macro variables (such as deficit and debt levels).

Political Preconditions

Next to economic convergence a stronger governance and discipline around the budget of Euro member countries should be in place. The measures taken at the recent Euro summit of 8th December 2011 are a step in this direction, but are certainly not enough for a successful introduction of Stability Bonds. Measures that enhance a fiscal union should be accompanied by strong surveillance and regulations to circumvent issues with unsustainable debt levels by Euro members. This basically entails the transfer of budget and economic sovereignty to “Europe”, where "Europe" is not an intergovernmental body, but either the Commission or another politically independent body like the IMF.

Legal Framework

Before issuing Stability Bonds it is required to have a clear legal framework which covers situations of a country defaulting on its obligations. Preferably Stability Bonds should be issued under UK Law, as most market participants are familiar with this framework in the context of bond issues. Furthermore, since the UK is not party to the Stability Bonds, it will provide comfort to investors that they will not be restricted in their rights going forward.

Furthermore, the documentation should explicitly address the consequences for countries that exceed the pre-agreed debt to GDP ratio of 60%. In that case they will need to issue junior bonds and accept increased surveillance and possible IMF involvement. Also, the terms and conditions of the Stability Bonds should not change during the lifetime of the bond issue. Recent experience shows that any (perceived) change to these terms and conditions leads to surprises and market uncertainty with adverse pricing and liquidity consequences, which hampers the functioning of financial markets.

Financial Framework

This section presents suggestions for the framework under which the Stability Bonds should be issued. The suggestions are geared towards creating maximum fiscal discipline, liquidity and transparency for the Stability Bonds. This will ensure that the Stability Bonds will serve as risk free securities. Risk free securities are crucial for well-functioning financial markets. They are used by banks for liquidity management in accordance with Basel 3 rules and as collateral in interbank transactions. Furthermore, investors use them as the foundation of their investment portfolios. They are also used as reference benchmarks for pricing purposes.

Risk free securities require not only minimum credit risk, but also a large liquid market, as well as a clear and transparent pricing mechanism. Joint issuance, with joint and several guarantees of all issuing sovereigns, will create a market that can truly be seen as deep (expected size compared to US market).

This will be beneficial for all Euro sovereigns, as this will translate into favourable pricing of the Stability Bonds. The benefit for European banks is the increased supply of high quality liquid assets they require for their liquidity investments.

Our proposal comes closest to option (2) described in the Green Paper. In our proposal we would distinguish blue and red bonds. A lot of detailed papers have been drafted on blue/red bond concepts, including the internal pricing. We refer to these documents for further details. As stated in the introduction, we would welcome a more fundamental discussion and decision first, before engaging in more technical issues.

The blue bonds or Stability Bonds are jointly issued by the Euro members, while the red bonds are issued by the individual national governments. The Stability Bonds should be issued by a single, central debt agency that has direct links to a body that has the power to raise any fiscal measures. Countries can only participate in the Stability Bonds when their Debt to GDP ratio is below a ceiling of 60%. These blue or Stability Bonds will be ECB eligible.

Whenever a government budget exceeds the 60% Debt to GDP level, the sovereign may no longer finance its excess funding needs through Stability Bonds. It then needs to issue red, or national government bonds. These bonds rank junior to the Stability Bonds and are not ECB eligible. The advantage of having this threshold is twofold:

(1) It will provide comfort to the ECB to take on the role of lender-of-last resort with respect to the funding through the Stability Bonds.
(2) It will discipline governments to remain within the agreements of the Growth and Stability Pact, as the need to issue outside of the Stability Bonds framework will be negatively perceived by the market and hence costly.

Concluding Remark

ING clearly sees benefits to develop a Stability Bond framework under joint and several liability up to 60% of Debt to GDP (so called blue/red bond option) for both sovereigns (lower pricing) and investor communities (increased liquidity). Before engaging into technical details we would welcome a decision to explore this route. We are available for more in-depth discussions on details of the framework outlined in the previous sections.

For more information, please contact:

ING Group N.V.
Public and Government Affairs
E johanneke.weitjens@ing.com
ING Corporate Credit Risk Management Bank
E bartje.schotman-kruiten@ing.nl