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UniCredit's reply to the European Commission Consultation on Stability Bonds (ID Number 03094871618-32)

UniCredit is a major international financial institution with strong roots in 22 European countries, active in approximately 50 markets, with 9.585 branches and more than 161.000 employees. UniCredit is among the top market players in Italy, Austria, Poland and Germany. In the CEE region, UniCredit operates the largest international banking network with around 4.000 branches and outlets. UniCredit Group is a market leader in the CEE region. Furthermore UniCredit has been recognized as Global Systemically Important Financial Institution in the recent G20 London meeting.

Executive Summary

UniCredit is firmly convinced that there is a need to reinforce the architecture of the Economic and Monetary Union with a long term vision, whose implementation must be credible and without any further and undesirable delay.

Even if the latest December political agreement at the EU and Euro area levels is quite late given the ongoing significant markets pressures on the Euro area, it is definitely a step in the right direction. However, the lack of details on any form of risk sharing implied by the forthcoming EU Treaty changes, the role of the EU institutions in the to-be-reformed EMU economic governance, as well as the uncertainty on the effective enforcement of Treaty changes are raising several doubts on the ability of this recent political agreement to be able per-sè to restore confidence about the future of the EU and the single currency in the long term.

The **Stability Bonds** proposed by the EU **Commission are a key ultimate target of a convergence process towards a genuine "fiscal stability union"**, as called in the statement of the Euro area heads of state or government on 9 December 2011.

Specifically **concerning the options** proposed by the EU Commission on the stability bonds, we conclude as follows:

- due to its complex structure option 3 (partial substitution without joint guarantees), which could most likely be realised in the short term, does not seem to be suited to contain the sustained current massive loss of confidence in the markets. Confidence boosting measures adopted by lower rated States, such as providing additional collateral, would create in turn additional negative effects for outstanding bonds already issued by these States. It is hence questionable if the proposal will really be beneficial overall;

- from our perspective we deem **option 1 (full substitution with joint guarantees) to be the best suited to contribute to restore confidence, satisfy the EU Commission preconditions** (i.e. moral hazard and high credit quality) **and anchor long term market expectations**, ideally at EU level, otherwise with an enhanced cooperation in the EU legal institutional framework.

Specific Considerations

Which pre-conditions are needed, EU Treaty Changes and perimeter?

Unicredit is of the view that common issuance of Stability Bonds (SBs) would also require, for the Economic and Monetary Union, a quantum leap towards a common economic and fiscal policy. The EU Commission reference to the name of "stability" bonds is understandable but also the fiscal implications stemming from an **integrated European economic and fiscal policy should be adequately recognised.** SBs must restore confidence in the ability of the Euro area to face its financing needs, not only in the short term (markets are expected to discount immediately future benefits in terms of stability deriving from the introduction of SBs) but also and especially in the medium/long term. Therefore such remedies must be set-up as structural measures, instead of being considered unconventional emergency actions, even if they imply **EU Treaty changes and forms of Enhanced Cooperation, including opt in clauses for non-Euro area Members.**

On Timing: a quick or gradual phase in?

Following the Political Commitment, among most EU member states, to contribute restoring confidence and therefore anchoring the medium and long term financial markets' expectations, a further key decision is needed, on top of the other short-term measures that the ECB and the EFSF will be called upon. We consider that such decision is a credible Political Agreement to be taken in parallel to the Treaty changes foreseen in March 2012. The political agreement should be based on a credible **Road Map towards the implementation of the reformed EMU governance into a more ambitious pooling of fiscal sovereignty**.

Such Road Map seems warranted as Option I is the ideal target solution and financial markets need to have a pre-defined path, along similar lines of the Three Stages to the EMU in the '90s. However we must realistically acknowledge that it may take years to fully accomplish such ambitious target and that **a first necessary step of the road map is a bridge solution.** On this respect, UniCredit welcomes the increased capabilities of the European Financial Stability Facility, with the ECB acting as operational agent, and the **European Stabilisation Mechanism** (ESM), expected to replace the EFSF and to be deployed as early as July 2012 (instead of June 2013, as originally thought). Once provided with the necessary and significant financial resources, the earlier entry into force date of the **ESM** can be very important to allow bridge solutions, in view of its broader range of powers and instruments, including the capability to purchase government bonds in the primary and secondary markets, as well as the possibility, especially for multinational banks, to release guarantees to bank debt, on top of the senior guarantees released by the member state of the home competent authorities[1].

On the liability side, also with a view to ensure a prompt and sizable intervention, with the highest rating as possible, it should also be investigated the opportunity of these ad-hoc facilities/mechanisms to deploy unconventional types of funding instruments. For instance it could be investigated the merits and risks of issuing tranches of different seniority targeted to different investors.

A note of caution about the current arrangements refers to the publicity on the supranational conditionality of the EU stability programmes, which may act as a procyclical measures creating adverse market conditions that in the end result in a closure of market access for the requestor (stigma effect). For Member States where solvency is currently not an issue, the individual conditionality with the related stigma should be rapidly replaced by a reformed economic governance, made by an ongoing strict and credible fiscal surveillance (made by EU authorities), having also effective powers to restore a sustainable path for individual Member States.

From a capital market perspective, the major "con" for an accelerated phasing-in (conversion of existing debt) is that it does not allow for any kind of errors. If something goes wrong (leading to the market not accepting the new bonds) there is no way back, while a gradual phasing-in allows for some (albeit limited) on-the-fly corrections.

Market participants may perceive a "big-bang" approach as risky and very sensitive to operational risks. Moreover, it would lead also to large scale price adjustments over the very short term, given that prices of all outstanding bonds have to immediately converge into a single "curve". Such rapid and potentially steep price movements are always risky also from a systemic point of view. However, also a gradual phasing-in strategy may have some drawbacks: for example, it may impact

[1] See for instance "European Safe Bonds" Brunnermeier et al. September 2011, www.euro-nomics.com.).

the outstanding debt liquidity. Of course, this can cause some problems in the marketplace, since many investors hold government bonds to meet their specific liquidity needs. This case would be even more relevant when there is a full bond replacements.

The above-mentioned cons related to the accelerated phasing-in option of a "big bang" risk can be mitigated by a gradual phasing-in, in which national issuance is partly, or fully, replaced by the SBs. The cons of a gradual phasing-in (liquidity issues on outstanding debt) could be mitigated by a central Debt Management Office (DMO), which could act as market maker and could also offer (if requested by market participants) individual switches from old bonds into new bonds.

On Implementation issues: Centralised vs decentralised issuing agency?

The positive experience of the Eurosystem model, concerning the implementation of monetary policy in the Euro area, shows that the issuance of SBs could be efficiently addressed by a **European Issuing agency**, with a proper mix of responsibilities, while some forms of specializations are delegated by the European level to some national agencies (i.e.: not all countries need to perform the same tasks related to the issuance procedures, which may be delegated exclusively to some countries).

Also, with respect to the topic of the distribution of the revenues arising from the issuance of the SBs, the allocation of the costs to the respective beneficiaries and the pooling of credit risk, the Eurosystem's approach to the burden sharing issue concerning losses derived from its credit operations should be taken into account as a good reference.

A centralised entity would constantly ensure smooth operations on a single well-established platform and allows for an additional level of control. In addition, setting up a special dedicated unit seems to be appropriate given the systemic importance of the SBs. Moreover, separation of the DMO from a potential bail-out/support function (EFSF/ESM) seems to be appropriate as well. The latter may be a crucial issue particularly important in case of a partial replacements, which continues to involve default risk of individual Member States.

With reference to the options analyzed in the Green Paper for the DMO to on-lend the funds raised to the Member States (section 4.1.1., pag 24), again the optimal choice would depend on the Option chosen: in case of a full replacement, both options (i.e.: either on-lending in the form of direct loans or the direct purchase of all government bonds) would be the same (as there is no more outstanding bonds, i.e. the bonds would take over the role of loans). In case of partial replacements, the direct purchase of all government bonds from the Member State by the DMO in the primary market would allow for far larger issue sizes compared to the option of on-lending in the form of direct loans. However, the participation of the central DMO in the primary market could involve questions about fairness and equal treatment of all issuers by the DMO.

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On Liquidity risk

The expected liquidity premium savings depends upon the chosen structural option. SBs may (at least temporarily) improve the situation for government bond market which are currently in trouble (for example, Italy, Spain, etc), but they will probably reduce liquidity in others (like German Bunds or Länder). With reference to the estimates mentioned in box 1, pag 5 of the Green Paper, we would like to point out that the assessment of Carstensen (2011) contains in our view – from a methodological perspective – some weaknesses. Carstensen argues that the appropriate market yield will be the weighted average yield of the individual bonds. Compared to German Bund yield, the weighted average yield of the individual bonds resulted (at the time of the study) in a yield difference of 200bp. This analysis misses that 1) German Bund yields appear to be "artificially" low as Bunds benefit from safe haven status (note that short-dated Bunds currently trade at negative yields, despite inflation rates are in the 2% area); 2) Yields of periphery bonds are far higher than fundamentally justified, as concerns regarding Spain and Italy appear to be driven by funding liquidity concerns rather than solvency concerns. Hence, the result of Carstensen's study overestimates the positive impact of the SBs. All other studies come to quite similar (and substantially lower) effects, which appear to be more realistic in our view. Having said that however, an implementation of SBs that does not convince markets would result in refinancing costs that would be on average much higher than without SBs.

On Eligibility Criteria

Which reference to "red" debt arising in case Option 2 is chosen, UniCredit believes that it should be eligible for ECB refinancing operations, but haircuts and eligibility should depend on the rating. The same is true for capital requirements that should be based on ratings.

Current regulation prescribes that assets with any kind of subordination cannot be used in ECB refinancing operations. This requirement is explicated for non government bonds, but we agree that the same criteria could be logically applied to government bonds, once we would have this new type of *de facto* non-senior govies. If this will be the case, we believe that it will be necessary a change in current regulation to allow ECB receiving national government bonds as eligible collateral for refinancing operations, to avoid local market disruption. With reference to market disruption, sufficiently long transition periods are necessary in order to avoid disruptions and to preserve the ability for governments to tap markets with red bonds.

On Market conventions

Coupon types (fixed, variable, zero, inflation-linked): UCG agrees that for a start and to facilitate the development of benchmark status, it may be preferable to concentrate the issuance on plain vanilla security bonds. The primary target for SBs is to attract liquidity. The simpler and more

acceptable the SBs are from a structural perspective to a broad range of investors, the more funds would flows into this market.

Stock exchange: based on the premises that the higher the accessibility of the bonds, the better the acceptance, UCG suggests using the same as the broad market of eurozone government bonds.

Settlement conventions: UniCredit suggests to stick to the established rules for government bonds.

The opportunity to introduce **Collective Action Clauses** (CAC) depends upon the Option that is chosen. In case of a full replacement of national issuance, there is no coutry-specific risk anymore, which makes the CAC less important (who needs CAC when the eurozone as a whole would be in default?). However, in case of a partial replacement (such as in the "Blue Bond – Red Bond" concept) the introduction of CACs for the red bonds will be an important element to facilitate a potential debt restructuring.

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