



Federal Republic of Germany
Finance Agency

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for the German Finance Agency

Germany's shift to portfolio - driven debt management

It's now starting to wade into splashier dollar bonds and linkers. But throughout its five-year history, the German Finance Agency has been quietly making the transition to a portfolio-driven sovereign debt manager where transparency and cost-saving are key.

It hasn't been an easy road, even when you're the European benchmark for sovereign debt with vast amounts of issuance and liquidity. But it's been an exercise in political cooperation as much as it has been a determined move to a more investor oriented government borrower in a different competitive environment.

History

Managing director Gerhard Schleif has been at the helm since the German Finance Agency was first set up by Finance Minister Hans Eichel in 2000. Schleif, who was joined by fellow managing director Werner Gatzert in May this year, cites one of the agency's major achievements as reaching swift agreement with the Finance Ministry on a clear 10-year strategy. "We reached agreement with the Ministry of Finance within about 2 years on the basis of the overall strategy," he says. "This was a fairly short period of time given what was involved."

As part of that strategy, there have been many changes in the four years since the agency swung into operation in June 2001, not least of which is the structure of the standing credit portfolio. Back then, the agency inherited a portfolio, where the overwhelming part of the credit portfolio was funded by medium to longer term issues. The 10-year Bund clearly dominated. That was hardly surprising since the Bundesbank, with its dual role as fiscal adviser and also with responsibility for monetary policy, was rightfully reluctant to issue short term paper, in the interest of avoiding any conflict of interest. But since the Finance Agency took on the role of trader, issuer and manager of German government debt, the strategy has evolved to a clearly defined policy of high risk diversification over the whole maturity range.

Shorter maturities like the 6-month Bubills and the 2-year Schatz now have far more weight in the portfolio than before, and at the same time, rising interest for long term paper over the last two to three years has seen a larger role for the 30 year Bunds, (see graph). Even after all those changes, the percentage of the overall funding that is money market related remains in the low single digits - still well below the average in the Eurozone and much where it was when the agency started out.

New transaction instruments

Six new instruments, mainly money-market related, have been introduced to the German repertoire, ranging from repos to interest rate swaps. "All of the instruments we are using are day to day transactions for us so we cannot say we are doing things better, but we are allowed to do things differently compared to the period before the agency was set up," Schleif says.

What that means is a lot more active debt management, and a move to broaden the Federal Government's market appearance. But the agency is not about taking unnecessary risks, setting trends or

moving markets. "We come to it from a different angle," says Schleif. "To us, cost savings is the most important factor. We believe you should not be innovative at any cost, that's not the dominating factor, but if we are convinced that an issue can help in reaching this goal or target, we'll use it. We are quite emotionless."

With €218 billion in issuance for 2005, and a total portfolio of €850 to €900 billion, this process of structural adjustment of the portfolio is not something that can be done in three or four years without moving markets and prices.

So to better manage that process, the agency has the flexibility to make those adjustments each year through its annual issuance and by using interest rate swaps. A benchmark managing committee (Finance Ministry and Finance Agency) meets regularly to decide on the mix, and an annual issuance calendar is publicly released to flag the agency's intentions at the end of each year for the following. But balancing investor requirements of sufficient liquidity in the cash market against the agency's goal to diversify risk wherever possible can be an issue.

"The only mix and the only combination that makes sense is on the one side to have the issuing calendar and on the other side to make the proper adjustments by using interest rate swaps," Schleif says. "The major target of course is reducing overall funding costs by restructuring the standing portfolio and by certain changes in the structure of the issuing calendar."

Starting with a €20 billion annual budgetary allocation for swaps in 2002 which has now increased to €80 billion in 2004 and 2005, the agency may have been expected to make more waves in that market. But Schleif says they keep a deliberately low profile in swaps because they don't appear as a dominant player in the market. Instead, the aim is for maximum transparency on the issuing side via the annual issuance calendar. That allows investors to plan in advance, and according to the agency, helps reduce volatility ahead of auctions.

The whole auction process has also been transformed this year by an innovative new Web-based system developed by the Bundesbank and the Finance Agency. The Bund Bidding System was introduced in April and allows authorized bidders to participate from throughout the EU. Not only can bids be readily changed in the lead-up to the 11am auction closing, but the exciting development for traders is that waiting time for results is now just about one minute. By 11.01 the decision is posted, and participants know the details of their allocation, drastically cutting their entire risk period to just minutes.

Foreign currency and inflation-linked bonds

What has also captured market interest this year has been the agency's plans to move into foreign currency and inflation-linked bonds.

"The German issuer is the only one, compared to others of a similar size, that does not have a primary dealer group, so it is very important to have as many funding tools as possible," Schleif says." Therefore any new instrument that we can add to our toolbox helps us with regard to optimal flexibility. That's why the Ministry decided last year that we should be in a position to issue bonds in foreign currency and also to enter the market for inflation-linked bonds."

The successful launch of Germany's first dollar-denominated bond in 50 years – a tightly-priced \$5 billion deal in May with a final order book of more than €14 billion – will be followed by inflation-linkers when the 'time is right'.

Despite other issuers' linkers underperforming conventional bonds in recent months, the agency says it is keen to expand its funding toolbox whenever the opportunity arises. "Our overriding target is to save money wherever you can and to use opportunities to save money by issuing inflation linked paper vis-a-vis the regular Euro denominated paper," Schleif says. "The last couple of months have not been too favourable for inflation linked paper but we are in a long term process and we are waiting for opportunities in the future."

Besides waiting for the right timing for linkers, it's also about changing mindsets on buying a product that protects against inflation at a time when inflation isn't an issue. "It is a difficult product, it needs to be explained," says Andreas Ricker, the Finance Agency's Head of Strategy. "We know that a few investors in Germany did buy available inflation-linked bonds but many are just looking at it, saying 'we'll wait until Germany's issuing, then we'll move into the market.'"

Although it would be the last G7 issuer to enter an inflation-linked sovereign market in Europe which was first tapped by the british debt management office in the early 1980's, there are advantages to Germany biding its time.

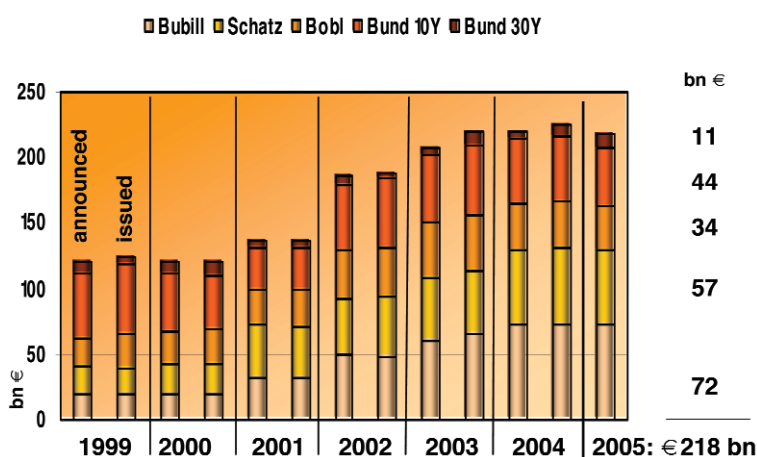
Setting up innovative markets can be costly, and the argument goes that just because it's been France, Greece and Italy making all the forays into linkers doesn't mean there won't be an appetite for German paper. Long term structural demand from pension funds is here to stay as the European population ages, and market watchers say that a steady supply of quality inflation-linked bonds is likely to be welcomed.

Germany's benchmark status in the Euro bond market is expected to carry through to the linkers when it eventually dips its toes in that market, even though it won't have the nominal market advantage of futures. All of this having been said, moves by Germany into foreign currency or inflation-linked paper are, for the time being at least, not part of Germany's regular budget funding. It is purely and simply to increase the flexibility in the funding policy.

As for competition in linkers, the Finance Agency doesn't foresee any problems with sharing that space with the market pioneers. "It won't change the dynamics as we are not in competition with other European issuers, in fact they have encouraged us to join," Schleif says. "It's a market segment that is still developing and I'm sure that others will welcome Germany's participation."



Managing Directors of the German Finance Agency and Federal Minister of Finance Hans Eichel



Clear and reliable issuance calendar and structure by instruments. Volume 2005: € 218 billion

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