

# Bund extends scope with linkers

Europe's fast-growing market for inflation-linked bonds was given an important vote of confidence in March when Germany launched its first bond linked to the Harmonised Eurozone Inflation Index (HICP) excluding tobacco. Eagerly anticipated by investors looking to diversify their portfolios of triple-A rated inflation-linked paper, the 10 year €5.5 billion transaction generated total demand of about €8 billion.

Germany's very well-received debut linker achieved a number of key objectives for the Federal Government. It gave the Bund added flexibility in covering its financing needs and in optimizing the management of its debt portfolio, and it played a valuable role in diversifying the government's international investor base. From an issuer's perspective, the benefits of incorporating inflation-linked bonds into a broader debt portfolio management strategy are analysed based on three key considerations: cost, risk, and diversification.

The cost-risk profile significantly improves the diversification of the issuer's debt portfolio while leaving its total cost and risk unchanged. With regard to the cost aspect, an issuer will theoretically benefit from an inflation risk premium because investors are prepared to accept slightly lower yields in exchange for the hedge against inflation. In practice, however, a liquidity premium compensates for this risk premium: in other words, investors will generally seek slightly higher yields as long as inflation-linked securities are less liquid than nominal bonds.

The Federal Government's analysis into the relationship between risk and liquidity suggests that the maturity of inflation-linked bonds as an asset class is such that these premiums counterbalance each other very efficiently. There is therefore no reason why the issuer should incur higher costs than in the market for nominal bonds of identical maturities, which was an important precondition for the Bund in deciding to tap the market.

The Federal Government is fully committed to supporting liquidity in its inflation-linked programme. It has therefore indicated that it will be providing liquidity to members of the

Auction Group by tapping the new bond up to three times over the next two years in order to bring its size up to between €10 billion and €15 billion. By complementing its debut 10-year benchmark issue, the Bund will build a complete yield curve within the next few years. The issuance model that evolves as a result will be comparable to the one that is used for nominal bond issuance. The syndicate members appointed to distribute the Federal Government's inaugural linker were selected on the basis of the consistency of their participation in the Bund's nominal auctions together with their product and market expertise and the quality of their advice. The decision to issue the first linker via syndication (rather than auction) was based on the belief that this would ensure a secure and successful placement at fair market value, distribution to a high quality investor base and appropriate secondary market performance.

The Finance Minister announced the planned launch of the linker at the end of February, following which there was an intense phase of discussions with the lead managers to determine the principal terms of the bond. Having identified a 10-year, €5.5 billion transaction as one that would maximize investor demand and liquidity, the next step was an agreement between the banks and the Federal Government on the indicative fair pricing level. Well-attended presentations in Frankfurt, Paris and Amsterdam, twinned with a series of worldwide telephone conferences all helped to stimulate extensive investor interest in the transaction.

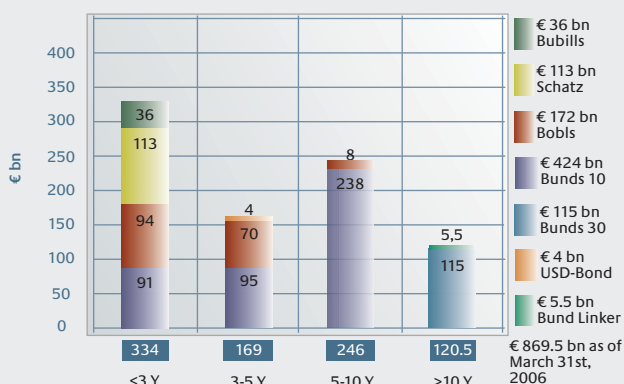
From the moment the order books were opened on the morning of March 6th it was evident that investors would reward the issuer for its very thorough preparation. Within the first day of bookbuilding, the transaction had generated a healthy level of over-subscription, with the structure and quality of the bids confirming that the bond's terms and conditions were very well aligned with investors' requirements. With around 200 bids received from 160 institutions, pricing was set at 207bp through the January 2016 benchmark bund.

The participation of many pension funds and insurance companies new to the German credit was especially gratifying. The issuance volume of €5.5 billion means that Germany now accounts for 4% of the European market for sovereign inflation-linked bonds. For the Bund as well as the broader European bond market, Germany's successful step into the European linker market bodes well for its future development.

**“cost-risk profile significantly improves”**

## Strategical Debt Management

Remaining time to maturity of German Government Securities as of March 31st, 2006



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