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AMTE, The Euro Debt Market Association
The EFFAS European Bond Commission
CNO, the French Bond Association

French inflation-linked bond market eligible for stripping operations

AMTE, EFFAS European Bond Commission and CNO approve the methodology proposed by the working group on stripping of OATi, BTAN€i and OAT€i. Even on amounts of around 10 billion euros, i.e. which would mean the full stripping of an inflation-linked bond, these modalities do not lead to material differences between the cash flows paid on the different coupons merged under a coupon strip, regardless of the characteristics of the underlying bonds. This fungibility is consistent with the rule of providing the same rights of claims among the holders of the same face value of a same bond, strip certificates being dealt with as separate issuances.

To match the demand for zero coupon bonds (which notably protect the investors from coupon reinvestment risk), Agence France Trésor began organising in 1991 the stripping of fixed rate OATs. From the inception of French inflation-linked bond market, these securities had been designed to facilitate their stripping at a later stage, when their liquidity would be sufficient. With a monthly average of 37 billion euros of transactions reported by the SVTs (Spécialistes en Valeurs du Trésor, primary dealers) in the secondary market in 2006 and an outstanding of 111 billion euros at end-2006, Agence France Trésor now judges that the liquidity of inflation-linked bonds is now significant enough to authorise the stripping of these securities. Following the results of a working group with the participation of the SVTs, AMT€ (the Euro Debt Market Association) and Euroclear France, the central depository, **Agence France Trésor has selected stripping modalities. SVTs will be able to strip inflation-linked securities with Euroclear France at the end of May.**

The CNO has approved these modalities, which are described hereunder:

- OATi, OAT€i and BTAN€i bear 25th of July coupon and maturity dates. Each cash flow paid corresponds then to an inflation-linked zero coupon referenced to the performance of the price index since the launch of the bond. As of now, the stripping would result in the creation of inflation-linked zero coupon bonds with maturities from 25 July 2007 to 25 July 2029 on the French inflation-linked real rate curve, and from 25 July 2007 to 25 July 2040 on the European inflation-linked real rate curve.

- Each inflation-linked bond has a specific base index corresponding to the value of daily inflation reference on the first interest accrual date. The heterogeneity of these base indexes could have hindered the fungibility of coupons stripped from different bonds. To solve this potential problem, 100 has been retained as the base index for any stripped coupon. Provided that computation does not involve any intermediary rounding, this methodology, already adopted by the US Treasury for stripping US TIPS, guarantees the coupons' fungibility, independently of their origin. Of course, this methodology (excluding rounding) applies only to stripped coupons. Non-stripped inflation-linked securities, as well as stripped principals, keep their initial base index and continue to use an index ratio rounded to 5 decimals, so as to maintain the consistency with other inflation-linked bonds markets and to conform to standard settlement systems. Coupons of BTAN€i and OAT€is will be fungible. Coupons of OATis will be fungible. There will be no fungibility between coupons indexed on heterogeneous inflations (French or European).

Example : a SVT wishes to strip a nominal amount of 1 million euros of OAT€i 3% 2012. The base index of this OAT€I is 92.98393. The adjusted value of each interest component is equal to:
1 million X 3% X 100 / 92.98393 = 32 263.63953.
This amount, rounded to the second decimal and multiplied by 100 corresponds to 3 226 634 interest certificates of 1 cent each, expressed with a 100 inflation index base. These certificates will be delivered to the SVT in exchange of each coupon. At the certificates' date of maturity, the daily index reference will be applied to their adjusted value expressed with a 100 base.

Even on amounts of around 10 billion euros (roughly the full stripping of an inflation-linked bond), these modalities do note lead to material differences between the cash flows paid, regardless of the origin of the coupons.

AMTE **EFFAS European Bond Commission** **CNO**