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New fixing for the Livret A

More demand, more imbalances, more opportunities

A new formula introduced by the French government that fixes the rate of the Livret A could have strong implications on the French inflation market and could create conditions for attractive inflation structured products

Last February, the French government decided to change the formula that fixes the rate of the Livret A. Anything revolving around the Livret A is a hot topic in France as it is a very popular tax-free savings account that impacts directly or indirectly on more than €300 billion of French savings and is a benchmark for the financing of social real estate. In addition, this change in the fixing of the Livret A is to take place by 2009, when all French banks will be allowed to offer Livret A savings accounts to their clients. At this time, only three are able to do so. This new formula and liberalisation process could have strong implications on the French inflation market and beyond. It could also create favourable conditions for attractive inflation structured products.

By changing the formula that fixes the rate of the Livret A, the French government had two intentions: first, to provide a rate of return for French savers above inflation to protect their purchasing power, and second, limiting the cost of the financial crisis on the financing of the social real estate sector. The former was addressed through the guarantee that the rate of the Livret A will be at the minimum equal to (inflation +25 basis points (bp)), while the latter introduced the reference to the euro overnight index average (Eonia) compared to only the three-month Euribor rate previously.

So, while previously we had:

$$Livret\ A\ rate = \frac{(inflation\ +\ Euribor)}{2} + 25bp$$

It now becomes:

$$Livret\ A\ rate = Max\left[\frac{(Euribor + Eonia)/2 + inflation}{2}\ ;\ inflation + 25bp\right]$$

When in 2004 the Livret A rate first started to be partially indexed to inflation, it became an important driver of inflation flows on the French inflation market on the back of strong hedging demand from retail banks and real estate companies. We think that the restructuring of old Livret A to new Livret A positions could provide another boost to the inflation market.

Restructuring makes sense from an investor's perspective as it offers an attractive financial gain through a lower cost compared to the old formula. Looking to the core of the formula, it is the result of, first, the disappearance of the 25bp premium in the new formula and, second, the introduction of the (Euribor/Eonia) spread. This latest spread offers an extra pick-up that is all the more attractive at this time. While this spread is historically small, it has widened significantly both on the spot and in the forwards on the back of the financial crisis, fixing between 25 and 30bp on a 10-year horizon, for example. With this spread accounting for one-quarter of the cost in the formula, it could potentially lower the cost for the investor by an additional 6–8bp.

On the other side, an extra cost comes from the fact that the new formula will fix at least inflation +25bp. So, there is now an implicit floor. This price of the option varies from one trading desk to another, depending on home-made assumptions on the inflation, Eonia and Euribor volatilities and the correlation between them. There is no doubt that all of these volatilities have increased with the recent crisis and the sharp acceleration of inflation, making the price of the option more expensive. Nonetheless, restructuring remains a net gain for the investor.

To maximise its gains, there could be temptation for the investor to avoid paying the option. Looking to the forward, the probability of having to use the option is low, with the spread between inflation + 25bp being an average close to 100bp below [Eonia + Euribor/2 + inflation]/2. However, recent history has shown that this probability is not null as the management of the monetary policy has proven to be more challenging in economies increasingly sensitive to asset price developments. Since 1999, using the new fixing of the Livret A, the option would have been activated in 10% of cases.

Livret A restructuring flows could therefore have strong implications on the inflation market, depending on investors' willingness or not to pay the option. Previously, the exposure to inflation represented only half the size of the portfolio. Looking to the probability of this risk in the recent period, it could create an extra 10% demand of hedging flows in a market that is already characterised by strong imbalances between supply and demand.

The first Livret A coupon to be paid with the new formula will be made in February 2009 under the fixing calculated in August 2008 coming from the result of French inflation, Euribor and Eonia rates in June. Thus, the impact of restructuring on the flows is likely to continue to impact the market for the next three quarters.

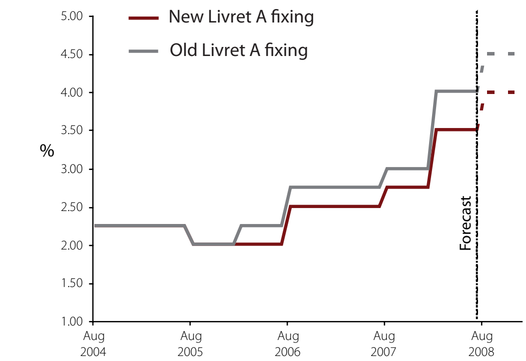
The timing of the first coupon paid in the new Livret A fixing will also correspond with the liberalisation of the market. With all of the banks being in position to propose the Livret A, a boost to the flows appears likely, especially at a time when its rate of return is increasing. Indeed, rising interest rates and inflation mean that there is a high probability that the rate of the Livret A will reach 4.0% in August from its current 3.5%. It remains to be seen if this 4.0% will be confirmed as this level was already seen as costly for the financing of the real estate sector. It was partly to avoid this shock that the government decided at the beginning of the year to change the formula. While the correlation between the rate of the Livret A and savings flows is not always perfect, estimates indicate that a 50bp increase in the rate boosts saving flows by around €5 billion, which would further add to the imbalances of the supply/demand on the inflation market.

Beyond the direct flow's impact on the inflation market, the new Livret A could also impact flows in other markets and be the trigger for new developments. Indeed, the new formula involves the need for trading desks to hedge the Euribor/Eonia risk. In the previous formula, only Euribor hedging was necessary. While, until recently the correlation between Euribor and Eonia was strong, the crisis showed that this relationship could not be as stable as previously thought. In the meantime, from an inflation trading desk perspective, the implementation of the new Livret A means becoming short of volatilities on inflation, Euribor and Eonia. Also, it implies a short position on the Euribor/Eonia correlation but a long one on the inflation/Euribor correlation. As a consequence, inflation trading desks become structural buyers of volatility, accentuating the current trend of rising volatility. It remains to be seen how inflation trading desks will arbitrate this risk in the current environment. However, it could the trigger for the development of a more liquid and deeper market on the Eonia, especially on long-term maturities. The behaviour of vanilla trading desks, and whether or not they grab this opportunity to develop this market in the future, will be worth watching.

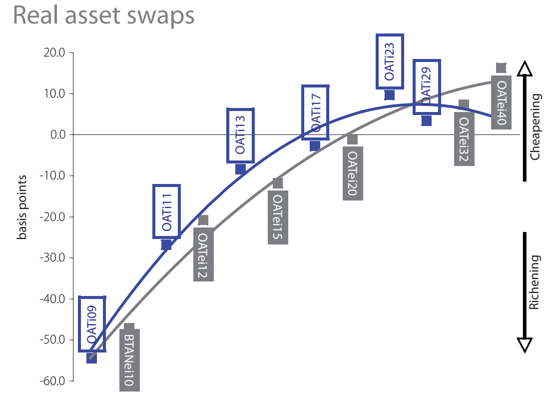
Additional hedging flows on the inflation market mean further demand through the French inflation swap market, which is structurally imbalanced as supply is traditionally poor. Indeed, compared to the UK situation, the French inflation swap market does not benefit from strong inflation offer coming from infrastructure projects, utilities. As a consequence, distortion on the French inflation swap to artificially high levels will increase throughout the entire span of the curve and puts the European Monetary Union (EMU)-French inflation spread at zero or in negative territory, a situation out of line with economic fundamentals. Also, to hedge their positions, trading desks find liquidity by buying indexed inflation bonds (OATi) and selling the asset swaps in order to get rid of the credit risk. This situation tends to cheapen French real asset swaps on three- to 15-year maturities relative to European ones.

In the past, part of this imbalance was offset by flows coming from hedge funds playing wider French-EMU inflation differential on the swaps. Also, a number of structured products based on the expectations of a greater inflation spread between French and the EMU helped to limit the impact of the demand/supply imbalances. However, over the most recent period, hedge fund activity on the inflation market has reduced. In the meantime, the rise in French inflation and the narrowing of the French-EMU inflation gap in recent months, as well as the uncertainty regarding the implementation in France of a social value-added tax (VAT) rate hike, have increased the lack of visibility on the French-EMU inflation spread. On the other side, the prospect of higher demand flows linked to the restructuring of the new Livret A, the increase in the rate and the impact of the liberalisation has again pushed the French inflation swap curve above the EMU inflation forward for the next 10 years for the first time in almost two years. This situation creates, in our view, very favourable conditions to capture very attractive pick-up in structured products playing a larger EMU-French inflation differential. Adding to the structure options, such as receiving a fixed rate during the first years or, more directly, French inflation to the structure could help hedging the uncertainty regarding the social VAT hike risk. So, it seems that the new Livret A brings French-EMU inflation arbitrage back under the spotlight.

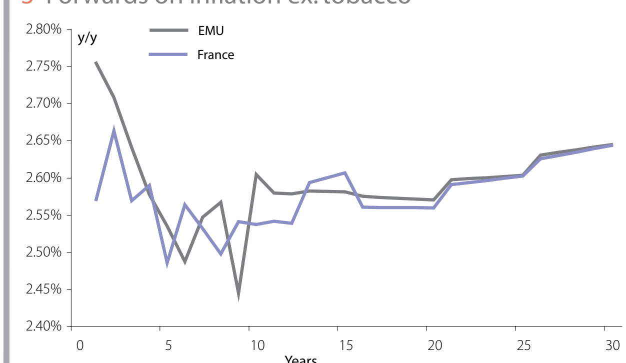
1 Old and new Livret A fixings



2 Real asset swaps



3 Forwards on inflation ex. tobacco



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