

DISCUSSION PAPER

Intended replacement of the South African Overnight Interbank Average (Saonia) rate with an improved benchmark call rate

16 October 2006

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South African Overnight Interbank Average (Saonia) rate
with an improved benchmark call rate**

Introduction

The purpose of this document is to provide information and solicit comments on an improved benchmark call rate that is being developed by the South African Reserve Bank (SARB), and which is intended to replace the current South African Overnight Interbank Average (Saonia) rate and other overnight rates that are published by the SARB.

The proposals are a result of a combined effort by the SARB and the banking sector, under the auspices of the Money Market Liaison Group (MMLG), a committee comprising representatives from the major domestic banks, the International Banking Association, the Bond Exchange of South Africa (Besa), the Yield-X division of the JSE, the Association of Corporate Treasurers in South Africa (Actsa) and other major participants in the domestic money market. Input was also obtained from other stakeholders in the money market, such as asset managers.

The discussion document explains the reasons for the proposed replacement of the Saonia rate and sets out the definitions of the new benchmark rates that have been developed. It also provides some results of the trial run with the new rates, which were conducted since August 2006. The intention is to replace the overnight rates that the SARB currently publishes on a daily basis with the new rates in January 2007, subject to the outcome of this consultation process and the final approval by the MMLG at its next meeting on 7 November 2006.

Any comments or questions relating to this project can be directed to Ms Trudie Coode, at telephone number (012) 313-3355 and e-mail address trudie.coode@resbank.co.za before 7 November 2006. Until the project is fully implemented, daily information on the new rates can be obtained by requesting Ms Coode to add your name to the electronic mailing list.

Background

In 2001, the SARB announced some changes to its refinancing system. As part of this initiative, the South African Overnight Interbank Average (Saonia) rate was launched. The objective with the calculation and publication of this rate was to provide a benchmark for rates paid on overnight interbank funding as part of enhancing the transparency and price discovery in the interbank market. In addition, it was intended to be a reliable indicator of liquidity conditions in the overnight market.¹

In 2004, the SARB initiated consultations with money-market participants with the aim of further refining its refinancing procedures. Surveys were sent to all banks to obtain their input on various aspects of the SARB's activities in the money market. During this process, it became evident that the Saonia rate suffered from a number of shortcomings and, as a result, market participants did not use it as a benchmark or reference rate. The following shortcomings of the Saonia rate were identified:

- It lacks credibility because the information submitted by banks was not verified by the SARB;
- it is very volatile. Moreover, this volatility is unrelated to changes in underlying liquidity or market conditions, but rather reflects shifts of weighting among different categories of banks;
- it does not reflect market conditions and has little relation to other money-market rates. Many potential users expressed the view that the Saonia rate was not relevant to where they could place or obtain funding; and
- it is not representative. Because it included only interbank transactions, it captured only a very small portion of the overnight money market.

The SARB itself also found the information content of the Saonia rate lacking, for similar reasons.

In 2005, the MMLG established a working group, comprising members from both the banking sector and the SARB, to determine whether there is a need for a reliable

1. For more background on the existing Saonia rate, please refer to the full document on this topic, on the SARB website, under Financial Markets/Market Research.

benchmark call rate and, if so, how the existing Saonia rate could be improved. The working group concluded that there was indeed a need for a benchmark rate for a number of reasons, such as to:

- facilitate the development of derivative products;
- facilitate the rebalancing of Alco books to overnight to reduce volatility experienced as a result of AC133;
- link with longer-term money market rates and bond yields, thereby reflecting a realistic starting point for the yield curve. This would also refine the interest-rate transmission mechanism;
- serve as an indicator of liquidity conditions in the overnight money market, thereby assisting in the implementation of monetary policy; and
- provide a transparent and consistent benchmark to which other lending and funding rates could be linked.

The working group subsequently embarked on an intensive information gathering exercise to obtain input on how the shortcomings of the Saonia rate could be overcome. This information was gathered by means of questionnaires as well as discussions with banks, asset managers, the Bond Exchange of South Africa (BESA), the Yield-X division of the JSE and other stakeholders. Views were obtained on issues such as preferences with regard to the definition, the publishing time of the rate, additional information to be submitted and how to improve the credibility of the rate. Subsequently, a workshop attended by all the major stakeholders was held, at which the proposed new definitions and processes were refined for consideration by the MMLG.

Summary of decisions by the MMLG

At its meeting on 11 July 2006, the following decisions were taken by the MMLG with regard to the implementation of this project.

1. It was confirmed that there is a need for an improved benchmark wholesale call rate (the “new rate”) to replace the existing Saonia rate. The base of this new rate was broadened to include not only interbank funding (which is how the current
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Saonia rate is calculated), but also a portion of non-bank wholesale funding and rand funding obtained in the foreign exchange swap market. In addition, the information on overnight foreign exchange swaps was expanded to include Tom next transactions, in order to capture a greater portion of this market.

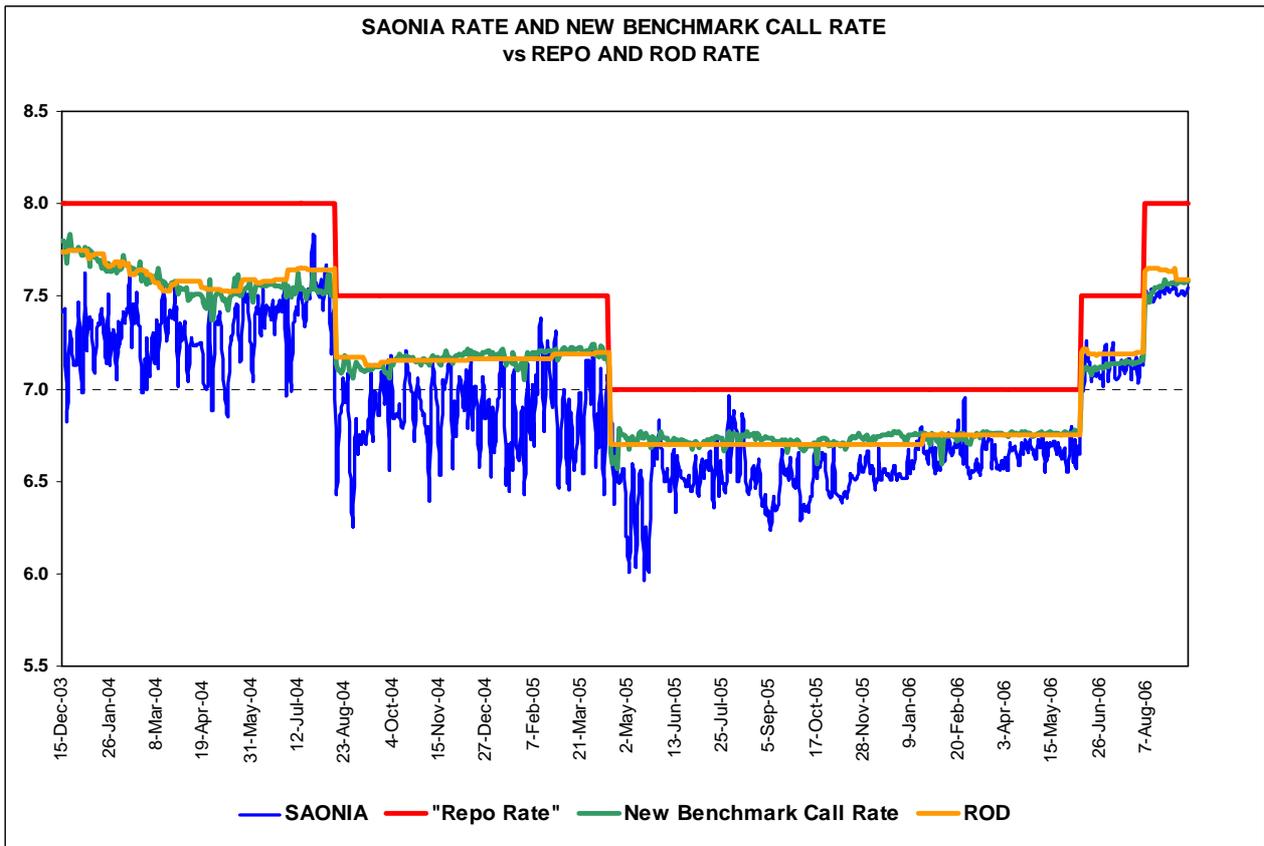
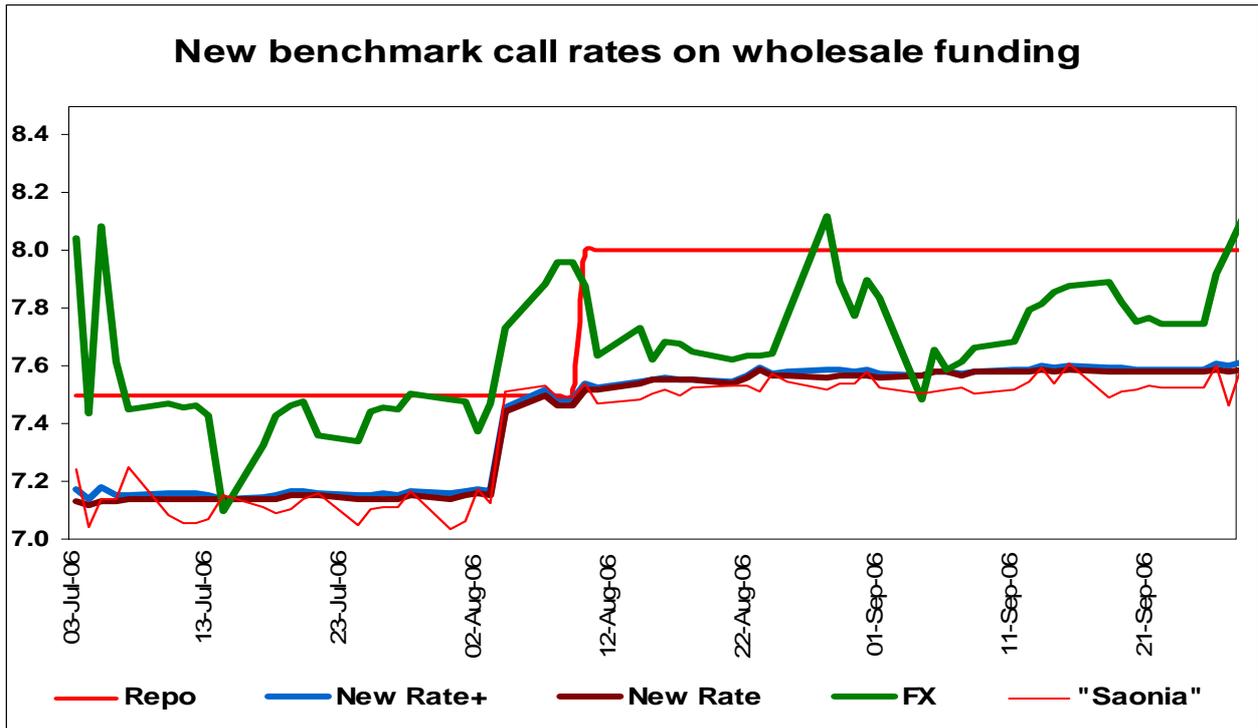
2. The Financial Markets Department (FMD) of the SARB started to calculate the new rate on a trial basis from 7 August 2006, and released this to a closed group, consisting of the participants involved in the process as well as to all contributing banks. At the next MMLG meeting on 7 November 2006, a final decision will be taken on the combination and definition of rates (as listed below), subject to which this rate will become publicly available and replace the Soania and other overnight rates currently published on the SARB website and its contribution pages on Reuters.
3. Three rates are compiled by the SARB during this trial period:
 - Rate 1: A volume-weighted rate comprising the total interbank funding at rates other than repo, and the Top 20 rates paid to clients (by rate and then volume).
 - Rate 2: The weighted average rate on rand funding in the foreign exchange swap market, including both overnight and Tom next transactions, irrespective of the type of counterparty.
 - Rate 3: A combination of Rate 1 and Rate 2, with a 95-per-cent weight for Rate 1 and a 5-per-cent weight for Rate 2.
4. Due to the inclusion of the Top 20 rates in the definition, the benchmark rate captures the high end of rates paid in the money market. It is recognised that the majority of rates paid to smaller clients would be below this rate.
5. Annexure 1 contains the draft definitions of the various rates. In order to refine and finalise these definitions by the time the changes are fully implemented, banks are providing input and further clarification, as deemed necessary during the trial period. Any uncertainties or ambiguities are brought to the attention of the relevant staff members of the SARB.

6. The credibility of the new rate has been improved by incorporating a process of assessing the reasonableness of the underlying information submitted by banks, instead of accepting the overall weighted average rate on face value. The ideal way to ensure credibility would be to obtain the required information automatically from banks' systems, without any manual intervention by the SARB or the banks. However, recognising that this is a medium-term objective, an interim measure was agreed upon, in terms of which banks are submitting underlying information to allow the SARB to assess the reasonableness, accuracy and completeness of the weighted average rate, with due consideration being given to issues of client confidentiality.

7. In order to avoid confusion between the new rate and the Saonia, the name of the rate will change, also to reflect its broader base (not only interbank funding). Any suggestions for a new name for the overnight benchmark rate would be most welcome, as part of this consultation process.

Observations during the trial period

The following graph reflects the new benchmark call rates and the foreign exchange rate as calculated since 7 August 2006. Prior to this date, these rates are reflected by using the information provided for the calculation of the Saonia rate, including data reported on the top 20 clients.



From observations during the trial period, it is evident that the new rates are less volatile and, more importantly, giving a better reflection of underlying market conditions.

In the SARB's view, the credibility and quality of the information supplied by the banks has also improved substantially. The rate is broadly based, including amounts of over R70 billion on a daily basis, spread across a large number of depositors (at least 20 per bank).

Providing an improved and credible benchmark for funding available on demand is seen as a step forward in improving the efficiency of and transparency in the very short end of the money market. The SARB and the MMLG are committed to continue improving the functioning of the domestic money market.

A D MMINELE
Executive General Manager: Markets
Chairman of the MMLG

**ANNEXURE 1: RATES AND VOLUMES OF FUNDING AS SUBMITTED
SINCE 7 AUGUST 2006**

1. Total volume of overnight interbank funding at the repo rate

The definition of this component remains unchanged, namely the volume of overnight rand deposits raised in the interbank market at the prevailing repo rate. Intragroup transactions are not included if both parties are banks.

2. Weighted average rate and total volume of overnight interbank funding at rates other than the repo rate

The definition of this component remains unchanged, namely the weighted average rate paid on overnight rand deposits raised in the interbank market, excluding funding at the prevailing repo rate. Intragroup transactions are not included if both parties are banks.

3. The rate on overnight funding in the carry market

The definition of this rate remains unchanged. This information should still be submitted during the trial period, but the intention is that it would be discontinued upon final implementation.

4. Forward foreign exchange transactions

The weighted average rate of rand deposits raised by a bank on an overnight and Tom next basis in the forward foreign exchange market. All transactions are included, including transactions with banks (intragroup transactions are not included if both parties are banks), non-banks and non-residents. Transactions are reported on the settlement date and not on the transaction date.

5. Top 20 call rate

- The weighted average of the twenty highest rates paid on deposits by non-bank clients that are available on demand, excluding rates with a fixed link to the prime rate, the SARB's repo rate, or any other term rate.
- The rate is determined by using the interest rate paid on deposits as the first criterion and the size of the deposits as the second criterion. The second

criterion is only used to determine the cut-off point of the deposits to be included in the calculation (i.e. if there are a number of clients receiving the same rate as number 20).

- Clients are firstly ranked according to the rates that they receive on their deposits (high to low), and secondly according to the size of their deposits (large to small).
- In cases where clients have various accounts, the weighted average rate per client should be used (i.e. not the rate on an individual deposit).