South African Reserve Bank

Financial Markets Department

An implementation paper on the changes to the monetary policy operational procedures of the South African Reserve Bank

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An implementation paper on changes to the monetary policy operational procedures of the South African Reserve Bank

1. Summary

1.1 This paper provides background on the changes made to the South African Reserve Bank's (Bank) monetary policy operational framework implemented in August 2010 and March 2011. Furthermore, the paper serves to inform and solicit comments from market participants and other stakeholders on further enhancements to the Bank's monetary policy operational framework to be implemented on 1 March 2012.

1.2 Any comments or questions can be addressed to Messrs Callie Hugo (Callie.Hugo@resbank.co.za) or Tom Khosa (Tom.Khosa@resbank.co.za) by 10 February 2012.

2. Background

2.1 The Bank assesses its monetary policy operating framework on a regular basis for effectiveness and efficiency, and changes are effected if deemed necessary.

2.2 The Bank's repurchase system was introduced on 9 March 1998. A number of refinements were made in April 2001 (which became effective in September 2001). While the Bank was satisfied with the changes implemented in 2001, the need for further modifications to the monetary policy implementation framework arose, and further changes were made in 2005 and 2007. Changes made in May 2005 centred on procedures intended to improve the effectiveness of the refinancing system, while those made in May 2007 were in response to the limited availability of liquid assets in the market at the time. This led to the introduction of Category 2 assets for use in the Bank's refinancing operations in order to free up liquid assets for prudential requirements.

2.3 The Bank further effected a number of operational changes to its monetary policy operating framework in August 2010 and March 2011. These changes resulted from certain challenges encountered with the effective conduct of the Bank's open-market operations (OMOs), which resulted in the money-market liquidity shortage declining to very low levels thereby increasing the risk of the monetary policy operational framework becoming less effective.

2.4 Following previous research into improving its operations, a need arose to establish a forum between the Bank and key market participants to discuss the development of the domestic money-market. This forum was named the Money Market Liaison Group (MMLG). The changes in 2005 and 2007 were effected after consultations within the MMLG and with other market participants. The modifications implemented in August 2010 and in March 2011 also benefited from inputs from the MMLG and other affected parties such as state-owned entities (SOEs) who issue the bonds previously classified as Category 2 assets.

2.5 The MMLG was restructured and renamed the Financial Markets Liaison Group (FMLG) on 6 November 2010. The FMLG functions through subcommittees in order to address specific market concerns. The FMLG comprises the Money Market Sub-committee (MMS), Foreign Exchange (Forex) Sub-committee and the Fixed Income and Derivatives (FI&D) sub-committee. The FMLG is chaired by the Deputy Governor responsible for markets and the membership consists of the Head of the Bank's Financial Markets Department, a senior representative of the National Payments System Department, Group Treasurers and Heads of Global Markets of the five major banks in South Africa, the chairperson of the International Banking Association, a representative of the National Treasury and the chairpersons of the sub-committees. A Financial Markets Infrastructure Sub-committee meets on an ad hoc basis to discuss infrastructure matters that may require attention.

2.6 The current changes were deliberated upon within the MMS and the FMLG, the Bank and with affected parties, for example, asset managers.

3 Purpose of the implementation paper

3.1 The main objective of the Bank's operations in the money-market is to implement the Monetary Policy Committee's (MPC) decisions of maintaining Consumer Price Inflation (CPI) within the stipulated range of 3 to 6 per cent. Through its monetary policy operations, the Bank also aims to promote financial stability by managing the liquidity needs of the banking sector as a whole. Furthermore, through the Bank's activities in the market and through its general market conduct, it also contributes to the development and efficient functioning of the financial markets in general, and in particular, the interbank market.

3.2 This paper serves to announce further refinements to the Bank's operational procedures and to solicit views from market participants ahead of the implementation which is scheduled for 1 March 2012.

3.3 While the changes introduced in August 2010 and March 2011 had the desired effect, the need arose to introduce further enhancements to the Bank's monetary policy operational procedures to enhance the effectiveness of the earlier changes.

4 Previous changes to the South African Reserve Bank's monetary policy operational procedures[1]

4.1 The following changes to the operational procedures were introduced in August 2010 and March 2011:

4.1.1 Conducting longer-term foreign exchange (FX) swaps.

4.1.2 Discontinuing the practice of announcing the estimated weekly liquidity ranges.

4.1.3 Announcing the previous day's actual liquidity requirement to the market on a daily basis.

4.1.4 Announcing the phasing out of Category 2 assets as eligible collateral in the Bank's refinancing operations.

4.1.5 Introducing the automated final end-of-day square-off processes at prevailing standing facility rates.

4.1.6 Widening the spread between the repurchase (repo) rate and standing facilities from 50 to 100 basis points above or below the prevailing repo rate.

4.2 The changes implemented in August 2010 and March 2011, have impacted positively on the Bank's OMOs resulting in a higher level of participation in SARB debenture auctions. The money-market liquidity shortage is also now generally at more acceptable levels and tends to better reflect the underlying conditions, trending higher towards month-ends when there is a higher

[1] Refer to the press statement issued on 26 August 2010: http://www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=3732

demand for notes and coin and trending lower during the middle of the month when notes and coin are returned to the Bank.

4.3 The Bank's daily interventions in the money-market to manage the liquidity shortage have been reduced substantially since the announcements of liquidity ranges were abolished. Consequently, intra-month FX swaps for purposes of influencing domestic liquidity are not conducted as regularly as before. Furthermore, supplementary auctions have not been offered since the implementation of the changes in August 2010.

4.4 The introduction of longer-term swaps with maturities of up to 12 months has added to the Bank's instruments of draining excess liquidity, particularly liquidity stemming from FX purchases.

5 Further enhancements to the Bank's monetary policy operational procedures to be effected on 1 March 2012

5.1 A need has arisen to introduce further changes to the Bank's procedures and these are the following:

5.1.1 Allocating the amounts tendered by banks in the weekly main repo auctions on a pro rata basis, up to the announced average daily liquidity requirement for the week in instances where the auction is over-subscribed.

5.1.1.1 Since the introduction of the announcement of liquidity ranges to the market during the 2005 refinements, participants used to tender for amounts in the main repo auctions that totalled the announced average daily liquidity requirement for the week, and were able to absorb the whole amount offered at the auction.

5.1.1.2 However, as a result of increased participation in the repo auctions, recently the total amounts tendered for in the main repo auctions have been in excess of the announced average daily liquidity requirement for the week. Consequently, the money-market has tended to remain in a surplus position which banks have to carry for the rest of the week, unless autonomous factors[2] move in the opposite direction of the forecast, and thereby neutralise the surplus position. The banks' concern is that they are penalised as this surplus position is deposited overnight with the Bank at a penalty rate of repo minus 100 basis points, or deposited into the affected banks' cash reserves accounts, which are not remunerated. The change is aimed at overcoming this problem and the details of how this is to be done are set out in Annexure 1.

5.1.2 Conducting two- and five-day main repo transactions during the week of the MPC meetings.

5.1.2.1 The MPC announces its decision on the repo rate on Thursdays and it becomes effective on Fridays. Overnight rates in the interbank market, however, adjust daily. This proposal aims to address the problem that arises from the lack of synchronisation between the Bank's main repo auctions and the MPC interest rate announcements. Should the repo rate be changed, the problem that arises is that the previous repo rate would still apply for the remainder of the week for the main repo transactions entered into on Wednesday. The new repo rate will only be applied at the main repo auction to be conducted the following week. This misalignment of interest rates can lead to some dislocation of interest rates in the interbank market, especially overnight rates.

5.1.2.2 The interest rate mismatch will be solved by introducing two- and five-day main repo transactions during the week of the MPC meetings. The first

[2] Factors outside of the Bank's control, such as notes and coin flows, as apposed to factors that the Bank can influence such as foreign exchange transactions, government transactions and open-market operations.

auction will be conducted on Wednesday to mature on the Friday following the MPC announcement, when the new rate becomes effective. The second "auction" will be conducted for five days (on Friday) with the same banks at the same pre-allocated amounts at the new repo rate, and will mature the following Wednesday. Thereafter, the main repo operations will revert to the normal seven-day cycle.

5.1.2.3 The Friday "auction" will be mechanistic wherein the banks that were successful during the Wednesday auction will roll the amounts as previously allocated, but at any new repo rate that may have been announced after the MPC meeting. On the Friday, banks will be obliged to submit, via the Money Market Internet System (MMIS), the same amount as was allocated to them at the Wednesday auction. These repos would be captured for a period of five days and banks will have an option to lodge the same or alternative assets to ensure that sufficient collateral is available to cover the repo amount plus interest.

5.1.3 Issuing SARB debentures and reverse repo (RR) transactions with seven- and fourteen-day maturities.

5.1.3.1 The Bank would like to further enhance the effectiveness of its operations in conducting its OMOs. These OMOs are currently conducted for 28- and 56-day maturities. However, since the Bank is active in the short end of the money-market curve, which is the area where monetary policy is implemented, shorter-dated SARB debentures and RR transactions with maturities of 7- and 14 days are deemed to be appropriate.

5.1.3.2 The increased number of maturities will provide investors with more flexibility to participate in the OMOs offered by the Bank.

6 Implementation plan

6.1 In order to ensure proper and seamless implementation of the changes, the following implementation plan will be followed:

Dates	Action
27 January 2012	Send the document out to market participants for comments and suggestions.
10 February 2012	Final day for receipt of comments and suggestions from market participants.
22 February 2012	- Announcement on wire services and issuance of a press statement. - Publish updated Operational Notice. - Publish SARB debentures terms of issuance.
1 March 2012	Implementation date for the changes.

Annexure 1

Allocation of main repo auctions on a pro rata basis

1. If the total bids received in the main repo exceed the announced average weekly liquidity requirement, the Bank will allocate the auction on a pro rata basis using the formula below:

$$Allotment = \sum_{x=1}^{n} \left[\frac{a^{x}}{b} \times c \right]$$

Where:

Allotment	***= the total amount allotted***
n	***= the number of banks participating in the auction***
a	***= the bids of the individual banks***
b	***= the total amount of bids received***
c	***= the amount on offer***

2. The table below illustrates how the allocation of an amount totalling R14,0 billion would be effected.

Table: Example of a pro rata allocation

Participant	**Time bids received**	**Bids received**	**Bids allotted**
Bank A	12:01	3 500	3 141
Bank B	12:01	200	179
Bank C	12:03	2 800	2 513
Bank D	12:04	3 200	2 872
Bank E	12:04	2 500	2 244
Bank F	12:05	3 400	3 051
Total		**15 600**	**14 000**

3. Notes on pro rata allocation process

3.1 If banks tender for a total amount of R15 600 million in the main repo, but the announced daily average liquidity requirement is R14 000 million, banks will be allocated 89,7 per cent of the bid amount.

3.2 If banks are allocated R1 million above or below the average amount due to rounding, the following adjustment should be effected:

3.3 If the auction is over-allocated by R1 million, R1 million would be deducted from the bank that was the last in submitting its tender. For example, Bank F would get R1 million less, considering the timing of tenders submitted.

3.4 If the auction is under-allocated by R1 million, the bank that tendered first would receive R1 million. For example, Bank A would receive the extra R1 million, considering the time the tenders were received.