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Remarks by Dr X.P. Guma at a High-level workshop on "Developing Bond Markets in Emerging Economies" – Frankfurt am Main, 9-10 May 2007

1. Introduction

1. Honourable Ministers, distinguished guests, fellow participants, ladies and gentlemen, let me begin by thanking the organisers of this workshop for having invited me to participate. It is always beneficial to interact with persons of the calibre present at this workshop.

The initial invitation was subsequently upgraded to that of "speaking for about 15 minutes to shed some light on the challenge faced in South Africa"; a task to which I will devote the next 14 minutes. Upgrades are not always without some pain!

2. A Brief Review of the South African Experience

There exists at present a relatively sophisticated bond market in South Africa, which market has shown significant growth and development since the 1980s when the government issued bonds only on demand: that is, on an open-ended tap basis. At that time, there were no government (or other) benchmark bonds; nor could any refined yield curve be discerned because it did not exist.

Issuance and secondary-market trading were dominated by government and quasi-government issued debt, the major issuers being the National Treasury, the Landbank and public utilities such as Eskom, Telkom and Transnet. The South African Reserve Bank (SARB) served as the principal underwriter.

Following an investigation by a Commission of Inquiry chaired by Dr J. Jacobs[1], the market opted for self-regulation in the form of the Bond Market Association (BMA), comprising bond issuers, intermediaries, banks, brokers and investors. The SARB was a founding member of (and active participant in) this Association which attempted to formalise the market, achieve greater depth and increase transparency.

In 1996, the BMA was granted an exchange license and was transformed into the Bond Exchange of South Africa (BESA), a development that was facilitated, in part, by the decision taken by the government in 1989, to consolidate smaller issuances in order to create benchmark bonds and, thereby, enhance the liquidity and efficiency of this market. In addition, trading on the gilts floors of the Johannesburg Stock Exchange came to an end in November 1995, shifting to the BMA which then operated an informal screen and telephone trading system with the Universal Exchange Corporation Ltd (Unexcor) serving as the clearing house. The Rule Book and the principles underlying the operation of the market were approved in March 1996 and BESA was licensed (and started) to trade on 15 May 1996.

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1. See Jacobs, AJ (1988). The South African Bond Market. Report by the Committee appointed to examine the Market for Public Sector Securities. May.

Some major developments subsequent to this time include the introduction of electronic trading, matching and settlement; the immobilisation and later, dematerialisation of bonds listed on BESA, the development of a series of total-return indices for government and corporate bonds and the development of a more refined yield curve.

2.1 Since the late 1990s, the South African bond market has increased in depth and sophistication. Developments include the introduction of inflation-linked bonds, floating rate notes, a strip programme (an acronym for Separate Trading of Registered Interest and Principal), retail bonds and municipal bonds. The corporate bond market has also grown substantially from net issuance of more than R10 billion in 2001 to net issuance of almost R70 billion in 2006.

The development of the corporate bond market has been assisted by the decline in issuance of government bonds, a low interest rate environment – at least in relative terms-, mergers and acquisitions, the narrowing of spreads and improved liquidity. Significant also has been the expansion of the regional dimension of this market with the raising, by the Mauritius Commercial Bank, of R350 million – the first inward-listed bond to be raised by a non-resident in South Africa.

Regarding sophistication, it is the case that the role of the SARB has changed. In the past, the SARB served as an underwriter and then as a market-maker, quoting two-way prices in the secondary bond market. These activities ended in 1998 when the government adopted a system of regular, weekly, pre-announced auctions. A panel of 12 primary dealers – all being banks – was appointed to participate in the auctions which were, and still are, conducted by the SARB.[2]

3. The current conjuncture

The introduction of the Global Bond Index Emerging Markets (GBI-EM+) by JP Morgan, which tracks changes in emerging-market local-currency bond prices, has been particularly helpful to South Africa, given that most of the country's debt is denominated in local currency, contrary to the practice in most other emerging markets. In addition, it also implies more dedicated bond inflows into our market, possibly of a more lasting nature. Another area of the bond market, which has seen significant issuance over the years, is that of the Eurorand bond market. The demand for rand-denominated bonds issued by highly rated non-resident institutions contributes positively to the value of both the rand and domestic bonds.

The government debt consolidation process has allowed the cost of borrowing to decline markedly. Sound debt management has been such that new issuance is spread across the maturity spectrum of the yield curve. The bond market has become a more appealing corporate finance tool and, as such, corporate listings have become more popular. Since the very first listing of a corporate bond (South African Breweries) in 1994, the corporate bond market has increased considerably in size. Innovation in this sector has been

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2. The number of primary dealers is currently 9, following some consolidation in the banking sector during the early part of this century.

impressive – from issuance of vanilla bonds to securitisations and commercial paper. Not only do these innovations offer debt at lower interest rates than vanilla bonds, but also provide lower income groups with access to home mortgage finance.

The introduction of inflation-linked government bonds in 2000 was a further significant innovation and is quite helpful in providing monetary policymakers and analysts with important information on inflation expectations through readings of the so-called breakeven inflation rate. Whilst much has been achieved, there are still many opportunities and challenges ahead. Non-government bond issuance has increased sharply; however, banks continue to account for the bulk of this issuance. In addition, the buy-and-hold approach to corporate bonds and inflation-linked bonds, in particular, renders these segments of the bond market relatively illiquid. The municipal bond market is still in a developing stage but can certainly contribute to enhancing the breadth and depth of the domestic bond market. Finally, the significant amount of infrastructure spending planned for the next few years is likely to boost the supply of corporate bonds and therefore increase liquidity in this market.

The corporate bond market has increased in size from accounting for 5 per cent of the total bond market at the end of 2001 to almost 30 per cent today. This increase in corporate sector issuance was mainly due to the reduction in the supply of government bonds, lower financing costs and an upbeat corporate sector. In 2006, net issuance in the non-government sector amounted to R41,0 billion (excluding securitised assets).

Net issuance emanated mainly from the corporate sector, with only R7,2 billion emanating from parastatals and municipalities. Issuance in the corporate market has increased, with both new and old issuers active in the domestic market. For the bond market as a whole the number of issuers has increased, by 38 to 99 while the number of listings increased by 348 to 725 from 2004 to 2006. Of this, corporate bonds in terms of issuers increased almost twofold and listings threefold to respectively 83 and 563 over the same period.

4. Legal and regulatory framework that supports the development of capital markets

According to the Bond Exchange of South Africa the purpose of a legal and regulatory framework is to strengthen and develop the debt capital market, to monitor the debt capital market, and to provide investor protection. The framework is also important for the development of the debt capital market since it provides for an institutional organisation to enforce the rules. Many exchanges across the world have developed as self-regulatory organisations under the supervision of a national regulator.

Debt capital market regulation should provide:

1. rules, processes and procedures to deal with listings of bonds, trading, trade capture, matching of trades, clearing and settlement, surveillance, dispute resolution, failed trades, default procedures, appeal processes;
2. sanctions regarding market manipulation and providing misleading information;

3. licensing, monitoring, sanctions and penalties of inter-dealer brokers;
4. licensing powers, duties and responsibilities of self-regulatory organisation and supervisory bodies;
5. ownership, transfer, pledge of securities and security depositories;
6. internationally accepted accounting standards, practices and corporate governance;
7. capital adequacy requirements;
8. legislation to prevent money-laundering, fraud and other white collar crime;
9. legislation to permit institutional investment into debt capital markets.

To encourage local and foreign investment into debt capital markets, governments have to ensure that the legislation and regulations that govern the debt capital markets comply with international standards. BESA has ensured that the rules of the exchange are G30-compliant. It continuously strives to benchmark its rules according to international best practice.

5. General debt capital market infrastructure

Moreover, according to BESA, it is essential to develop an appropriate infrastructure for a debt capital market which inter alia consists of:

1. financial intermediaries or an inter-dealer broker network to support the bond market and promote liquidity;
2. a platform for electronic trade capture and matching;

3. an efficient settlement system that meets the BIS recommendations, e.g. DvP, T+3;
4. a central securities depository to facilitate transfer of ownership of scrip;
5. centralised distribution of market information;
6. a centralised pool of liquidity, e.g. central and transparent price dissemination from a central platform.

Whether or not these requirements are supply-leading, demand-following or some permutation of these and other determinants remains moot.

Conclusion

The challenges to which the bond market will have to respond appear, to me, to be principally two. First, the market will have to adopt to the fiscal stance of central government. This stance will reduce the need for government to fund itself through this market, in the near- and medium terms.

Second, I suggest, the market will need to address the problem of "original sin" on the sub-continent: that is, the inability of adjacent emerging and developing economies to raise financing in their own currencies beyond their own borders. Resolving this dilemma on a regional basis constitutes a formidable challenge – as does the resolution of most sins!

Thank you for your attention.