

Practical Issues in Assuring Durable Market Access for New and Infrequent Users

Graham Smale : OECD Africa Conference Jun 2011



JOHANNESBURG STOCK EXCHANGE
Interest Rates

GEMX Index Factors

What factors do international investors look at?

Category	Indicator	Weight
A. Access	Access to securities market	35% 13%
	Access to money markets	8%
	Access to derivatives markets	4%
	Effective rate of taxation for a fund	10%
A. Liquidity	Turnover ratio	35% 9%
	Bid-Ask spread	11%
	Benchmark yield curve	2.5%
	Centralized bond pricing	2.5%
	Institutional investor base	10%
A. Infrastructure	Regulatory quality	30% 10%
	Creditor rights	5%
	Asset servicing	7.5%
	Clearing and settlement	5%
	Safekeeping safety/soundness	2.5%

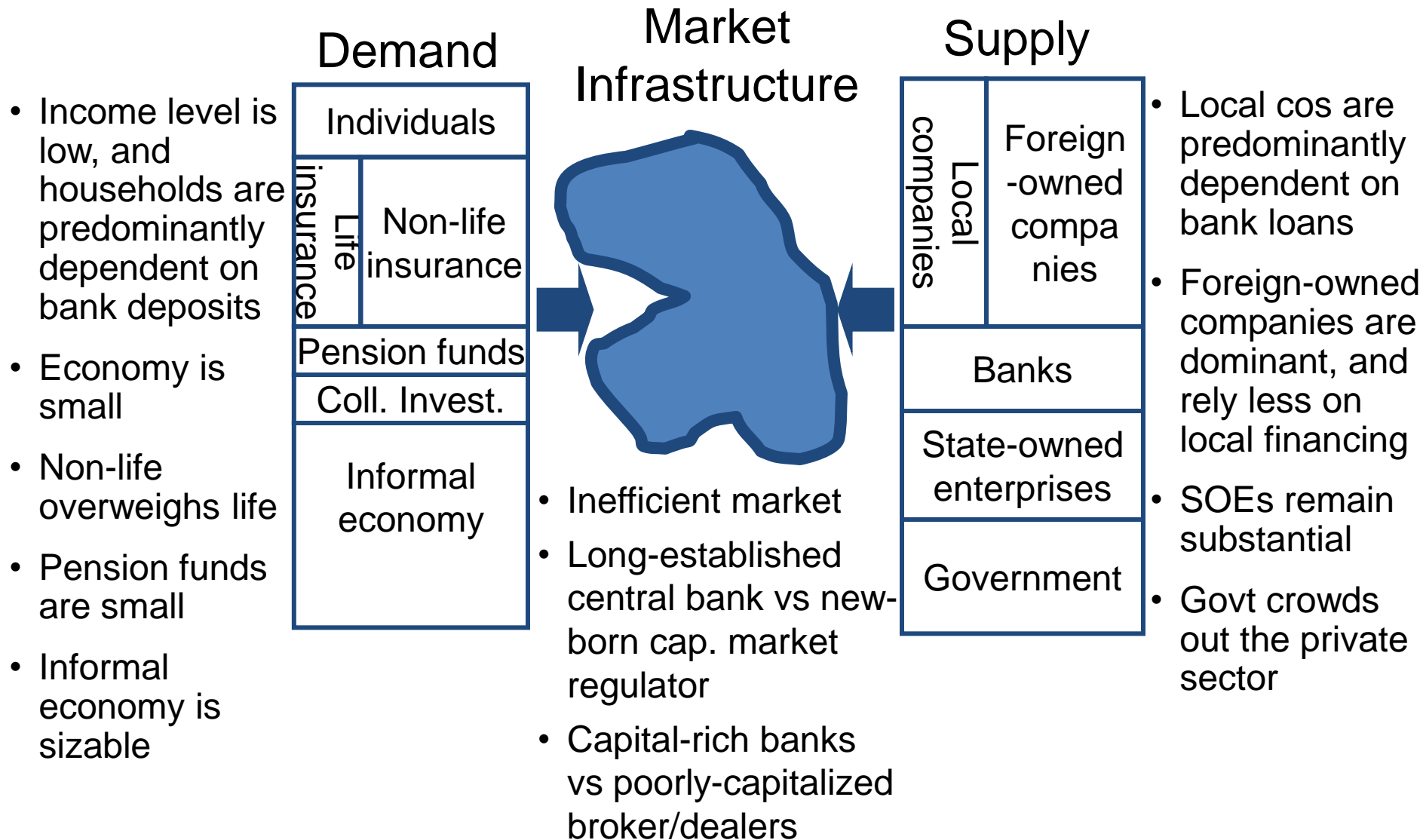
SA Ranking in GEMX Indices

Country	Capital Controls	Liquidity + Efficiency	Regulatory Quality + Creditor Rights	Market Infrastructure	Taxation	Domestic Investor Base	Capital Controls + Taxation	Liquidity + Investor Base	Regulatory quality + Infrastructure	Total
Malaysia	88	86	73	73	100	90	91	87	73	84
South Africa	71	92	63	75	100	90	79	91	69	81
Chile	88	76	75	55	93	90	89	80	65	79
Hungary	100	66	77	57	0	60	100	64	67	78
Poland	92	83	59	53	100	75	94	81	56	78
Mexico	88	83	49	57	100	75	91	81	53	76
Thailand	80	82	58	60	100	75	86	80	59	76
Slovakia	96	57	85	46	100	40	97	52	66	72
Indonesia	84	72	45	63	83	40	84	63	54	68
Brazil	54	78	43	66	54	90	54	81	54	64
Turkey	71	71	49	49	100	40	79	62	49	64
Peru	100	48	51	53	25	75	79	56	52	63
Russia	75	67	33	56	100	40	82	59	44	63
India	46	78	49	68	31	60	42	73	58	58
Nigeria	67	55	37	51	83	40	71	51	44	56
Philippines	55	68	45	57	65	40	58	60	51	56
Colombia	50	77	47	59	18	60	41	72	53	55
China	29	81	37	44	100	40	49	69	41	54
Morocco	59	42	42	39	83	75	66	51	40	53
Egypt	55	43	37	49	65	60	58	48	43	50

A primary prerequisite for bond market liquidity is a framework that balances the demand and supply side factors. A well-organized market infrastructure is often secondary.

Capital Market Profile

Developing Economies



Supply- & demand-side principles to support market liquidity

Supply
side

- Sizable,
- Regular,
- Stable (predictable),
- Transparent and
- Market-based supply of bonds of
 - High quality, and
 - Uniform characteristics,

and,

Demand
side

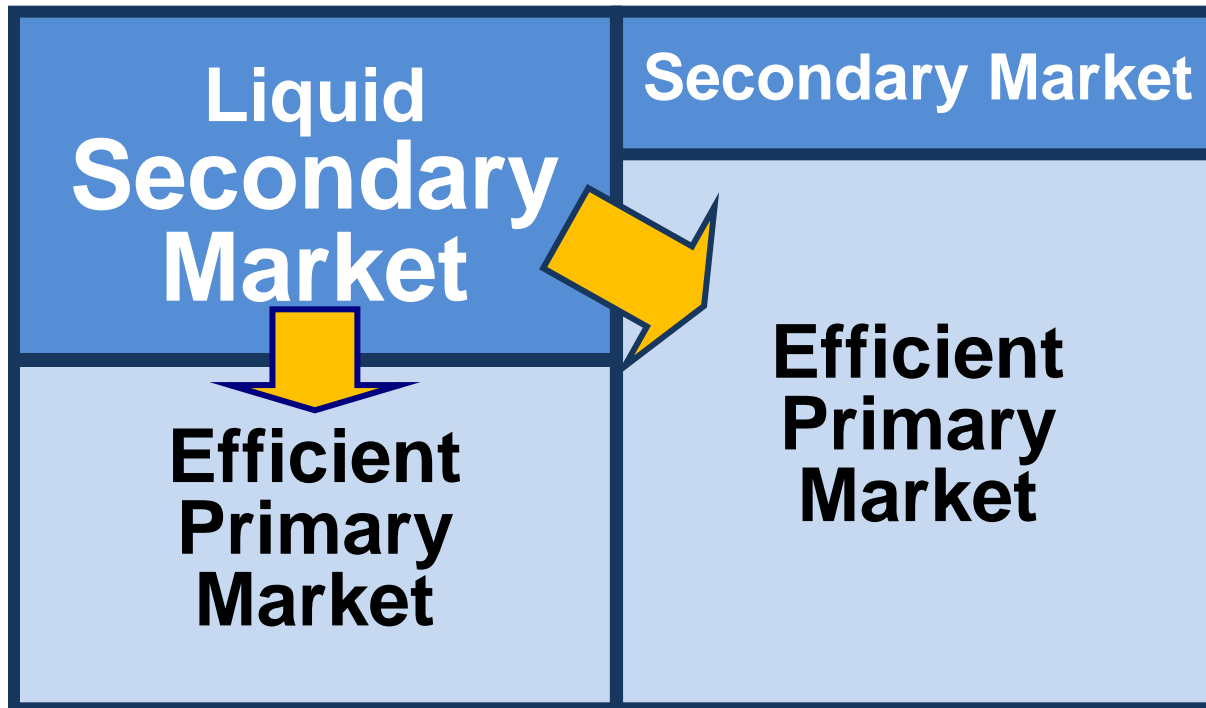
- Many,
- Incessant,
- Competitive, and
- Diversified demands for the bonds

Why Does Efficiency Matter?(3)

The basis for efficient primary markets

Govt Bonds

Corporate Bonds



- A liquid secondary market of gov't bonds is the basis for the efficient primary markets of both gov't and corporate bonds
- A policy weight of the secondary market of gov't bonds is large.

Clearing, Settlement & Depository

Increase efficiencies

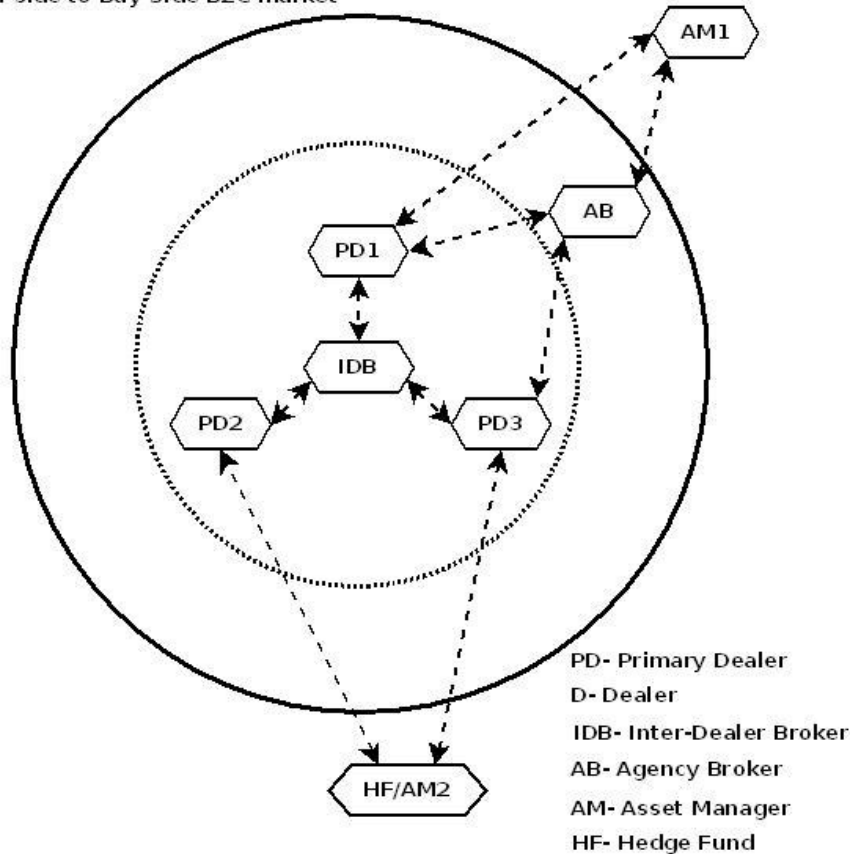
- DVP (← payment system)
- Rolling settlement
- Book-entry system
- “Fail” system
- Straight-through processing (STP)
- Linkage with international settlement systems

Manually possible, but No **efficient** bond market without a computerized central depository

Market Microstructure

Example: Idealised bond market structure

- Inter-dealer B2B market
- Sell-side to Buy-Side B2C market



- The diagram represents an “idealised” market structure for the secondary market in government bonds in developed markets
 - Primary Dealers with quote obligations in the secondary market
 - Inter-dealer brokers
 - Agency brokers
 - Asset managers (the traditional long-only “buy-side”)
 - Hedge funds (the active, leveraged “buy-side”)

Design a Transparency Regime

Example: IDB Reuters Page for Government bonds

13:14 12MAR10	ICAP			UK69580			4GBC
JHB 276 9025	BID	OFF	VOL	LDN 44 207 532 4800	BID	OFF	VOL
STOCK				SWITCH			
.							
R157	8.18/	8.175	5:5	17 H R157/R201	/	-1.0	:5
*AN R157	/		:	R157/R206	/		:
R186	/		:	R201/R206	/		:
*AN R186	/		:	R207/R204	/		:
R209	/		:	R208/R203	/		:
R208	/		:	R186/R157	/		:
R207	8.90/		5:	R186/R208	+6.0	/	5:
R206	/		:	R186/R207	+11.0	/	5:
R204	/		:	R186/R204	/		:
R203	/		:	78 T R204/R203	+7.0	/	5:
R201	/		:	R209/R186	-5.0	/ -6.0	5:5
R154	/		:	R203/R157	/		-5.0 H
R155	/		:	R204/R157	/		:
R197	3.29/	3.27	5:5	29 T R207/R157	+71.5	/	5:
R189	/		:	R208/R157	/		:
R202	/		:	R209/R157	/		:
R210	/		:	R208/R207	+5.0	/ +3.5	5:5
WS05	/		:	R208/R204	/		:
E170	/		:	R209/R207	/		:
.			:	R209/R203	/		:
.			:	R209/R204	/		:
.			:	.			:

Why Does Efficiency Matter? (1)

How much does trading affect total returns?

Trading in response to an interest rate decline

- Buy a bond
- An interest rate declines
- Get the initial investment back and a **CAPITAL GAIN**
- Reinvest them in a new opportunity for the remaining maturity
- How much do the total returns improve?
- **NOTHING!**

The generation of return requires the taking of risk

- Term
- Default
- Liquidity

Why Does Efficiency Matter? (2)

Implications of the return profile of bonds

The generation of return requires the taking of risk

- Term
- Default
- Liquidity

Returns are **EXTREMELY SENSITIVE TO COSTS**

- Transaction cost
- Taxes
- Liquidity and impact costs (the implementation shortfall)

What interest rate?

The building blocks

- An interest rate is built up from a number of pieces
 - Inflation and inflationary expectations
 - Real interest rates, the risk premium over inflation
 - Probability of default
 - Expected liquidity
- The yields on instruments issued by the government are assumed to be **RISK FREE**



① Risk free rate = Inflation + Real rate

② Risky rate = Risk free rate + Risky variables

③ Risky rate = 6% + 2.5% + 1% + 0.25% = 9.75%

Summary - The starting ticket to the game

- Government Policy
 - Transparent fiscal policy: Budgeting and benchmark issuance
 - Transparent monetary policy: Stable inflation needs to be balanced with development and employment needs
- Regulation/Legislation
 - Banking: Development of the money market and commercial paper (supply)
 - Securities legislation (enabler)
 - Prudential regulation: Pension/Insurance reform (demand)
 - Collective investments (demand)
 - Securitisation (supply)

Summary – Market infrastructure

- Electronic CSD (efficiency)
- Development of benchmark rates (pricing)
- Regularisation of the market (trust)
 - Primary market rules including Prospectus/Listings rules
 - Secondary market rules including transparency
- Developed repo market to permit shorting (efficiency)
- Market microstructure (enabler)
 - Design to take into account local conditions, the roles and number of players
 - The need for human versus electronic intermediation

In Closing

- There is no single factor that optimises the result
- All are important
- Sequencing is the key
- Early issues will always be expensive - It requires commitment to the long-term to see the results
- Keep all levels of costs down!

Any questions?

