Research Assignment on the South African Bond Market Structure

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Introduction

The report “Establishing viable capital markets”, was issued by the Bank for International Settlements, and it provides specific criteria which enables capital markets to be more efficient and effective, as well as highlighting vital policies that are associated with the bond market. The report has listed two key factors which enable capital markets.

The first factor is the analysis of market trends, which includes an in-depth analysis of the various aspects of market trends such as market size, access, liquidity and resilience. The second factor investigates the drivers of the capital markets, which include macroeconomic stability, market autonomy, rule of law and an efficient legal and judicial framework, effective and efficient regulatory regime, disclosure, diversified investor base, internationalization, and the infrastructure of primary markets, trading systems, complementary markets and financial markets.

This report evaluates the South African bond market against each criterion listed under the abovementioned factors, by analyzing information released regarding the South African bond market.

Trends

Market Size

The South African market falls under the emerging market economies. A significant difference exists in the market size of bonds market across both advanced and emerging market economies (BIS, 2019). The bonds market in general has been growing steadily over the past twenty years, allowing them to come closer to equities (BIS, 2019). Although the emerging market economies are catching up to advance economies, there is still a gap between both economies (BIS, 2019).

The improvement of the instrument mix and liquidity of the South African fixed income market has assisted with the closing down of the huge gap between their emerging market economy and the advanced economy (Horne, 2018). South Africa’s market size is gauged from outstanding securities relative to the gross domestic product (BIS, 2019). Equity has remained flat on average, while the South African capital market has grown over the past two decades, especially after the great financial crisis (BIS, 2019). Capital markets have served a great purpose as they played a key role in financing the recovery of economies during the finance crisis period.

The growth in the South African bonds market was also influenced by decreasing credit ratings in banks to avoid credit risks and implementing stricter policies for credit borrowings. The attractiveness of the South African bonds market to foreign investors has accelerated the development and increased the local market size (BIS, 2019).

Access

Market access looks to represent the breadth of issuers able to meet their funding needs in capital markets and captures the second dimension together with the trading of diverse instruments which are able to transfer risks between market participants (BIS, 2019). This is partly facilitated by The Bond Exchange of South Africa (BESA) which was attained by the JSE in 2009 to incorporate debt capital markets (Horne, 2018).

In order for an institution to participate in the trading of any listed bond, it can only do so through a JSE-member institution, and will also need a custody account with a licensed South African CSD in order to allow trade settlements and transfer of securities between parties (Horne, 2018). This may seem tedious to some parties, but it also shows the how seriously the JSE takes security and that will increase investor confidence.

There have been large improvements in the access indicators of EME. However, improvements are, to some extent, flattered by firms where the government is the majority owner (BIS, 2019). Which is the case for the South African bond market where the composition of the listed market includes 67% attributed to the sovereign (Horne, 2018).

The general outlook on market access is positive due to the introduction of the electronic trading platform in 2018. The ETP is expected to amplify and upgrade transparency of the South African bond market by moving to an electronic platform from a bilateral one and thus also enable NT to more accurately monitor the activities of the PDs (Horne, 2018).

Liquidity

Liquidity incorporates standards of measurement that identify the ease at which the value of securities as well as the costs of transactions can be realized by investors (BIS, 2019). However, liquidity data that is accurate and comparable is rare or difficult to find for local currency bond markets in particular (BIS, 2019).

South Africa is one of the countries that experienced improvement in its local currency government bond market, with bid-ask spreads of 10 basis points matching with Korea and the Netherlands (BIS, 2019). It has experienced an increase in interest from foreign investors which has increased market development (Horne, 2018). The recent movement towards trading fixed income securities on an electronic platform, The Johannesburg Stock Exchange limits the immediate impact on the investors as trading only occurs through the nine primary dealers that South Africa currently has (Horne, 2018). This is one aspect of the concerns raised amongst the people towards bond market liquidity as the banks are no longer able to smooth out price moves if something goes wrong (Levine, 2019). It is also less convenient for buyers and sellers as they must go through longer means of carrying out these transactions

(Levine, 2019). However, other people support not trading directly with the bank as they would prefer the bond investors to lose money over the banks, the latter more likely to cause a huge crisis (Levine, 2019). The non- competitive auction benefits such as the option to take up an extra fifty percent of their allocated auction amount at the auction clearing up to two days later gives the primary dealers an incentive to participate successfully in the primary market which increases the provision of liquidity (Horne, 2018). Despite the limitations, this movement towards trading on an electronic platform is meant to improve the market liquidity over some time.

Repo financing reflects the financing liquidity available in the market (Horne, 2018). Over the past ten years this has been increasing consistently in the secondary market indicating that secondary listed debt market trading is very liquid (Horne, 2018). This is the result of the two distinct market characteristics of the South African financial system. One of them being that the banking sector is not limited by the leverage factor and low domestic household savings, leverage is accessible to the local financial institutions which enables them to source excess returns given the savings shortfall (Horne, 2018). There is also high liquidity in the secondary market of Treasury bills (Horne, 2018).

Resilience

Resilience of the capital/bond markets pertains to the ability of the market to recover from the difficulties which may affect them directly or indirectly (BIS, 2019). There are no specific metrics used in order to assess the resiliency of the capital markets, but we can use available data and attempt to draw correlations or analyse data for clues. In terms of the South African capital markets, it is observed that high liquidity exists due to increasing demand for short dated liquidity instruments (Horne, 2018). The possession of liquid assets may prove to be beneficial in times high stress, as liquidity allows more freedom of movement. Short term assets debt securities help achieve liquidity, one such example is that some domestic bonds hold the option for a split maturity date, by dividing maturity dates in equal portions (Horne, 2018). In fact, 90% of traded stock, can be classified as holding one week in tenor (Horne, 2018). With split stock maturity, her forth the market is better equipped to manage risk and subsequently develop resiliency (Horne, 2018).

Resiliency also deals with the attitude and confidence of investors and thereby need to assess the demand and the drivers thereof (BIS, 2019). Analysing the demand for debt securities in the secondary market, it is observable that there is a steady growth in repo financing movement, and it holds 70% of bond movements (Horne, 2018). This proves to be a just mirroring of the confidence that the market holds for traded stocks, to the extent that it is willing to employ it in collateralised transactions (Horne, 2018). Coming back to the effect of liquidity, this above-mentioned steady growth reflects the availability of financing liquidity present in the market.

Drivers

Macroeconomic Stability

This entails an economy with low and stable inflation and is the first factor that creates favourable conditions for financial contracts and enables financial market development, in other words, macroeconomic stability is an enabling environment (BIS, 2019). This factor leads to increases in investment and demand for external finance. In South Africa, auctions of the inflation-linked bonds are limited to all members of the JSE (Horne, 2018). Since the 1990s there has been an improvement in the macroeconomic stability of emerging market economies such as South Africa (BIS, 2019). Having macroeconomic stability is important and reflected in the concerns towards high and uncertain inflation exceeding that of liquidity and market infrastructure risks (BIS, 2019). The stage of development that the country is in has an impact on the market size of securities.

Market Autonomy

When dealing with autonomy, restrictions on independence needs to be addressed. As stated in the BIS (2019), that repressive policies restrict autonomy and in many advanced economies, they are in the process of relaxing such restrictive policies to achieve liberalisation and ultimately uplift domestic corporate securities markets.

In the BIS (2019) report, it becomes apparent that repressive policies are far more prevalent in emerging market economies than their counterparts. It is arguable that these policies have their place in emerging economies as it serves as a brace for future advancement and growth. These restrictive policies could also be abused to funnel funds to nepotistic type borrowers and thereby allowing governments to borrow at below market rates (BIS, 2019). In a corruption laden emerging market, such as South Africa, market autonomy would serve in the markets best interest to achieve growth. This would hold true especially for South Africa as 67% of outstanding debt capital, is Government Issue (Horne, 2018). It then becomes apparent that policy and regulation is closely tied to the South African fixed income market.

Rule of Law and an Efficient Legal and Judicial Framework

Effective and transparent creditor rights as well as efficient insolvency regimes provide greater assurance that investors will get their money on time and that the debts are settled (BIS, 2019). In South Africa, the issuance of securities is overlooked by the Financial Markets Act, who ensure to promote transparency, fairness and efficiency in financial markets while enhancing stability and reducing systemic risk (Horne, 2018).

Effective and efficient regulatory regime

South Africa utilises a highly sophisticated and well-developed financial system that assets regulatory authorities to ensure that international best practice standards are adhered to in market infrastructure design and operations (Horne, 2018). South African bonds market are governed by The Financial Market Act (Act No. 12 of 2012) and regulated by Financial Services Conduct Authority (Horne, 2018). Regulators are needed to enforce laws and regulation which protect investors and ensure that markets operate fairly and efficiently (BIS, 2019).

" Effective regulatory regimes specify obligations of the firms to their investors and oversees few things such as licensing, operations, risk management and detect and deter unfair trading practices" (BIS, 2019). Efficient regulations are implemented in the local (South African) capital markets to balances the trade-off between investor's protection and issuers cost (BIS, 2019).

The South African Reserve Bank plays a key role in enhancing the South African fixed income market, as they contribute in overseeing the payment infrastructure and lead in a role of design and modification of capital interest rates (Horne, 2018). For efficiency and effectiveness in the local market, responsibilities should be clearly and objectively stated

Disclosure

Information that is made available for the public must be transparent and reliable as it serves as a well function in the bonds market (BIS, 2019). False or misleading information could lead to adverse selection (BIS, 2019). "Delayed disclosures of material information create moral hazard, giving insiders time to trade profits and avoid losses" (BIS, 2019). Both incidents can result in investors losing confidence in the local (South African) market. Having information that is realistic, reliable, accurate and transparent will keep the peace in the markets between investors and financial institution, and this also has a positive impact in the South African capital market.

Diversified Investor Base

An investor base that is large and diversified helps to support liquidity, depth and stability. EMEs with the greatest corporate securities markets compared to GDP, South Africa being one, have great private pension, insurance and mutual fund sectors. An institutional investor base's depth is highly correlated to capital market growth. The greater the size of the investor base, the greater the positive and stabilizing effect on long term government bond yields. However, there are differences in how the funds are allocated across different countries. As the capital market develops, it helps to increase economies of scale for investment funds and decreases the asset management fees. This therefore, facilitates added savings into capital markets (Working Group, 2019: 30-31). An investor base can be grown through an increase in investment options as well as better transparency and investor education which assists in more effective choices of these options (Working group, 2019:50).

Internationalization

By allowing access to international markets, domestic businesses and investors will have more opportunities to issue and invest. There is greater participation. This increases the opportunity for saving, permitting the issuing more securities at lesser expected yields (Working Group, 2019:38). The freeing of the market decreases the cost of capital through the division of risk between foreign and domestic brokers. The entry of foreign investors expands domestic market liquidity and depth. The increased competition encourages the promotion of implementing international best practices and standards. The issuing of larger issues at decreased yields and longer maturities can be made more viably abroad than in domestic markets. Domestic bond markets attracting foreign investors creates diversity to the market and depth to domestic hedging markets. These issuers want to switch their proceeds into their home currency. Therefore, a natural complement to local firms wanting to hedge foreign currency borrowings emerges (Working Group, 2019:32-35). Through open communication with local and foreign investors, information on insights and perspectives can be beneficial in increasing participation (Working group, 2019:51).

For EMEs like South Africa, market participants expect stronger spillovers in equity markets due to the development of global markets. With the large investor base through internationalization, the greater the share of assets held by local mutual and pension funds and insurance companies, the lesser the impact from global financial shocks (Working Group, 2019:36). In order to maintain this, South Africa inflation expectations need to be anchored (Working Group, 2019:51). In South Africa, the non-resident participation in the market has grown. In March 2018, these holdings peaked at 42.8% mostly in fixed-rate bonds showing the internationalization of the South African capital market (Horne, 2018:4).

Primary Markets, Trading Systems, Complementary Markets and Financial Market Infrastructures

With better predictability and use of bond reopening, cost of issuing has declined, and liquidity of the government securities market has improved. Therefore, the organizational structure of the market is a vital driver (Working Group, 2019:36). When issuance occurs, intermediaries help in the pricing and distribution of securities (Working Group, 2019:37). South Africa utilizes primary dealers (Horne, 2018:4). Greater predictability in issuance systems lowers the risk of not finding enough purchasers of government bonds. Underwriters have regulations.

In the South African fixed income market, primary dealers have certain obligations in terms of compulsory participation in auctions. Better transparency has been achieved through Electronic Communication Networks. South Africa introduced a bond electronic trading platform that will work alongside the JSE reported government bond market. This introduction not only improves transparency but makes pre- and post-trading smoother (Horne 2018:4-5).

Liquid derivatives, repo and securities lending markets enables funding and hedging which encourages market growth. These markets can be developed through providing a helpful legal and regulatory environment (Working Group, 2019: 54). Secondary market trading in South Africa is very liquid. There has been a steady rise in the repo financing activity (Horne, 2018:7). Market infrastructures need to be effective to offset financial stability risks. Together with transparency and sound infrastructures, confidence can be preserved during financially stressful times (Working group, 2019: 54).

Conclusion

South Africa is an emerging market which has experienced large growth over the years due to the implementation of stricter policies and the introduction of the Johannesburg Stock Exchange (JSE). The JSE has increased investor confidence and limits the participants which results in greater security. However, the South African government is the majority owner of the firms listed in the JSE which has a negative impact on the market.

The introduction of the Electronic Trading Platform has increased transparency, access, ensures a smoother trading and has a long-term objective of improving market liquidity. Foreign investors have an increased interest in the South African market due to the improved currency and internationalization. This has resulted in a large, diversified investor base and it is advised for South Africa to stabilize their inflation expectations so that this may be maintained.

Repo financing has been steadily growing which indicates that the secondary market is highly liquid due to the demand of short-term instruments. This growth is a strong reflection of investor confidence in South Africa.

Although the restrictive policies may repress market autonomy and access, it ensures for greater transparency, especially as South Africa is highly affected by corruption. The importance of transparency is further emphasized by the strict compliance to the Financial Market Act and the regulation implemented by the Financial Services Conduct Authority. Transparent and reliable information is accessible to the public. The South African Reserve bank also plays a vital role in the improvement of the financial market.

Overall, the South African bond market is consistently growing and improving in all aspects that are vital for capital markets, which were mentioned in the BIS report.

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