Daniel Mminele: Financial market and reserve management challenges in South Africa

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the 7th Annual Financial Markets Department Cocktail, South African Reserve Bank, Pretoria, 30 May 2013.

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1. Introduction

Good evening and welcome to the South African Reserve Bank.

It gives me great pleasure to welcome you all to the 7th annual cocktail function of the Financial Markets Department. As usual there are two reasons for this function tonight. The first one is to update you on the Financial Market Department's (FMD) market operations and to inform you about the progress made with regard to various initiatives we are involved in, which are aimed at developing our markets and making them more efficient. The second reason is to thank you for your co-operation during the past financial year and to provide an opportunity to exchange notes and interact with one another.

You will be glad to know that I am the only speaker, the rest of the programme should be fine and entertaining. I will try and be relatively brief, because they say it's best to leave your audience before your audience leaves you. Allow me to formally introduce the new Head of the FMD, who is well known to most of you. Leon Myburgh joined the Bank on 1 March 2013, to take up this very challenging but rewarding role, and we wish him every success. I have no doubt that he can count on your support and cooperation.

I don't think it would be appropriate to address a Financial Markets cocktail function and not at least touch on the latest developments. I would like to spend just a few minutes taking stock of the economic and financial market landscape, before turning to matters related to the Department and market development initiatives.

When we last met in May 2012, the key challenges we faced related mostly to an uncertain and fragile global economic and financial markets environment, in particular the euro zone crisis and the US fiscal situation. Even if we can't quite declare victory, the global economy and financial markets have witnessed some improvement since then, as continued action by the world's major central banks to provide the necessary liquidity to sustain the global economic recovery has largely removed the "tail risks" that unsettled global markets. While these actions have removed acute financial stability risks, the transmission mechanism into the real economy remains generally impaired, resulting in what continues to be a slow, unbalanced and fragile recovery. As you are aware, possible risks attached to the timing and pace of the reversal of these extraordinary measures, are the subjects of intense debate at the moment, including the possible impact on higher yielding assets of emerging economies, such as South Africa.

Unfortunately, despite the easing in some global risks, the challenges in the domestic environment have intensified. The rand has been on a depreciating trend, partly explained by the recent strengthening of the US dollar and the decline in commodity prices. The rand exchange rate has steadily underperformed the currencies of its commodity-producing or emerging market "peers" over the past year. This trend, which contrasted with the more stable pattern of the rand versus its peers in earlier years, clearly indicates a growing sensitivity of the currency to domestic factors such as concerns about the funding of a wider current account deficit, as well as broader socio-economic issues illustrated by increasingly violent labour conflicts in the mining and other sectors.

While an adjustment of the currency to changing economic fundamentals represents one of the benefits of a flexible exchange rate, excessive currency volatility and vulnerability of investor sentiment, increasingly risk complicating the tasks of both monetary and fiscal policy. The most recent exchange rate movements, including today's, are somewhat exaggerated. The SARB continues to be committed to a flexible exchange rate and does not have an exchange rate target. This commitment should not be misread to suggest that any abrupt and disorderly movements in the exchange rate would not be of concern to us.

For most of the past year and until recently, the bond market had shown little sensitivity to the currency's depreciating trend, as it was underpinned by a combination of "push and pull" factors: Global investors' search for higher returns; the inclusion of SA bonds in Citi's World Government Bond Index; and a relatively benign domestic inflation environment which led market participants to reduce the probability attached to an early start of the eventual policy tightening cycle. In April, in particular, one witnessed a flattening of the bond yield curve, with larger declines seen in yields of longer dated bonds, those very maturities where National Treasury had just been increasing its issuance levels. The most recent episode of rand weakness has not left the bond market untouched, however, and the sell-off has been more pronounced at the long end. The equity market clearly reflects the challenges present, and although the Alsi is up almost 7 per cent year to date, the mining, platinum and gold sectors have witnessed hefty declines, while in US dollar terms, the MSCI for South Africa is almost 13 per cent lower.

2. Financial market operations

Over the past year domestic money market operations have continued in an orderly manner. The money market shortage increased from R20.6 billion in March 2012 to over R24.0 billion in March 2013. This increase was largely due to a 14 per cent or R13.0 billion rise in notes and coin in circulation to R103.1 billion, and a R2.6 billion increase in the cash reserve balances of banks to R66.1 billion. These actions were somewhat offset by declines in outstanding debentures, longer-term reverse repos and CPD balances with the Bank. Foreign exchange swaps, both for liquidity management purposes and to sterilise foreign exchange purchases amounted to R43.7 billion as compared to R53.9 billion in March 2012.

Swaps previously conducted to sterilise foreign exchange purchases amounting to R16.2 billion were matured, which increased the level of gross reserves, but were offset by sizeable valuation adjustments during the year emanating from the appreciation of the US dollar against other major currencies and the decline in the gold price. As such, the country's gross reserves declined marginally from US$50.7 billion to US$50.0 billion between March 2012 and 2013, increasing marginally to US$50.3 billion in April 2013.

From time to time the Bank reviews its operations in the money market with the aim of enhancing their effectiveness. The last enhancements to the Bank's market operations were implemented in March 2012. The changes were implemented successfully, but there were also some unintended consequences. Since the introduction of the enhancements, the main repo auctions have reflected tendencies of commercial banks overbidding so as to ensure adequate allocation of funds. While this overbidding is not indicative of any stresses in the market, it does interfere with the signalling mechanism and would make it more difficult for the Bank to detect any possible stresses in the market should they arise. The Bank is currently looking at various options by which it can ensure that such overbidding does not continue.

The Bank is also currently investigating the efficient functioning of the interbank money market, the over-utilisation of the automated standing facilities and the averaging on the banks' cash reserves for the daily end-of-day square-off. In addition, one of the key strategic focus areas for the Financial Markets Department is a comprehensive review of the Bank's monetary policy implementation framework, and the money market shortage as it relates to achieving the intended purpose of ensuring that decisions of the Monetary Policy Committee are transmitted effectively through the interbank market.

3. Financial market development

Well-developed and smoothly operating financial markets promote investment, growth and job creation and contribute to a healthier and more efficient economy. During the past year the FMD has continued to work closely with the Financial Markets Liaison Group (FMLG), which is a consultative forum between the Bank and market participants, meant for information sharing and identification and management of challenges facing the South African financial markets in the interest of efficiency and further development.

One of the major projects undertaken during the past year was the review of reference rates, and specifically the Johannesburg Interbank Agreed Rate (Jibar) which was completed successfully, with the co-operation of many people here tonight. This project was part of the normal work programme of the Money-Market Subcommittee (MMS) of the FMLG which had already commenced in 2011. However, the events that took place in the international market regarding the manipulation of the Libor heightened the urgency of the Jibar project. On 16 November 2012, the Bank published two documents. The first, "A review of the rate-setting process of the Johannesburg Interbank Agreed Rate as an interest rate benchmark", presented the findings and recommendations that emanated from the review of the Jibar. The review indicated that while there were no fundamental concerns around the Jibar determination process, and no trends and patterns of anomaly, certain aspects of the process could benefit from enhancements and formalisation, more specifically the governance process. The second document, "The Johannesburg Interbank Average Rate (Jibar): Code of Conduct, Governance Process and Operating Rules" released together with the review document, was for public comment. The Code of Conduct, implemented on 1 March 2013, formalised the recommendations of the review project and is important to ensure the integrity and reliability of the determination process of the Jibar.

The Bank is responsible for ensuring overall compliance with the Code of Conduct, and does so through the Reference Rate Oversight Committee (RROC). The RROC had its inaugural meeting earlier this week and will serve as an interim arrangement pending the finalisation of the legislation relating to the Twin Peaks model of financial regulation, after which this function, given that it relates to market conduct, will likely be transferred to the market conduct regulator.

Since the Libor scandal, many institutions (including the Monetary Authority of Singapore, The European Security and Markets Authority, the European Banking Authority, and the Bank for International Settlements) have undertaken reviews of their reference rates and FMD continued to monitor these reviews and recommendations for relevance to our endeavours regarding the publication of credible reference rates.

Currently, the MMS is working on a review of the South African Benchmark Overnight Rate on deposits (SABOR) and will report back to the FMLG its findings and recommendations. This work will feed into another project being undertaken by the Fixed Income & Derivatives subcommittee of the FMLG, namely, the development of the South African Overnight Index Swap[1] (rand OIS). A well-developed rand OIS market would have many risk management benefits. Market participants predominantly use the OIS market for hedging activities, to hedge either their funding costs or their exposure to short-term interest rate movements, and to alter the term structure of a portfolio. The fixed-rate portion is also used by some market participants to derive market expectations of the Bank's future policy rate changes. This work will culminate in an industry-wide consultation to deliberate on the format of a rand OIS

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[1] An interest rate swap involving the floating rate being exchanged for a fixed interest rate. An overnight index swap is a particular form of interest rate swap, whereby parties agree to swap a floating interest rate – based on compounded overnight interest rates (eg EONIA, SONIA) – for a fixed interest rate (ie, the OIS rate). The overnight index is considered to be a good indicator of the interbank credit markets, and less risky than other traditional interest rate spreads.

product that would enable South Africa to be on par with its developed market peers, and to be part of a handful of emerging markets to deliver a more sound derivatives pricing and risk management landscape. The central banks of most jurisdictions play a key role in the collation of information and the publication of the overnight reference rates, which are subsequently used in the OIS markets and in other money-market indices. Much work still has to be done to develop a fully-fledged rand OIS market, but the working group is making good progress.

The Foreign Exchange Subcommittee has embarked on a project to formalise a rand fixing at prescribed intervals during trading hours. This project is necessitated by the need for local foreign-exchange market players to have a local fixing page for the rand. With the development of the currency futures market, it would provide quicker dissemination of fixing information across the market. A daily rand fixing will also enhance market transparency and can be used as an objective and verifiable reference rate for the settlement of foreign exchange transactions.

Through the FMLG and its subcommittees, a Liquidity Forum has been established, whose mandate is to deliberate on market liquidity including the viability of a collateralised interbank market. This Forum will address other liquidity challenges and settlement issues that could arise.

Another area of important consultation and co-operation between the Bank, through FMD and the Banking Supervision Department, has been the operationalization of the Committed Liquidity Facility (CLF) as part of Basel III implementation. In May 2012, the Banking Supervision released a guidance note on the CLF, which would be made available to banks to assist with meeting the Basel III Liquidity Coverage Ratio (LCR). Since then, market consultations on the outstanding issues around the CLF have been concluded and the Bank Supervision Department is finalising a revised Guidance Note, which will be issued together with an updated Operational Notice from FMD dealing with collateral arrangements for the CLF.

4. Reserves management

The Bank has continued to make good progress in enhancing its reserves management operations. During the past year the Bank has faced numerous challenges in managing and maintaining high quality liquid foreign reserves portfolios in a low-yield environment, which was compounded by the on-going European sovereign debt crisis and numerous ratings downgrades. The Bank did, however, benefit from the increase in liquidity and the improvement in the credit risk profile of its investments as the euro zone authorities and the International Monetary Fund (IMF) have enhanced their efforts in solving the financial crisis. The Bank remained prudent and risk-averse in its investment strategies and the Bank’s holdings continued to be dominated by government bonds, supranational agency debt and high quality and short-term money market securities.

The Bank benchmarked and just recently completed a review of its Investment Policy and also reviewed the Strategic Asset Allocation (SAA), to take into account the current low-yielding environment and expectations of future monetary policy actions by major central banks. The new SAA will encompass a wider variety of investments, in order to improve the diversification of reserves, while not abandoning the basic principles of portfolio construction based on our traditional objectives of capital preservation, liquidity and return enhancement within clearly defined risk parameters. Included in this is the investment in the onshore Chinese interbank bond market. Apart from ensuring that the currency composition of reserves better reflects underlying shifts in trade patterns, investing in the Chinese markets will provide an opportunity to familiarise ourselves with this market, given the expected major role that the Renminbi is going to play in the future. The Bank is finalising operational arrangements pertaining to this investment.

In March this year, the Reserves Management Unit started trading in interest rate futures, which allows for more efficient portfolio management, and in particular as a hedging mechanism to more optimally manage the risk of negative returns in a rising interest rate environment.

The Bank reviews its external fund management programme approximately every three and a half years. We are busy with this process at the moment and expect to appoint external fund managers and implement the programme by September 2013.

The FMD is currently also reviewing its custodial arrangements alongside a Systems Renewal Project which commenced in 2011. Much progress has been made on both fronts, and it is expected that the final system selection will be completed in August 2013, with the implementation of new custodial arrangements taking place soon thereafter.

5. Conclusion

As you can tell, the Financial Markets Department has had an incredibly busy year with many projects on the go simultaneously, both internally as well as with market participants. All of this can only be achieved with committed, dedicated and passionate people, who understand the importance of their role. I would like to extend thanks to the Department, its management and staff, for the hard work, professionalism and commitment shown. The fact that many of these projects, which by no means are small projects, are near completion and moving into implementation phase is a reflection of this. Thank you also to the colleagues from other departments within the Bank, who work closely with the Financial Markets Department and contribute to the success of the Department. I also thank all market participants for your co-operation and willingness to work with the Bank and helping develop South Africa's financial markets. I would also like to take this opportunity to congratulate all the winners of the Financial Mail 2013 rankings of broking firms and analysts, well done to you all!

Finally, to the staff of the Reserve Bank's Conference Centre, thank you for once again arranging this function for us. They have agreed that, because my colleagues from the FMD are your hosts tonight, they will take care of liquidity management operations tonight.

Thank you.