CONDITIONS OF EXCHANGE FOR SWITCH AUCTIONS TO BE HELD BY THE NATIONAL TREASURY

The South African National Treasury has, during the past 12 months, worked on the formulation of a draft switch auction programme. While the National Treasury shared ideas with market participants across the market, including the primary dealers, it is still evident that the majority of market participants have not yet provided the National Treasury with their views. The National Treasury is publishing the proposed rules, terms and conditions by which switch auctions would be effected with a view to obtaining comments from a broader constituent of market participants. As stated in the 2000 Budget Review, the National Treasury intends to begin to actively manage the government debt portfolio with effect from this fiscal year. This consultative process is aimed at ensuring that we are able to conduct switches in a more efficient manner, where a product that is provided is compatible with the requirements of the investors.

The proposed rules describe a process by which an entity may submit competitive offers to sell securities to the National Treasury. This includes the number of days between the announcement of the auction and the auction procedure to be followed. The pricing methodology on how an instrument would be exchanged for the other is also included. For more information please see our web site at: **www.finance.gov.za**

Closing Date for Submitting Comments: 25-08-2000; Time 10h00

Contact Persons & e-mail: **Phakamani Hadebe (**Hadebep@finance.pwv.gov.za)
Phumzile H Maseko (Maseko@finance.pwv.gov.za)
Jim Matsemela (Matsemej@finance.pwv.gov.za)

Fax: +27 12 326 7552 or +27 12 323 1783

1. Background

During the second part of the 1999/00 fiscal year, the borrowing needs declined significantly as a result of government's improved fiscal position. The net borrowing requirement during 1999/00 fiscal year was substantially reduced to R14,3 billion, largely because of privatisation proceeds. At the end of 1999/00, total government debt amounted to 46.4 per cent of GDP, down from a high of 48,2 per cent in 1996/97. The net borrowing requirement in the 2000/01 financial year is projected at R20,3 billion. Of this amount, R13,6 billion is estimated to be financed in the domestic market and the balance (about US$ 1 billion) in foreign capital markets. The foreign borrowing programme for 2000/01 has already been concluded. Based on the projected budget deficit, and asset restructuring proceeds for 2001/02 and 2002/03, it is regarded that the total net loan debt will decline further to 42.0 percent of GDP by 31 March 2003. With the ongoing declining budget deficit, auction sizes of government bonds will also be declining over time. The declining government borrowing requirements will be accompanied by a reduction in the amount of new debt issued and this might have a negative effect on the liquidity of the securities market. The switch auction programme is intended to be used to enhance the liquidity of the securities market amidst the declining new issues. This could be done by repurchasing in advance of maturity some less-liquid issues, while financing these bond purchases through larger new issues of benchmark bonds.

Over the last number of years, the Department of Finance strongly supported the orderly development of the domestic securities market by establishing a more balanced maturity structure and enhancing liquidity in government's liquid benchmark bonds. This initiative will now be taken forward by reducing the number of outstanding issues through consolidating a number of bonds into fewer, larger bonds.

In a switch operation, we would redeem securities by purchasing them from current owners. The most equitable method for determining redemption prices is through a process whereby market participants submit competitive offers to sell particular government securities to the National Treasury. The National Treasury will announce its intention to purchase specified government securities, including the approximate total amount that will be purchased, and the deadlines for offers and settlement.

2. Rationale for Switch Auctions

- Switches will provide the government with a powerful tool to rapidly restructure the maturity profile of outstanding debt. With the declining deficit (and without a switch programme), further reductions in new issue sizes and frequencies might reduce the liquidity of government bonds.

- Switches will concentrate liquidity across the yield curve by reducing the number of illiquid small issues, and consolidating them into larger more liquid stocks. While not a primary objective, over the long term, this enhanced market liquidity could reduce the government's interest expense and promote more efficient capital markets.

- Switches will also be used as a cash management tool. They will reduce the refinancing risks by smoothing the domestic maturity profile, especially towards bond redemptions.

- Switches will also be used to build-up the size of the benchmark bonds more quickly than can be achieved through conventional weekly auctions. This has become more important in the expected low-issuance environment amidst the goal of the National Treasury of introducing a strip market. The switches will be used to increase liquidity of the benchmark issues and accelerate the start of a strip market.

3. **Methodology**: A cash neutral switch method will be used **based on dirty prices pricing method.**

4. Proposals

4.1 **Participation**: Exchanges are effected on voluntary basis. **Only primary dealers are eligible to submit offers.**

4.2 The National Treasury reserves the right to buy back nothing or less than the announced amount if warranted by market conditions.

4.3 The National Treasury may hold a number of switch auctions of a particular bond over a period of time, if necessary.

4.4 The National Treasury will not fix the minimum size for source bonds after the switches.

4.5 Only bonds with a minimum nominal outstanding debt of R1 billion will be considered as a source bond. Bonds with outstanding debt of less than R1 billion will only be considered for buy-backs (payment in the form of cash).

4.6 The National Treasury will not issue a new bond through the process of a switch auction.

4.7 No bond will be a source bond in a switch auction within 12 months of its last auction date as a destination bond, except for bonds with only 24 months to redemption.

4.8 Switches between bonds will not be restricted to pairs within the same maturity bracket.

4.9 There will be no limitation on the number of offers for each security.

4.10 Switch auctions will be conducted on a multiple-price basis, where successful bidders will switch at the price they bid. There will not be a non-competitive bidding facility.

4.11 The bidding format would be that the market participants, following the publication by the National Treasury of an indicative clean price of the existing **source bond (at 10.30am)**, will bid a quantity of the **source** bond, in minimum units of R10 million nominal and multiples of 5 thereafter, and a clean price for the new destination bond (5 Decimal places), which will be assessed against the undisclosed fair market value that would have been determined in advance by the National Treasury. Whilst all bidding and the 10.30 am indicative price would be in terms of clean prices, the switch ratio will be based in terms of dirty (i.e. settlement) prices.

4.12 The National Treasury will retain the option not to allot bonds to bids at a switch auction if they are not regarded by the National Treasury as fair market value.

4.13 Settlement will be t+3

4.14 Timetable for the Conduct of a Switch Auction

- Switch auctions will be pre-announced in the **quarterly auction calendar**. The National Treasury will schedule switch auctions for the forthcoming quarter on the last working day of the preceding quarter.

- **30 days before auction:** The National Treasury will preannounce the auction and settlement date(s) of switch auction(s) including the bonds involved.

- **A week before the auction (7 days),** a press notice will be issued confirming the details of the switch auction, settlement details and the maximum size.

- **On the day of the auction**:
- **At 10.30am**, the National Treasury will publish an indicative clean price for the source bond involved in the switch auction.
- **Between 10.30am and 11.00am**, the market participants will be allowed to offer their bids to switch a nominal quantity of the source bond into the destination bond at the clean price of the destination bond (given the indicated 10.30am clean price of the source bond).
- **By 11.30am** the Reserve Bank will aim to publish the results of the switch auction. These would include the highest, lowest and average clean prices of the destination bond which were successful, and their dirty price ratio equivalents; the percentage allotted of the bids at the lowest accepted price; the nominal amount of the source bond that will be switched; and the nominal amount of the destination bond that will be created as a result.