SPLITTING OF THE THREE-LEGGED INSTRUMENTS

1. As recently as 1988, the government's debt policy was not designed to enhance the marketability of government debt. Whenever the Government had a funding requirement, a new bond was issued. For example, if the Government had R500 million funding requirement, a new R500 million instrument with its own terms and conditions of issue would be issued. Once issued, the bond would never be re-opened. This led to the existence of a large number of bonds with small nominal amount outstanding. It is mainly due to this approach that there was no government debt yield curve and there was a lack of liquidity.

2. After consultations with domestic merchant banks and investors, and the appointment of Finansbank and Senbank as Project Managers in 1989, the Department of Finance resolved to consolidate its issued stock and to replace these with four new three-legged issues which had been created for this purpose.

3. The objective of the consolidation scheme was three-pronged:

   - To increase the marketability of government stock;

   - To increase the competitiveness of the State as a borrower in the capital markets; and

   - To create benchmark bonds across the yield curve.

4. Bonds were grouped into four categories according to their maturities:

   - Group (i) – 13 bonds with maturity dates between 1994 and 1996 were consolidated into R144 (1996)

- Group (ii) – 16 bonds with maturity dates between 1996 and 2000 were consolidated into R147 (2000)

- Group (iii) – 12 bonds with maturity dates between 2001 and 2005 were consolidated into R150 (2005)

- Group (iv) – 4 bonds with maturity dates between 2006 and 2008 were consolidated into R153 (2010)

5. In order to develop deep liquid instruments, the Project Managers thought it prudent for these four new bonds to have three maturities. The aim was to increase the nominal outstanding amount of these bonds without increasing the refinancing risks.

6. From 1990, the liquidity of the government bonds improved.

7. The unintended side effect of these three-legged bonds is that the majority of bullet bonds became grossly illiquid since 1989. This created a chain-reaction in which only three-legged instruments could be liquid bonds and the Government therefore had to continue issuing these bonds. This process led to the issuance of the R157 (2015), the R186 (2026) and recently the issuing of the R194 (2007). Bullet bonds such as the R184 (2007); R179 (2013) and R177 (2006), while boasting of large nominal outstanding amounts, remained illiquid.

8. While three-legged instruments have had a positive impact on the government securities market, in retrospect, the objectives of the three-legged bonds could have been achieved even if only bullet bonds had been issued. In fact, South Africa is the only country with these three-legged instruments and explaining this to foreign investors who do not know the South African Government's Securities Market is not a pleasant exercise. The main problem is that when these instruments were introduced, the main objective was to enhance the

marketability of government bonds, unfortunately, the importance of price efficiency was never considered.

9. The three-legged instruments are priced on the mid (second) leg. This means that three maturities in the government yield curve have the same price. This is not accurate as the implied zero yield curve indicates different price levels across all the maturities of the yield curve. Further, the government yield curve is upward slopping between the three maturities of the R150 which, technically, means that the quoted prices are not precise as the different legs of the R150 should have different price levels.

10. The comprehensive programme of reforms to the domestic debt market makes South Africa's government securities market the most sophisticated bond market in the 'emerging world'. However, to compete with the best in the global markets, we need to keep abreast of time and adopt appropriate strategies while discarding those deemed tactless. While some could argue that the three-legged instruments were a good idea, there seems to be consensus that their time is long gone. A number of investors who are active in the government securities market have indicated to the National Treasury that the three-legged bonds should be split into bullet instruments.

11. The discarding of three-legged bonds is further supported by the global trend which is shifting from the acceptable callable bonds[1] to bullet bonds due to their (bullet bonds) price efficiency. The domestic capital market cannot afford to endevour in an opposite direction, by ignoring these trends. The splitting of the three-legged instruments will ensure price efficiency and this will have a direct impact on price discovery.

12. The splitting of these bonds should be regarded as a natural development phenomenon of the government securities market which should further enhance the integrity and professionalism of the government securities market.

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[1] Callable bonds are bonds with different maturities. An investor has options of redeeming the bond.

13. As mentioned earlier, so long as the National Treasury continue to issue three-legged instruments, bullet instruments will remain illiquid. This poses a big challenge to the National Treasury as there is only a 2 year gap-maturity (2013 and 2014) between the R153 (2010) and the R157 (2015). This means that in future the National Treasury will be unable to issue a new three legged instrument in this maturity. Assuming that the National Treasury decides to issue a new instrument in this maturity, does it mean that a new 'two-legged' instrument should be introduced or do we introduce two bullet bonds, which inevitably, will be illiquid.

14. The same problem will also be encountered between the R157 (2015) and the R186 (2027). Between these two bonds there are eight maturities which can only accommodate 2 three-legged instruments leaving a 2 year gap-maturity. It is therefore lucid that the three-legged bond system is unsustainable.

15. The current pricing problem of the different legs of the R150 which is affecting the market participants signifies the three-legged bond problems that have to be avoided by splitting them. Understandable, the market participants have put pressure on the National Treasury to split the R150. While pressure that is being mounted is on the R150, the National Treasury believes that it will have to take a long-term view by splitting all the bonds.

16. A question could be asked about the National Treasury's logic of introducing the R194, a three-legged instrument, and splitting it within a year. The objective of introducing the R194 was mainly to consolidate twelve illiquid bonds into a benchmark bond thereby creating a liquid bond in the medium area of the curve. The issuing of this bond has since brought down the government yield curve in the medium area. Further, the aim was to avoid a situation where more than two bonds with varying prices and coupons have the same maturity (i.e. R177, R184, R126, R163, R176, R133, R173, R180 and R164 were all at the same maturity) as this tends to undermine the integrity of the government yield curve. This has since been achieved.

17. The National Treasury could also be asked whether we are shifting away from our strategy of consolidating debt into fewer benchmark bonds. The answer to this question is that we are not shifting from our policy. While the three-legged instruments are generally regarded as single bonds, they are technically three instruments that redeem in different years. By splitting the bonds, we would be allowing all maturities to trade on their own merit thereby avoiding the perception, especially from foreign investors, that the three-legged instruments are providing a 'liquidity captured market' to the National Treasury.

18. The three-legged instruments that are currently in issue and their proposed new codes are as follows:

Bond Code	**Coupon**	**Maturity**	**New Codes**
• R150	12.5%	28 Feb 2004	R006
		28 Feb 2005	R151
		28 Feb 2006	R152
• R194	10.0%	28 Feb 2007	R007
		28 Feb 2008	R195
		28 Feb 2009	R196
• R153	13.0%	31 Aug 2009	R008
		31 Aug 2010	R154
		31 Aug 2011	R155
• R157	13.5%	15 Sept 2014	R009
		15 Sept 2115	R158
		15 Sept 2016	R159

Bond Code	Coupon	Maturity	New Codes
• R186	10.5%	21 Dec 2025	R010
		21 Dec 2026	R187
		21 Dec 2027	R188

19. In terms of the conditions of issue of the above mentioned bonds, the repayment of the capital shall be in three equal amounts on the relevant redemption dates. The conditions of issue further state that one third of the nominal amount of the relevant loan, rounded off to the nearest R1,00 will be redeemed on the first redemption date, after which no further interest will accrue on the said amount. New bond certificates will be issued for the two-thirds balance in equal proportions for the remaining redemption dates and with the same coupon. The new proposed codes are already on the terms and conditions of the three-legged instruments, the only difference is that the splitting proposal will use them before the bonds reach the redemption period (i.e. before one third of the total nominal amount is redeemed on the first redemption date).

20. Although the terms and conditions of issue of the three-legged bonds state that the issuer will not redeem the bonds before redemption date, the Public Finance Management Act, No.1 of 1999 provides the Minister of Finance with the authority to borrow money and to convert such loans into any other loans with the concurrence of the lender.

21. The National Treasury can therefore, through the agreement with the lenders, announce the splitting of three-legged instruments into bullet bonds. It is because of this reason that the National Treasury invites lenders and other market participants to comment on this proposal.

22. To ensure liquidity of the new bonds created by splitting the three-legged instruments, the National Treasury would prefer to announce that as from the splitting date all three-legged bonds cease to exist and be split into their

respective new bonds (refer to paragraph 20). At this point the Central Depository, holding about 95% of all government bonds in a dematerialised form, will split all three-legged bonds held in a dematerialised form on behalf of investors. Investors holding three-legged bond certificates will have to surrender these certificates to the National Treasury to split.

23. Since the splitting of the bonds has legal implications, the National Treasury is soliciting legal opinion from legal advisors. The Bond Exchange of South Africa (BESA) has also been asked to mediate and is currently seeking legal opinion regarding the above issue. Through the legal opinions that will be given to the National Treasury and BESA and also the comments from the market, a detailed legal procedure of how the splitting of three-legged bonds can be conceded will be provided to the market in a near future.

24. The splitting of the three-legged instruments will not have a negative impact on the strip market as the strip codes have already been split and they will be using the new codes listed here.

25. The National Treasury intends to split the three-legged instruments at the beginning of the next fiscal year (1 April 2002).

26. The National Treasury would welcome comments on the issues raised by 23 November 2001.

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