Market Notice

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Valuations of Listed Debt
25 March 2014

Currently the JSE has 1,633 listed debt instruments on the debt market placed by 134 issuers. These instruments turn over roughly R25 Billion each day and account for a large part of investor allocations in portfolios that hold these instruments. Listed instruments are issued by the RSA Government, State owned Companies, Corporates, Banks and Foreign entities.

Post the 2008 financial crisis the regulation of capital markets has been on the increase. Foreign legislation has had an impact on foreign banks that have a local presence and the markets that they trade in. The JSE has historically relied on inputs from market participants in order to value listed instruments however various participants have expressed concerns relating to the indicative nature of this information post the LIBOR scandal of 2012.

The JSE published a revised MTM methodology document 30 August 2013 which outlines the process for daily MTM however the reliance on inputs has become cause of concern for the JSE, investors and price makers. The underlying principles for the current process state that only a Mark to Market approach is used and that no models will be applied to determine fair value of any instrument. However, in order to determine a fair value based on this process the JSE requires fairly consistent trade or price information in order to apply the rules as set out.

The majority of listed instruments (especially corporate) rarely trade and as such pre and post trade information is infrequent. The JSE will revalue all listed instruments where the instrument can be linked to an underlying yield curve or liquid instrument, based on parallel shifts in the yield curve but any isolated credit\liquidity type adjustments will only be reflected on the back of pre or post trade activity as defined by the rules.

Corporate bonds consistently only account for about 4% of total yearly spot turnover. Nominal traded for corporate bonds has increased from R197 Billion in 2007 to a high of R347 Billion in 2012 (as depicted in the table below). 2013 saw a slight decrease in nominal traded and was at R298 Billion.

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	Number of Trades	Nominal Traded
2007	24 705	197 842 410 688
2008	26 006	138 704 169 674
2009	23 571	153 066 629 788
2010	26 271	195 671 071 665
2011	30 342	263 960 891 530
2012	36 534	347 116 610 329
2013	36 529	298 697 743 609

The above table shows that corporate bond trade activity in the secondary market is limited with roughly 150 trades a day being reported in 2013 for all listed corporate bonds.

The positive consequence of this valuation methodology is that any subjectivity or possibility of manipulation is limited; however the negative consequence is that due to the lack of input information, valuations can and do become "stale" resulting in valuations which appear inaccurate in comparison to similar instruments which have traded or been issued more recently.

As can be seen in the below example, the following three African Bank bond valuations are inconsistent with one another. The spreads are misaligned due to the lack of trades and pre trade activity in the respective bonds as depicted by the last trade date column. ABLI02 has a BP Spread of 505 whereas ABLI03 has a BP Spread of 135. This 370 basis point difference highlights the fact that bonds with similar maturity can trade at vastly different spreads due to the lack of trade information available to the JSE.

Bond Code	ISIN Code	Maturity	Companion Bond	BP Spread	Last Trade Date
ABLI02	ZAG000067364	08-May-14	R211	505	06-June-13
ABLI03	ZAG000076068	15-Mar-15	R197	135	15-Oct-13
ABLI04	ZAG000080953	11-Oct-16	R211	335	02-Feb-14

Credit Linked Notes pose a specific problem due to the bespoke nature of the investment and the extreme illiquidity of the transaction. If the referenced underpinning the note revalues, the debt instrument will not revalue unless the above mentioned MTM rules are complied with.

Based on various consultations with market participants, the JSE has undertaken to complete a full review of the Mark to Market process with relevant market participants and continue to enhance the transparency of the process.

The following steps are being taken:

- A revised set of rules for the Mark to Market Process which will increase the pool of transactions that are captured by the revaluation net. These rules can be found at http://www.jse.co.za/Markets/Interest-Rate-Market/Spot-Bonds-overview/Bond-pricing-documents.aspx
- Introduce more transparency on the daily valuations file to indicate when the instrument was last traded and when it was last revalued, allowing investors sight into whether the pricing is potentially "stale"

- Work with the market on a professional board for the listings of instruments that are illiquid and bespoke and are typically only to be taken up by institutions with the capability to make informed investment decisions
- Continue to work with the market on additional methods to improve the valuation process
- The JSE has been in consultation with the market about the introduction of a corporate bond trading platform with the aim of improving centralised pre trade price transparency

While the JSE undertakes to provide accurate valuations for all listed debt, the lack of information limits the quality of these valuations.

The JSE is not in a position to determine the theoretical value of instruments and relies heavily on inputs from market participants that are actively involved in trading, listing and valuations of these instruments.

Any potential investors are therefore requested to ensure that they are well versed on the valuations rules and consider the impact of illiquidity of the instrument to make an informed investment decision.

The JSE, in conjunction with BASA (The Banking Association of South Africa), ASISA (The Association for Savings and Investment South Africa) and various market participants will continue to work together to enhance the valuation processes and rules of all listed debt to ensure more accurate valuations.

Should you require any additional information please feel free to contact the JSE:

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