

LEGAL NOTICE NO. 34 OF 2001

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TRADING IN GOVERNMENT OF LESOTHO TREASURY BILLS (REGULATIONS) 2001

In exercise of the powers conferred by section 20 of the Local Loans Act 2001, I

MOHLABI KENNETH TSEKOA

Minister of Finance, make the following Regulations –

PART I

PRELIMINARY

1. Citation and Commencement

These Regulations may be cited as Trading in Government of Lesotho Treasury Bills Regulations 2001 and shall come into operation on the date of publication in the Gazette.

2. Objective

These regulations are meant to:

- (i) provide for the issuance of government securities in a manner consistent with monetary or fiscal policy objectives of government; and
- (ii) generally to provide for the well functioning of the process of issuance and redemption of government securities;

3. Interpretation

In these regulations, unless stated otherwise –

“Auction Date” means the date on which the Central Bank will announce the results of the auction;

“Bank” means Central Bank of Lesotho;

“Collateral Account” means a collateral account created by the Bank in terms of section 11(2) of these regulations;

“Government” means Government of Lesotho;

“Minister” means Minister of Finance and in relation to the issuance of securities includes a person appointed by him for the that purpose;

“Securities” means documents issued under the authority of the Minister as evidence of loans raised under the Local Loans Act 2001;

“Securities Account” means a securities account created in terms of section 11(2) of these regulations;

“Treasury Bills” means treasury bills issued under section 5 of the Local loans Act 2001;

“Treasury Bills Acknowledgement Receipt” means a receipt issued by the Bank in terms of section 16(1) of these regulations;

“Unclaimed Securities Account” means a securities account created by the Bank in terms of section 16(2) of these regulations

PART II

PRIMARY MARKET TRADING

2. General

(1) The Bank may at any time issue government treasury bills with maturity not exceeding 182 days. The issues will normally take place on a regular basis. The Bank shall determine the manner of issuance and allocation of treasury bills.

(2) Treasury bills shall be issued on a discount basis, for face values in multiples of M100, and shall be redeemed at their full face value at maturity. Prior to maturity the market price of treasury bills may vary depending on market conditions.

(3)The computation of the bid price, given the rate of discount, shall be based on the actual number of days to maturity, with a year consisting of 365 days, using the formula shown below.

$$\text{Bid Price} = \text{FV} - (\text{FV} \cdot \text{DR} \cdot \text{Days to Maturity}/365)$$

Where; FV = face value and DR = discount rate

(4)Announcements relating to new issues of treasury bills shall be made primarily through public notices on the noticeboard in the reception hall of the Bank, notices in local newspapers, on radio, television, or through any other suitable media.

(5)The Bank reserves the right to accept or reject all or any portion of any or all applications.

3. Participation

(1) Treasury bills may be purchased by any person or entity. The Bank shall issue two sets of securities with maturity of 91 and 182 days, or with maturities as close to 91 days or 182 days as possible to take account of for example, public holidays.

(2) The minimum bid for the 91-day treasury bills shall be M250 000.0. Bidders may submit multiple bids for 91-day treasury bills.

(3) The minimum bid for 182-day treasury bills shall be M5 000.0.

(4) The Bank shall not accept bids in amounts less than M5 000.0.

(5) Any bid in amount of at least M250 000.0 shall be regarded as a competitive bid and any bid in amount of less than M250 000.0 shall be regarded as a non-competitive bid.

(6) The Bank shall not accept multiple bids in the non-competitive category.

4. Frequency

(1) Auctions for the 91-day and 182-day bills shall ordinarily be held once a month and once every two months respectively.

5. Invitations for Bids

(1) Invitations for bids shall begin 7 days before the auction date and continue until the day before the auction date.

(2) The Bank will include the following information in each invitation for tenders:

-The auction date

-The deadline for submission of bids

-The term (91 or 182-day) or maturity dates of bills

-Registration number of the issue

-The day and time for announcement of results of the tender

-The deadline for making payments for successful bids

-The total face value of bills to be auctioned

-In the case of 182-day bills, the amount reserved for non-competitive bidders and the margin (in yield terms) that will apply to non-competitive bids.

-The price that cleared the market and total allotment in the last similar auction.

6. Submission of Bids

(1) Bids must be submitted on forms CBL/TBR/1A or CBL/TBR/1B as attached in Appendix 1 or legible copies thereof. Bid forms must be signed by the individual whose name appears on the bid form or, in the case of institutions, the authorised signatories of that institution.

(2) The forms must be completed in full and bear no alterations whatsoever.

(3) Tender forms must be delivered to the Bank at the designated reception point between 9 a.m. and 3.00 p.m. each day during the period specified for the receipt of bids. The deadline for receipt of forms is 3.00 p.m. on the day preceeding the auction date. Tenders submitted to the Bank after the deadline will not be accepted, nor will the Bank entertain any requests to alter or withdraw tenders submitted within the appropriate time limit.

(4) The forms must be submitted in sealed envelopes clearly marked "Tender for Treasury Bills Registration Number...(reflecting the registration number given to the issue and shown on the invitation to tender)". Envelopes should also be marked "competitive" or "non-competitive", as the case may be.

(5) Competitive bidders shall specify the amount of the bid and the price offered. The price should be specified per M100.00 to three (3) decimal places, provided that the third decimal is a multiple of 0.005.

(6) Both competitive and non-competitive bids must be in multiples of M100.00 face value.

7. Method of Auction

(1) Competitive bids or bids in amounts equal to M250 000.00 or higher, shall be made by completing form CBL/TBR/1A.

(2) Allocations under competitive bidding process will be made starting with the bid offering the highest price until the entire allotment has been exhausted. All successful bidders however, will be allocated treasury bills at a uniform price corresponding to the bid price at which the entire allotment was exhausted.

(3) Non-competitive bids or bids in amounts equal to M5 000.00 or higher but less than M250 000.00 shall be made by completing form CBL/TBR/1B.

(4) All non-competitive bids shall be allocated at a margin above the price at which allocation was made in the competitive bid in the same auction. Such a margin shall be determined by the Bank from time to time.

8. Acceptance/Rejection of Bids

(1) The Bank reserves the right to accept or reject all or a portion of any or all bids. Should a bid be rejected, the Bank shall inform the applicant.

(2) If in case of a competitive bidding process, an auction is oversubscribed, that is, the demand for bills in a given auction exceeds the amount announced as the total face value of the bids to be auctioned, the Bank shall not issue more than the amount announced. In this case, allocation shall be made from the highest bidder (in terms of price) downwards until the amount announced is exhausted. Where there is more than one bidder at the cut-off price,

allocation shall be made on a pro-rata basis.

(3) If in the case of a non-competitive bidding process, an auction is oversubscribed, allocation shall be made on a pro-rata basis.

9. Announcement of Results

(1) The results of the tender shall usually be announced at 2.00 p.m. on the auction day. The announcement shall be in the form of written notifications to all applicants. Letters on individual notification will include amounts accepted and the accepted price. for successful applications. Unsuccessful applicants shall be informed accordingly.

(2) Bidders, or their representatives, shall be required to present themselves at the Bank after 2.00 p.m. on the auction day to receive the notification of the results of the bids. Failure to collect the notifications shall be tantamount to failure to pay for the successful amount and such bidders shall be barred from participating in future auctions for a period of 6 months.

10. Acceptable Methods of Payment

(1) Payments for allocations shall be received immediately after announcement of results on the auction day until 3:00 p.m. the following day.

(2) Bidders with cash accounts with the Bank shall be required to issue standing instructions to the Bank to debit their accounts in payment for securities allocated.

(3) Bidders that do not hold accounts with the Bank may effect payment in cash, a commercial bank payment instruction, a Bank cheque, a Bank-guaranteed cheque, or personal cheques. An allocation of treasury bills will be irrevocably effected two days after the auction day for bidders using the above-mentioned payment methods except for those bidders who will make payment by own-cheques.

(4) In the case of bidders who make payment by personal-cheques, irrevocable allocations will be made seven (7) days after the cheque is received.

(5) In all cases where settlement is done within the stipulated time period, interest will be accrued from the auction date.

(6) Successful applicants who fail to settle their bid application will be barred for a period of 6 months and shall be informed in writing.

(7) The Bank shall purchase at the market-clearing price, all treasury bills for which settlement is not effected.

11. Method of Recording Ownership of Treasury Bills

(1) The Bank will issue treasury bill certificates to investors but shall keep them in a central repository on their behalf.

(2) The Bank shall create a securities account for each holder of securities for purposes of keeping an electronic register or record of ownership of the securities

(2) The Bank shall issue a Treasury Bill Acknowledgement Receipt confirming the ownership of treasury bills.

(3) Investors may request a statement of the balance of treasury bills holdings. Such a statement shall only reflect the face value (not the market value) and maturity date of their holdings.

PART III SECONDARY MARKET TRADING

12. General

(1) Holders of securities are free to trade treasury bills with any counterpart in the market.

(2) Changes in ownership shall only be effected by both parties to a transaction and upon completion of form CBL/TBR/ 2 shown in the Appendix. The form shall be completed in triplicate. The seller and the buyer shall keep one copy each.

(3) On the day the transaction takes place, both the buyer and the seller, or their respective authorised representatives, shall present themselves simultaneously at the Bank to deliver form CBL/TBR/2 and to receive receipts attesting to the change of ownership.

(4) The Bank shall only act upon instructions contained in form CBL/TBR/2 and completed and signed by authorised signatories of both parties to the transaction. The parties must ensure that their identities as they appear in the records held by the Bank are properly reflected.

(5) The Bank shall make every effort to ensure that all accounts are operated with utmost integrity and shall take appropriate action to protect treasury bill holders. However, the Bank cannot guarantee against fraudulent activity and consequently cannot undertake to indemnify losses incurred by any party as a result of fraudulent transfers of securities.

13. Conditions for Transfers

(1) In the case in which both parties to a transfer transaction have a cash account with the Bank, the Bank shall transfer securities from the securities account of the seller into the securities account of the buyer against a transfer of funds in the opposite direction. For this to happen, the relevant part of form CBL/TBR/2, which contains funds transfer details, shall have to be completed by the buyer. Where funds are not being authorised for transfer, a line should be put through the 'funds transfer' section of the form.

(2) In the case in which at least one party to a transfer transaction does not have a cash account with the Bank, the Bank shall still effect the transfer of securities by transferring the securities from the securities account of the seller into the securities account of the buyer only upon receiving duly completed and signed form CBL/TBR/2. The Bank shall assume that the terms of payment have been agreed and effected between the two counterparties to the deal.

(3) The completed form must be delivered by hand to the Bank on the day of the transaction and both parties to the transaction must simultaneously present themselves to the Bank on this day.

(4) Notifications of transfer of ownership must be received by the Bank not later than five (5) business days before the date of maturity of the bills in question.

(5) The Bank will issue a statement to both parties involved in the transfer of bills confirming the transfer.

14. Premature Disinvestment

(1) The Bank will stand ready to buy treasury bills from investors provided that such a purchase shall take place at least five (5) working days prior to maturity date of the securities.

(2) The Bank will purchase the securities at a price calculated such that the interest rate payable on such securities is four (4) percentage points below the prevailing market interest rate on such securities.

PART IV SECURITIES USED AS COLLATERAL

15. General

(1) Investors may use their securities as collateral against borrowing from third parties provided that the maturity date of the loan comes before the maturity date of the securities being used as collateral.

(2) Parties to a secured transaction shall be required to notify the Bank by completing form CBL/TBR/3A in the case in which the lender has a cash account with the Bank and form CBL/TBR/3B in all other cases.

(3) Once submitted to the Bank the forms shall not be withdrawn.

16. Collateral Accounts and Unclaimed Securities Account

(1) The Bank shall create Collateral Accounts for purposes of recording transactions of treasury bills being used as collateral.

(2) The Bank shall create an Unclaimed Securities Account for purposes of recording securities that have not been claimed.

17. Transfer of Securities from the Collateral Account

(1) Upon receipt of a properly completed form CBL/TBR/3A from parties to a secured transaction, the Bank shall transfer securities from the borrowing party's treasury bill account to the lending party's collateral account. At the same time, the Bank shall transfer the agreed amount from the lending party's cash account to the borrowing party's cash account. In the case where the borrowing party does not hold a cash account with the Bank, a cheque will be issued to the borrower.

(2) Upon receipt of a properly completed form CBL/TBR/3B, The Bank shall transfer the agreed face value of securities from the borrowing party's treasury bill account to the lending party's collateral account provided the borrower has surrendered his treasury bill acknowledgement receipt to the Bank

(3) Confirmations of the collateral transactions will be available for collection by both parties to a collateral transaction by the close of business the next working day. In the case in which the Bank deems the application for a collateral transaction unacceptable, the Bank shall similarly notify the parties the next working day.

(4) The Bank shall not be involved in the transfer of funds from lender to borrower and in the case in which the lender does not have a cash account with the Bank and as such, shall not be held responsible for transactions that are not fully completed in this case .

(5) Upon maturity of a secured transaction, the Bank shall transfer back the bills to the securities account of borrower only upon receipt of a duly completed collateral release form, CBL/TBR/4 completed by both parties to the transaction.

(6) If this form has not been received by the Bank by the maturity date of the securities in question, or there is a dispute between parties to a secured transaction, the Bank shall transfer the securities from the lending party's collateral account into an unclaimed securities account.

18. Redemption

(1) On maturity date, payments will be made to all treasury bill holders based only upon the information available to the Bank from securities accounts of investors.

(2) In the case of account holders at the Bank, their accounts will be credited with the face value by close of business on maturity day.

(3) In the case of investors that do not hold cash accounts with the Bank, the Bank will issue cheques for the face value of their bills from 8.00 a.m. on maturity date. Cheques not collected on this date shall be kept by the Bank until

collected.

HISTORY OF TREASURY BILLS

1. INTRODUCTION

During the late 1980s, the government of Lesotho took a policy decision to actively promote the development of money markets. The decision was made as part of broad-based financial sector reforms sponsored by the World Bank and the International Monetary Fund (IMF). The objectives of this policy were: to improve financial intermediation by expanding and creating alternative investment and borrowing instruments; to broaden participation in short-term financial instruments; and to create a vehicle through which monetary policy decisions of the Central Bank could be effected.

Prior to this period, there was limited, infrequent, and tightly controlled trading in government securities. In fact, government securities were the only instruments that were traded albeit within a highly restrictive environment. These securities were issued under the Local Loans (Amendment) Act of 1967. In terms of this Act, the Minister of Finance was given the right to determine the price and therefore yield applicable on these securities. The minister was also given exclusive powers to set the terms and conditions for the issuance of such securities. Other restrictive practices involved the requirement that participants could only trade in securities as long as their total holding was to be no less than M1.0 million at any given point in time. Regulatory powers on all matters relating trading of securities remained with the Minister.

Government treasury bills were first issued in 1978 for an amount of M2.1 million while government bonds were issued a year later for an amount of M1.0 million. At their peak, government securities issued reached M234.4 million in 1988.

The restrictive practices mentioned above stalled the development of money markets in Lesotho. Securities were always held until maturity and there was very little secondary market activity. It was in recognition of these deficiencies that the government adopted, in the late 1980s, a policy to actively promote the development of money markets in Lesotho. In 1993, a number of amendments were made to the Local Loans Act (1967) to remove restrictive practices that had inhibited the orderly development of the money market. These included the repeal of sections of the Act that gave the Minister powers set prices, interest rates and other conditions related to the issuance of government securities. In order to broaden participation into the securities of markets and encourage competition, the regulations were changed to allow for the issuance of treasury bills in smaller denominations of M100.0 from the previous minimum of M1.0. Effective price discovery was facilitated through the adoption, in April 1992, of an English Auction System for treasury bills. In order to facilitate reliance on market based methods of monetary management, the Central Bank of Lesotho Act (1978) was amended to allow the CBL to issue its own securities in order to supplement existing government securities.

Despite these changes, the experience over the past eight years indicates that the success achieved has been limited. Whereas progress achieved in so far as broadening participation has been notable, money markets have not as yet developed to a stage where the Central Bank can use them as a vehicle of effecting its monetary policy decisions. Consequently the bank has continued to rely on direct methods for monetary management. The secondary market has failed to develop sufficiently to provide an efficient and effective price discovery mechanisms. The result is that domestic interest rates are not responsive to local liquidity conditions. At the operational level, the policy of broadening participation to low-income savers with high liquidity needs coupled with lack of intermediaries for re-discounting of securities has placed enormous strains on Central Bank's resources. The Bank has now assumed the position of a buyer of "first" resort rather than of last resort in the secondary market.

In order to correct these deficiencies, that the Bank decided to put in place alternative strategies for the development of the money markets in Lesotho. The ultimate objective of this paper is to outline these strategies and procedures. As a starting point however, it is necessary to revisit the rationale for the development of money markets in Lesotho. This is achieved in Chapter 2 of this paper. Chapter 3 of the paper examines the shortcomings of the present system. Some positive attributes are also examined. Chapter 4 outlines basic features of the proposed system and the reasons underlying the introduction of the new system. The final chapter examines implementation modalities.

2. THE REASONS FOR DEVELOPING MONEY MARKETS IN LESOTHO

2.1 To help increase the overall level of savings

One of the most important reasons for pursuing the objective of the development of money markets in Lesotho is the desire to encourage individuals and companies to save more. Efficient and well functioning money markets can contribute in this regard in several ways in Lesotho. Interest rates obtainable in the money market are generally higher than those obtainable from traditional savings deposits and yet the risks associated with investing in money markets are not materially higher. For example, during June 1999, the maximum interest rate obtainable on savings deposits was 6.0 per cent per annum while the yield on government treasury bills during the same period was more than double at 12.6 per cent. Such a differential, although unlikely to be sustained once markets begin to work well, more than compensates investors for the level of risk associated with investing in treasury bills. Yields on treasury bills in Lesotho have also been consistently higher than the rate of inflation meaning that investors in these securities are afforded the opportunity to protect their savings against an erosion in purchasing power. The generally higher interest rates in the money market are therefore likely to increase the pool of funds being recycled on a short-term basis thereby effectively increasing the national savings level.

The need to increase national savings is more pressing considering the fact that at present, these savings are inadequate to finance desired growth rates of 6 to 8 per cent per annum. These rates of growth require annual investment of 35 per cent of GNP. With present savings levels of 13 GNP, this would imply unsustainably high foreign borrowings of 22 per cent in order to finance the required investment. Thus, the only way to generate growth rates of 6 – 8 per cent per annum, on a sustainable basis is to improve the national savings rate to about 30 of GNP from the present level of 13 of GNP. Efficient and well functioning money markets can contribute towards the achievement of this objective.

Well functioning money markets can help improve national savings in other indirect ways. Higher rates obtainable in the money markets could cause savers to shift their savings away from traditional low-interest savings deposits into money markets instruments. Such a reallocation will increase competition for funds. Banks might react by increasing rates on savings deposits in order to stem the outflow of funds. Commercial banks in the Republic of South Africa (RSA), for example are known to offer selected depositors interest rates comparable or linked to money market rates. In this way, higher interest rates can permeate into traditional savings deposits and contribute to generally higher savings rates in the economy.

2.2 To deepen and widen the range of investment and borrowing opportunities

The second reason for encouraging the development of money markets is the desire to broaden and deepen available short-term investment and borrowing instruments. A well-developed money market is better able to meet the wide range of needs for investors and borrowers. In some business environments, companies often experience short-lived cash surpluses followed by cash deficits. For these companies, their financial position would be improved if they could find investment avenues for their short-lived cash surpluses. A well-developed money market will provide such avenues.

With a wider range of short-term investment outlets, institutions such as banks are better able to manage their liquidity needs without sacrificing income. Holding cash to meet liquidity needs is costly to banks as cash does not generate any income. However, with a wide range of money markets instruments, and different dates of maturities, commercial banks can minimise their cash holdings and still be able to meet their liquidity needs.

Short-term borrowers too can benefit from the existence of several avenues to meet their short-term cash needs. At present, borrowers in Lesotho have bank overdrafts as their only recourse. Instruments such as commercial paper would allow companies to raise short-term finance from institutions other than banks.

The government as one of the important borrowers also stands to gain from a well functioning money market. It can borrow from a wide range of institutions outside the domestic banking system. In this way, the government is better able to structure its debt profile in line with its projected cash flows.

The more the government can borrow from sources other than banks, the better it is for the economy in general. The inflationary impact of such borrowing will be minimum as such borrowing shifts spending power from the private sector to the government sector. By contrast, when the government borrows from the domestic banking system, a potential is created for money supply to grow rapidly thereby increasing the risk of higher inflation. Thus, a well-developed money market given added flexibility for improved macroeconomic management.

A wider range of borrowing and investment opportunities is also desirable from another perspective. The more wide

the range of investments the higher degree of competition. With a high degree of competition, interest rates are likely to be competitive. Borrowers will borrow at rates that are more reflective of their individual risk profiles. Investors too will get returns that are commensurate with the risk underlying their investments.

2.3 To create a vehicle through which monetary policy decisions could be affected

In economies where money markets are still rudimentary, Central Banks often rely on direct controls as key instruments of monetary policy. In Lesotho, these direct controls included credit ceilings for banks, minimum deposit rates, maximum prime lending rate and restrictions on foreign assets holdings by banks. However, direct controls are undesirable for a number of reasons. When used for too long they ultimately become ineffective as banks and other financial institutions find ways of circumventing them. Interest rate controls, if set at levels other than market clearing levels, can distort the normal economic behaviour of sub optimal. For example, when interest rates are set at levels that are below their market clearing level there will be a tendency for market players to engage in excessive borrowing. On the other hand, if they are set above their market clearing levels it will lead to an unduly restrictive usage of funds.

For these reasons most Central Banks prefer to pursue their monetary policy objectives using market-oriented policy instruments in order to avoid unnecessary distortions. Market based policy instruments are non-distortionary primarily because they seek to change the incentives faced by market players and in the process ultimately change the behaviour of these players. Direct controls on the other hand may attempt to place quantity restrictions without changing the behaviour of players. The result is that artificial shortage or surpluses exist which are not accompanied by a change in behaviour. Where there is an artificial, banks will find ways of circumventing the shortages. Thus, the only way to achieve an effective and non-distortionary change is to alter the incentives faced by banks and allow the price to move in response to changing market conditions.

An important precondition for an effective Central Bank intervention in pursuance of its monetary policy objectives, is the existence of a competitive, broad, and active secondary market. Such a market can be said to exist when market players, mostly banks and other financial institutions enter into borrowing and lending transactions with each other at mutually agreed interest rates. Such transactions will usually involve discounting of short-term securities. If the secondary market competitive, the mutually agreed discount rate will represent the true scarcity of fund in the market. In this way, continuous information is generated relating to general liquidity conditions in the market through the signal of interest rates.

Should the Central Bank decide that it is in the wider national interest to increase rates, it can intervene in the market by selling additional securities. Such intervention will initially lead to an increase in interest rates in the market for short-term funds. Provided the markets' for funds are in general are competitive and there is broad participation, increases in short-term rates will soon permeate throughout the entire market for lending and borrowing. In this way, the Central Bank will have effectively changed the incentive structure faced by market players. Faced with higher borrowing cost, borrowing costs, borrowers will voluntarily decide that it is in their best interest to economise on the use of funds. Therefore, by acting through the medium of the market, the Central Bank can achieve its monetary policy objectives in an orderly, effective, and non-distortionary manner.

The basic conclusion remains valid even in the presence of the present institutional arrangements between Lesotho and the Republic of South Africa (RSA). The fixed exchange rate and relatively free capital mobility only place a limit to which the Central Bank of Lesotho can influence interest rates. Such a limit will primarily be determined by the extent to which funds can move between RSA to Lesotho in search of higher returns. To the extent that funds inflows will be limited, the Central Bank of Lesotho can edge interest rates to levels higher than those prevailing in the RSA. Irrespective of the degree of capital mobility, open market operations will remain the least distortionary and orderly way of pursuing monetary policy objectives.

3. THE PRESENT SYSTEM AND ITS SHORTCOMINGS

Although the policy decision to actively promote the development of money markets was taken in 1988, it was not until early 1990's that the authorities began to take decisive steps to implement strategies aimed at the attainment of this objective. In 1993, the Local Loans Act (1967) was amended such that the Minister of Finance was no longer responsible for setting prices and interest rates applicable on government securities. The regulations governing the issuance of treasury bills were also revised to allow for the issuance of these bills in the smaller denominations of

M100.00 from the original amount of M1.0 million.

Earlier, in 1992, the Central Bank had put in place an English Auction System for public issuance of treasury bills. Under this system, the Central Bank announces a reserve price for securities on the day of the auction and participants are invited to submit bids. Securities are then sold to the highest bidder provided the bid is above the reserve price. The Central Bank also embarked on a massive public campaign, to inform and teach the general public of the new system.

In the meantime, the policy decision was made to actively change the structure of government debt so as to reduce its overdraft position with commercial banks and increase its borrowing from non-bank sector through the issuance of more government securities. Despite this policy decision, the government started to gradually redeem its outstanding stock of bonds so that by 1993 total outstanding securities stood at M154.0million from a peak of M234.4 million in 1998. They have since remained at this level and consist entirely of treasury bills.

As a result, when the present system effectively started in April 1992, trading was in only 91 days in treasury bills amounting to M154.0 million. Initially, auctions were held every three months but was later restructured such that auctions were held every month – a practice that has persisted to this day.

Treasury bills are payable either to the person whose name appears on the bill or to the bearer. When treasury bills are issued in the name of a specific person, ownership can be transferred by endorsement and delivery. This ease of transferability affords investors an opportunity to sell the bills to a willing buyer before maturity. Should holders of the bills wish to liquidate them before maturity, they are encouraged to sell them in the open market and only come to the Central Bank as a last resort.

The experience of the past eight years demonstrates that these strategies have had limited success in achieving their set objectives. Among the successes achieved can be mentioned broadening of participation in the treasury bill market. Prior to 1992, over 90 per cent of outstanding stock of treasury bills were held by commercial banks. By July 1999, commercial bank holding of treasury bills had dropped to around 18 per cent while the holding by the non-bank sector stood at 78 per cent with the remaining 4 per cent held by Central Bank. Within the non-bank sector, individuals held the largest proportion. Indeed, by July 1999 there were approximately 6000 individual participants in the market with holding per individual typically less than M10 000.

Apart from broadening participation, the present system failed to achieve a number of key objectives fundamental to the orderly and efficient operation of the financial system and the economic in general. Some eight years after the introduction of the new system, gross national savings have not improved appreciably. Whereas private sector savings stood at 9.3 per cent of GNP in 1998, they had in fact edged downwards by 1998 to 8.5 per cent of GNP. The introduction of additional savings alternative in the form of treasury bills has failed to put upward pressure on rates of interest offered by commercial banks. As a result, a wide margin continues to prevail between rates on traditional savings deposits and yields on treasury bills.

More importantly, the present system has failed to bring about the emergence a well functioning secondary market through which the Central Bank can effect its monetary policy objectives. Participants in this market have continued to present their bills for rediscounting to the to the Central Bank as a "first" resort rather than as a last resort. Because the Central Bank came to assume the role of a discount house, price-setting in the 'secondary' market continued to be the preserve of the Central Bank. As part of this problem, price-setting remained discontinuous with the CBL setting the reserve price once a month and using the same rate to rediscount treasury bills during the month. In a nutshell, effective and continuous price discovery mechanism has failed to develop. As a result interest rates applicable in the money markets in Lesotho were not responsive to changing market conditions.

An association shortcoming was that trading in the 'secondary' market continued to be thin. On a typical day, the volume of trading amounts to around M2.0 million. In addition trading in the secondary market consists almost entirely of individuals. On any given day approximately 288 individuals present their bills for re-discounting to the Central Bank. Commercial banks usually hold treasury bills to maturity because of their strong liquidity position.

The absence of intermediaries for issuance or re-discounting of treasury bills has also led to severe operational problems for the Central Bank. The high volume of individuals showing up at the Central Bank either to purchase, redeem, or present the bills for re-discounting has completely outstripped the capacity of Central Bank to process

these individuals promptly and efficiently. The problem has become so acute that it is beginning to threaten further participation in this market by individuals who may not tolerate waiting in long queues at the Central Bank.

A number of factors some of a design nature, and others of the operational nature have prevented the present system from attaining its intended objectives. Also responsible for the failures of the present system are the structural features of Lesotho's financial sector.

3.1 Features of the Lesotho's financial sector that have stalled the emergency of the secondary markets

3.1.1 Excess Liquidity of commercial banks

With hindsight, it is now clear that the secondary market for treasury bills cannot take off in an environment in which commercial banks have cash assets that are far in excess of their requirements. As at June 1999, commercial banks surplus funds held with the Central Bank amounted to M... million. The excessive built up of commercial bank liquidity position is a result of several factors. On the supply side, the strong economic growth during the years 1993 to 1997, led to the strong rise in the deposit base of the commercial banks which was not matched by the rise in loan advances to the private sector. Several structural factors are responsible for the slow growth of private sector lending. The most important of this is the perceived high risks of private sector lending by banks. This in turn has its roots in the weak judicial and legal framework in the country, the culture of non-repayment of loans by a majority of borrowers, and the excessive intrusion of government sector in private sector activities through the establishment of state enterprises.

In an environment where all commercial banks have cash assets far in excess of the prudential requirement, the need to present treasury bills for re-discounting will never arise. A bank that finds itself in a deficit cash position will simply draw down on its deposits with the Central Bank instead of liquidating its securities.[1]

But, in an environment where one commercial bank suddenly finds that it does not have sufficient cash to meet its requirements, it will be forced to enter into a transaction with another bank that has surplus cash. The deficit bank will be forced to present its treasury bills to a surplus bank for re-discounting. In this way the secondary market for treasury bills can develop.

Thus, an important precondition for the emergence of the secondary market to exist, if for the conditions to be created which will eliminate, through productive investments of course, to absorb all existing excess liquidity of commercial banks. The most economically beneficial way in which this could be done is if banks could convert the excess liquidity into loans that would benefit the domestic private sector.[2] Another alternative would be for government to issue long-dated securities such as bonds to absorb the existing liquidity. The third alternative might involve an elimination of existing control of foreign assets holdings by commercial banks.

3.1.2 Government Budget Surpluses

In addition to the problem of excess liquidity of commercial banks, the policy of the development of money markets was being pursued in an environment in which the government budgetary situation was strong. In 1992 when the implementation process effectively took off the ground, the government budget outturn turned from a deficit to almost a balanced budget. The situation was to improve even further in the subsequent years with the government running budget surpluses which reached a peak of 3 percent of GNP in 199.... In such an environment, there was clearly no need for the government to increase its borrowing for purposes of financing its budgetary position. It therefore became difficult for the government to increase the stock of government securities in issue. In fact the government in these years had sufficient money to retire all its outstanding stock of treasury bills that had at this time remained steady at M154.0 million. To its credit, the government decided to keep this stock of treasury bills in issue, purely for the purposes encouraging the development of the money markets.

This situation retarded the process of the deepening of the money market. The outstanding stock of government securities in issue has since stood at M154.0 million since 1993 despite the demonstrated appetite by the market to invest in these securities. On any given auction day, the amount of treasury bills offered for auction is always oversubscribed. In recent months for example the amount of over-subscription has never been less than M15.0 million.

Had the government budgetary situation been weaker and therefore necessitated government borrowing, the

government would be able to raise at least M300.0 million from the domestic banking system based on the present surplus funds of commercial banks held with the Central Bank. In fact, the amount could even be much higher than this had it not been because of the financial problems experienced by one the commercial banks in the country. There were times in which surpluses funds of commercial banks held with the central bank went as high as M..... million.

In recognition of this, a policy decision was made to supplement existing stock of government securities with Central Bank securities. Central Bank of Lesotho securities were first issued in 1994 for an amount of M20.4 million and reached a peak of M71.0 million in 1995. The securities were all redeemed in 1996 when it became clear that private sector credit was growing too slowly and that commercial bank's investment in gilt-edged paper was beginning to be at the disadvantage of private sector lending.

3.2 Problems with the design of the present system

The manner in which the present system has been designed has also inhibited the orderly development of money markets in Lesotho. One important weakness was the absence of intermediaries in the placement of the securities. This would not have necessarily posed a problem if the only participants in the primary market were banks and other institutional investors. However, the fact that participation in the primary market is usually open to institutional investors as well as individuals tends to strain the administrative resources of the Bank. On a typical auction day as much as Individual bidders with up at the central bank with some often bidding for as little as M100.0. Although the Bank endeavours to process all applicants on the day of the auction, this normally causes considerable delays and results in long queues at the Bank. It is now clear that the presence of a suitable intermediary with adequate capacity to handle large volumes of individual participants has is crucial for the smooth operation of the process of issuance. Such an intermediary could collect and process all bids for onward transmission to the Central Bank.

The presence of an intermediary, might also facilitate the emergence of the secondary market. Individual participants, having obtained the treasury bills from the intermediary, are more likely to turn to the same intermediary for rediscounting of their treasury bills. At present, individuals who experience liquidity shortages before maturity of their treasury bills all turn up at the Central Bank to liquidate their securities. The Central Bank has now become the buyer of first resort of treasury bills in the secondary market.

3.3 Administrative and operational shortcomings of the present system

Most of the weaknesses of the present system are to be found in the manner in which the policies were actually implemented rather with the way the system was designed. When the system was implemented, it was implemented as though the sole objective was to increase participation by individuals in the treasury bill market. While this was a worthwhile objective, and was indeed attained to fair degree, other objectives of the policy were not given much prominence during the implementation process. The objectives of increasing the national savings rate, the development of the secondary market, and the creation of a vehicle through which the central bank could effect its monetary policy decisions were all marginalised during the implementation process. What was given prominence was the objective of increasing participation of individuals in the treasury bill market.

3.3.1 Performance was given to individuals irrespective of the level of their bids

Nowhere is this fact more evident than in the manner in which treasury bills were allocated to the bidders. In terms of the English Auction system which the Central Bank put in place in April 1992, treasury bills are supposed to be allocated to the highest bidder as long as such a bid is above the reserve price. As the implementation process progressed, it became obvious that commercial banks were always outbidding individuals. It has to be mentioned that due to lack of experience by individual participants, the Central Bank, again in its desire to increase the participation of individuals in the market, assumed the role of the agent for these individual bidders and always placed bids on their behalf by adding a loading factor of 0.0025 to the reserve price. As it turned out, commercial banks always won the bids and received the largest proportion of the treasury bills on offer on the day of the auction.

Upon realising this, the Central Bank, deviated from the pure English Auction system and allocated treasury bills first to individuals who in all cases bought treasury bills at 0.0025 above the reserve price. Commercial banks were then given residual irrespective of the level of their bids.

3.3.2 Non-issuance of Treasury Bills Certificates

The second shortcoming at the operational level had to do with the issuance of treasury bills certificates. After allocating treasury bills, the Central Bank is supposed to deliver treasury bill certificates physically to the participants who have 'won' bids. However, due to the high volume of individual participants, the Central Bank ultimately stopped issuing the actual certificates to individuals. Instead, individuals were given a receipt showing the amount by which the individual had purchased the securities. This practice stalled the development of the secondary markets in Lesotho as individuals who would have otherwise sold the treasury bills in the open market did not actually hold the certificates.

3.3.3 No penal rate if individuals presented their bills for rediscounting to the Central Bank

The third shortcoming at the operational level was the fact that the Central Bank did not impose any penalty rate to participants who came to present the certificates for rediscounting. This practice tacitly encouraged individuals to present their bills at the Central Bank as their first choice rather than as a last resort. If individuals came to know that they can always get the best rate in the open market, they would first try to sell their securities in the open market where they would get a favourable rate, rather than come to the Central Bank which would, as a matter of policy, give them a lower rate.

4. PROPOSED SYSTEM

The factors that have stalled the orderly development of money markets in Lesotho are at various levels. Some have to do with the general environment within Lesotho's financial sector, particularly the situation of excess liquidity within the banking sector. This excess liquidity is primarily a result of the general lack of effective demand for these funds partly as a result of the government strong fiscal position in the past eight years and partly as a result of the perceived and real high risks associated with lending to the private sector. There were also deficiencies in the manner in which the present system was designed. Specifically, the absence of intermediaries has inhibited the smooth functioning of the money markets. A number of weaknesses are also prevalent at the operational level. Most of these weaknesses derive from strong prominence given to the objective of increasing participation of individuals almost to the total exclusion of other objectives of the policy. During the implementation process, insufficient attention was devoted to the objective of evolving the well functioning secondary market and the creation of a vehicle through which the Central Bank could effect its monetary policy decisions.

4.1 Objectives of the Proposed System

The general objective of the proposed system is still to encourage an orderly development of money markets in Lesotho by correcting the deficiencies of the old system. The specific objectives of the proposed system are:

- (i) to create a vehicle through which the Central Bank could effect its monetary policy decisions;
- (ii) to help increase the overall level of savings;
- (iii) to deepen and widen the range of investment and borrowing opportunities;
- (iv) to encourage the orderly and effective evolution of the secondary markets for short-term securities; and
- (v) to broaden participation and encourage competition in the money market.

4.2 Structural Features of the Proposed System

4.2.1 The Instruments

One of the important shortcomings of the old system was that only one instrument was used to pursue multiple objectives. The 91-days treasury bill was originally intended to be used by the Central Bank to effect its monetary policy decisions. It was also used to afford small investors the opportunity of participating in the money market. Given that only one instrument was used to pursue more than one objective, it is not surprising that not all of these objectives were achieved. In order to overcome this deficiency, it is intended that three instruments will be issued. Each of these instruments will be used to attain a particular objective.

The 91-days Treasury Bills

The primary purpose for issuing 91-days treasury bills will be to create the vehicle through which the Central Bank can effect its monetary policy decisions. Accordingly, the 91-days treasury bills will be targeted mostly at commercial banks. However, limiting participation in this market to commercial banks only will tend to stifle competition as there are presently only three commercial banks in the country. In order to broaden participation and encourage

competition, other institutional investors will be allowed to participate in this market.

The smallest denomination for the 91-days treasury bills will be M250 000. This will ensure that only commercial banks and other non-bank institutional investors participate this market.

It is expected that the secondary market for the – 91-days treasury bill market will emerge, be active, and have sufficient depth to allow the Central Bank to effect its monetary policy decisions. Commercial banks by their nature are repositories of societal funds. They also have high liquidity needs. These two features of their business environment make it such that they often go through periods of large cash surpluses, and cash deficits and thereby making their participation in the money market frequent and with sufficient depth.

182-days Treasury Bills

The main objective in issuing the 182-days treasury bills is to widen the existing range of investment opportunities. In the old system, institutional investors with longer-term liabilities, and therefore relatively lower liquidity needs, had limited avenues for investing their funds. Such investors had to continuously rollover their 91-days investments or had to look elsewhere, mostly the RSA, for investments opportunities that suited the maturity profiles of their liabilities. The 182-days government securities are intended to meet the investment needs of this class of investors and stem the potential outflow of capital.

Although participation in this market will be aimed mostly at the non-bank institutional investors such as pension funds, commercial banks will not necessarily be barred from participating in this market. The broader participation will help encourage a degree of competition. As in the case of the 91-days treasury bills, the smallest denominations for the 182-days treasury bills will be M250 000. This will ensure that participation in this market is limited to institutional investors.

The 365-days Treasury Bills

The objectives for issuing these securities are two-fold. The first is to provide a mechanism for financing government deficit. Accordingly, the issuance of these securities will be done once a year and will be made to coincide with the beginning of the government fiscal year. As soon as the government's borrowing requirement is known, the government, in consultation with the Central Bank, will decide on the best possible way of meeting this borrowing requirement consistent with domestic as well as external macroeconomic objectives.

The second objective for issuing the 365-days treasury bills is to allow individuals and small investors to participate in the money market. Once, the domestic borrowing requirement by the government in a particular year has been ascertained, the Central Bank will then invite bids from individual participants and small investors.

The smallest denominations for 365-days treasury bills will be M100.00. This will allow for the effective participation of individual investors and other small and medium scale enterprises. The longer-term nature of these securities is also intended to build a culture of savings. One of the shortcomings of the old system was that small investors tended to engage in frequent liquidation of their investment often in small amounts to meet their short-term liquidity needs. This practice did not help build the culture of savings. The practice also tended to strain the administrative capabilities of the Central Bank which had also assumed the role of discount house. By limiting the participation of individuals to the long-dated securities, it anticipated that not only will the culture of savings emerge, but also that the administrative costs associated with processing of the securities in the secondary market will be considerably reduced.

4.2.2 The Method of Auction

The English auction system, adopted under the old system proved to be somewhat complicated and confusing to first-time participants in the securities market. Under this old system, securities were sold at the discount to their face value and the Central Bank would announce a reserve price after which the bids would be allocated to the highest bidder.

Thus, under this system, the main method of bidding was the price and it was often difficult for first time investors to relate the price to rate of interest that would accrue on their investment. Also it was often difficult for first time investors, to appreciate the gains realised on their investments since, under this method, investors get the rate of interest in advance. In order to overcome this deficiencies, it is proposed that a much more simpler method of auction, the Dutch Auction system, be used to allocate securities to bidders.

Modus Operanti Under the Dutch Auction System

The proposed Dutch Auction system, will work as follows:

- (i) on the day of the auction, the Central Bank will invite bids from suitable participants for a particular class of securities;
- (ii) participants will submit sealed bids on prescribed forms to the Central Banks;
- (iii) the method of quotation will be the rate of interest and each bid will include the interest rate and the amount that the participant wishes to invest at that rate;
- (iv) securities will be sold at their face value;
- (v) the Central Bank will establish the demand curve based on the bids that have been submitted on the day of the auction and decide on the amount of securities to be auctioned;
- (vi) the market-clearing rate of interest will be the rate of interest at which the demand for securities is equal to the amount of securities that the Central Bank has decided to put out for the Auction;
- (vii) all bids below the market-clearing rate of interest will allocated securities in accordance with the amounts indicated on the bids;
- (viii) the rate of interest that will apply on all allocations will be the market-clearing rate of interest on the day of the auction;
- (ix) the Central Bank of Lesotho will determine the amount of securities that will be put up for auction in accordance with its monetary policy objectives.

Advantages of the Dutch Auction System

Under this system, participants quote the interest rate that they wish to realise on their investments and securities are sold at their face value. Thus, an individual who had placed and won the bid for M100.00 at 12 percent rate of interest per annum, will get M112.00 at the end of the year. This M112.00 will made up of his original investment of M100.00 and the accrued interest of M12.00. Thus, in this system, there is a much more direct link between the method of bidding and the interest rate that the investor will accrue. In fact, the investor quotes the interest rate directly rather than indirectly rather than indirectly through the bidding price.

The system is also easier to relate to in that the investor can compare the rate that he is bidding for and the rate that is prevailing in the market. The investor does not have to make calculations of the discount price that would yield the desired rate of interest. In this system, 'what the investor quotes is what the investor gets'. There are no complex calculations of the relevant discount price. The manner in which the accrued interest is calculated is similar to the method of calculating interest on traditional savings deposits to which the small investor is much more accustomed to.

The third advantage of the Dutch Auction system is that it is much more transparent than the English system. Investors get the interest at the end of the holding period and can therefore easily compare the accrued interest with that which they had bid for.

4.2.3 The Process of Issuance

Appointment of Intermediaries

One of the main administrative shortcomings of the old system was the lack of intermediaries for the issuance of securities. The absence of intermediaries put considerable strain on Central Bank administrative capacity. The Central Bank, generally accustomed to handling three commercial banks had a few other institutional investors per month, suddenly had to learn to cope with approximately 6000 participants on a monthly basis. This not only created an administrative backlog in terms of the processing of bids but also required the kind of accounting infrastructure not

normally available to Central Banks including the need to provide real time balances to investors.

In order to overcome these administrative shortcomings while at the same time ensuring a broad-based participation in the money market, the Central Bank will appoint suitable intermediaries to assist in the process of issuing money markets securities.

Functions to be Performed by Intermediaries

Unlike in the previous system where all participants submitted bids directly to the Central Bank, only banks will be allowed to submit their bids directly to the Central Bank. All other participants will be required to route their bids through the appointed intermediaries. The appointed intermediaries will be expected to perform the general agency functions for individuals and other non-bank institutional investors. Specifically, they will be expected to perform the following functions:

(i) to provide and make public latest information relating to the rates of interest applicable to the class of securities that participants wish to tender for;

(ii) to assist their customers by providing them with the necessary forms to be completed for preparation of the bids;

(iii) to collate all bids applications and transmit such bids to the Central Bank;

(iv) to inform participants on the status of their bids whether successful or unsuccessful;

(v) to make payment on behalf of all those applications whose bids have been successful and to recover the payments from participants' accounts;

(vi) to provide rediscounting services for those participants who may wish to retire their securities prior to maturity.

Advantages of Intermediaries

The appointment of intermediaries is expected to provide several advantages. Firstly, intermediaries will facilitate the smooth functioning of the issuance process as such intermediaries will have, as a prerequisite, a demonstrated administrative capacity to handle large volumes of participants. In this regard, it is anticipated that initially, commercial banks will perform this role, as they have the necessary market credibility and facilities. The Central Bank's role as the primary issuer will therefore be greatly facilitated as it will only handle applications from commercial banks. This will obviate the need on the part of the Central Bank to have accounting systems that are capable of providing customers with real time balances.

Secondly, the appointment of intermediaries will greatly reduce the costs associated with the printing of certificates. With intermediaries in place, the need to issue certificates is obviated. Intermediaries will perform a book-entry system to keep track of participants' investments. Transfers of securities between a buyer and a seller in the secondary market will likewise be effected through a book-entry system.

Thirdly, the appointment of intermediaries will facilitate the emergence of a well functioning secondary market. In the old system, participants used the Central Bank as the buyer of 'first' resort for securities in the secondary market. This tended to stifle effective price discovery mechanism and the Central Bank ended up directly setting interest rates in the secondary market rather than influencing these rates.

4.3 Creation of an Enabling Environment

4.3.1 Absorption of Existing Excess Liquidity within the Banking System

One of the most important structural impediments to the development of the secondary markets for government securities in Lesotho has been the excess liquidity position of commercial banks. Under such an environment, the need for banks to borrow from each other does not arise. Banks typically hold the securities until maturity. In order to pave way for the evolution of secondary market, there is need to absorb existing excess liquidity within the commercial banking system. Such liquidity will be absorbed through the issuance of long-dated securities by government in order to finance its development expenditure. This will be complemented by the removal of remaining restrictions of foreign assets holding by commercial banks by scrapping of the Minimum Local Assets Requirement

(MLAR). These two measures will help channel funds to where they are needed the most.

Given the projected weakening of the government fiscal position the foreseeable future, opportunities have arisen for the absorption of existing excess liquidity of the banking system in a non-inflationary manner. Channelling these funds to government development expenditure programmes, not only eliminates excess liquidity but can potentially lead to the general improvement in economic conditions as the social returns of increased government investment are likely to be higher than the present returns realised by investing these with the Central Bank.

4.4 Central Bank Intervention

As the 91-days treasury bill market is expected to be the most active and most representative of the general liquidity conditions in the economy, the Central Bank will intervene in this market in order to effect its monetary policy decisions.

5. IMPLEMENTATION MODALITIES

The system became effective in September 2001. The bank had to involve negotiations with various stakeholders to canvass their views on the new approach. A massive public campaign was embarked upon to inform and educate the general public of the reasons underlying the new approach. An important aspect of the education campaign was to sensitise the public about the basic opportunities and risks of investing in money market instruments.

1] The yield on treasury bills is usually higher than on call deposits of comparable maturity. Since the risk levels are practically the same, a bank faced with a cash shortage would liquidate an investment with lower return in order to minimise the forgone interest.

[2] This option might take a long time to effect as it involves elimination of barriers to increased commercial bank lending such as the reform of the judicial system to expedite the hearing of commercial court cases.