



SAFEX AGRICULTURAL MARKETS DIVISION

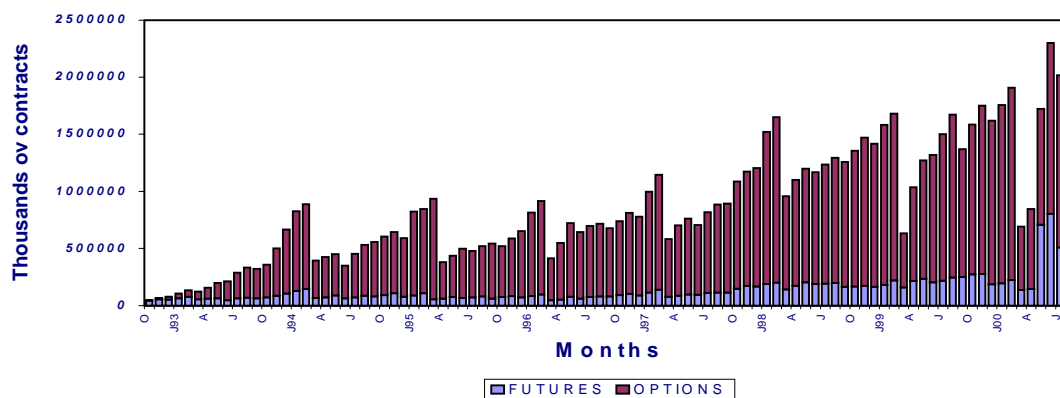
Lessons Learnt and Experience Gained by an Emerging Exchange South Africa

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I Introduction

The South African Futures Exchange grew out of an informal market that was started in South Africa by a local merchant bank, Rand Merchant Bank, in April 1987. In September 1988 it was decided to broaden the market and ensure widespread trust in the independence of the exchange and clearing house by forming Safex and the Safex Clearing Company (Pty) Limited (Safcom). It has been this integrity, which has been maintained and strengthened, which has been the core element in building both the financial market and in later years, the agricultural market. Safcom took over the management of the informal futures market in April 1990 and Safex was granted an official license from the Financial Services Board in terms of the Financial Markets Control Act on 10 August 1990. Significant milestones in the development of the market include the introduction of option contracts in October 1992 and the introduction of a fully automated trading system in May 1996. The volumes in the financial market (presently over 80 000 contracts per day) continue to be dominated by equity index products with the concentration being in the top 40 companies All Share Index (ALSI) futures and options and the top 25 Industrial Index (INDI) products. Options presently account for approximately 65% of volumes and 80% of open interest.

**Monthly Volumes
Financial Instruments
Oct 1992 - Jul 2000**



It is important to take note of the solid foundation laid by the financial derivative market in South Africa because not only did it provide a valuable pool of knowledge and

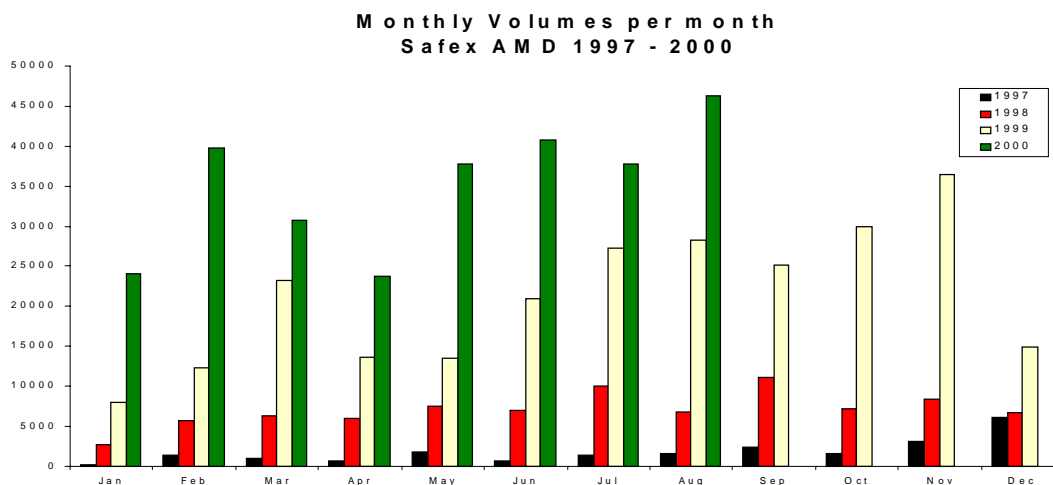
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understanding, but it also provided the critical requirement of integrity that is fundamental to the development of any market.

The agricultural market in South Africa had been highly regulated for over 40 years with the prices of the major commodities fixed through government-enabled legislation and organizations, such as the South African Maize Board. As the pressures to deregulate the agricultural market place increased both domestically and internationally, the interest in an agricultural commodity derivatives market mounted. Research as to feasibility of such a market was undertaken and in early 1995 the Agricultural Markets Division (AMD) was established as a separate independent division of Safex. A limited number of 84 trading seats were issued, raising a start up capital of R4,2 million. The seats were taken up by Safex financial members, being financial institutions and financial brokers and by agricultural commodity trading houses. As a separate membership association, although trading under the Safex license and being a division of Safex, the AMD functions largely as a separate exchange and through its elected Management Committee decides on the details and the operation of the contracts traded on the market.

The AMD presently trades contracts on white and yellow maize, bread milling wheat and sunflower seeds. Volumes in the AMD are dominated by the maize contracts, particularly the white maize futures contract. Option contracts were successfully introduced in March 1998.



The average number of contracts traded monthly on the AMD increased from 1800 in 1996, through 7200 in 1997 and 18100 in 1999 to above 33000 in the year 2000.

II Lessons Learnt and Experience Gained

The elements leading to the successful development of an exchange or the successful listing of a particular contract are not always easy to define, nor are they necessarily separately identifiable. If it were so, there would be a manual on how to proceed and 10 easy steps on how to establish a successful futures exchange. The elements listed hereunder include those that Safex AMD has identified, however it is



certainly not a fully inclusive or exclusive list. Safex AMD certainly does not claim that it has found all the answers or learnt all the lessons – indeed, the success of an exchange is not only in its establishment, but also in its continued operation and Safex AMD is facing ongoing challenges. Very often it is the correct combination of factors and the timing thereof that is crucial.

This brief paper does not deal with the given, such as relative size of the market, price volatility, the ability to standardize the product and competition on either side of the market – these are well known and well researched elements. It seeks to delve into the “gray areas” that are not so easily definable.

1. Integrity

At the top of the list is INTEGRITY. Admittedly this is somewhat of a chicken and egg syndrome in that it goes hand in hand with the establishment of a market and what is the priority requirement. However, the way in which a market is established, the structure of the exchange, the participants and the process followed is vital to the later success thereof. In the case of the Safex AMD, the integrity enjoyed was primarily as a result of osmosis from the financial market that had built integrity exactly on the elements indicated above – the participants, the structure, the process and the people.

Two areas that need to be separately identified when dealing with integrity are regulation and risk management. The practical and sensible approach undertaken by the South African Financial Services Board not only added integrity to the market, but through the working relationship of mutual cooperation and understanding, solutions and not problems were sought and the aim was the simplification rather than the complication of issues.

The simple risk management philosophy of Safex that, “you stand good for your client” has added to the integrity of the market, both for the financial as well as the agricultural market. In a pyramid structure, the clearing member will stand good for the member and the member for the client. This places the onus of proper risk management squarely on the shoulders of the clearing members. Coupled to sound risk management is a simple, but robust, margining methodology based on SPAN (Standard Portfolio Analysis of Risk)

Added to the above are the Rules of Safex, the membership requirements and procedure for both members and officers and the ongoing compliance and surveillance undertaken by the exchange.

2. Market Involvement

The mutual structure of the exchange was certainly beneficial in not only helping to establish integrity, but also in getting the buy-in of market participants. There can be no doubt that having members of the exchange helps in cementing the relationships within the market. Members who have committed to the market by way of contributing



tangibly towards the establishment thereof also add valuable resources in terms of time and energy to the marketing effort. It is true that the establishment of a derivatives market often goes hand in hand with a change in an existing marketing system. As previously indicated, this was the case in South Africa, and a delicate balance of confrontation and cooperation needs to be pursued in ensuring that the market accepts and adopts the new way of marketing epitomized by the futures market. The design and implementation of contracts also needs to be carried out in conjunction with the market. It is a well-known fact that “ownership” of a concept contributes greatly towards acceptance thereof and participation therein.

As intimated earlier, several of the elements mentioned here overlap. One such overlap is that between market participation and integrity. It has already been suggested that the character of the participants involved lends much to the integrity of the market, but the nature of the participants is also important. A futures market must be based and founded on the market participants who are active in the underlying market. As important as speculators are to a futures market, it is the natural hedgers who will add integrity and substance to the market. Safex AMD concentrated 99% of its effort on participants in the underlying market in generating market participation. Speculators will follow hedgers, but hedgers will not follow speculators.

Safex and Safex AMD have largely followed a policy of reacting to the market as regards the development of new products. This policy has most probably led to a lack of initiative from the exchange, but it has encouraged initiative and market participation and certainly kept down the costs of a large R & D department.

The exchange must add and be seen to add value to the market. It must provide a better way of doing things – as regards ease of entry, reduction of risk, increase of opportunity and reduction of costs. Market participation can be encouraged, cajoled and touted by various means, but at the end of the day the fundamentals will prevail.

3. Operations

The word operations is used here in the broadest sense – it is used *inter alia* to cover the method (system) of trading, the underlying infrastructure in the market and the efficiency of operation.

There are undoubtedly “horses for course”, but the decision by Safex and subsequently by Safex AMD, to trade electronically on a fully automated trading system (ATS) has proved to be the correct one. As indicated under point 2 above, relationships are very important within the agricultural sector, and the ATS has enabled members to be distributed throughout the country and trade directly from rural areas.

The existing underlying infrastructure of the market place consisting of a rail network for transport and adequate and sound storage facilities (silos / warehouses) allowed Safex AMD to concentrate on the actual market, rather than spending time on ensuring that the necessary infrastructure was in place. Safex AMD did however play a



leading role in reintroducing the silo receipt as the instrument of trading grains. Emerging exchanges must be prepared to pioneer and be involved in such developments.

The nature of the grains market in South Africa was such that in the absence of a central physical market, the futures market took over from the single channel system as the price discovery mechanism for the whole market. Originally, the plan was to have a limited number of delivery points where delivery in fulfillment of a futures contract could take place. At present Safex AMD has over 140 delivery points (silos), each at a location differential (discount) off the standard contract. Although this might surprise and even alarm the purists, it has contributed to the establishment of the market and has been a plus factor in its development. Safex AMD also introduced a “constant month” futures contract, introduced 15 trading days preceding a non-standard month. This provides a daily price, enables participants to use the market year round and allows for positions to be rolled over. It could well be argued that the multiple delivery locations and the introduction of the constant month contracts are contrary to the objectives of a futures market and encourage delivery on the contracts, however these developments have been positive in the South African experience. It should be stressed that the point is not to follow what Safex AMD did, but rather to learn the lesson that the development of an emerging futures market can encompass operations that enhance the futures market within a specific set-up or region.

Since the establishment of Safex AMD it has sought to follow the example of the financial market in South Africa and reduce trading fees, thereby passing on the efficiency of the market to the members of the exchange. This not only benefits the members, but encourages all round efficiency in the wider market.

4. Marketing and training

Safex AMD took a view very early on in the development of the market that the marketing effort would be heavily weighted towards education and “eyeball-to-eyeball” education at that. No expense was spared in getting out to the market participants to educate, discuss and debate the concepts of risk management and price discovery on a futures market. Presentations were made across the country, to small groups of farmers and large gatherings at agricultural conferences, at any time of day or night. The philosophy was, “we’ll come to you, you don’t have to come to us.” Again, it must be stated that members of the AMD who committed time and effort to education multiplied the impact of this campaign. A winning formula that was often used was a presentation by Safex AMD on the operation of the futures market and an explanation of the instruments traded on the market, followed by a presentation by a member of the AMD outlining the services that they could offer. There was no doubt that education in small groups with leading participants in an area or within an industry was most effective.

One of the questions the AMD faced, and one which most emerging markets will undoubtedly face, is again the chicken and egg syndrome of which comes first, marketing the concept or introducing the contract. The experience of Safex AMD leans towards introducing the contract first. Even though initially this led to concerns of low liquidity



and low volumes (always difficult to market), it enabled education based on real concepts backed up by real prices which certainly helps in conveying the message. It is important to note here that the first two contracts introduced by Safex AMD were not successful and were subsequently delisted. It is difficult to correctly identify the factors that led to their demise, however it was certainly easier to market a contract that was trading, even at very limited levels.

The advertising that was placed concentrated on exposure of the market in selected relevant media publications on a very basic black and white basis. Basic hand-outs using practical examples were also used in educating the market and the Internet was used as a central focal point (www.safex.co.za). The prices generated on the market were as widely distributed as possible based on the philosophy that the core function of the market was trading and not the sale of information or generation of income therefrom.

5. People

Although it is now widely argued that a good system can replace just about anything, the experience of Safex AMD points to the invaluable role of committed, enthusiastic and passionate people. The very nature of “emerging” points to the need of adequately and effectively communicating new and different concepts. Not only must this be done professionally, but also with drive and passion. Enthusiasm is contagious, and enthusiasm backed by a good product is a winner! The total personnel of Safex is less than 40 persons and the AMD has a staff component of 4 persons.

III Conclusion

As a division of Safex, the AMD subscribes to the Safex mission statement that is short and simple:

"Safex seeks to provide the secure and efficient market for trading derivatives in South Africa."

The brevity of this statement reflects the focus that Safex has on its core functions. Through this focus, Safex has created and developed a market that is comparable with many of the world's major financial centres, at an incredibly low cost. The Safex mission statement is not static and as South Africa opens up to the international standards for financial markets, we aim to continually enhance the facilities offered for trading derivatives to the local, regional and international community alike.

The objective of this paper was neither to dictate to others, nor to revel in success, but rather to share some lessons learnt and experience gained in the hope that these may contribute to the development of emerging futures markets around the world.

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