



OPERATIONAL FRAMEWORK FOR MGS SWITCH AUCTION

**JABATAN OPERASI PELABURAN DAN PASARAN KEWANGAN
BANK NEGARA MALAYSIA**

10th January 2007

1 Introduction

- 1.1 The Operational Framework for Malaysian Government Securities (MGS) Switch Auction sets out the terms and conditions for the conversion of any MGS in exchange for another MGS as provided under section 11B of the Loan (Local) Act 1959. The Framework shall be effective from 10th January 2007.
- 1.2 The MGS conversion (“hereinafter referred to as MGS switch auction”) will be undertaken by Bank Negara Malaysia (BNM) on behalf of the Government of Malaysia to exchange off-the-run MGS with benchmark MGS.
- 1.3 The aims of the MGS switch auction are to: -
 - Create more liquidity in the bond market by increasing the issuance of benchmark MGS and reducing the outstanding amount of off-the-run MGS;
 - Enable the Government to restructure its debt profile, smoothen interest payment and debt repayment as well as managing its borrowing costs more effectively; and
 - Enable the Government to continue issuing benchmark MGS while managing its debt level during periods of reduced government’s financing needs.

2 Scope of Framework

- 2.1 The Framework will apply to the MGS switch auction conducted by BNM, on behalf of the Government.
- 2.2 This Framework should be read together with the following : -
 - The ACI Model Code with Malaysia’s local addendum;
 - The Malaysian Code of Conduct for Principals and Brokers in the Wholesale Money and Foreign Exchange Markets 1994 with its appendices;
 - The Rules on the Scripless Securities under the Real Time Electronic Transfer of Funds and Securities (RENTAS) System;
 - Rules on FAST;
 - Rules on BIDS; and
 - Any other rules, guidelines and directives issued by BNM from time to time.

- 2.3 Any amendments to any of these rules, guidelines and directives will apply to the MGS switch auction.
- 2.4 In the event of any inconsistency between the Framework and the above mentioned rules, guidelines and directives in relation to MGS switch auction, this Framework shall prevail unless otherwise specified by BNM.

3 Definitions

- 3.1 Unless the context otherwise requires, the following expressions shall bear the following meanings: -

“**BNM**” means Bank Negara Malaysia, a body corporate established under the Central Bank of Malaysia Act 1958;

“**Framework**” means the Operational Framework for MGS Switch Auction;

“**FAST**” means Fully Automated System for Issuing/Tendering;

“**RENTAS**” means Real Time Electronic Transfer of Funds and Securities System which is the real time gross settlement system operated by BNM which provides for: –

- interbank funds transfers in Malaysia
- scripless securities transfers on delivery-versus-payment mode; and
- such other transaction or transactions as may be approved by BNM from time to time.

“**SSTS**” means Scripless Securities Trading System;

“**repurchase bond**” means the off-the-run MGS that will be purchased by BNM, on behalf of the government;

“**replacement bond**” means the benchmark MGS that will be given to successful participants in exchange for the repurchase bond;

“**conversion ratio**” means the nominal amount of replacement bond given for every repurchase bond in the switch auction;

“**nominal amount**” means the face value or par value of the bond;

“**maturity basket**” means the category in which all bonds have the stipulated remaining time-to-maturity;

“switch date” means the settlement date which is two (2) business days after the tender closing date;

“value of bonds” means the bonds’ worth, calculated based on the clean prices and accrued interests in the tender results;

“free-of-payment” means the transfer of bonds without any corresponding cash proceeds in RENTAS; and

“price” means the clean price of the bond, unless otherwise mentioned.

4 Methods of MGS Switch Auction

4.1 The MGS switch auction may be conducted on the basis of nominal-neutral, duration-neutral or cashflow-neutral methods.

4.2 Nominal-neutral

4.2.1 The nominal amount of replacement bond provided will be equal to the nominal amount of repurchase bonds.

4.2.2 Conversion ratio is 1.

4.3 Duration-neutral

4.3.1 Market participants will receive an amount of replacement bond that will leave the effective duration approximation of their holdings unchanged.

4.3.2 The nominal amount of the replacement bond will typically be rounded to the nearest amount in line with the standard lot of MGS in the secondary market.

4.3.3 Due to the rounding practice, effective duration approximation may not be precisely matched.

4.3.4 BNM may choose not to round the replacement bond such as in paragraph 4.3.2 in order to match duration more precisely in certain tenders. BNM will announce in FAST, fourteen (14) calendar days prior to the switch date in the event BNM chooses not to round the replacement bond.

4.3.5 Conversion ratio is calculated in accordance to the following:

$$\frac{[(\text{Price repurchase}_{-1\text{bp}}) - (\text{Price repurchase}_{+1\text{bp}})] (\text{Price replacement})}{[(\text{Price replacement}_{-1\text{bp}}) - (\text{Price replacement}_{+1\text{bp}})] (\text{Price repurchase})}$$

Where:

Price repurchase_{-1bp}: Price of repurchase bond when yield decreased by 1 bp

Price repurchase_{+1bp}: Price of repurchase bond when yield increased by 1 bp

Price replacement_{-1bp}: Price of replacement bond when yield decreased by 1 bp

Price replacement_{+1bp}: Price of replacement bond when yield increased by 1bp

4.4 Cashflow-Neutral

4.4.1 The value of replacement bond will be as close as possible to the value of the repurchase bonds in order to minimise the net cash settlement.

4.4.2 Conversion ratio is calculated in accordance to the following:

$$\frac{(\text{Dirty price of repurchase bond})}{(\text{Dirty price of replacement bond})}$$

5 Details on the MGS Switch Auction

- 5.1 In all the MGS switch auction methods specified in this paragraph, participants may submit their tenders for the repurchase bonds in odd-lot amounts, subject to RENTAS minimum denomination.
- 5.2 Nominal allotment of replacement bonds will be rounded to the nearest amount corresponding to RENTAS minimum denomination except in the case of duration-neutral method which may be rounded to the nearest amount corresponding to the MGS standard trading lot in secondary market.
- 5.3 Net cash proceeds will be calculated based on the difference between the bond values of repurchase and replacement bonds. If the value of the repurchase bonds exceeds that of the replacement bonds, BNM will pay net cash proceeds to the participants. If the value of the replacement bonds exceeds that of the repurchase bonds, participants will pay net cash proceeds to BNM.

6 Auction Type

- 6.1 The auction basis will be conducted on competitive multiple-price auction basis. Tender should be submitted in yields, up to three decimal places.
- 6.2 However, BNM may conduct bilateral switches under certain circumstances. The transaction will be announced in FAST upon the conclusion of such switches.
- 6.3 BNM may also conduct non-competitive MGS switch auction upon terms and conditions to be specified by BNM.

7 Participation in the MGS Switch Auction

- 7.1 The switch auction on FAST is only open to Principal Dealers (PDs). Non-PDs wishing to participate must submit their offers through their designated PDs.
- 7.2 Participation is voluntary to all participants. However, PDs are strongly encouraged to participate in all MGS switch auctions.
- 7.3 Maximum allotment limit is not applicable in MGS switch auctions. However, BNM may impose a maximum allotment limit when it is deemed necessary.
- 7.4 Participants shall have legal and beneficial ownership of repurchase bonds offered in any MGS switch auction. Participants shall also ensure that the repurchase bonds offered are free and clear of all charges, claims, encumbrances, security interests or any other form of restriction.
- 7.5 BNM may also participate in any MGS switch auction and will offer repurchase bonds at the weighted average yields of the successful offers for any particular repurchase bond.

8 Selection of the Repurchase Bonds

- 8.1 The repurchase bond selected by BNM will not consist of MGS that have been issued, reopened or exchanged via MGS switch auction in the 6 months prior to the MGS switch date unless announced by BNM in FAST.
- 8.2 Eligible repurchase bonds for switch auction will be announced by referring to either a specific stock code or maturity basket. In the case of maturity basket, a negative list may apply.

9 Selection of the Replacement Bonds

- 9.1 The replacement bond will only consist of benchmark MGS that have been issued.
- 9.2 The replacement bond issued under a MGS switch auction shall be considered as a 'reopening' of a benchmark MGS.

10 Determination of the Yield of Replacement Bond

- 10.1 The yield of replacement bond will be announced up to three decimal places by 9.30am on the tender closing date via FAST.
- 10.2 The prevailing market yield for the replacement bond will be used if it is actively traded in market. The market yield will be compared to BNM's internal fair value yield to determine any significant deviation. BNM will also monitor the trading activity of the replacement bond prior to the MGS switch auction to ensure that market players do not manipulate yields to their advantage. BNM reserves the right to use the internal fair value yield when market yield deviates substantially from the fair value.

11 Timeline for the Offering Process

- 11.1 The MGS switch auction details, including the switch auction method, replacement bond, eligible repurchase bonds and the switch date will be announced at least fourteen (14) calendar days prior to the MGS switch date. BNM may also announce the target amount of repurchase bonds which may be in the form of a maximum, minimum or a range of amounts.
- 11.2 The tender will be opened five (5) business days prior to the MGS switch date. PDs can begin submission of offers via FAST upon opening of tender.
- 11.3 Offers of repurchase bonds are to be submitted by specifying the yields, up to 3 decimal places.
- 11.4 Tenders will be closed for processing on the tender closing date and tender results will be released on the same day. The yield of the replacement bond will be announced to the market by 9.30am on the tender closing date and the tender will close at 11.30am on the same day. BNM aims to release the tender results by 3.00pm on the tender closing date with information on the amounts of repurchase bonds to be converted and the range of yields of the successful offers.

12 Methodology used during Processing

- 12.1 BNM uses its internally generated zero-coupon yield curve to derive fair values for each repurchase bond.
- 12.2 Offers with the highest spread to the respective fair value yields will be accepted first.
- 12.3 BNM reserves the right to accept or reject any or all offers of repurchase bonds, in whole or in part.
- 12.4 BNM also reserves the right to accept offers for an amount which varies from the announced target amount of repurchase bonds.

13 Settlement

- 13.1 The tender results in FAST will constitute binding obligations of the participants to settle the transactions on the switch date which is two (2) business days after the tender closing date.
- 13.2 Upon the release of tender results via FAST, the PD shall transfer its own repurchase bonds (free-of-payment) to BNM's own Securities Account using the Transaction Code "T" latest by 4.30pm on tender closing date, for value on switch date. If the PD is tendering on behalf of a non-PD, the non-PD must ensure that its repurchase bonds which were successfully auctioned, must be transferred (free-of-payment) to the PD's own Securities Account by 12.30pm on the next business day after the tender closing date, for value on switch date. The PD will onward transfer the non-PD's repurchase bonds to BNM's own Securities Account (free-of-payment) by 3.30pm on the next business day after the tender closing date, for value on switch date. The names of the non-PDs (as indicated in the FAST results) will be entered by the PDs in the "Seller to Buyer" field of the SSTS Transfer Confirmation (Completion Advice); for example, "Switch Auction – XYZ Berhad".
- 13.3 The PD must send the SSTS Transfer Confirmation for the repurchase bonds to BNM's own Securities Account for itself and its non-PDs separately to facilitate reconciliation and minimise settlement failure.
- 13.4 BNM will credit the PD's Securities Accounts with the corresponding replacement bond for value on the switch date.
- 13.5 The value of bonds will be calculated based on prices that are rounded to the nearest three decimal places during the yield-to-price conversion.

- 13.6 Accrued interests for each bond are taken into account in the calculation of the bond value and net cash proceeds for settlement.
- 13.7 Depending on the difference in value between the replacement and repurchase bonds stipulated in tender results published on the FAST website, BNM will credit or debit the PDs' Cash Accounts with the net cash proceeds on the switch date. PDs will settle the net cash proceeds with each non-PD separately on the same day.

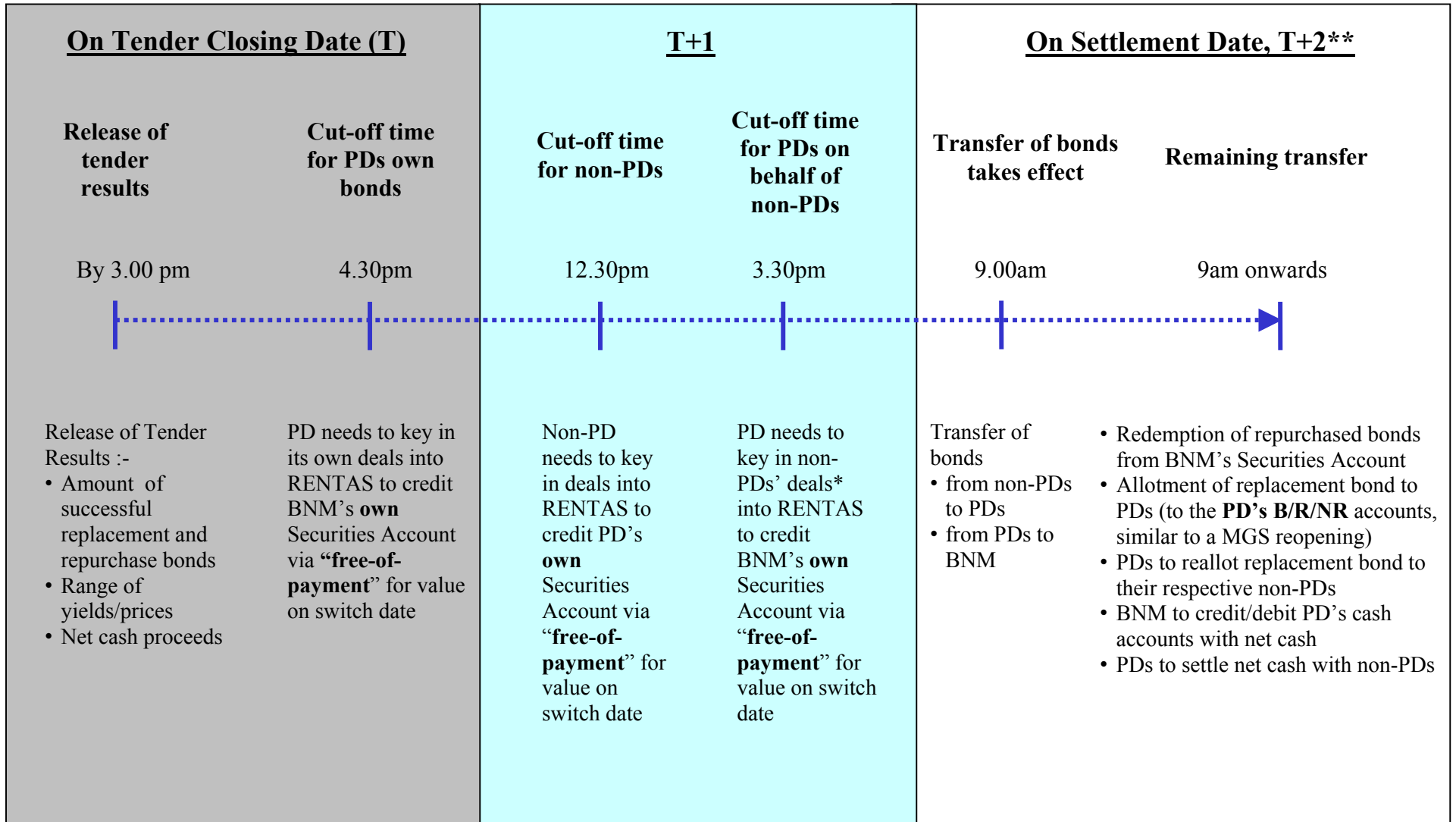
14 Penalty Charges for Failure to Deliver Repurchase Bonds

- 14.1 In the event that a participant has not transferred the repurchase bonds by 9am on the switch date, BNM may deem the transfer to be pending or cancel the transfer. If the transfer is deemed as pending or BNM cancels the transfer, compensation charges and the loss of accrued interest will apply in accordance with Rules on the Scripless Securities under the RENTAS System Part VII Section 7.2.
- 14.2 If the transfer of the repurchase bonds does not take place by the end of the switch date and replacement bonds have been transferred to the participants on the switch date, BNM will attempt to execute a buy-in of the repurchase bond on behalf of the participant on the next business day in accordance with the procedure specified in Rules on the Scripless Securities under the RENTAS System Part VII Section 8. The compensation charge and loss of accrued interest as stated in Rules on the RENTAS System Part VII Section 7.3 shall continue to apply until the buy-in is completed. The costs of the buy-in shall be fully borne by the participant.

15 Variation of Rules

- 15.1 This Operational Framework may from time to time be varied, added or revoked in whole or in part at the discretion of BNM.

Settlement Timeline of MGS Switch Auction



* PDs should enter transaction for each party **separately** to minimise risk of settlement failure. PDs should also specify the non-PDs’ names in the “Seller to Buyer” field (eg. “Switch Auction – XYZ Bhd)

** Physical transfer of MGS (from non-PDs to PDs, PDs to BNM) only occur on T+2