PRIMARY DEALERSHIP AND THE REPO MARKET IN EUROPE: A MARKET MAKER POINT OF VIEW

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JPMorgan

Primary Dealership and the Repo Market in Europe: a Market Maker point of view

- Liquidity investments, Central Banks operations and bond traders positions, all impact the repo market activity
- The activity of a Primary Dealer is strictly related with the financing & covering of his positions. An efficient Repo market is key to the implementation of trading and market making strategies, as well as to the enhancement of the liquidity of government debt market
- Primary Dealers trading strategies, EU government bond repo markets structure, Treasury role, settlement and documentations are all crucial to the shaping of an efficient market for government debt

Agenda

- Repo Market Role in Financial Markets
- Market Maker’s Role in the Bond Market
- Market Making activity and Repo
- Relative Value and Repo Rates drivers
- Treasury’s Roles in the Repo Markets
- Settlement systems
- Legal Documentation
- Repo & Primary Dealership: a Market Maker’s Recommendation
- Annexes

Repo Market Role in Financial Markets

The Repo market is at the centre of the Money Market in Europe

- Repo as a liquidity product
  - Securitized Loan
    - Deposit/Investment tool
    - Central Banks monetary policy intervention

- Repo as a security product
  - Underlying Security becomes the driver
    - Financing & covering of Bond positions
    - Instrumental to support all Market Maker and Primary Dealership activities

Market Maker's Role in the Bond Market

Government Bond Market is characterized by:

- Bonds having high correlation and high substitution level (among themselves)
- Single Bond liquidity relatively limited vs. market size and the investors allocation
- Issuer Debt Profile, driven by redemption & new issuance, is not necessarily timed with market expectations and Investors allocation' choices
- Directional trading concentrated on Futures contracts & Benchmarks

As a result the role of the Market Makers is to step in to provide single bond liquidity with the objective of minimizing bond market bid offer. Their activity is therefore key to create a buffer and match short-term supply & demand imbalance in the bond market.

Market Making activity and Repo

The activity of the Market Maker is more specifically aimed to:

- Make market to clients, distribute auctions “underwriting”
- Trade Relative Value positions across the Bond Curve (bonds mispricing, arbitrages)
- Positioning on market expectations (directional & curve trades)

The objective of most of these strategies is to combine correlated bond & spread positions that will (hopefully) realign with time, while contributing to improve the overall market liquidity.

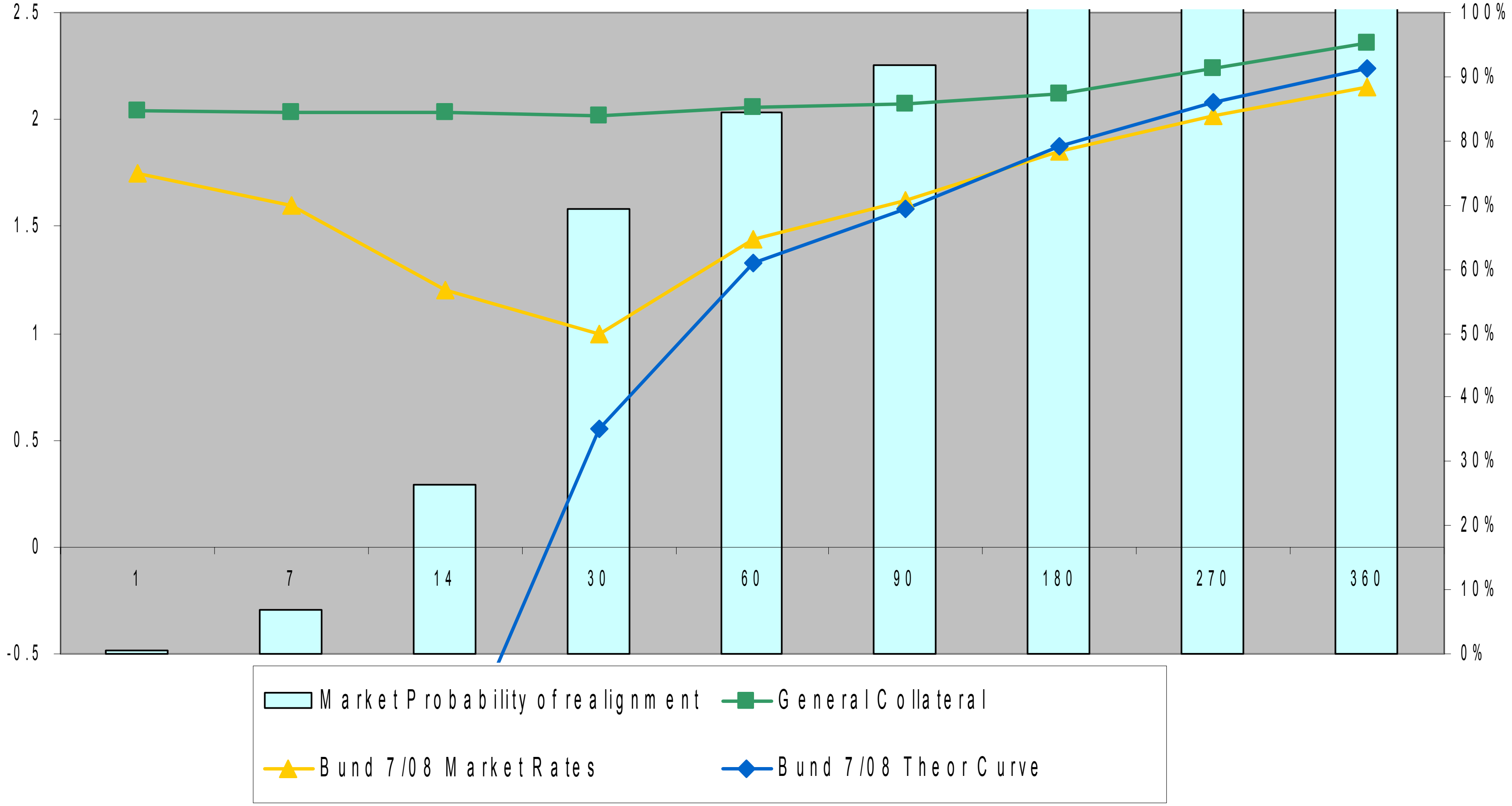
The successful implementation of trading and market making strategies involves entering into Long and Short Bonds positions that have to be carried over time: therefore the efficient financing and sourcing of the related securities is key to the enhancement of the liquidity of government debt market, through the reduction of cash market bid offer.

Relative Value and Repo Rates drivers

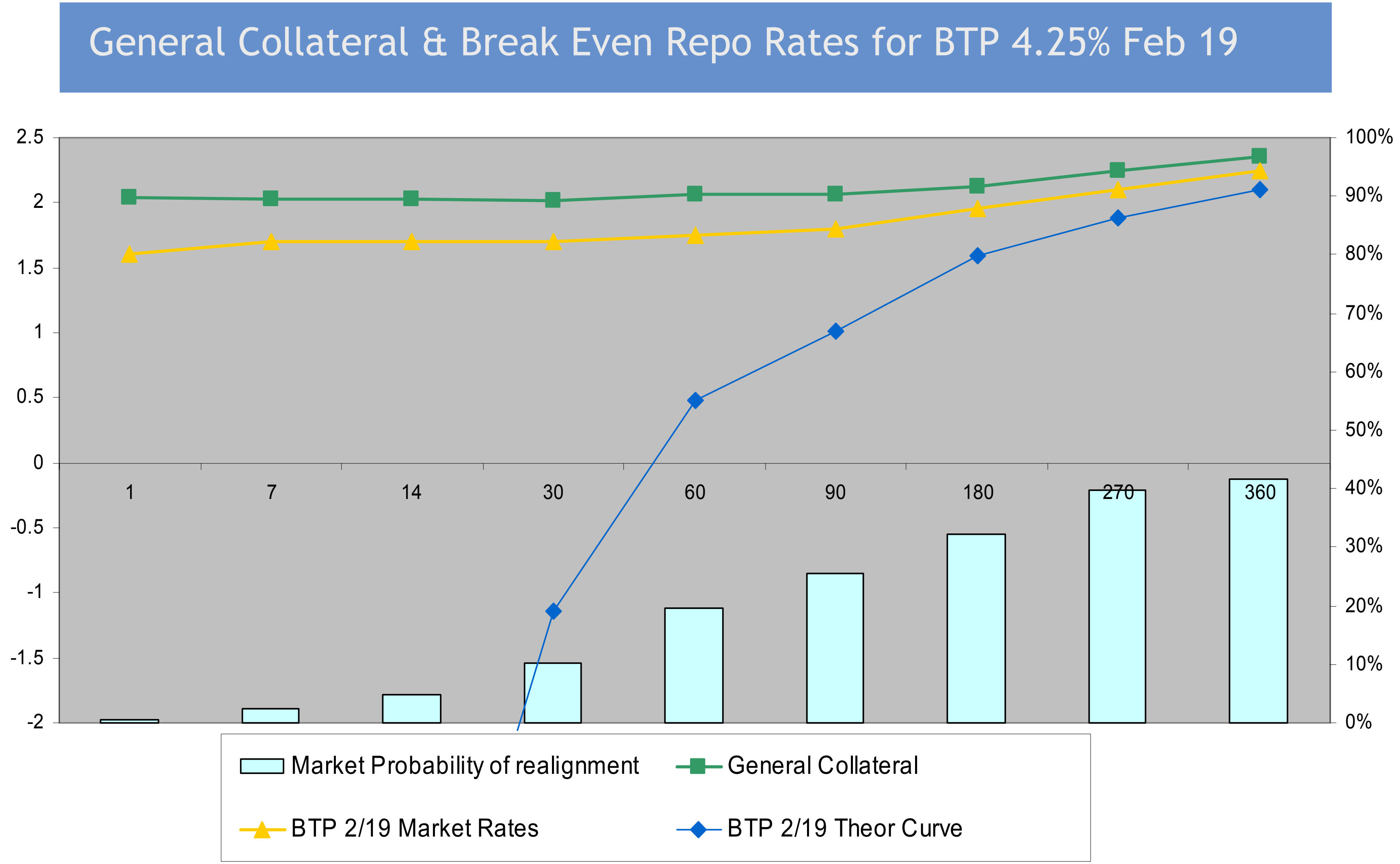
- **Supply & Demand of bonds define bond repo level vs. General Collateral funding level**
- **Theoretical repo rate & forward asset swap**
  - Bund 4.75% 4/7/08 trading in the cash market @ 104.40 for value 14/11/03, dirty price 106.1261
  - Asset Swap: L–12 bp
  - PVBP: 4.33
  - Target Fair Value: L-9 bp
  - The Theoretical repo rate is such to realign the bond to his fair value (asset swap) for any given term horizon, in other words we make the assumption that all the bonds trade at their fair value on a forward basis
- Market should trade between GC level and the Bond Theoretical curve
  - Expected return of strategies is positive
  - Realignment timeframe can be event driven (auction, year end)
  - Bond supply overcome market demands/positions
  - EOC stock lending/DVP fail
  - Treasuries' intervention
- Market can also overshoot the Theoretical repo rate (market specialness higher than theoretical) because of:
  - Market segmentation (cash vs. repo, high retail & mutual funds holdings)
  - Lack of transparency
  - Specific Event (auction, buy-back, buy-in)

Relative Value and Repo Rates drivers

General Collateral & Break Even Repo Rates for Bund 4.75% Jul 08



Relative Value and Repo Rates drivers



Relative Value and Repo Rates drivers

Bond specialness is a combination of forces pulling in different directions, these are the major Repo Rate drivers,

- Market dynamics and lenders/borrowers preferences:
  - Market Positions & Client Flows +/-
  - Bond asset swap/bond basis richness +
  - Accounting, regulatory & tax issues +/-
  - Country preferences (settlement & ECB repo) +
- Bond and repo specifics:
  - Repo term -
  - Bond maturity +
  - Bond outstanding -
  - Specific events (Auctions, Buy-Backs) +
- Market distortions and inefficiencies
  - Retail/mutual funds/Central Banks net buyers of bonds +
  - DVP settlement -
  - Non DVP/EUREX Delivery/Buy-in procedures +

Treasury's Roles in the Repo Market

- Treasuries' attitudes and activity in the Repo Market are relatively differentiated:
  - Cash Management operations, mostly aiming to place liquidity (UK, FR, BEF, HOL, DEM, SP, FIN)
  - Primary Dealers Repo Facility (UK, BEF, HOL, FIN)
  - Discretionary market intervention (FR, DEM, FIN)
  - Dealership evaluation and market monitoring (IT, FR)

- Primary Dealer Repo Facility is clearly the market preferred approach:
  - Supports Primary Dealers in their market making obligations
  - Helps absorbing client flows
  - May represent a floor to repo rates/help settlement efficiency

- Discretionary Market Intervention is clearly a more flexible approach:
  - It doesn't incentive any moral hazard
  - Constitutes a "parachute" to save from market dislocation & manipulation

Settlement Systems

- Settlement System still very fragmented
  - Euroclear & Clearstream leading consolidation process
  - Consolidation is happening at the company level, whereas procedures & systems are yet to become fully integrated
  - Cross Border settlement & Central Bank repo participation can still be an issue due to position pre-funding
  - Fail repairs & Overnight market activity still limited (except UK)
  - Need to develop more Automatic Settlement Lending Programs in domestic markets (I.e. EOC, Clearstream)

Legal Documentation

- Executed documents are essential to minimize credit exposure:
  - Collateral Management (MTM, haircuts, margins)
  - Positions Netting
  - Right to liquidate securities in case of counterparty default

- Documentation
  - Standard document for non $ Repo: GMRA (Global Master Repo Agreement), EMA (European Master Agreement) and GPSLA (Global Master Securities Lending Agreement)
  - But also domestic agreement: French and German Master Repo Agreement (AFTB and Rahmenvertrag fuer Wertpapier darlehen)

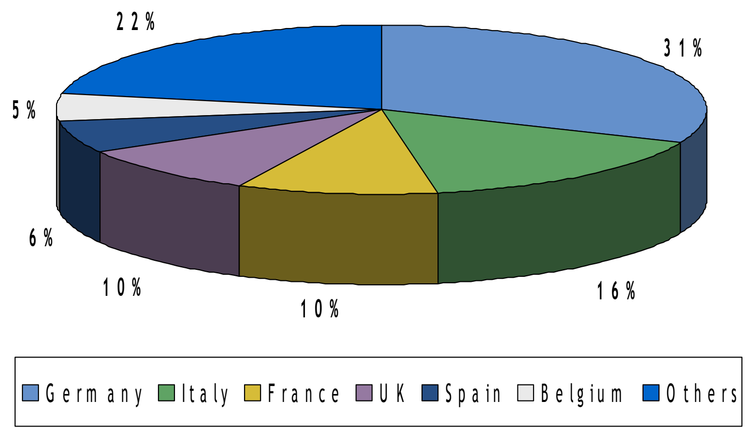
Repo & Primary Dealership: a Market Maker's Recommendation

- Repo activity included in Primary Dealership rules
  - Activity can be monitored, favoured but not subject to mandatory requirement (it is a "credit" product requiring balance sheet usage)
  - Monitoring criteria: volumes, term period & specials
- Development of Electronic Trading Platforms
  - Price distribution
  - Improve liquidity
  - Sustain volume growth/Improve straight through processing & settlement efficiency
- Treasury should play some degree of market activity
  - Cash management
  - Bond lending
- Settlement system should be designed to limit the amount of "unproductive" collateral
  - Settlement cycles, O/N activity
  - Efficient Cross Border deliveries
  - Automatic Bond Lending (Euroclear/Clearstream model)
- Effort to incentive the adoption of a legal standard
  - Providing for Netting and Liquidation rights
  - Possibly based on ISMA/EMA to facilitate international involvement
  - Cross products netting agreement

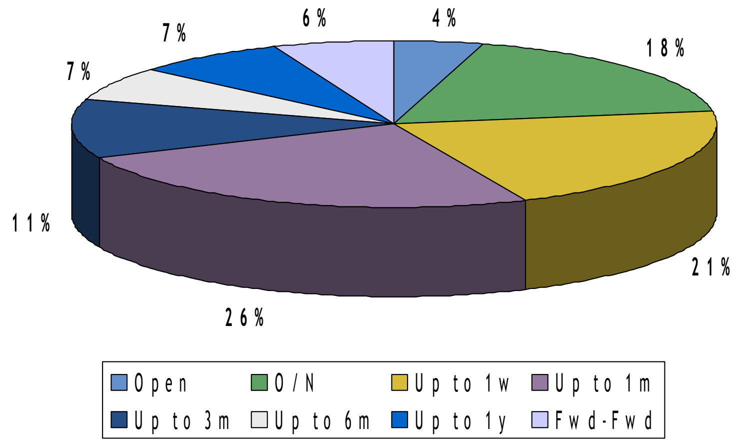
Annex: the European Repo market in a snapshot

- Total outstanding: 4,050 billion (up 23% from last year)
- Cash currency: EUR 76%, GBP 9%, USD 9%, JPY 3%
- Negotiation type: direct 52%, voice brokers 30%, e-trading 18%
- Underlying collateral type: Euro-15 Government 77%, corporate and agency 10%, others 13%

- Country of underlying collateral



- Term of transactions



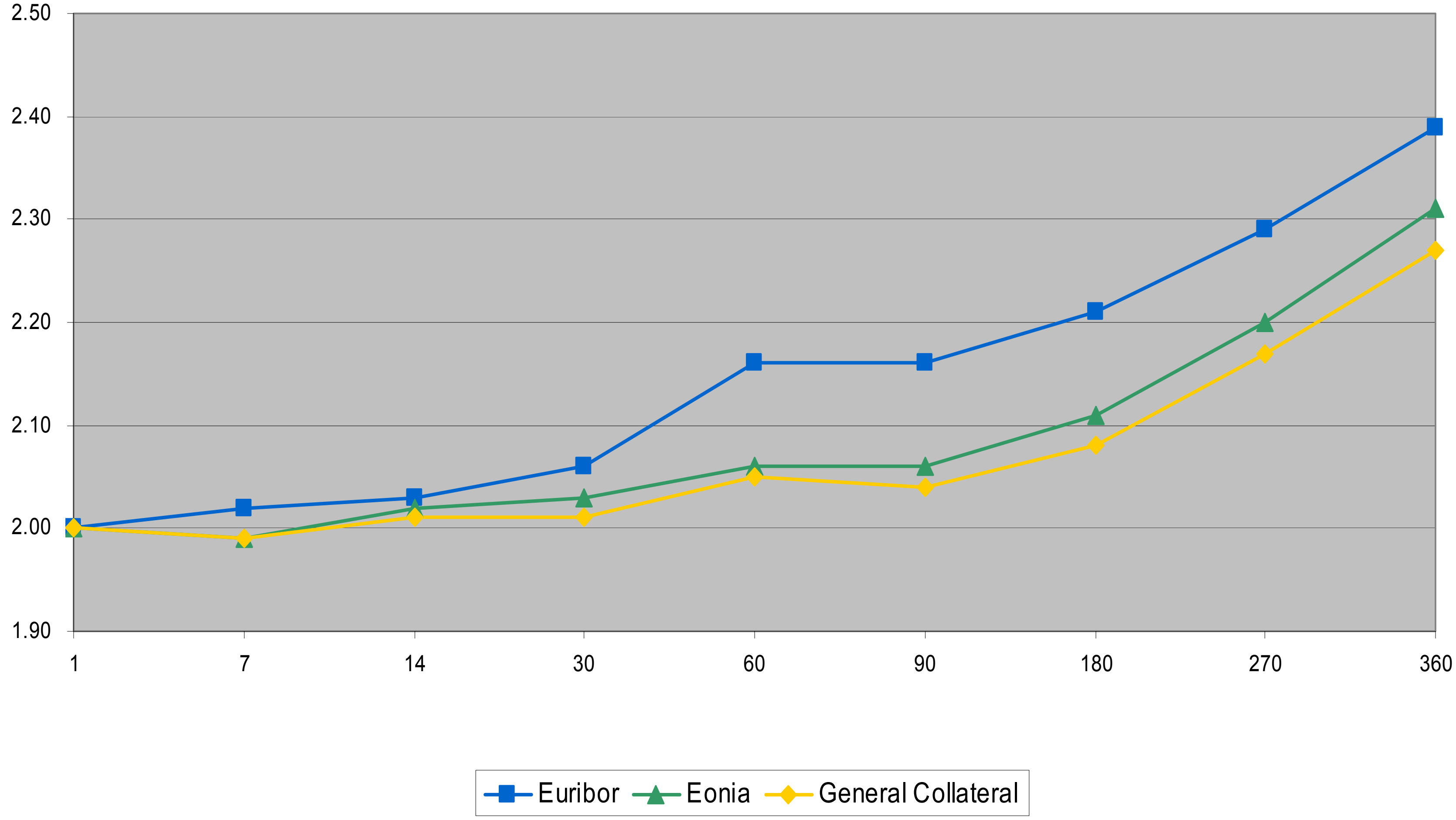
Source: ISMA European Repo market survey - June 2003

Annex: Recent Trends in the Government Repo Market in Europe

- Increase of Electronic Trading volumes
  - Liquidity
  - Straight through settlement/Cost Efficiency
  - Automation: position, quotation
- Expansion of Central Counterparties products
  - Balance Sheet & Settlement Netting
  - Anonymous Trading
  - Credit Protection
- The Future
  - Growth of anonymous trading
  - Merger of European Clearing Houses (LCH, Clearnet) to allow for new netting opportunities
  - Increased integration of repo markets in Europe: settlement, market conventions, cross-border moves

Annex: General Collateral Repo Rates vs. Money Market Rates

EUR GC tracks Eonia Curve: plentiful supply of Euro Govies collateral



Annex: General Collateral Repo Rates vs. Money Market Rates

GBP GC tracks Libor with wider spread: relatively scarce Gilts supply