

Morgan Stanley

OTC Derivatives

1st International Seminar on Fixed Income Over-the-Counter Market

September 29, 2006

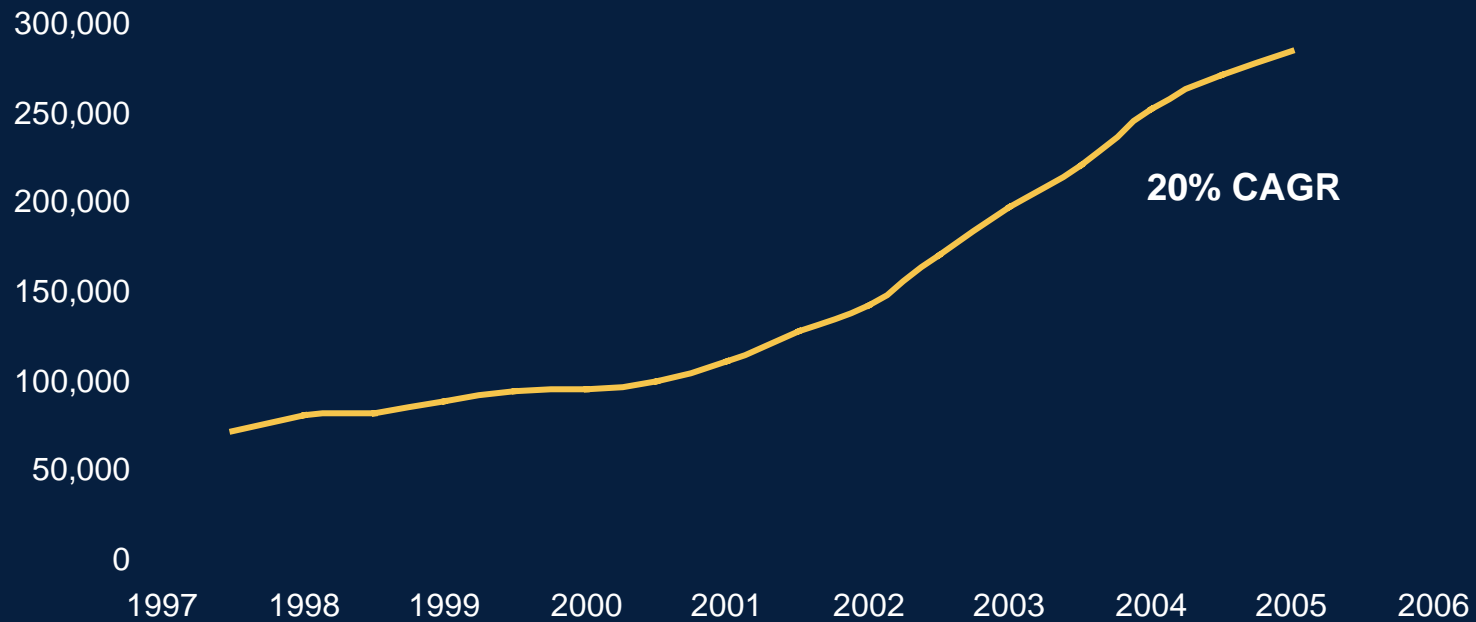
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OTC Market - Explosive Growth

Notional Amount Outstanding

US\$Bn

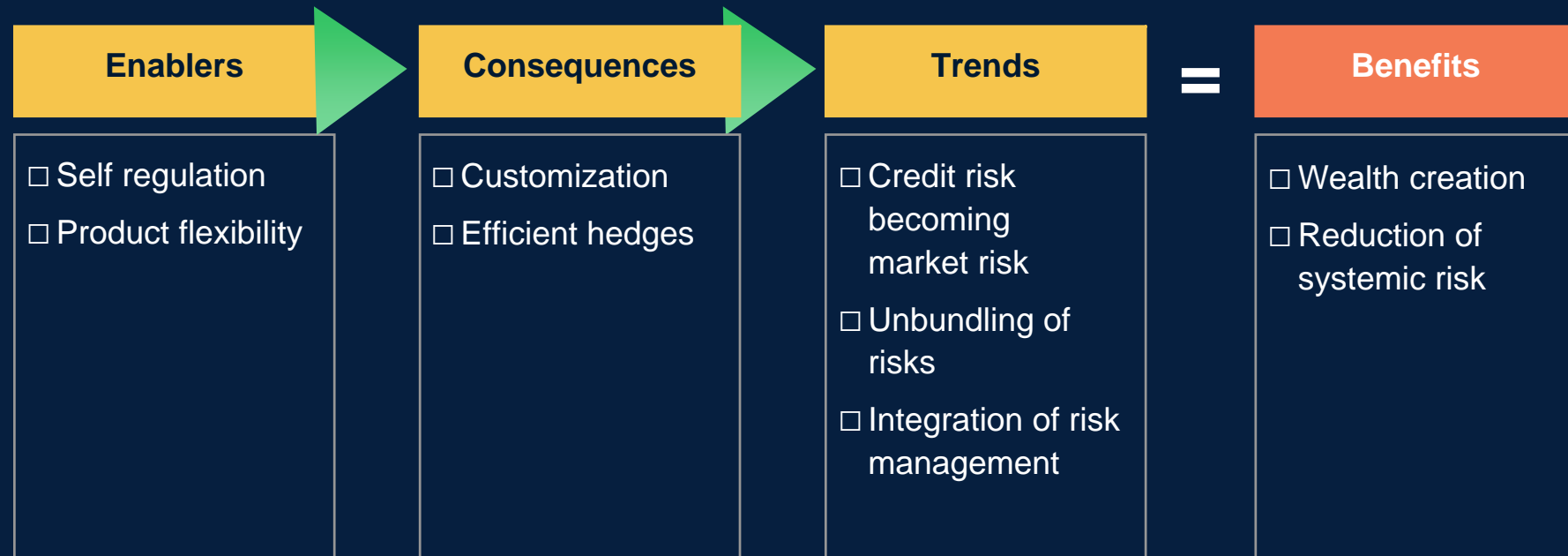


Source: Bank of International Settlements

OTC Market - Overview

Explosive Growth

- US\$285 trillion in notional amount outstanding by December 2005
- Used by 90% of the world's top 500 companies

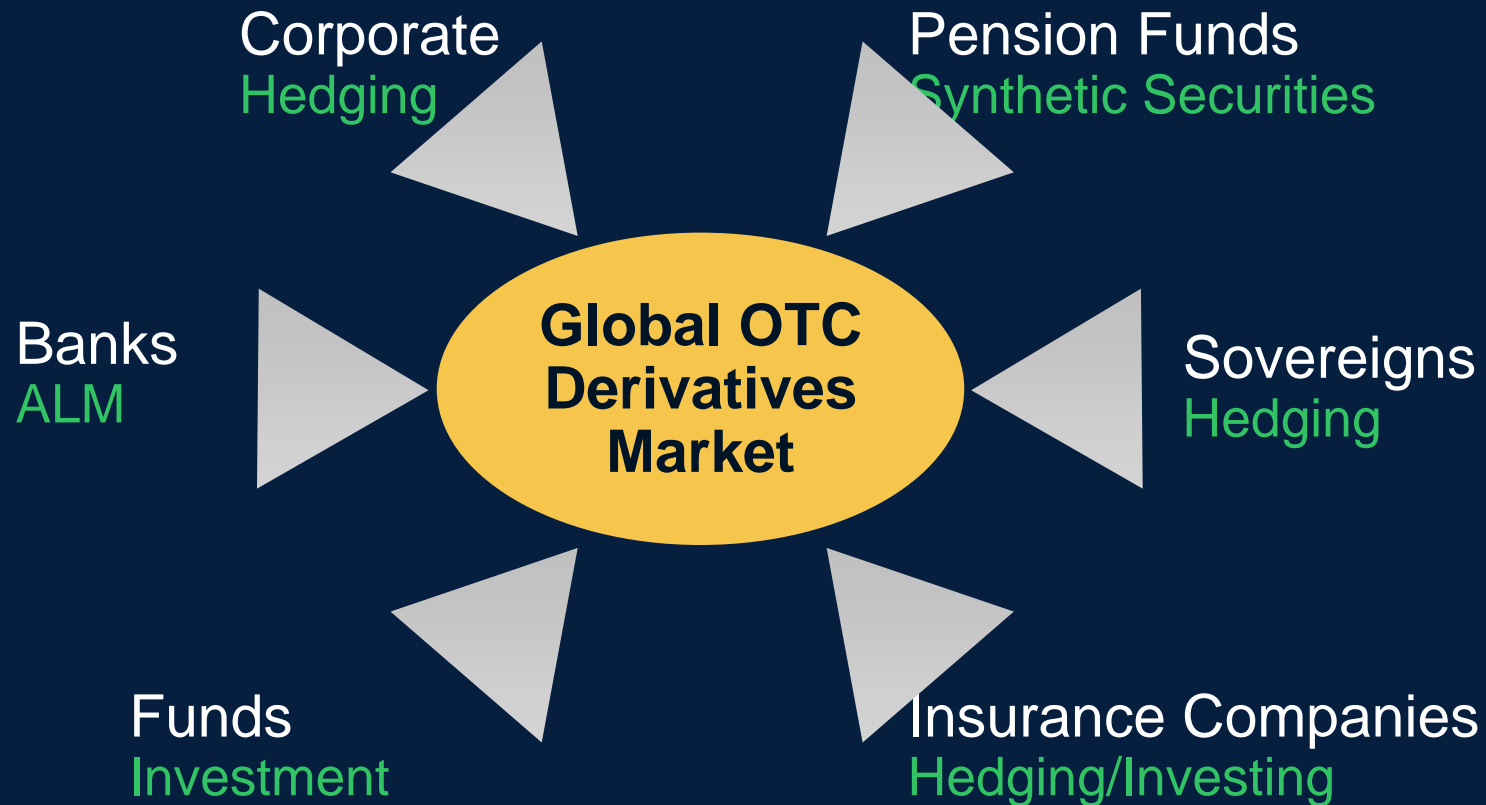


OTC Market - Supply Meets Demand

- Self regulation of international OTC enables product development
 - Products are not regulated
 - Entities are regulated
- Market grows at the speed of risk management needs – supply vs. demand equilibrium
- Customization
- Hedge efficiency

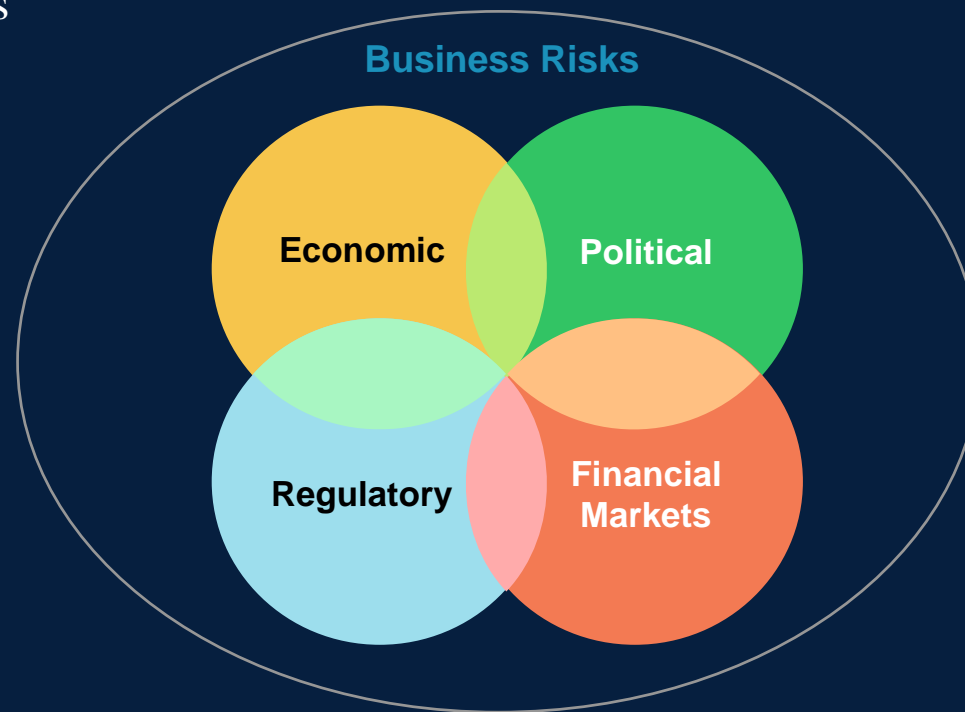


OTC Market - Complementary Needs



Trend: Integrated Risk Management

- Risk management is most effective when it defines risk comprehensively and adopts an integrated approach
 - An attempt to control one dimension of risk often leads to an increase in another dimension. Therefore, compartmentalized approaches will be less effective in managing risks



Risk Management Framework

Risk Identification – Financial Statements

- An integrated risk management approach incorporates how all risks impact the balance sheet and income statement

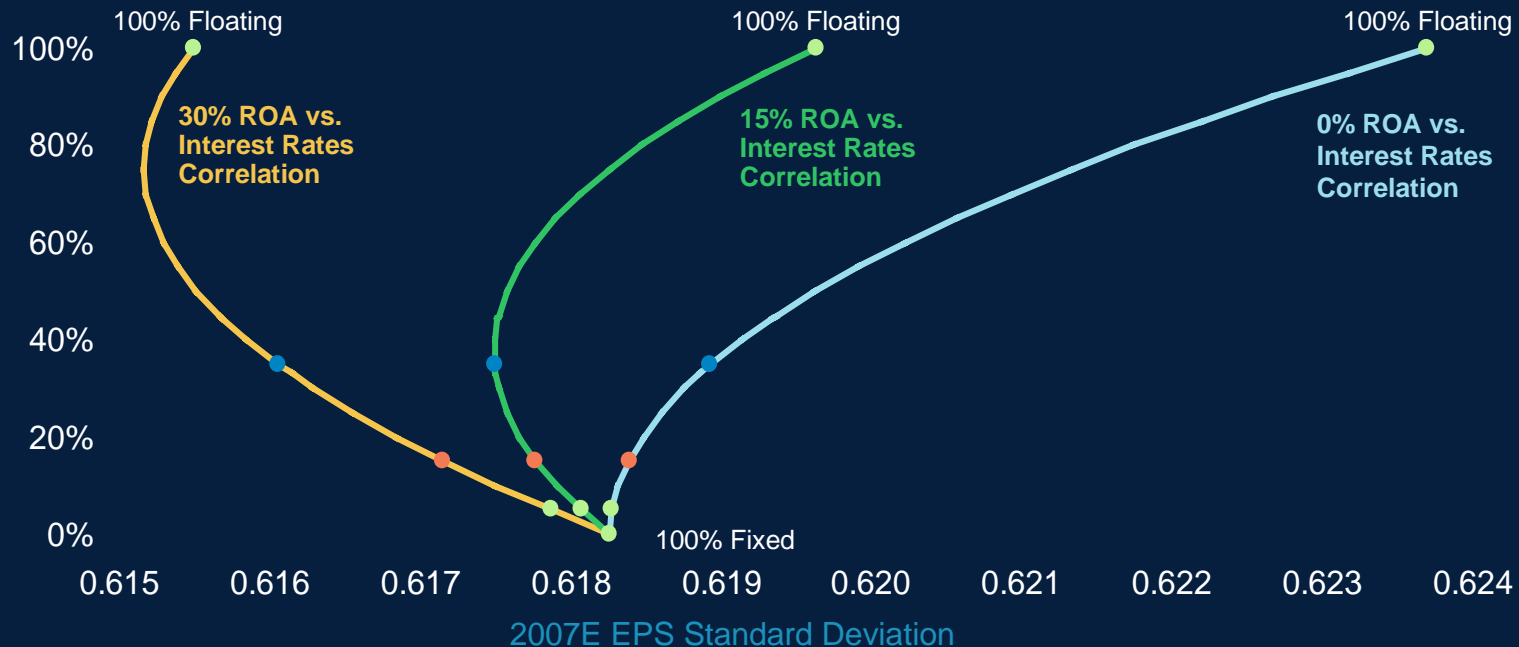
	Assets	Liabilities
Interest Rates	Cash and Equivalents	Short Term Borrowing
Credit	Accounts Receivable	Accounts Payable
Commodities	Inventories	Long Term Debt
Currencies	Investments	Long Term Labor Contracts
Inflation	Plant & Equipment	
GDP	Equity in Affiliates	
	Income Statement	
	Revenue Line	
	Revenues From Foreign Subsidiaries	
	Cost of Goods Sold	
	Interest Expense	
	Loss Due to Default on Receivables	
	Net Income	

OTC Market - Integrated Solutions

Optimizing Fixed/Floating Mix Allows Companies to Achieve More Efficient Portfolios

Take Advantage of Company Cyclicity

% of Floating Rate



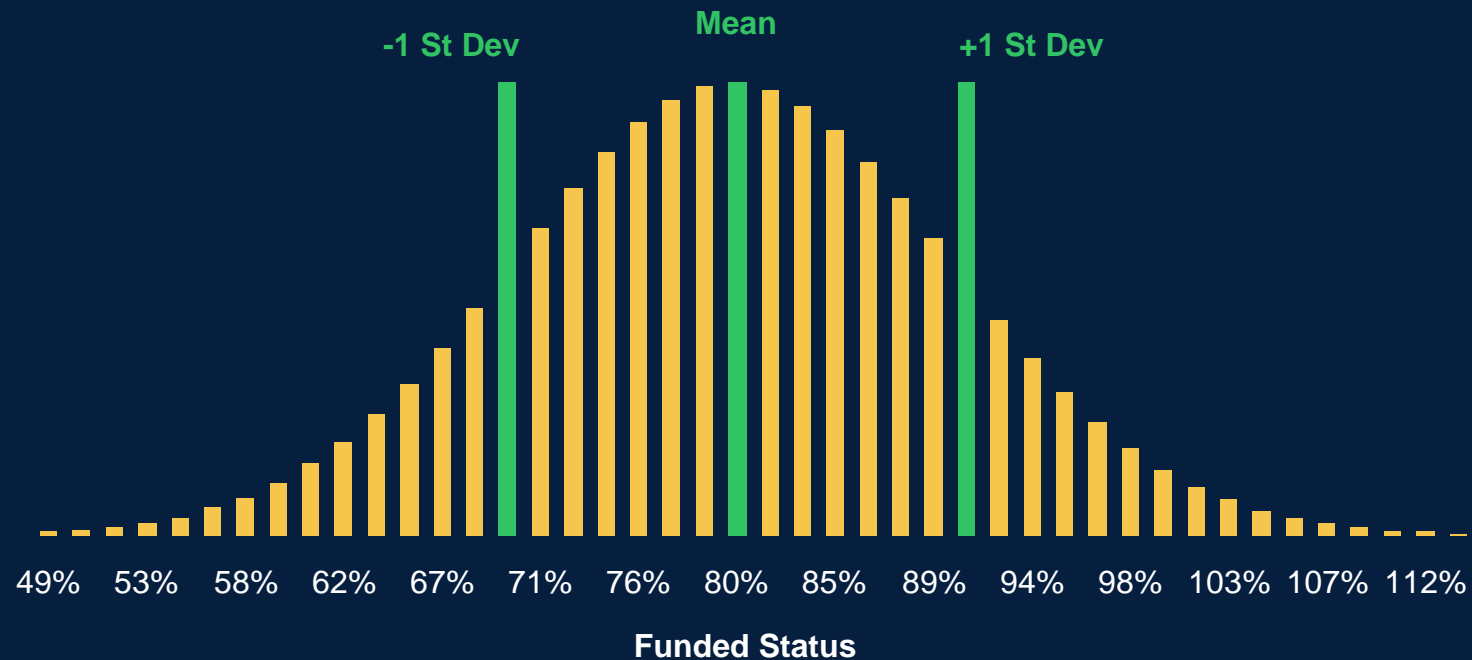
Source: Morgan Stanley

OTC Market - Integrated Solutions

Pension Plans: Bringing Assets and Liabilities Together

Strategy 1: 65% Equity / 35% Fixed

Mean: \$200MM Deficit
St Dev: \$177MM



Source: Morgan Stanley

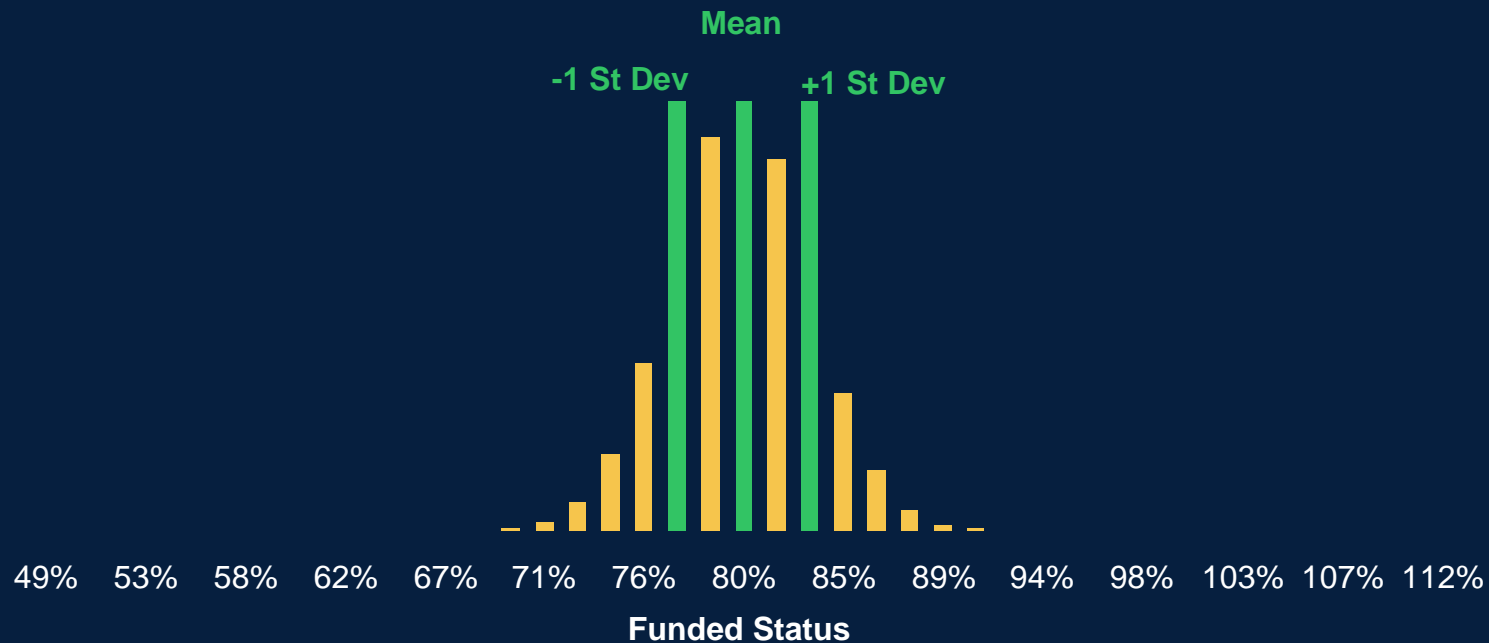
- The portfolio is composed of 65% equity and 35% fixed with fixed duration 5

OTC Market - Integrated Solutions

Pension Plans: Bringing Assets and Liabilities Together (cont'd)

Strategy 2: 20% Equity / 80% Fixed

Mean: \$200MM Deficit
St Dev: \$37MM



Source: Morgan Stanley

- The portfolio is composed of 20% equity and 80% fixed with fixed duration 15
- This strategy can be obtained with derivatives

OTC Market - Customized and Efficient Hedges



OTC Market - Credit Risk Becomes Hedgeable

The OTC Market Has Enabled Credit Risk to Be Hedged

Notional Outstanding

US\$Bn



Sources: Bank of International Settlements & SDC™ (Thomson Financial)

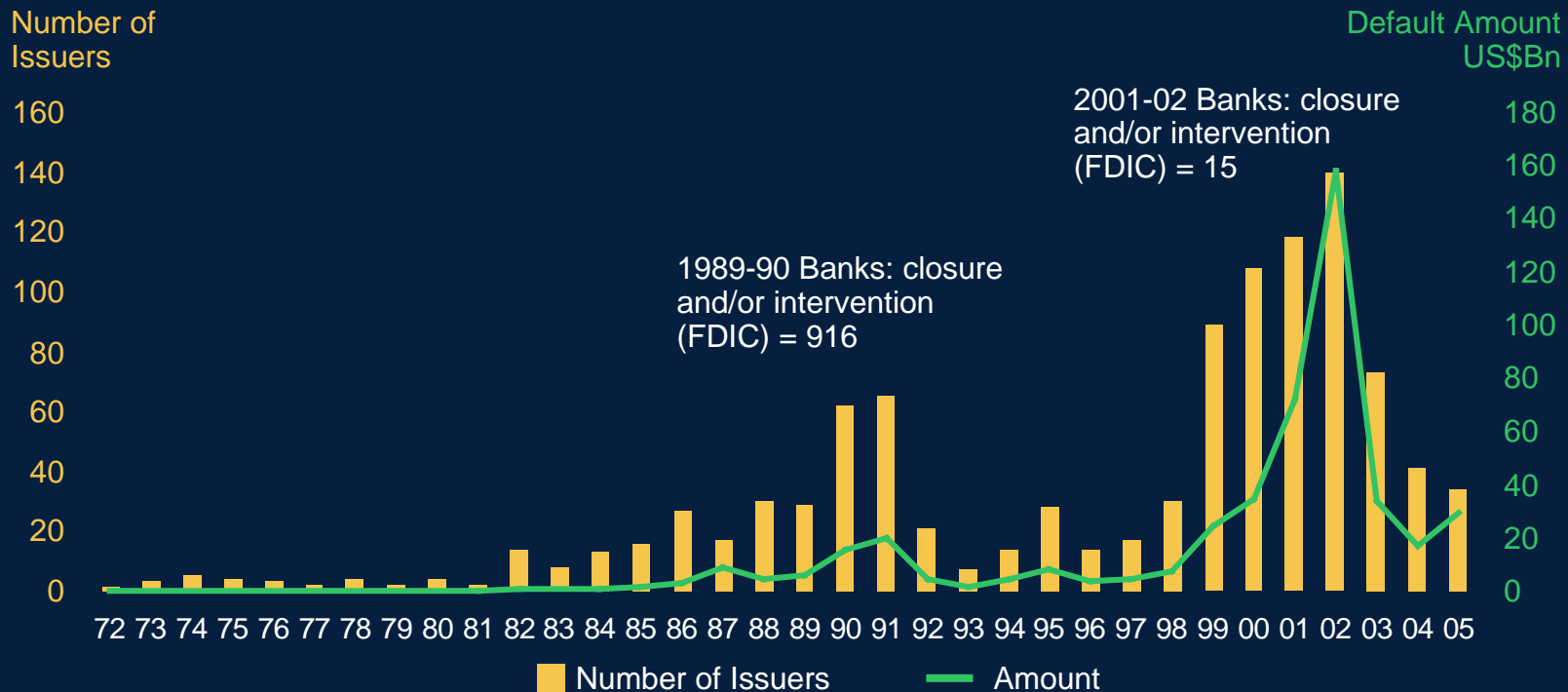
• Bond Market totals exclude ABS, MBS, US Tax Munis and Convertibles

- Credit Derivatives – Average annual global growth rate of 110 % over the last 5 years
- Amounts globally to US\$17.1 trillion in notional outstanding
- As a comparison, in 2005 the bond market size was US \$14.8 trillion

OTC Market - Reducing Systemic Risk

Credit Hedging Prevented Serious Problems in 2001-02

Rated Corporate Bonds Defaulting



Source: Standard & Poor's Global Fixed Income Research

“...The use of a growing array of derivatives and the related application of more-sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions, which was so evident during the credit cycle of 2001–02.”

— A. Greenspan
May 5, 2005

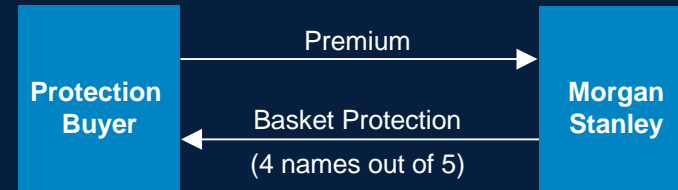
OTC Market - Customized Efficient Solutions

- Customization
- Lower cost

Reference Portfolio Designation

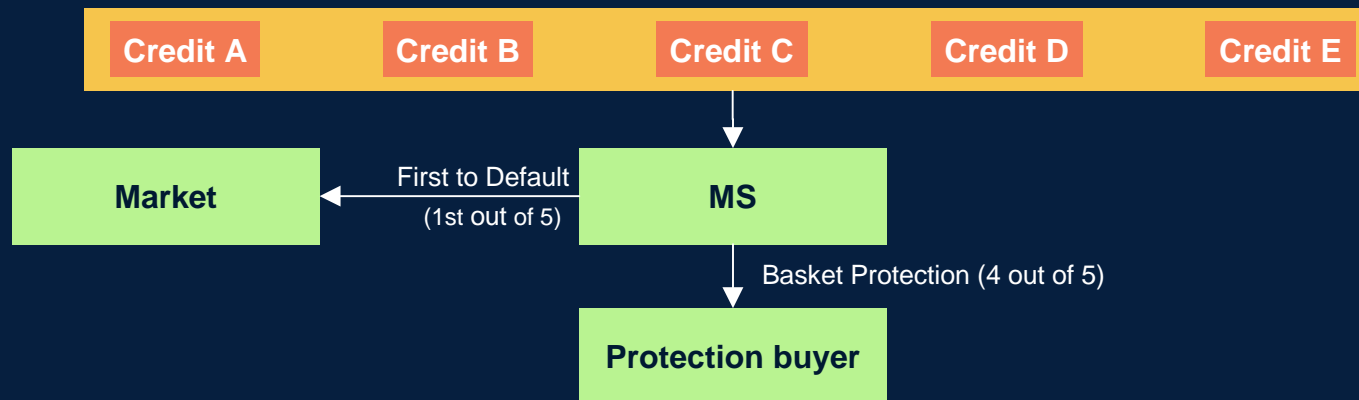


At the Time of the Contract



Distribution of Risk at the Time of Contract:

[x] bps per annum on Notional for 5 years



Hedge Concentration Risk

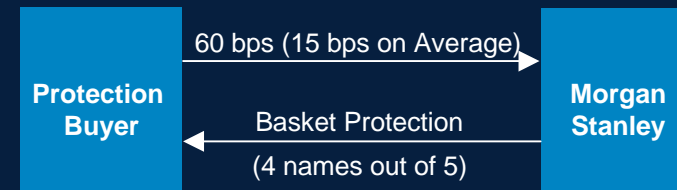
- Cost drops from 44 bps on average to 15 bps on average

Reference Portfolio Designation

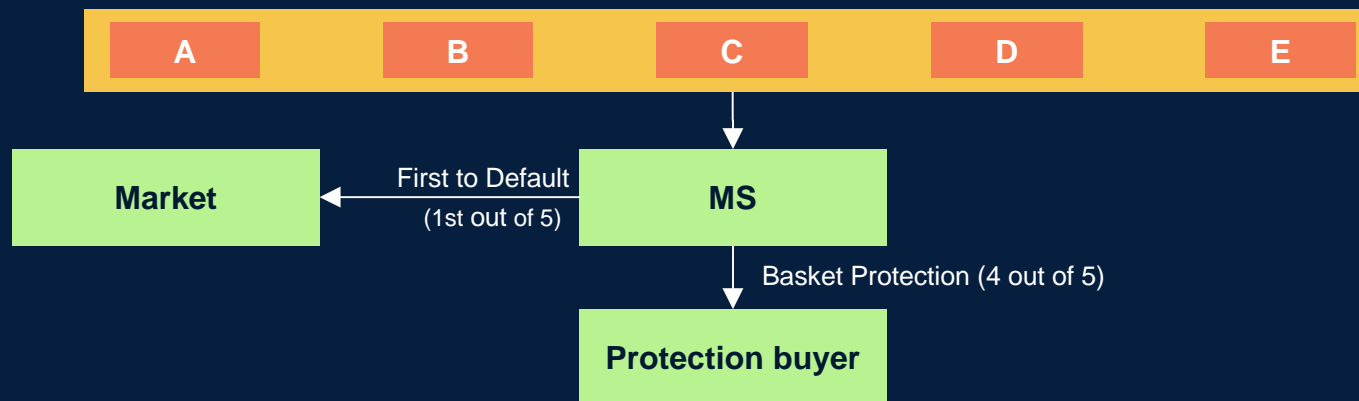
Industrial A	→ 24 bps
Industrial B	→ 12 bps
Industrial C	→ 52 bps
Industrial D	→ 67 bps
Industrial E	→ 67 bps

Total/Average Cost 222/44 bps

At the Time of the Contract



Company Is Protected in 2nd – 5th TD



Summary

- International OTC market has grown at a speed dictated by market needs
- Risk management is evolving into an integrated process – risks are unbundled and hedged
- Credit risk is becoming hedgeable and looked at as another market risk
- Customization is leading to more efficient hedging
- Systemic market risk is decreasing as a result

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