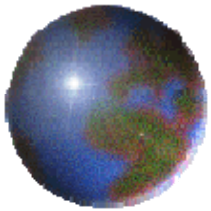


OTC Derivatives and Central Clearing

John Hull

Moody's/NYU Conference, May 2010

Central Clearing

- Two parties A and B negotiate a transaction
- It is presented to a CPP
- The CCP accepts it and becomes the counterparty to each side
- Initial and variation margins are posted by each side with the CCP

The Current Proposals

- "Standardized" transactions to be cleared (possibly some exceptions)
- Non-cleared transactions will require much higher capital than cleared transactions

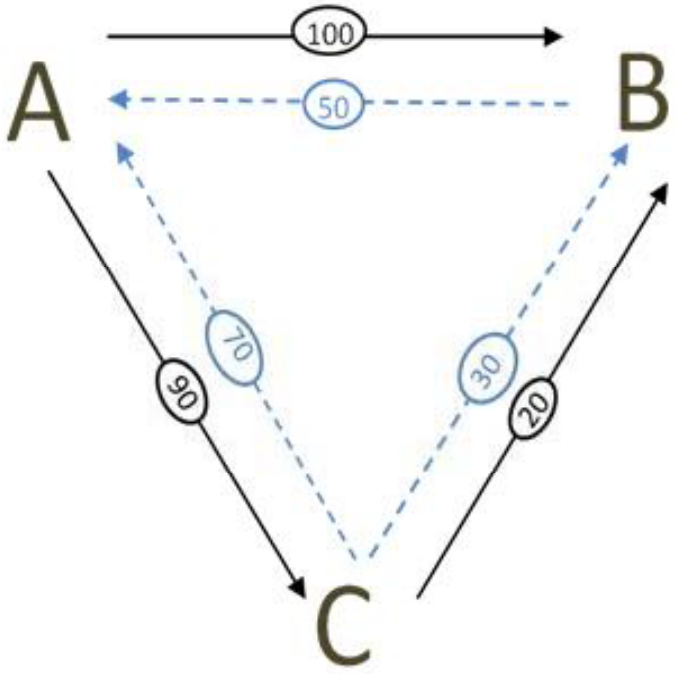
Objectives of Proposals

- Prevent future crises
- Reduce credit risk for financial institutions and thereby reduce systemic risk
- Increase transparency so that regulators can more easily monitor what is going on

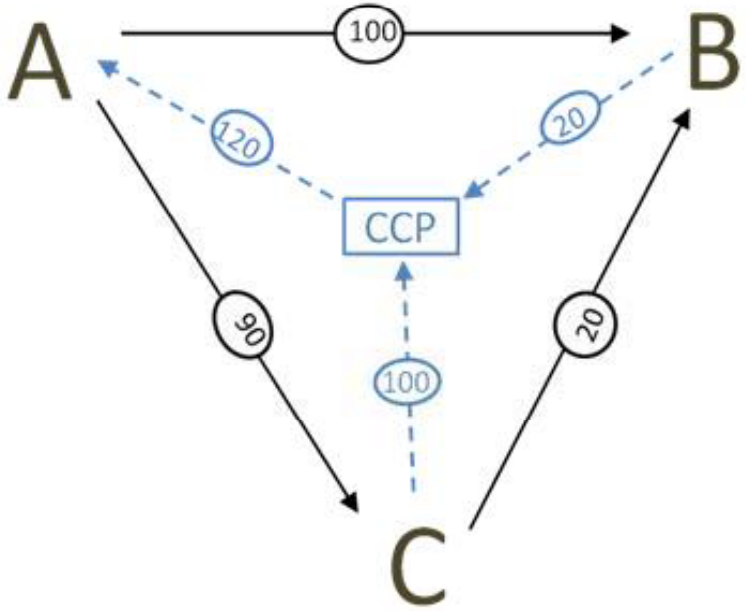
Dealer Exposures Before and After Netting *(Source: BIS June 2009)*

Asset Class	Exposure ($ billions)
Foreign Exchange	2,470
Interest Rate	15,478
Equity-linked	879
Commodity	689
Credit Default Swaps	2,987
Unallocated	2,868
Total	25,372
Total after netting	3,744

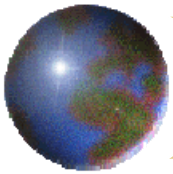
Using CCP for Only Some OTC Derivatives Can Increase Average Exposures



Ave Exp = 40

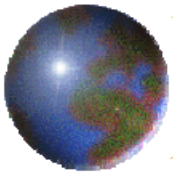


Ave Exp incl. CCP =110
Ave Exp excl. CCP =70



Why We Should Aim to Clear All OTC Derivatives

- Reduction in counterparty risk maximized
- Regulators have a better handle on the risks being taken and can more easily carry out stress tests
- Often non-standard OTC derivatives are the ones that prove to be systemically important
- The next crisis could involve large speculative positions being taken in a derivative that has not yet been invented...



Categories of Derivatives

- Plain vanilla derivatives with standard maturity dates
- Plain vanilla derivatives with non-standard maturities dates
- Non-standard derivatives for which there are well established pricing models
- Highly structured deals