BBA Credit Derivatives Report 2006

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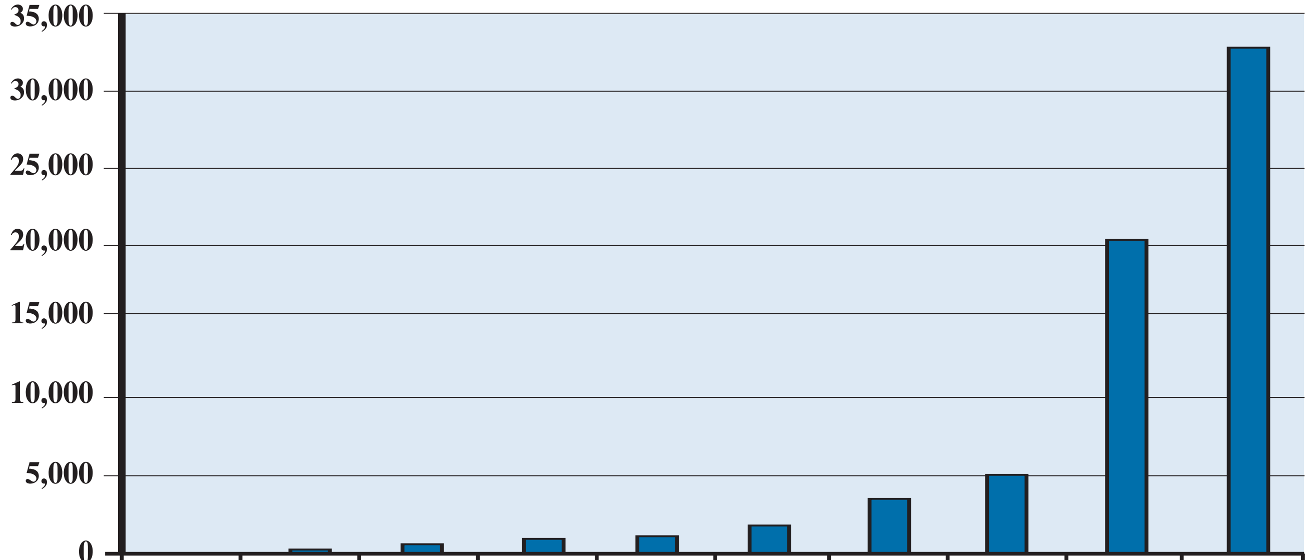
1 Executive Summary

1. Global market growth

Credit derivatives represent one of the most significant markets in banking today. On a commercial level growth continues to outstrip expectations, and on a regulatory level the size and relative youth of the market present many challenges to the industry. This survey is the latest in a series dating back to 1998. It provides a bank of data and consistent methodology that is unparalleled in the London market. The main evolution in this year's survey is to obtain qualitative comment from participants to give colour to the numbers rather than simply listing a series of statistics. The aim is to present some of the insight and experience of those actively trading in the market every day, to a wider audience.



	1996	1998	1999	2000	2001	2002	2003	2004	2006	2008 (est.)
USD (bn)	180	350	586	893	1,189	1,952	3,548	5,021	20,207	33,120

Global Credit Derivatives Market $bn

The growth of the global credit derivatives market has outperformed the expectations from the 2004 BBA survey which predicted a market size $8.2 trillion by 2006. This year's survey estimates that by the end of 2006 the size of the market will be **$20 trillion**. Banks this year now consider that at the end of 2008 the global credit derivatives market will have expanded to **$33 trillion**. This growth is expected to continue. It is not just the size of the market that has continued to grow but also the diversity of products. The expansion of index trades, tranched index trades and equity-linked products – to highlight but a few – have created an unprecedented variety of traded products in the credit derivatives market.

2. London market growth

This year, estimates of London's market share have continued to be stable, although they have dipped slightly to just under **40%** from the 2004 survey. Overall volume in London continues to rise in line with the growth in the global market expansion. The rest of Europe (outside London) has begun to expand into global derivatives volume, with estimated market share breaching **10%** for the first time.

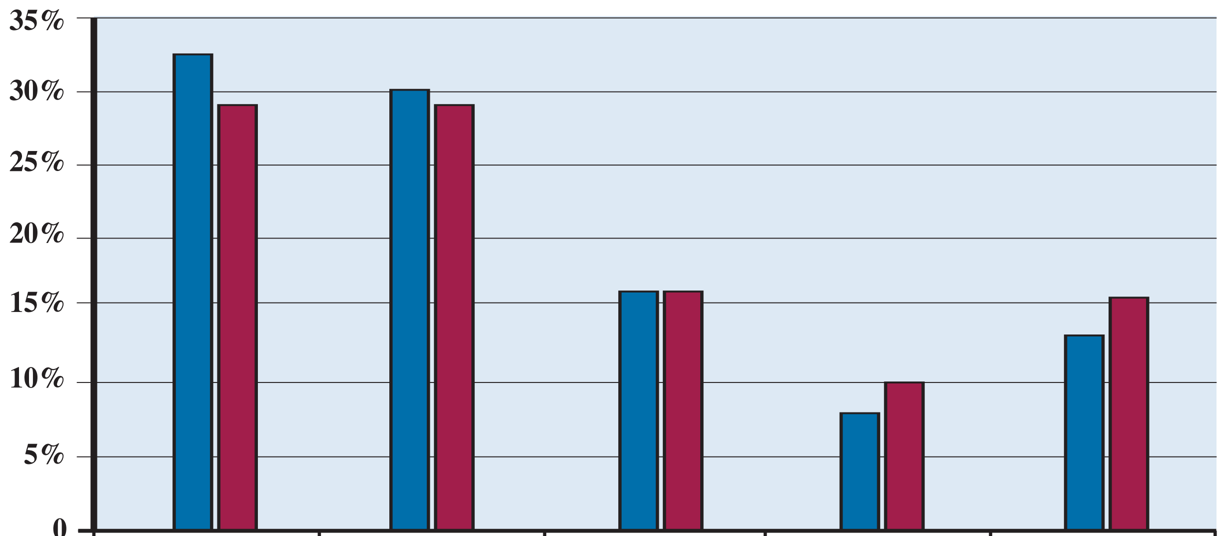
3. Market participants

As predicted in the previous survey, hedge funds have become a major force in the credit derivatives market, their share of volume in both buying and selling credit protection having almost **doubled** since 2004. Banks still constitute the majority of market participation. Following consultation with the BBA Credit Derivatives Panel, the Securities House split has been removed in favour of credit derivative activity due to 'Banks – Trading Activities' and 'Banks – Loan Portfolio' to provide an emphasis on why activity was taking place rather than a distinction between the types of banks involved. This has highlighted that almost **two thirds** of banks' derivatives volume is due to trading and a **third** is related to their loan book.

4. Product range

In line with the view of the BBA Credit Derivatives Panel, the range of products included in the survey questionnaire has been heavily revised to reflect current market trends. Single name credit default swaps still represent a substantial section of the market, however the share has fallen to **33%**. Index trades have become the **second largest** product representing **30%** as at Q1 2006. The last two years have seen a tremendous increase in the speed of development of credit derivatives products, with continuing diversification expected. Synthetic CDOs (collateralised debt obligation) have continued to maintain position at **16%** of the market.

Type	2000	2002	2004	2006
Basket products	6.0%	6.0%	4.0%	1.8%
Credit linked notes	10.0%	8.0%	6.0%	3.1%
Credit spread options	5.0%	5.0%	2.0%	1.3%
Equity linked credit products	n/a	n/a	1.0%	0.4%
Full index trades	n/a	n/a	9.0%	30.1%
Single-name credit default swaps	38.0%	45.0%	51.0%	32.9%
Swaptions	n/a	n/a	1.0%	0.8%
Synthetic CDOs – full capital	n/a	n/a	6.0%	3.7%
Synthetic CDOs – partial capital	n/a	n/a	10.0%	12.6%
Tranched index trades	n/a	n/a	2.0%	7.6%
Others	41.0%	36.0%	8.0%	5.7%

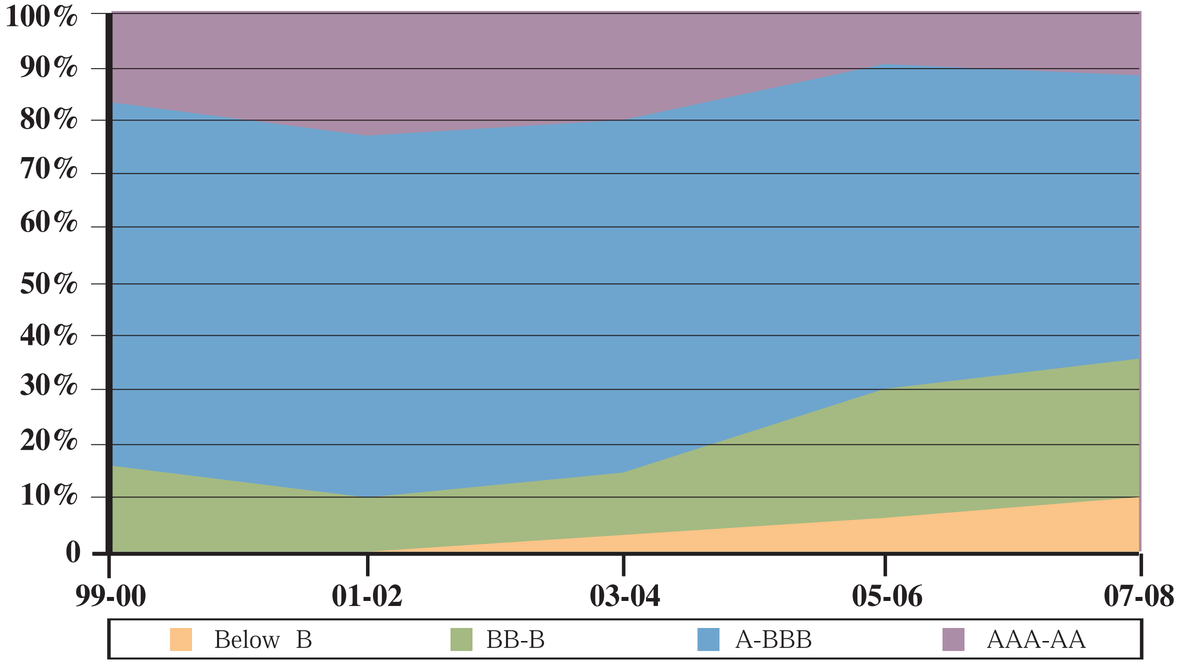


	Single-name credit default swaps	Full index trades	Synthetic CDOs	Tranched index trades	Others
End 06	33%	30%	16%	8%	13%
End 08	29%	29%	16%	10%	16%

Credit Derivatives Products

5. Rating of underlying assets

In this year's survey a much more granular view has been taken of the ratings of the underlying assets than previously. Underlying ratings of assets in CDS and Indices are now split out. Overall there has been a downward migration of average rating of underlying assets. For CDS the AAA – BBB category has fallen from **65%** in 2004 to **59%** in 2006 and this is estimated to continue to fall to **52%** by end of 2008. Conversely the BB - B category has expanded from **13%** to **23%** and is expected to continue to grow to **27%** by end 2008.



Rating of Underlying CDS

6. Credit events

Every respondent has experienced credit events that triggered payment over the period. The highest number of credit events occurred in the high yield sector. There was an even spread of events across the categories specified: Investment grade Europe, Investment grade US, Emerging markets, high yield, Asia/Australia and other. Delphi, Dana Corp, and Delta were the credits most frequently referred to as triggering payment.

7. Payouts

In contrast to the 2004 survey physical settlement has dropped from 86% down to **73%**. The main shift has been toward cash settlement which has more than doubled to **23%** from 11% last year. Fixed amount settlement remained the same at **3%**. Quarterly settlement has continued to have an impact on firms.

Selected Participant Comment:

1. *In the long term, the move to quarterly settlement will improve credit derivatives markets by increasing standardization of product, which in turn drives liquidity. In the short term, quarterly settlement has made the business more operationally intensive which has increased costs. Therefore, the short term benefit is less clear given the increased operational intensity.*

8. Indices

Index trades in the wide variety of forms currently being traded have had a tremendous impact on the credit derivatives market, now being second only to Credit Default Swaps in terms of volume and value of transactions. However, as outlined in the previous survey, contributors would like to see further standardisation of index documentation and a move to a single suite index which would reduce the number of indices that market makers needed to track.

Selected Participant Comment:

2. The lack of homogeneity of European and US documents remains an outstanding issue for indices.

9. Survey participants

Since its inception in 1996, market practitioners have had vital input into the BBA Credit Derivatives Report, ensuring that it addresses current key issues whilst maintaining continuity of methodology and comparability of results. The majority of the institutions that submitted detailed questionnaires have committed considerable time and resource in compiling their contributions. The survey concentrated on key players from a large range of home countries, although a few smaller companies were also invited to participate.

It was decided by the BBA Survey Panel to remove the categories of outstanding position and replace it with an absolute value as the market has been growing so rapidly. The average outstanding of this year's respondents to the survey was just under **$1 trillion**.

Credit derivatives were reported for the first time in the first quarter of 1997. Currently, the Call Report does not differentiate credit derivatives by product and thus they have been added as a separate category. As of 1997, credit derivatives have been included in the sum of total derivatives in this chart. Note: numbers may not add due to rounding. 1Credit derivatives, as reported here, comprise credit default swaps, credit-linked notes, and portfolio swaps. 2Data for 2005 are only available through the third quarter. kets, and also what factors have influenced their growth, how they have increasingly facili-tated risk transfer, and their implications for financial stability.Â The BBA (2004) survey estimated hedge fund exposure at $2 trillion. 55. Chapter II the influence of credit derivative and structured credit markets on financial stability. Source: BBA Credit Derivatives Report 2003/2004. Based on 2004 estimates. Chart 6: Credit Derivative Reference Entity By Rating.Â Outstanding volumes of credit derivatives comfortably exceed those of corporate bonds, which we attribute both to the growing popularity of credit derivatives and significant slowdown in corporate bond issuance.