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Credit Derivatives: Transforming the market

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The importance of credit derivatives?

“...what is striking is how few companies have traded in derivatives...Less than half of America’s top 1000 companies have ever used derivatives, and only the biggest 5% of the country’s banks. The use of credit derivatives is restricted to a mere 0.2% of American banks.”

“Off target”, *The Economist*, 15 March 2003

Transforming the debt capital markets

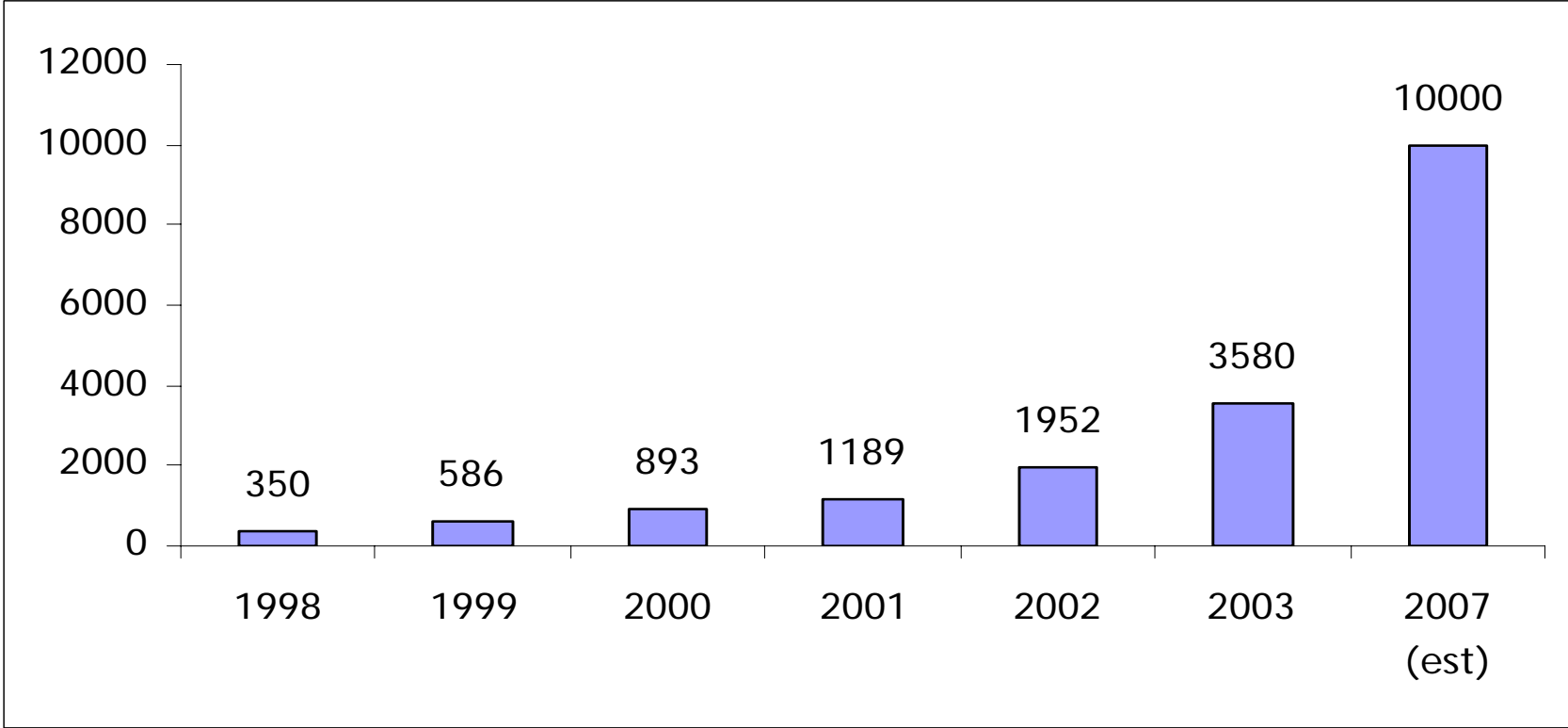
Coming of age...

Credit derivatives are set to transform credit markets in the same way derivatives did with interest-rate markets in the early 1980s

This reflects the great flexibility of the instruments themselves and the increasing transparency of the credit derivatives market

The key is familiarity...ordinary-ness...accessibility...and the widest possible application

Credit derivatives volumes, \$bln notional plus estimate



Source: BBA, ISDA

Transforming the debt capital markets

Proof of the pudding...

Coming thru market correction from 2001 onwards

Default test of market, eg., Parmalat

Developments in standardised legal documentation

Easily available third-party pricing

Credit indices

More market makers

More understanding

Talking points

Indices

The new iTraxx and EDX indices

Exchange-listed possibilities

Investment options on a standard benchmark:

- Curve trades on the index

- Sectoral trades on the index

- Single name versus the index

Tranched iTraxx

Talking points...

Structured credit products

Maturing market in products such as synthetic CDOs

Single-tranche CDOs

CDO-squared (CDO²)

Synthetic conduits: new possibilities for raising funding

Synthetic and hybrid MTN vehicles

Talking points...

Structured finance CDS

Allowing access where supply is limited in cash products

ABS

CMBS

Home Equity, etc

Matching pay dates, maturity dates

A negative basis due to supply and demand factors

Where next?

New market participants

Smaller banks, regional banks, retail banks

More corporates

More insurance companies

Product development

Standardised index, exchange-traded

Portfolio / correlation structured products

New reference assets

Medium-sized corporates and their bank loans

Receivable assets and cashflows (mortgages, etc)

Where next?...

More applications

Expanding the risk-management applications

Tailor-made CDS for specific risk exposure

Regulatory capital and Basel II

More investor applications

Electronic trading platforms

The importance of promoting credit derivatives...

Knowledge isn't a zero-sum game, for a firm or industry. If Miller and Modigliani, Markowitz, Sharpe, Lintner and Treynor, Black, Scholes and Merton, or Ross had suppressed their discoveries, the world would be a poorer place, in both senses of the world.....Whenever possible, I believe we owe it to ourselves and the world to spread ideas.

--- Professor Emanuel Derman, "For our eyes only?", *RISK*, August 2004

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