

Markit Recap – 7/21/2014

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European banks are no strangers to unpleasant shocks. The latest came from Portugal, where Banco Espirito Santo (BES) came under pressure following news that the Espirito Santo holding company – BES’s largest shareholder – had run into financial difficulties.

BES’s senior CDS spreads widened from 161bps on June 9 to 480bps on July 15, a dramatic move, particularly in a climate of low volatility. However, the deterioration in subordinated credit was even more notable – sub CDS widened from 198bps to 924bps over the same period.

This makes sense. If BES receives funds for recapitalisation from committed EU credit lines – the Portuguese government still has access, despite leaving its EU bailout in May – then subordinated bondholder may well be “bailed-in”. Taxpayers are no longer willing to take on the burden of rescuing banks, hence subordinated CDS can be expected to underperform.

But the effect on the broader market was relatively modest. Sticking with the same timeframe, the Markit iTraxx Senior Financials index widened from 58bps to 71bps, while the Markit iTraxx Subordinated Financials went from 86bps to 107bps. The ratio between the two indices moved from 1.48 to 1.53, a negligible move when placed in the context of recent history (see chart).

The stability in the ratio can perhaps be explained by current CDS contract definitions. If subordinated bank debt is restructured, this not only triggers subordinated CDS but also senior CDS. It is therefore unsurprising that the two tiers should be closely correlated (though this didn’t stop sharp divergences during the Great Financial Crisis).

This relationship will change in September. The introduction of new CDS definitions by ISDA will alter how financial CDS trade. Under the new terms, if subordinated CDS is triggered through a restructuring or governmental intervention (a new credit event), then senior CDS will not be triggered. This should increase the basis between senior and subordinated CDS, particularly for names that are in trouble and the risk of bailing-in is higher.

However, this doesn't explain why the BES flare-up didn't have a serious impact beyond Portugal. It is likely that the market views BES as an isolated case that poses little systemic risk. But the more pertinent factor may be that credit investors have a more sanguine view on bank debt in general. New capital requirements have strengthened bank balance sheets, which is a positive credit development. Equity investors are in a far weaker position, and it is share prices that have borne the brunt of the sell-off. The results of the Asset Quality Review and stress tests conducted by the ECB in preparation for its new role as single supervisor may accentuate this trend.

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