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# Markit Recap – 8/4/2014

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The legal machinations of the CDS market are probably not the main concern of Portugal's national government and its biggest bank. But the travails of Banco Espirito Santo (BES) are certainly capturing the attention of credit investors, not least because of its potential significance in a changing regulatory environment.

BES has been under pressure since its parent disclosed accounting irregularities last month, and its situation worsened this week with the release of its first-half results. The bank said it made a net loss of €3.5bn, far larger than expected. Impairment costs of €4.25bn relating to its exposure to other companies in the Espirito Santo group did the damage, and cut its common equity tier one capital ratio to 5%, below the regulatory minimum of 7%.

Credit investors, understandably, reacted negatively to BES's increasingly precarious position. The bank's senior CDS spreads were trading at 730bps on August 1, some 357bps wider than where they started the week. BES's subordinated spreads were at 1,200bps, nearly double the previous week's level.

But the following Monday, BES's senior CDS had bounced back to 398bps, while subordinated levels had recovered to 560bps. The volatility was driven by Portugal's response to BES's crisis, and a quirk in current CDS definitions. BES was split into a "good" and a "bad" bank: Novo Banco will hold the higher quality assets, and deposits and senior debt will move to the liability side of the balance sheet. The existing Banco Espirito Santo entity will hold the "toxic" assets, with subordinated bondholders and shareholders bearing the brunt of the effective bail-in.

One would have expected senior spreads to tighten sharply and sub spreads to widen dramatically on this news, and that is what happened in the cash market. But both senior and sub CDS rallied by several hundred bps after the announcement. This was due to an expectation that Novo Banco will be the successor entity for both senior and sub CDS. The current CDS definitions mean that if more than 75% of the total debt of the entity is transferred to another entity, then the latter entity is the successor, regardless of what tier. This means that, even though all of the sub debt remains at Banco Espirito Santo, the sub CDS will move to Novo Banco.

This is a similar situation to Bankia three years ago, and is exactly what the ISDA 2014 definitions – due to be implemented on September 22 – aim to fix. Under 2014 definitions, a Financial Reference Entity CDS will follow the debt in the event of a succession. So in this case, the senior CDS would have moved to Novo Banco and the sub would remain at Banco Espirito Santo (where there are subordinated deliverables). This prevents orphaning of CDS and inconsistent payouts in the event of a default (which is what happened when Bankia triggered in 2013).

The BES case highlights how contractual differences can have significant economic impact on how CDS trade. If BES had been split on or after September 22, the subordinated CDS would have widened sharply, rather than tightened 600bps.

BES's problems contributed to broader volatility in recent days, as did the default in Argentina. ISDA decided that the failure to pay was indeed a credit event, and an auction will be held in due course.

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