

Markit Recap – 8/11/2014

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We remarked last week that Banco Espirito Santo's travails may test current CDS definitions, and so they did.

But not in the way that we – or most market participants – expected. The Portuguese lender was split into a “good” bank – a new entity called Novo Banca – and the existing Banco Espirito Santo. The higher quality assets will reside at Novo Banca, with deposits and senior debts on the liability side of the balance sheet. Banco Espirito Santo will be left with the “toxic” assets, as well as the equity and subordinated bonds. BES will be wound down over a period of years.



This is effectively a bail-in of subordinated bondholders, but not in the explicit manner that was predicted by the markets and caused sub CDS spreads to widen well beyond 1,000bps on August 1. Government involvement and a consequent restructuring credit event seemed the most likely scenario, and the case of SNS Bank in 2013 showed that state intervention can pose significant problems for CDS triggering mechanisms.

However, the BES restructuring has shown that government action can expose flaws in CDS succession events, as well as credit events. ISDA ruled on August 8 that a succession event had taken place on BES, meaning that all the CDS will be transferred to Novo Banca. In the case of a financial entity, this entails both senior and subordinated CDS. This means that the latter will be “orphaned” – there will be no deliverables on Novo Banca sub CDS as all the sub bonds will remain obligations of banco Espirito Santo.

The market reaction? BES subordinated CDS tightened from 1161bps on the Friday preceding the weekend announcement to 500bps when the succession event was confirmed. Senior CDS rallied from 674bps to 350bps over the same period, a reflection of Novo Banca's stronger balance sheet and the reduced probability of a credit event (remember that a restructuring credit event on subordinated debt also triggers senior CDS under current

ISDA definitions).

How would this have played out if the ISDA 2014 definitions had already been implemented? Succession rules for financials would have been different, with amendments to take into account the possibility of a good bank-bad bank split. The example of Spanish institution Bankia had already showed that the current definitions failed to take this type of restructuring into account. Under 2014 rules, subordinated CDS will track the subordinated debt, so the orphaning of BES sub CDS holders probably wouldn't have happened. This is a common sense approach and seems obvious, but bank splits weren't everyday occurrences back in 2003, when the current ISDA definitions were drafted.

We have seen several bank restructurings forced by governments in recent years, and it will be no surprise to see more bail-ins in a climate when the official sector and taxpayers have been scarred by the costs of rescuing financial institutions. From the beginning of 2016, an EU directive forcing bail-in of bondholders – both subordinated and senior – will come into effect, and governments will have far less discretion in sharing the burden of bank rescues.

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