Markit Recap – 3/12/2018

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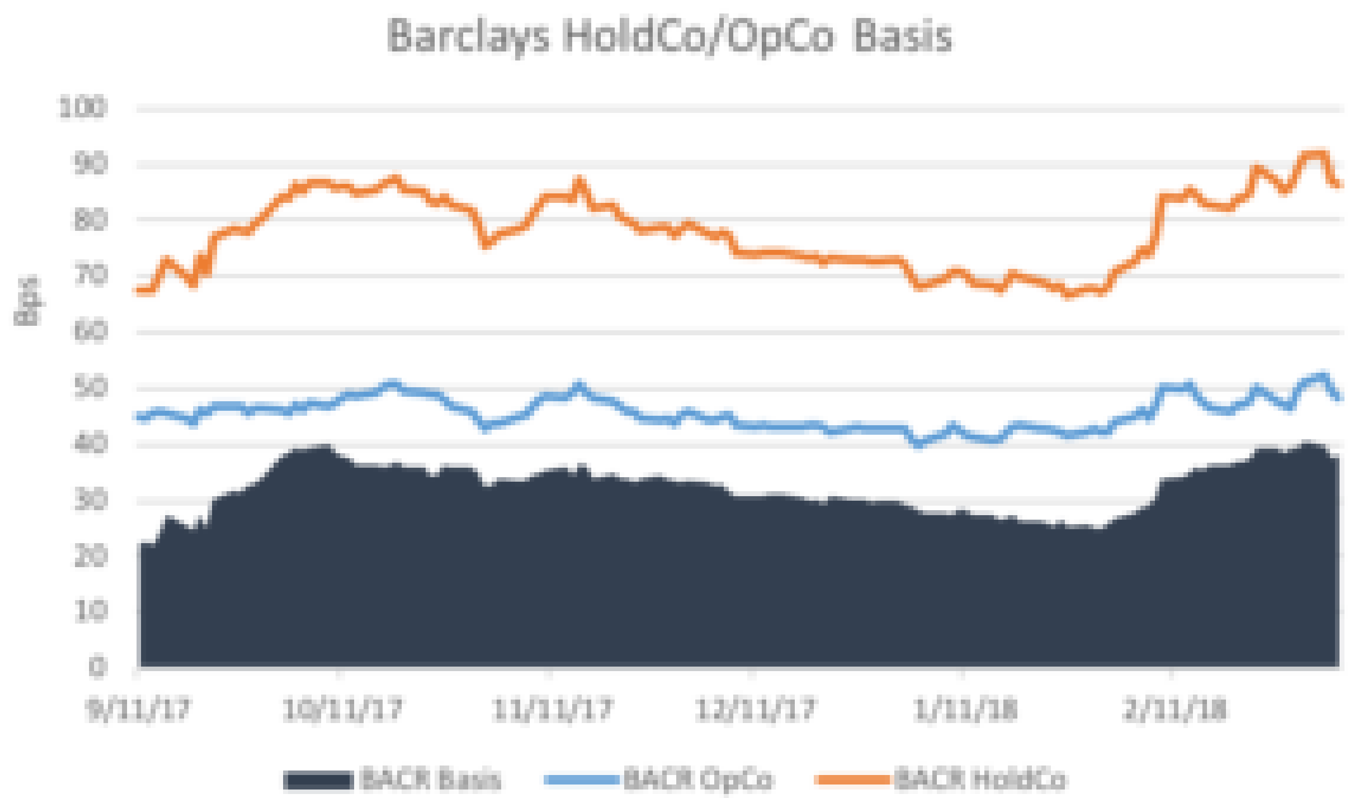

The year 2018 marks the 10th anniversary of the collapse of Bear Stearns and Lehman Brothers and still the task of tackling "Too Big To Fail" is far from complete. On the contrary, regulation aimed at preventing taxpayer-funded bailouts is yet to be fully implemented – a fact that may come as a surprise to many.

But that is about to change. Rules that force global systemically important banks (G-SIBs) to address inadequate loss absorbency will come into effect from January 2019 – the Total Loss Absorbing Capacity (TLAC) standard. Similar regulation encompassing smaller banks in Europe – the Minimum Requirement for own funds and Eligible Liabilities (MREL) – will soon follow. Bond markets have already felt the impact of these changes in the form of new issuance targeted at complying with the regulations. Inevitably, the CDS world will have to adapt to the shifting landscape in cash.

Senior non-preferred debt – a new tier created to comply with the TLAC subordination requirement – has generally been oversubscribed, suggesting strong appetite from investors looking to gain exposure to this new part of the bank capital structure.

But this presents a challenge for the CDS market. If the instrument is to stay relevant the legal and operational infrastructure has to evolve and accommodate the changes in the cash market.

Unlike in 2014, a new set of definitions wasn't required. A new transaction type (Standard European Senior Non Preferred Financial Corporate) has been created. ISDA has also published additional provisions for senior non-preferred reference obligations, along with an update Physical Settlement Matrix and related confirmation template incorporating the additional provisions. This will allow market participants to trade CDS referencing SNP debt. Note that these changes are not applicable to the other types of subordination. CDS referencing senior unsecured debt issued by Bank HoldCos (structural subordination) and senior bonds by German banks (statutory subordination) will continue to trade using the Standard European Financial Corporate transaction type.

In terms of price guidance, what can we expect from the new tier? There is currently little in the way of liquidity provision due to the tier being uncleared. The IHS Markit indices – both the main and Senior Financials – are also referencing the senior tier, which can inhibit liquidity. The three major French banks that are in the IHSM indices will now be referencing the senior non-preferred part of the capital stack

As for price guidance, we can get pointers from the existing CDS market, as well as the bond market. UK HoldCos were included in the IHSM indices from September last year, sparking an elevation in liquidity. The Chart shows the relative spread movements in the Barclays HoldCo (Barclays Plc) compared to the OpCo (Barclays Bank Plc). Barclays HoldCo widened from 70bps to over 90bps during the recent rocky start to the year, while the OpCo credit deterioration was a more modest 10bps. This resulted in the basis increasing – a similar pattern to that observed in the SNP bond market. We can expect CDS trading on the new tier to perform in a comparable fashion.

Contact: Gavan Nolan
Gavan.Nolan@ihsmarkit.com