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The ISDA basis reviewed

The introduction of ISDA 2014 CDS definitions has resulted in considerable contract basis for banks and sovereigns

- Subordinated basis is higher for peripheral banks
- Negligible basis on senior spreads
- Peripheral sovereigns have the largest basis

New CDS definitions for non-protocol names (predominantly banks and sovereigns) came into effect on September 22. This means that both 2003 and 2014 definitions can trade for non-protocol names, which gives the market an opportunity to assess the contractual basis. There is an economic difference between trades on the two different sets of definitions, hence the exclusion of banks and sovereigns from the protocol.

Banks

The 2014 definitions include a new credit event – Governmental Intervention – that covers a broader range of changes that can impinge on the credit standing of an obligation. This makes CDS under the new definitions more valuable to the protection buyer, and more likely to trigger if a government intervenes by expropriating subordinated debt, for example (as the Dutch government did with SNS Bank in 2013).

So it was expected that subordinated bank CDS would trade significantly wider under 2014 definitions compared to 2003 rules. But there was little consensus prior to September 22 on how big the basis would be, and there was a wide range of estimates. The data contributed to Markit this week gives a real picture on ISDA 2014 basis.

Name	5Y 2003	5Y 2014	Basis	% Basis
UBS	59	192	133	225%
Credit Suisse	70	201	131	187%
BBVA	89	174	85	95%
Santander	89	173	84	95%
Commerzbank	132	255	124	94%
RBS	102	198	95	93%
Intesa Sanpaolo	94	177	83	88%
UniCredit	124	225	101	81%
Deutsche Bk	88	156	68	77%
Std Chartered	99	172	73	74%
Barclays Bk	88	151	63	72%
Societe Generale	92	154	62	67%
Cr Agricole	82	133	51	62%
BNP Paribas	78	121	43	55%
LLOYDS BK	91	141	50	55%
HSBC Bk	69	106	37	53%

Fig. 1 ISDA 2014 basis on subordinated banks

Figure 1 shows that the market is not applying a standard basis to Europe's banks. The basis is around 200% for UBS and Credit Suisse and as low as 53% for HSBC. Swiss banks trade with the coco supplement as standard, which causes the basis to be far higher. Excluding the Swiss banks, the biggest basis is on Italian and Spanish institutions. The likes of BBVA, Santander, Unicredit and Intesa Sanpaolo all trade about 90% wider on 2014 definitions.

This may show that the markets view banks based in the periphery as more vulnerable to a government intervention, and therefore likely to trigger CDS. The results of the ECB stress tests are due to be released next month. Some banks may fail and require more capital, which will increase the probability of a bail-in and a CDS trigger.

Another consequence of the introduction of ISDA 2014 is a narrowing in CDS-bond basis. Traditionally, the basis was negative, meaning that CDS traded tight to bond asset swap spreads. As sub CDS trades wider under 2014 definitions, this should shrink the CDS-bond basis.

So far, there has been little impact on the pricing of senior bank CDS. The basis is very small, which in some way is surprising. Senior and subordinated CDS are split under the new definitions, so a restructuring or governmental intervention in subordinated CDS will not trigger the senior contracts. One might expect senior CDS to trade tighter as a result, but this has not yet happened. Perhaps this will change when the market settles down in the coming weeks.

Sovereigns

The introduction of the 2014 rules has also affected sovereign CDS, though not to the same extent as subordinated banks. The basis ranges from 2% in Finland to 15% in Italy. Again, it is clear that peripheral names are trading with a larger basis, with Ireland as an honourable exception.

Name	5Y 2003	5Y 2014	Basis	% Basis
Italy	92	106	14	16%
Spain	66	73	7	11%
Portugal	157	172	15	10%
Austria	24	25	2	8%
Netherlands	22	23	2	7%
UK	19	20	1	7%
Sweden	13	14	1	6%
France	41	43	3	6%
Germany	41	43	3	6%
Denmark	23	24	1	4%
Belgium	42	44	2	4%
Norway	12	12	0	3%
Ireland	52	53	1	2%
Finland	26	26	0	2%

Fig. 2 ISDA 2014 basis on Western European sovereigns

The new definitions have introduced the Asset Package Delivery measure, which was a solution to the problems encountered during the Greek credit event auction in 2012. A range of assets will now be deliverable, as long as they were designated as Package Observable Bonds prior to a restructuring.

This should give protection buyers more confidence that the final auction price will be accurate, and therefore increase the value of the 2014 contract compared to 2003.

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