CDS and Senior Loss Absorbing Capacity – A New Tier

Gavan Nolan, Director, Business Development and Research, Fixed Income Pricing

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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.

This paper will examine how banks are seeking to comply with TLAC and MREL, the new subordination of liabilities that will result from regulatory compliance, the performance of this new asset class and finally, how the CDS market will adjust in order to accommodate the changes in its bond counterpart.

Enter TLAC

If there was one aspect of the financial crisis that angered the general public more than most it was the use of taxpayer funds to bailout banks. Institutions that were deemed "Too Big to Fail" were rescued by governments across the globe amid concerns about systemic risk. The idea of bondholders sharing the burden of bank rescues was discussed and usually dismissed by the relevant authorities; contagion was the primary fear.

The justification of such actions is debatable and still a bone of contention, particularly in countries where the bailouts transferred huge amounts of debt to the public balance sheet. But in the aftermath it was clear that the TBTF problem had to be addressed. Regulations were needed that made it possible to resolve systemically important banks without the use of public funds. No more bailouts, but bail-ins.

Step forward the Financial Stability Board (at the behest of G20 leaders). After a lengthy period of consultation with the Basel Committee on Banking Supervision and industry participants, a new standard on Total Loss Absorbing Capacity was published on 9 November 2015.[1] The TLAC standard applies to all G-SIBs, of which there are 30 at the time of writing.[2] The BCBS followed soon after with a standard that establishes how G-SIBs take account of the TLAC requirement in relation to regulatory capital.[3]

The need for subordination

The principles of loss absorbency to aid an orderly resolution were laid out in the TLAC term sheet and seemed clear. But a bail-in of bank creditors is far from straightforward, not least from a legal standpoint. The "no creditor worse off" (NCWO) principle states that no creditor or shareholder shall incur greater losses than they would have incurred if the institution had been wound up under normal

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[1] http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf
[2] http://www.fsb.org/wp-content/uploads/P211117-1.pdf
[3] https://www.bis.org/bcbs/publ/d387.pdf

insolvency proceedings. In most jurisdictions senior bondholders rank pari passu with other liabilities, for example derivative liabilities, structured notes and deposits – all of which are excluded from TLAC. If senior bondholders were bailed-in but other liabilities ranked pari passu weren't, then that would create a material risk of legal challenge and prevent the orderly resolution of the bank.

Capital instruments – core equity tier one, additional tier one and tier two – are junior to excluded liabilities so in theory could meet the TLAC requirement and facilitate an orderly resolution. But in most cases this would prove insufficient; therefore an additional layer of liabilities subordinate to excluded liabilities is necessary.

The FSB term sheet outlines three different types of subordination that can achieve the aim of meeting the requisite amount of TLAC without violating NCWO:

1. Contractual subordination – liabilities subordinated by a clause in the debt contract
2. Statutory subordination – liabilities are made junior to excluded liabilities by statute (national law)
3. Structural subordination – debt issued by a holding company that is structurally subordinated to the operating company

The FSB doesn't state any preference; all three subordination approaches can minimize the risk of legal challenge in the event of a resolution.

A new tier: Senior Non-Preferred

But in November 2016 the European Commission decided to unify how EU banks should tackle the subordination issue. This was in response to the divergent routes taken by EU countries to the creditor hierarchy. In Germany, they took the statutory option – senior unsecured debt (existing and new) was subordinated to other liabilities that were previously pari passu. In the UK, banks took advantage of their HoldCo/OpCo structures to issue senior debt from the HoldCo (eligible for TLAC due to structural subordination). And in France banks issued a new form of debt called senior non-preferred[4], which fulfilled the contractual subordination specified by the FSB.

The Commission proposed the French method as the EU standard, i.e. contractual subordination through the issuance of senior non-preferred bonds. Article 108 of the EU's Bank Recovery and Resolution Directive (BRRD) was to be amended to reflect the harmonized approach to creditor hierarchy. This duly became law on 27 December 2017 when it was published in the EU official journal.

That begs the question if it is now EU law, then won't all member states follow this route to subordination? Unfortunately, it's not that simple. EU countries have their own national insolvency laws and distinctive bank capital structures, so divergent approaches will still exist. The UK has little reason to change from structural subordination, particularly as it is heading for the EU exit door. Germany's law subordinating senior unsecured bondholders is still in place, though there are

[4] Often colloquially called junior-senior or tier 3, though these terms are less common now

expectations of a grandfathering period for existing senior debt and an eventual transition to the EU harmonised approach.[5]

The majority of EU countries have either followed the example of France or stated that they intend to do so. In Spain, Banco Santander (a G-SIB) has issued senior non-preferred bonds, as has BBVA (not a G-SIB). Unicredit (G-SIB) issued its first SNP bond shortly after the Italian parliament passed long-awaited legislation allowing the issuance at the new tier.[6] Belgium also introduced similar legislation, with Belfius first to market in 2017.

Why have other European countries not rushed to follow their example? SNP issuance is still dominated by French banks, which should be expected given their relatively large TLAC shortfall (BNP alone stated in 2016 that it planned to issue €30bn in TLAC eligible senior debt before 1 January 2019). The short answer is that many G-SIBs have recourse to the structural and statutory subordination routes – they don't need to issue senior non-preferred bonds. Once UK, Swiss and German banks are removed from consideration, that leaves only ING Bank and Nordea as the outliers.

ING has a HoldCo (ING Group) and has issued TLAC eligible debt. Nordea recently changed the terms of its bonds to allow senior non-preferred issuance. Clauses in Tier 2 capital instruments preventing issuance of subordinated debt senior to existing tier 2 bonds have acted as a hurdle to banks issuing SNP, and not just in the Nordics. [7]Nordea's changes clear the path for SNP issuance, though its TLAC requirement is relatively small due to its strong capitalisation.

It's also important to note that while the country of domicile is a guide to which subordination method is adopted by banks, it is not a particularly reliable one. We have already highlighted the Belfius SNP issuance in 2017. But its Belgian peer KBC has a HoldCo/Opco structure and thus will issue MREL senior debt from the HoldCo entity. In the UK, we have seen Nationwide issue the first SNP bond from this jurisdiction.

Nationwide is a building society and doesn't share the HoldCo/OpCo structure of UK banks. Bank of Ireland took the unusual step of creating a holding company to issue eligible debt.

No doubt there will be further twists and turns, though in theory there should be a gradual shift to the EU harmonised approach, particularly in countries that have statutory subordination.

[5] It's also worth noting that The ECB recently changed its collateral eligibility rules, effectively excluding bonds that are statutorily, structurally or contractually subordinated. This may well have pricing and liquidity implications https://www.ecb.europa.eu/ecb/legal/pdf/ecb_2018_3_f_sign.pdf

[6] In addition, Italy's depositor preference law (similar, but not the same as Germany's) is due to come into force 2019

[7] Though Nykredit was something of a trailblazer with the issuance of its Senior Resolution Notes in 2016, since been amended to allow for EU harmonisation

TLAC and MREL – What's the Difference?

Regulatory divergence is a burden that market participants have to bear, and Loss Absorbing Capacity is no different. The TLAC was standardized in November 2015, but in the EU MREL was already part of the Bank Recovery and Resolution Directive. It is no surprise then that there are important differences, despite the two standards endeavoring to achieve the same objectives. The BRRD has been amended to merge the TLAC standard where it is applied to G-SIBs, which removes some, but not all of the divergence. Market participants should be aware of the following points of difference:

- Scope – TLAC applies to G-SIBs – currently there are 30 – but MREL applies to a far broader group of institutions. This includes the European G-SIBs, as well as all the Domestic Systemically Important Banks (approx. 130 -140 banks in total).
- Subordination – Under TLAC subordination is required but the FSB is agnostic on which method (contractual, structural, statutory). MREL doesn't explicitly require subordination, but the resolution authority (the EU's Single Resolution Broad) may require it on a case-by-case basis. The amendments to the BRRD in December 2017, including the provision for senior non-preferred debt, reflect the reality that some D-SIBs will need to issue eligible instruments to comply with the regulation. That explains why some D-SIBs (e.g. BBVA) have issued SNP debt, while others (Intesa Sanpaolo) have declared they have no plans to go down this route. It will be dictated by the capital position of the bank as viewed by the resolution authority
- Calibration – TLAC specifies a common minimum requirement (Pillar 1 type) plus an individual institution specific requirement (Pillar 2 type). MREL as it applies to D-SIBs is calibrated on Pillar 2 capital based on individual bank characteristics: risk profile, complexity etc.

There are other differences, such as the sizing of the Loss Absorption Amount. Overall, though, MREL allows for more flexibility, reflecting its broader applicability and the diversity of institutions covered.

The impact on the bond market

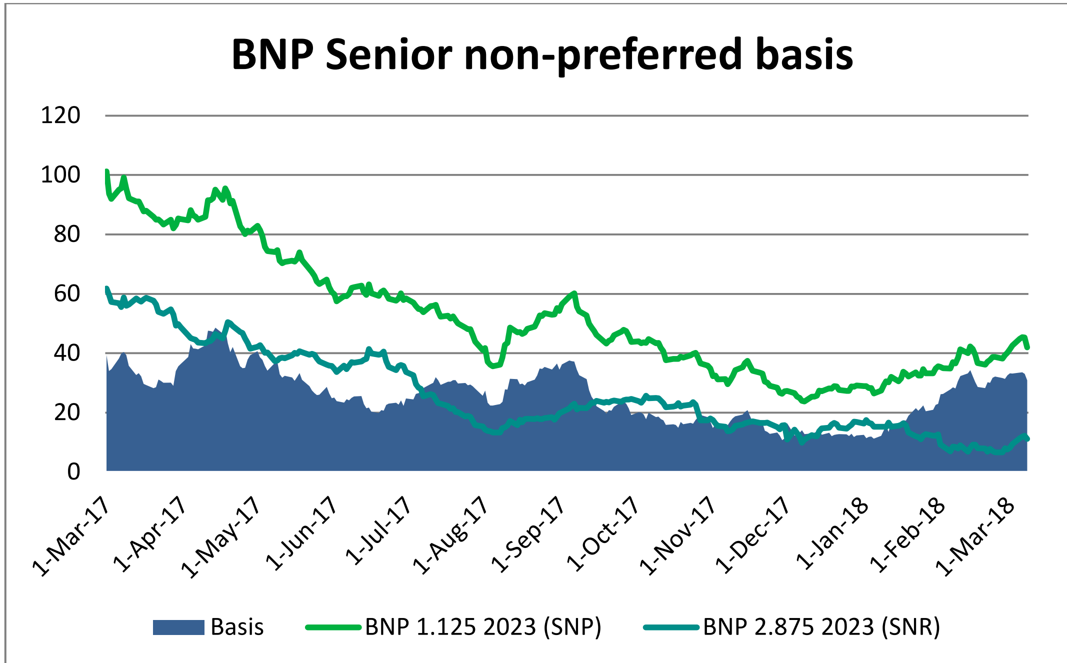
G-SIBs require a minimum TLAC of 16% of the resolution group's risk-weighted assets to comply with the regulation, and this has to be met by 1 January 2019. Hence it is no surprise that there has been considerable TLAC-eligible issuance since the FSB term sheet was published.

The plethora of new paper coming to market gives us ample data to examine how this class of debt has performed.

Figure 1 shows the evolution of credit risk - asset swap spreads - in BNP Paribas senior preferred and non-preferred bonds since the beginning of March 2017. We can see that spreads in both types of bonds have rallied, with most of the improvement occurring in the first-half of 2017. The senior non-preferred bond trades wider than the senior preferred, which is to be expected given their relative positions in the capital structure.

But the basis has not been constant. It has ranged between 49bps and 11bps, in part due to the absolute levels of spreads. However, we see that the SNP widens disproportionately during bouts of risk aversion. Indeed, the recent period of volatility – sparked largely by fears of rising rates – shows a dislocation between the two bonds. The SNP bond spread widened to about 40bps while the senior

preferred debt *tightened* to 7bps, causing a significant increase in the basis. Differences in liquidity can be responsible for such behavior but this is unlikely in this case as both bonds have Markit Liquidity Scores of '1' (the highest available). A more straightforward explanation is that SNP debt is more sensitive to risk given the higher probability of bail-in - senior preferred paper is benefitting from the additional protection afforded by the SNP. In short, the new tier of debt is doing its job.



CDS market needs to adapt

Banks have had no difficulty in selling SNP debt, 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. A similar challenge was faced with the era of state intervention in banks during the latter stages of the financial crisis. This resulted in the 2014 ISDA definitions, in particular the introduction of the new Governmental Intervention credit event and Asset Package Delivery provisions.[8]

The 2014 definitions are a marked improvement from the 2003 rules and have helped the single name product retain its usefulness as a hedging tool. Now the CDS industry has responded to the issuance of senior non-preferred by adapting to the new regulatory landscape.

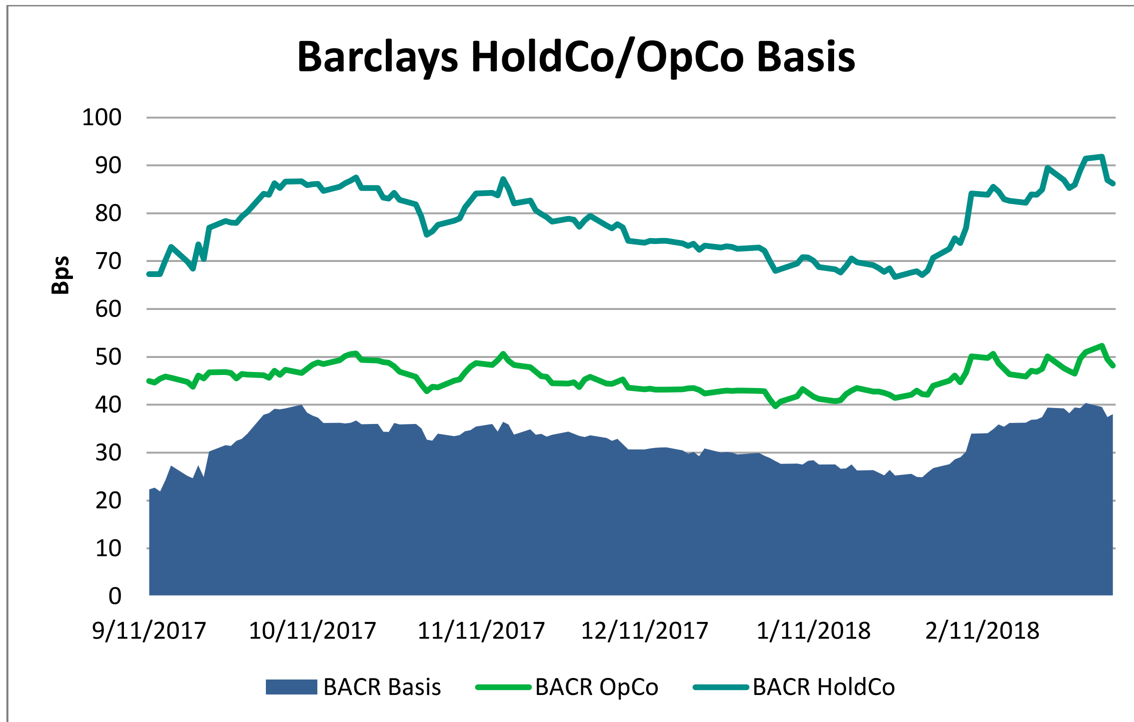
Transaction type

[8] https://www.markit.com/Commentary/NewsCommentarieFile?CMSID=d08dfb7f6e604f03b943224 7a8e3e9ae

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[9], along with an update Physical Settlement Matrix[10] and related confirmation template[11] 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.

Pricing

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 three major French banks should be cleared after the March 2018 roll). The Markit indices - both the main and Senior Financials - are also referencing the senior tier, which can inhibit liquidity (inclusion in the indices can boost liquidity, though there is no direct link – see below).



[9] https://www.isda.org/a/H6aEE/Additional_Provisions_for_Senior_Non-Preferred.pdf
[10] https://www.isda.org/a/mPwEE/Credit-Derivatives-Physical-Settlement-Matrix-03052018.xlsx
[11] https://www.isda.org/a/7PwEE/2014-Definitions-Confirmation-CDS-Matrix-v25Publication.docx

But there are two good indicators to how the new tier will price. First, we have already seen how SNP bonds have performed relative to their senior preferred counterparts. A persistent - if changeable - basis was observed, with SNP bonds wider during periods of risk aversion.

This is a clearly a useful pointer as to how SNP CDS will trade, though one has to bear in mind the relative factors that can drive CDS-bond basis – cost of repo, differing liquidity between the two instruments etc.

As well as the bond market, we can also get important information from the existing CDS market. UK HoldCos were included in the IHSM indices from September last year, sparking an elevation in liquidity. Figure 2 shows the relative spread movements in the Barclays HoldCo (Barclays Plc) compared to the OpCo (Barclays Bank Plc). The basis is less volatile than the BNP SNP/SNR cash basis, but there are some crucial similarities. 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 – as we saw with BNP bonds. We can expect CDS trading on the new tier to perform in a similar fashion and, if we consider the HoldCos to be a reliable guide, could trade about 70-100% wider than existing senior CDS.

Will we see a bifurcation in liquidity? Again, it is instructive to look at the UK HoldCos. As highlighted earlier, volumes picked up after the inclusion of HoldCos in the IHSM indices. But market risk activity hasn't ground to a halt on the OpCos since the September roll – indeed, it often exceeds the HoldCo.[12] This is a reflection of the diverse base of CDS end users. CVA desks may prefer to trade the entity that represents the part of the capital structure where derivative liabilities reside, while more conventional users of CDS would prefer to gain exposure to the riskier portion of the capital stack. In that case, we can expect dealers to continue to provide liquidity on both senior preferred and senior non-preferred CDS.[13]

The future

The CDS instrument continues to evolve in response to the shifting sands of regulation and changes in the bond market. This is no easy task – adjusting to the myriad of ways bonds can be impaired and banks resolved while maintaining standardization and ease of use is a Gordian Knot of a problem. But the industry has done its best to unravel the knot, first with the 2014 ISDA definitions and now with the introduction of infrastructure and documentation enabling CDS on senior non-preferred debt. TLAC and MREL are coming, and CDS will play an indispensable part in managing the challenges posed by this latest wave of regulation.

[12] DTCC data for the Barclays entities

[13] Providing there are deliverable obligations on each tier or entity

Appendix: IHS Markit and Senior Loss Absorbing Capacity

Pricing

From an IHSM perspective, a new tier has been created to price SNP CDS. The tier is called SNRLAC (Senior Loss Absorbing Capacity). The tier is flexible enough to allow entities where contractual, structural and statutory subordination applies, if and when the industry goes down this route. IHS Markit pricing methodology will be consistent with the existing SNRFOR and SUBLT2 curves. We know from the ISDA 2014 experience that the basis (between 2014 and 2003 curves) can take some time to settle, and the market will be observed very closely to ensure IHSM curves are as accurate as possible.

IHSM also prices senior non-preferred bonds in its Bond Pricing service using similar methodology as the other tiers of bank debt.

Indices

As already mentioned, in Series 28 of the Markit iTraxx Europe and Markit iTraxx Europe Senior Financials Indices the OpCo entities were replaced by HoldCo names for the relevant jurisdictions. UK banks, with their existing HoldCo structures and the PRA's early adoption of MREL, had already issued significant amounts of TLAC/MREL eligible debt, hence the inclusion of the HoldCos in the indices. Following feedback from market participants, three French banks (SocGen, BNP Paribas and Credit Agricole) were added to the Series 29 indices (starting on March 20 2018). These three banks are all G-SIBs and have been the largest issuers of senior non-preferred debt. IHSM will continue to monitor issuance and regulatory developments in other jurisdictions and discuss with market participants prior to the next roll.

IHSM also provides bond indices that cover this part of the capital structure, notably the Markit iBoxx EUR Banks Senior Bail-In Index. This covers bonds issued under structural, statutory and contractual subordination.

MarkitServ

The MarkitSERV confirmation and novation consent platforms have introduced support to allow participants to legally confirm and facilitate the clearing of transactions referencing newly introduced ISDA Matrix Transaction Type; STANDARD EUROPEAN SENIOR NON PREFERRED FINANCIAL CORPORATE. The MarkitSERV platforms will be adding support for two new transactions types:

- StandardEuropeanSeniorNonPreferredFinancialCorporate
- EuropeanSeniorNonPreferedFinancialCorporate

Reference Data - RED

Accurate reference data has always been crucial for participating in the CDS market, probably to a greater extent than other asset classes. IHSM has taken several steps to ensure that RED adapts to the new era of Senior Loss Absorbing Capacity:

RED

XML and GUI updates	• Debt Subordination field added • SNRLAC debt Tier added to table values
Standard Reference Obligation (SRO)	• A 3rd Tier of SRO created and linked to SNRLAC • Reference Obligations that meet SRO Deliverability Criteria will be aligned to the SRO-SNRLAC Tier

Legal Verification Process

Scrubbing	• Incorporate Subordination Type into RED Scrubbing Page • SNRLAC debt Tier added to table
Update RED Manual	• Allen and Overy have updated RED Manual incorporating legal review of SNRLAC