Markit Recap – 6/25/2018

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Credit Events often make the headlines in the CDS market, for good or ill. But the ISDA Determinations Committee also make other decisions, most often on Succession Events. These are typically straightforward determinations resulting from corporate actions such as mergers and acquisitions. In short, they are part and parcel of a CDS market that in the vast majority of cases functions efficiently in the background, contrary to what some of the more hysterical commentators in the press would have you believe.

But occasionally a succession event occurs that merits closer examination. A recent case is the question put to the DC on Royal Bank of Scotland plc (RBS plc) in May. Due to ring fencing legislation, all major UK banks must separate their retail banking operations from investment banking and non-EEA banking activities by January 1 2019. There are a myriad of ways that this separation could be enacted, but as part of the ringfencing procedure RBS chose to transfer its covered bond programme from RBS plc to National Westminster Bank PLC (NatWest Bank PLC). It also renamed RBS plc NatWest Markets Plc. The latter entity will be non-ringfenced – it is essentially the investment bank – while NatWest Bank will be ringfenced. The deposit taking entity will be "protected" from the risk-taking activities of the investment bank.

RBS has emphasised to its retail customers that the change in legal structure will have little impact on them. But it is a different matter for CDS end users. The transfer of the covered bond programme from NatWest Markets Plc (formerly known as RBC Plc and the operating company quoted in the CDS market) triggered a succession event. This is a result of the amount of the covered bond programme exceeding 25% of the relevant obligations, while NatWest Markets Plc also retaining more than 25% of the relevant obligations. This means that both NatWest Bank PLC and NatWest Markets PLC are successor entities and CDS positions will be split equally between the two entities.

It is important to note that it wasn't the ringfencing itself that triggered the succession event. Rather, it was the particular manner in how it was structured, namely the transfer of the covered bond programme from the existing CDS entity to another entity. It's also important to note that the succession event, while applying to both senior and subordinated transactions for contracts under 2003 definitions, only applies to senior transactions referencing 2014 definitions. This is due to terms in the 2014 definitions that split senior and subordinated contracts and the fact that there are no subordinated reference obligations for NatWest Bank Plc.

It is an interesting scenario that CDS contract holders will now have exposure to both a ring-fenced and non-ringfenced entity. The credit profile of the ringfenced entity should be significantly stronger due to its more stable funding mix, reliable profitability from low risk activities and higher possibility of government support. This is reflected in the three notch Moody's ratings differential between the two entities.

RBS is not the first bank to comply with ringfencing legislation – Barclays holds that honour. A new ringfenced entity, Barclays Bank UK Plc, was created and the requisite assets and liabilities were transferred. However, unlike RBS the transfer didn't result in a succession event as the amount moved to the new entity didn't exceed the 25% threshold.

So, the RBS ringfencing has been the only case so far to affect CDS contracts – so far. Other UK banks have still to enact the legislation, so it is vitally important that CDS market participants closely monitor the situation and ensure they have accurate pricing and reference data.

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