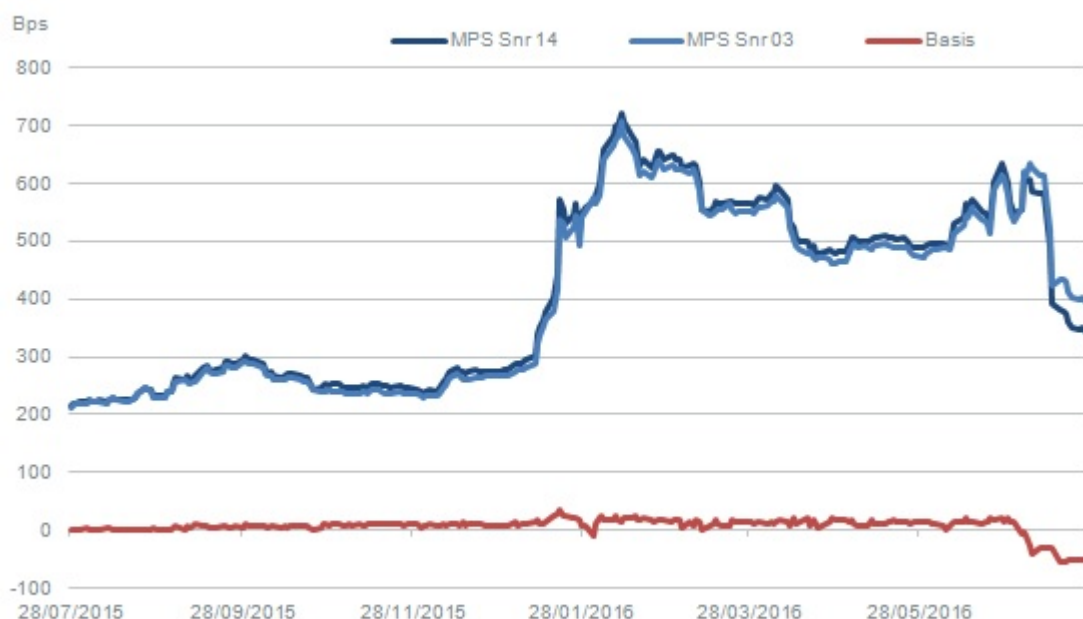


Markit Recap – 7/25/2016

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Back in July 2010, not long after the first Greek bailout, results of stress tests conducted by the Committee of European Banking Supervisors (the predecessor of the EBA) were released on the EU's banks. They didn't make for happy reading. Seven institutions failed, and they were required to raise additional capital to reach the 6% tier one ratio under the test's adverse scenario. Five of the failures were Spanish, along with one German and one Greek bank.



Six years later, it seems inconceivable that Italian banks, and one in particular, emerged unscathed from the tests. Monte dei Paschi de Siena (MPS) managed to pass the tests, albeit by a small margin. It also passed the following year, and it wasn't until 2014 that it failed.

The results of the 2016 tests due to be released after the close on July 29 won't classify banks as 'passed' or 'failed', but will specify capital shortfalls under shock scenarios. Given the deterioration in its balance sheet, it seems inevitable that MPS won't escape this time.

The CDS market has reflected MPS' dire predicament for some time, with spreads widening sharply earlier this year. But the increasing probability of default has also highlighted some of the idiosyncrasies in the CDS market. The bank's subordinated five-year spreads under 2014 definitions are trading at 25 points upfront, while the 2003 levels are a full 15 points lower. The gap reflects that 2014 protection buyers enjoy the benefit of an additional credit event: Governmental Intervention. We saw in the case of SNS Bank in 2013 that the 2003

definitions, particularly the Restructuring credit event, can struggle with states intervening in banks. If subordinated bondholders are bailed-in, then contracts under the 2014 definitions are more likely to trigger.

But it is not just the subordinated spreads of MPS that show the quirks of the CDS market. The performance of the bank's senior CDS has also shed light on how things have changed since the introduction of the new definitions. Unlike the subordinated spreads, MPS senior CDS is tighter under 2014 than 2003 – 345bps to 395bps respectively. How can this be when 2014 contracts include the Governmental Intervention credit event? The most likely explanation is that under 2014 definitions, if there is a Restructuring or Governmental Intervention on subordinated debt it won't also trigger the senior CDS. This is in contrast to 2003 contracts, where senior would trigger if there is an event on subordinated debt (as we saw with Novo Banco in 2014). This is if the bail-in only affected subordinated bonds, the senior CDS wouldn't trigger, hence the tighter spreads on 2014 contracts.

It may be that this is all moot if MPS manages to raise capital without enforcing burden sharing on bondholders. We should find out next week.

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