

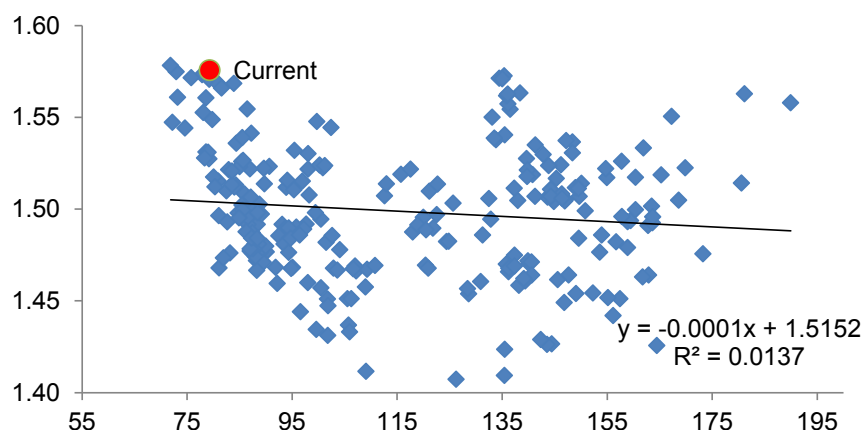
# Substitution in extra time

## Why Sub-Senior decompression has gone too far

- **Sub-Senior Fins Ratio at 1-year high:** The delay in the start date for the new Financial CDS contract to September has led to a decompression in the ratio between the Senior and Sub indices, which was previously near its post-crisis tights.
- **Unsustainable:** Despite a slightly more supportive technical backdrop for senior debt relative to sub, this will be insufficient to maintain it at its current highs, in our view. We believe the shift into the new contract due in September will drive S21 sub-senior compression.
- **Trade:** Long 5yr iTraxx Sub Fins S21 at a spread of 125bp. Short 5yr iTraxx Sen Fins S21 at 79.3bp. DV01-neutral ratio: 1.58

**Joseph M Faith**  
+44-20-7986-3050  
joseph.michael.faith@citi.com

Figure 1. Spread ratio between Senior and Sub Fins (y-axis) vs. Senior Spreads (x-axis), bp



Source: Citi Research, Markit, Daily data since May 2013

Figure 2. Trade details – long risk SubFin vs. SenFin; “zero-carry”.

Index	Protection	Spread (bp)	Notional (m)
Sub Fins. 5y S21	Sell	125.0	100
Sen Fins. 5y S21	Buy	79.3	158

Source: Citi Research, Markit. Indicative spreads shown

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

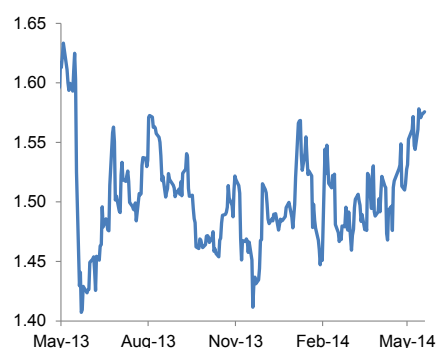
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## Sub underperforming – but not for long

The iTraxx Sub-Senior Fins ratio at almost 1.6x is now the highest in a year. Only in March it got to a low of 1.46x. In basis point terms, the underperformance of the sub index since then translates to 10bp at current levels for Senior.

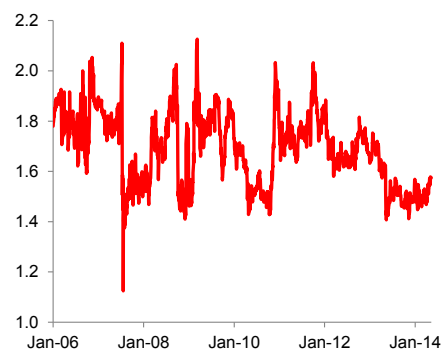
While the initial rise in the ratio following the delay to the expected launch of the new CDS contract to September was understandable, we now believe the decompression is overdone. We expect the ratio to shrink over the summer.

Figure 3. 1-year history of iTraxx Senior Fins / Sub Fins ratio



Source: Citi Research, Markit

Figure 4. 8-year history of iTraxx Senior Fins / Sub Fins ratio



Source: Citi Research, Markit

As the prospect of bail-ins has receded over the last couple of years, the Sub-Senior ratio has compressed significantly — from more than 2.0x in late 2011 to about 1.4x late last year.

The compression was given additional impetus in February last year, when the subordinated bondholders at SNS Reaal bank were expropriated by the Dutch government, leaving no subordinated bonds to be delivered into the sub contract (with the implication that recovery was set by the value of senior bonds).

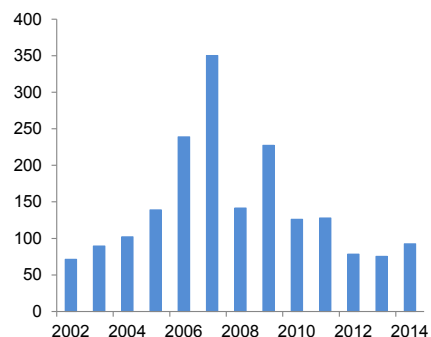
In May last year, ISDA began consulting on a new Financials CDS contract which would count “bail-ins” as a credit event and allow protection buyers to deliver the “bailed-in” contracts or whatever they receive in exchange for them. When it became apparent that this would not be applied retroactively there was a sharp compression in the sub-senior ratio. However, the delays in implementation have forced technical unwinds leading to gradual decompression.

The details of the new contract were finalised in the early part of this year. However, expectations that it would be launched in March were disappointed at the end of February, when ISDA announced that the changes would take place along with the September roll. We believe the pushing-back of the launch date of the new contract led to unwinds of compression trades that many leverage accounts had put on in anticipation that the desire to roll into the new contracts would cause a squeeze on spreads in the old sub index. The ratio was as low as 1.46x in early March, but has since then climbed to 1.58x.

Admittedly, other technical factors have played a least a peripheral role in the ratio's increase. Although senior financial issuance has accelerate recently, it remains in negative territory year-to-date and gross issuance levels remain well behind the average of the past decade. Sub bank debt, on the other hand, is being issued at its fastest pace since 2008. Besides for the imbalance in supply, the announcement of

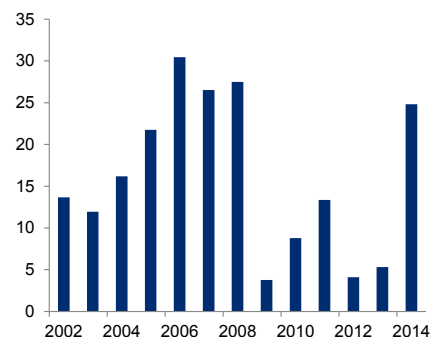
the [remarkably lenient](#) “stressed” scenarios for the upcoming EBA bank stress tests has diminished fears that senior bank debt would be exposed to risk of widespread bail-in this year.

Figure 5. € Senior bank debt issuance YTD, €bn



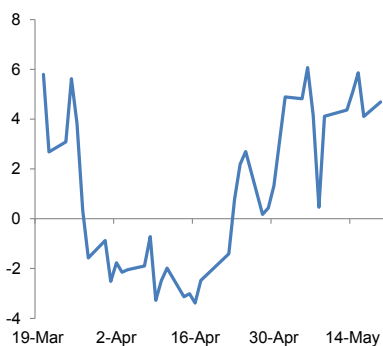
Source: Citi Research, Dealogic

Figure 6. € Sub bank debt issuance YTD, €bn



Source: Citi Research, Dealogic

Figure 7. Skew on iTraxx Sub Fins 5yr, bp



Source: Citi Research, Markit

Yet we struggle to see these factors inhibiting a decline in the ratio over the coming months. Given both that the launch date for the new contract is fast approaching, and the likelihood that most investors will move their trades into the new contract due to the greater security it offers, we think the ratio is unlikely to be sustained at current level.

As our iTraxx Intrinsic Report illustrates, the skew on the Sub Index over the last week has been around 5-6bp, its most positive level since late March. Some of the decline in the Sub-Senior ratio is likely to come from a neutralizing of this skew on the existing Sub Index, as the new index becomes the hedging instrument of choice for bank sub debt.

We'd expect the ratio to move towards its lows of 1.4x by September. If the iTraxx Senior Fins were to remain at its current levels, this would mean that the Sub index would trade at 111bp – 14bp tighter than it is now. To benefit from this compression, we would be long the iTraxx Sub 5yr and short the iTraxx Senior 5yr in DV01-neutral amounts. This amounts to buying 158 cents of Senior protection for every 100 cents of Sub protection sold.

## Appendix A-1

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