

Credit Default Swaps, Governmental Intervention and the ISDA Determinations Committee: The Novo Banco Experience

On 15 February 2016, the External Review Panel of the ISDA EMEA Determinations Committee handed down its first ever decision. The Panel had been asked to determine whether the announcement by the Bank of Portugal that the liability of Novo Banco, SA under certain bonds would be transferred so that they became liabilities of Banco Espirito Santo, SA constituted or resulted in a Governmental Intervention Credit Event under the ISDA 2014 Credit Derivatives Definitions. The Panel unanimously concluded that the answer to this question was "No".

Background

In August 2014, the Portuguese bank Banco Espirito Santo, SA ("**BES**") was restructured by Bank of Portugal (the "**BoP**") acting in its capacity as the Portuguese Resolution Authority. The restructuring involved splitting BES into a "good bank" and a "bad bank". The good bank was a new entity, Novo Banco, SA ("**Novo Banco**"), and the bulk of the assets and liabilities of BES were transferred to Novo Banco, including a number of bonds which had originally been issued by BES.

On 29 December 2015, BoP, again acting as the Portuguese Resolution Authority, announced that certain bonds which had previously been transferred from being obligations of BES to be obligations of Novo Banco would be transferred back, so that

they would once again be obligations of BES. At the same time, BoP announced its intention to request that the ECB withdraw the authorisation of BES, starting judicial liquidation proceedings. On the assumption that the transfer of liability on the affected bonds is effective under Portuguese law (as the governing law of the bonds), if BES is unable to meet all of its liabilities, then any holders of the affected bonds are unlikely to be paid in full.

Following BoP's announcement, a question was raised before the ISDA EMEA Determinations Committee (the "**Determinations Committee**") as to whether this announcement constituted or resulted in a Governmental Intervention Credit Event under the ISDA 2014 Credit Derivatives Definitions (the "**2014 Definitions**"). This is a new credit

Key issues

- The Panel distinguished between the "cancellation, conversion or exchange" of an obligation and a mere change or "transfer" of obligor.
- Other references to "transfer" in the 2014 Definitions indicated that if the draftsman had intended a transfer of obligor to be covered, they would have said so explicitly.
- The general reference to any event which has an analogous effect to a cancellation, conversion or exchange should be narrowly construed.

event which was introduced for the first time in the 2014 Definitions, against the backdrop of the then proposed EU Bank Recovery and Resolution Directive ("**BRRD**") and

the prospect that resolution measures would provide a method of dealing with banks which have got into financial difficulty prior to and/or as a means of avoiding formal insolvency proceedings, with all of the implications this might have for financial stability. When the Determinations Committee considered this issue, it was split 11 to 4 in favour of concluding that no credit event had occurred. As this did not meet the required 80% threshold for a binding determination, the question was referred to external review, the first time such a review had been required by the Determinations Committee.

If BoP's announcement did constitute or result in a Governmental Intervention Credit Event, then that would result in the settlement of all standard market credit default swap transactions referencing Novo Banco.

A separate question has also been raised before the Determinations Committee as to whether BoP's announcement has resulted in a Succession Event occurring in respect of CDS referencing Novo Banco. However, that question was not considered as part of this external review.

The External Review Decision

The External Review Panel (the "Panel") was comprised of a retired judge and two prominent Queen's Counsel, who reached their decision after considering submissions and hearing oral argument from counsel representing both the "Yes" and the "No" positions in relation to whether a Governmental Intervention Credit Event had occurred.

The key question to be resolved by the Panel was whether BoP's announcement constituted or resulted

The Governmental Intervention Credit Event

Section 4.8(a) of the 2014 Definitions defines a Governmental Intervention Credit Event as follows:

"Governmental Intervention" means that, with respect to one or more Obligations and in relation to an aggregate amount of not less than the Default Requirement, any one or more of the following events occurs as a result of action taken or an announcement made by a Governmental Authority pursuant to, or by means of, a restructuring and resolution law or regulation (or any other similar law or regulation), in each case, applicable to the Reference Entity in a form which is binding, irrespective of whether such event is expressly provided for under the terms of such Obligation:

- (i) *any event which would affect creditors' rights so as to cause:*
 - (A) *a reduction in the rate or amount of interest payable or the amount of scheduled interest accruals (including by way of redenomination);*
 - (B) *a reduction in the amount of principal or premium payable at redemption (including by way of redenomination);*
 - (C) *a postponement or other deferral of a date or dates for either (I) the payment or accrual of interest, or (II) the payment of principal or premium; or*
 - (D) *a change in the ranking in priority of payment of any Obligation, causing the Subordination of such Obligation to any other Obligation;*
- (ii) *an expropriation, transfer or other event which mandatorily changes the beneficial holder of the Obligation;*
- (iii) *a mandatory cancellation, conversion or exchange; or*
- (iv) *any event which has an analogous effect to any of the events specified in Sections 4.8(a)(i) to (iii).*

in either "a mandatory cancellation, conversion or exchange" of any of Novo Banco's obligations, or "any event which has an analogous effect to" a cancellation, conversion or exchange. The Panel unanimously concluded that it did not. In reaching this conclusion, the Panel placed primary significance on the fact that the most appropriate way to refer to BoP's announcement was that it would result in a "transfer" of the affected bonds. In other places in the 2014 Definitions, including in another limb of the Governmental Intervention Credit Event itself, the word "transfer" is used to refer to events having essentially the same effect as BoP's announcement – that is, a change of the obligor in respect of an obligation.

The Panel concluded that the absence of any reference to a "transfer" in the relevant part of the definition of a Governmental Intervention Credit Event indicated that it was not intended that this type of event would fall within the scope of that definition. To quote the decision: the "draftsman cannot have overlooked the possibility of referring to a transfer of an Obligation in subparagraph (iii), because he had just used the word 'transfer' in subparagraph (ii)".

The Panel also noted that the natural meaning of the terms "cancellation, conversion or exchange" did not include an event which merely constituted a change in obligor, with no other changes to the terms of the

obligations. Rather, a "conversion" is the alteration of an obligation into some other category of obligation (such as a conversion of debt to equity), while an "exchange" is the surrender of one obligation in exchange for a new obligation, having different terms. The Panel determined that the event was not a "cancellation", because the bonds continued in existence.

The Panel also determined that the reference in the definition to "any event which has an analogous effect to" a cancellation, conversion or exchange should be given a narrow meaning. Given the detailed and specific drafting of the rest of the definition, the Panel took the view that it would be inappropriate for this general reference to result in a significant broadening of the definition. Where the draftsman has taken the effort to define precisely what constitutes a Governmental Intervention Credit Event, the general catch-all provision should be construed narrowly so as to catch only events which might otherwise fall outside the scope of the definition for purely technical reasons. Finally, the Panel concluded that, while it is possible that the same economic effect could have been achieved by an event which would have constituted a conversion or exchange, just because an action could have been structured in a particular way does not mean that it should be treated as if it had been structured that way.

The Panel made its decision without considering a number of other arguments which had been advanced by the "No" position in their submissions, such as the fact that determining that a Governmental Intervention Credit Event had occurred could be inconsistent with the possibility that BoP's

announcement could also result in a Succession Event under the 2014 Definitions. In light of its approach to the construction of the relevant definition itself, the Panel was of the view that it was not necessary, and indeed might be "dangerous", to consider these other arguments given that, as noted above, the question of whether BoP's announcement had caused a Succession Event to occur in respect of Novo Banco had been separately raised before the Determinations Committee.

The Effect of the Decision

Assuming once again that the transfer of the affected bonds is effective under Portuguese law, the primary outcome of the Panel's decision is that the holders of any bonds which were transferred back to BES and who had purchased CDS protection on Novo Banco to hedge their exposure in respect of those bonds are left with protection that still references Novo Banco (in respect of which no credit event has occurred, and in respect of which they no longer have an exposure), while they have no protection against a future BES default under the affected bonds.

At the same time, however, had BoP's announcement resulted in a Governmental Intervention Credit Event, it would have resulted in the settlement process occurring in respect of Novo Banco (as the reference entity under the CDS), and not BES.

Thus, any settlement payments the bondholders received may not have reflected the anticipated recovery rates on BES's debt if BES does ultimately default on the bonds. In addition, given that the rationale for BoP's decision was, at least in theory, to improve the regulatory capital position of Novo Banco (by reducing its indebtedness), triggering a credit

event in respect of Novo Banco, despite BoP's announcement affecting only five series of bonds, would have had significant implications for all other buyers and sellers of credit protection on Novo Banco. Buyers would have had their protection triggered unnecessarily, while sellers would have been required to make settlement payments despite no default occurring in respect of Novo Banco.

Perhaps the real lesson to come out of the Novo Banco experience is the confirmation that, although the Governmental Intervention Credit Event was included in the 2014 Definitions at least partly in response to the prospect of future resolution action being taken in respect of financial institutions under BRRD, it is not the case that all resolution action will constitute a Governmental Intervention Credit Event. Rather only the specific types of action described in that definition will constitute a credit event. As has previously been the case with the Restructuring Credit Event, it can at times appear arbitrary whether a particular event falls on one side of the line or the other. But perhaps that merely reflects the inherent difficulty in trying to draft an objective definition to accommodate the almost infinite number of ways in which an entity's obligations can be restructured.

Finally, as reflected in the legal nature of the external review process, the 2014 Definitions ultimately take effect as a contract between the parties to a CDS transaction, and must be interpreted accordingly. It is not a case of the Determinations Committee substituting for the words of the contract an alternative definition reflecting what individual market participants may, with the benefit of hindsight, have felt it should have said.

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