Feature

KEY POINTS

- The Novo Banco Determination confirms that the Governmental Intervention Credit Event will not necessarily be triggered by all actions taken by resolution authorities to manage failing financial institutions.
- Arguably, three of the four resolution tools available under the EU Bank Recovery and Resolution Directive may not result in a Governmental Intervention Credit Event being triggered.
- The External Review process offers the possibility of transparent quasi-judicial determination of questions submitted by ISDA Credit Determinations Committees.

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CDS Governmental Intervention payment triggers: when can you rely on them?

This article considers the inaugural decision of the External Review Panel of the ISDA EMEA Determinations Committee as to whether a Governmental Intervention Credit Event had occurred upon the re-transfer of certain bonds from the bridge bank, Novo Banco S.A., back to Banco Espírito Santo, S.A. pursuant to a bank resolution measure, potentially entitling protection buyers to payment under their CDS contracts.

Introduced in 2009 to determine the occurrence of credit events and make certain other determinations pursuant to the Credit Derivatives Definitions, the ISDA Credit Derivatives Determinations Committees (Determinations Committees) play an important role in the market for Credit Default Swaps (CDS). Determinations Committees are able to refer certain questions for external review and an inaugural decision of an External Review Panel in Europe (appointed by the ISDA EMEA Determinations Committee) in respect of the Novo Banco S.A. (Novo Banco) resolution measures involved detailed consideration of the Governmental Intervention Credit Event.

ISDA CREDIT DERIVATIVES DETERMINATIONS COMMITTEES AND EXTERNAL REVIEW

Under the 2016 ISDA Credit Derivatives Determinations Committees Rules (the Determinations Committees Rules), the regional Determinations Committees are convened at the request of an eligible market participant (being a central counterparty clearing house or a party to a Credit Derivative Transaction) and comprise fifteen voting members, ten of whom are dealers (selected based on their overall trading volume and participation) and five non-dealer members (who satisfy size criteria and who nominate themselves for membership). Typically membership of the Determinations Committees will feature both protection buyers and protection sellers. Decisions of the Determinations Committees are published promptly by ISDA on its website.

For certain determinations of the Determinations Committees, including a determination that a Credit Event (ie, an event which triggers settlement of CDS contracts) has occurred in respect of a reference entity, an 80% supermajority consensus is required (ie, at least twelve of the fifteen members vote in favour). If a supermajority threshold is not met, the question proceeds to External Review.

The External Review process involves proceedings before three independent legal experts, selected by the Determinations Committee, involving oral arguments and written submissions. The question to be decided by the External Review must be decided in accordance with the vote of the Determinations Committee unless:

- all three experts agree in favour of another presented position (where more than 60% of Determinations Committee members voted in favour of the determination); or
- two of three experts agree in favour of another presented position (if 60% of Determinations Committee members or less voted in favour).

EXTERNAL REVIEW OF THE NOVO BANCO DETERMINATION

Until the beginning of 2016, Determinations Committees had only referred two reviewable questions to External Review (both referred by the Americas region Determinations Committee). In January 2016 the EMEA (Europe) Determinations Committee referred to an Expert Review Panel the question as to whether a Governmental Intervention Credit Event had occurred in respect of Novo Banco, following a December 2015 announcement by Banco de Portugal (acting as the Portuguese government Resolution Authority) that five senior unsecured bonds with a notional value of €1.941bn had been re-transferred from Novo Banco back to Banco Espírito Santo, S.A. (BES) as the obligor (the BES Transfer).

To the surprise of many observers of the CDS market (but not the majority of voting members of the Determinations Committee), the External Review Panel decided the better answer to the Determination Committee's question was that a Governmental Intervention Credit Event had *not* occurred.

THE GOVERNMENTAL INTERVENTION CREDIT EVENT (GICE)

The GICE was introduced in the 2014 ISDA Credit Derivatives Definitions after the limitations of the Restructuring Credit Event were revealed following the restructurings of two European banks in the aftermath of the 2007-8 financial crisis (then governed by the 2003 ISDA Credit Derivatives Definitions as supplemented by a July 2009 Supplement (the 2003 Definitions)).

In respect of both the bail-in of Dutch bank SNS Reaal N.V. by the Dutch government (which expropriated all of the bank's shares and subordinated bonds) and of Spanish bank Bankia S.A. by the Spanish Fund for Orderly Bank Restructuring (*Fondo de Reestructuración Ordenada Bancaria*) (which

exchanged the subordinated debt of Bankia S.A. for shares) in 2013, Determinations Committees were convened which did find that Restructuring Credit Events had occurred (although in neither case did the governmental intervention fit precisely within the scope of the Restructuring Credit Event under the 2003 Definitions).

Under s 4.8(a) of the Credit Derivatives Definitions, the GICE occurs when a governmental authority introduces a restructuring or resolution law applicable to a reference entity which results in binding changes to the relevant obligations of the reference entity and any one or more of the following events occurs as a result:

(i) reductions or deferral of interest and/or principal or subordination;
(ii) an expropriation, transfer or other event which mandatorily changes the beneficial holder;
(iii) a mandatory cancellation, conversion or exchange; or
(iv) any event which has an analogous effect.

The GICE applies where the reference entity is a bank, investment firm or other financial institution (and the Financial Reference Entity Terms are specified in the confirmation) and applies irrespective of whether such event is expressly provided for under the terms of such obligation (such as in accordance with Bank Recovery and Resolution Directive (2014/59/EU)(BRR Directive)).

Unlike for a Restructuring Credit Event, the GICE does not require a deterioration in the creditworthiness of the reference entity or for there to be multiple holders of the obligations being restructured. Also the "catch-all" provision in limb (iv), for events with an "analogous effect" to the trigger events, is not contained within the Restructuring Credit Event.

BACKGROUND OF THE NOVO BANCO DETERMINATION

Novo Banco was established as the "good bank" in the resolution of BES conducted by Banco de Portugal in 2014, receiving certain BES assets. In August 2014, a Determinations Committee determined that a succession event had occurred in respect of BES (such that more than 75% of all obligations constituting Relevant Obligations for the purposes of CDS contracts had been transferred to Novo Banco). The plan to sell Novo Banco was halted in November 2015 after Novo Banco failed a stress test conducted by the European Banking Authority, which found a significant capital shortfall. Shortly after, in December 2015, the BES Transfer took place, after which a judicial liquidation proceeding of BES was commenced.

Affected bondholders have commenced litigation to challenge the BES Transfer, including on the grounds that the selection of only five of the outstanding bonds for transfer (and imposition of losses arising when BES was substituted as the issuer) meant that bondholders of the same class had not been treated equally, such principle also being a requirement under the BRR Directive. At the time of writing it had been reported that the Lisbon Administrative Court has issued a precautionary injunction concerning one series of bonds which were the subject of the BES Transfer.

DETERMINATION OF THE EXTERNAL REVIEW PANEL

On 12 January, following deliberations, the Determinations Committee which had been convened regarding Novo Banco voted 11-4 against a resolution that a GICE had occurred, and being less than a Supermajority, the question was sent for External Review. The External Review Panel comprised a retired Court of Appeal judge and two Queen's Counsel. Written submissions were made to the External Review Panel by advocates on behalf of the 11 members who voted against the resolution (the No Position) and on behalf of the four members who voted in favour of the resolution (the Yes Position). This was subsequently followed by an oral hearing during which advocates for both sides presented their arguments to the Panel.

The members of the External Review Panel concluded unanimously that the better answer to the Determination Committee's question was that no GICE had occurred. While it was common ground amongst the parties that many of the anterior requirements for the GICE were established (such as the BES Transfer having been made pursuant to a restructuring and resolution law which was binding), the External Review Panel was required to consider whether the BES Transfer was an event within limbs (iii) and (iv) of the GICE definition (the parties agreeing that limbs (i) and (ii) of the definition were not applicable). The Panel ultimately concluded that the BES Transfer was not an event within limbs (iii) and (iv) of the GICE definition.

MANDATORY CANCELLATION, CONVERSION OR EXCHANGE

The Panel interpreted the GICE definition in accordance with the general principles of construction applied by the English courts and found that the most appropriate way of describing the BES Transfer would be by use of the word "transfer" and not as a "mandatory cancellation, conversion or exchange" (which does trigger a GICE under limb (iii)). The Panel placed significant emphasis on the absence of the word "transfer" from limb (iii) of the GICE definition, particularly given the fact that "transfer" does feature in limb (ii) and in other sections of the Credit Derivatives Definitions.

The Yes Position argued the BES Transfer constituted a conversion or exchange, characterising the BES Transfer as resulting in a separate claim with BES as obligor instead of Novo Banco (with holders of transferred bonds suffering losses as prices of the bonds fell with increased credit risk). The No Position submitted that an event which resulted solely in a change in obligor did not otherwise change the nature or terms of the obligation, such that the BES Transfer did not amount to a mandatory conversion or exchange.

The Panel considered the natural and ordinary meaning of those expressions and agreeing with the No Position found that a "conversion" is the alteration of an obligation into some other category or obligation (such as the conversion of debt into equity) and an "exchange" is the surrender of one obligation in exchange for a new obligation having different terms – neither of which were applicable to the BES Transfer. The Panel also found that the transfer could not be

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characterised as a "cancellation", noting that the Bonds continued to exist following the BES Transfer (with the same ISIN).

"ANALOGOUS EFFECT"

In respect of limb (iv), the Yes Position argued for a broad interpretation, pointing out that the BES Transfer could also have been achieved by an exchange (involving surrender and replacement of the relevant bonds) which would have the same result or "effect" as an exchange (such that the BES Transfer had an "analogous effect" to mandatory conversion or exchange).

The No Position argued for a narrow approach consistent with Briggs J in *Lomas v JFB Firth Rixson* [2010] EWHC 3372 (Ch) that provisions of the ISDA Master Agreement should be interpreted in a way that favours clarity. The No Position argued limb (iv) applied only to events which are analogous in effect, not events in which the consequences are analogous (such as the crystallising of risk and losses).

The Panel concluded that to give limb (iv) an expansive interpretation would give rise to considerable uncertainty and would be inconsistent with the careful and detailed drafting of limbs (i) to (iii) of the GICE definition. The Panel noted a broad interpretation would imply consideration of impairment suffered to limit the scope of limb (iv) which it declined to do. For such reasons, the Panel found that the BES Transfer did not fall within limb (iv).

Following the External Review Panel's decision, the Determinations Committee separately determined that the BES Transfer did not give rise to a Succession Event as less than 25% of the relevant obligations of the reference entity (ie, the five outstanding bonds) were transferred.

ISSUES ARISING FROM THE NOVO BANCO DETERMINATION

The determination of the Panel highlights the fact that the Credit Derivative Definitions take effect as a contract between the participants in CDS transactions and the construction of the definitions falls to be decided in accordance with the general principles of construction applied by the English courts.

In addition, significantly, the Novo Banco Determination confirms that the GICE will not necessarily be triggered by all actions taken by resolution authorities to manage failing financial institutions. This has meant holders of Novo Banco CDS contracts with Reference Obligations that are subject to the BES Transfer will sustain lower or no recovery and market participants may adjust their expectations.

Further, since the BES Transfer, the new resolution authority under the BRR Directive, the Single Resolution Board, has commenced its work as the resolution authority for significant banking groups of participating EU Member States and future resolutions may differ from those carried out so far by national resolution authorities.

Participants will need to consider the extent to which a GICE will be triggered by the use of resolution tools by the Single Resolution Board under the BRR Directive. Arguably, the deployment of three of the four resolution tools which involve the transfer of Reference Obligations (the sale of business tool, bridge institution tool and asset separation tool) may not, pursuant to the Novo Banco Determination, result in a GICE being triggered. The other resolution tool (the bail-in tool) is the exception as liabilities are written down or converted and its use will be expected to result in a GICE.

The External Review process is novel but offers the possibility of swift, certain and transparent quasi-judicial determination and may serve as a model in other questions of contractual interpretation that affect an entire market. The External Review process was completed in a three week period and copies of the submissions, the decision of the External Review Panel and a video recording of the oral argument have been published on the ISDA website.

CONCLUSION

The decision of the External Review Panel has clarified the scope of the Governmental Intervention Credit Event but holders of CDS contracts referencing financial reference entities will need to carefully consider the scope of Credit Events to determine risks and likely future recoveries.

Mayer Brown acted as Advocates for the Determinations Committee Members adopting the No Position. ■

Further Reading:

- The new 2014 ISDA Credit Derivatives Definitions [2014] 7 JIBFL 449.
- The imperfect hedge: bail-in risk and CDS contracts [2012] 2 JIBFL 95.
- LexisNexis Loan Ranger blog: Preparing for the new 2014 credit derivative definitions.