1. QUESTION PRESENTED

Has a Governmental Intervention Credit Event occurred with respect to credit default swaps ("CDS") referencing NOVO BANCO S.A. (the "Reference Entity")?[i]

2. OVERVIEW

On December 29th 2015, Banco de Portugal, acting as the Portuguese government Resolution Authority (the "Resolution Authority"), announced that five senior unsecured bonds (the "Transferred Bonds") would be transferred from the Reference Entity to Banco Espirito Santo, S.A. ("BES") (the "Transfer"). By completely extinguishing these obligations at the Reference Entity, the Transfer had an undeniably negative impact on holders of the Transferred Bonds. The obligations under the Transferred Bonds were transferred, without consent of or fair compensation to the holders, to an insolvent "bad bank" undergoing judicial liquidation proceedings and soon to be without a banking license, the effect of which transfer is equivalent to an impairment. Subsequently, the Transferred Bonds traded down approximately 75% of their par claim, resulting in substantial losses to creditors.

This Transfer constituted a "Governmental Intervention" (as defined in the 2014 ISDA Credit Derivatives Definitions (the "Definitions")) Credit Event on December 29th, 2015.

3. FACTUAL BACKGROUND

In August 2014, Banco de Portugal made the decision to apply resolution measure (the "Resolution Measure") to BES by transferring certain activities, assets and liabilities (including the Transferred Bonds) to a bridge bank, Novo Banco S.A. (*i.e.,* the Reference Entity), which is "duly capitalized and clean of problem assets."[1] The assets and liabilities not transferred to the bridge bank remained with BES, which would be placed into a judicial liquidation proceeding.[2]

These Resolution Measures were adopted under the Legal Framework of Credit Institutions and Financial Companies (*Regime Geral das Instituições de Crédito e Sociedades Financeiras*)("RGICSF"), approved by Decree-Law No 298/92 of 31 December 1992, as amended by Decree-Law No 31-A/2012 of 10 February.[3] Among other things, the Resolution Measures provide that "Banco de Portugal may at any time transfer or re-transmit assets, liabilities, off-balance-sheet items and assets under management between Banco Espirito Santo, S.A and Novo Banco, S.A., in accordance with Article 145-H(5) of RGICSF."[4]

Facing a capital shortfall in the fourth quarter of 2015, and with the aim of protecting "all depositors of Novo Banco, the creditors for services provided and other categories of unsecured creditors," the Resolution Authority made the decision to transfer 100% of certain individual tranches within the short-dated series of non-subordinated bonds of the Reference Entity (and none of the other bonds, thus disregarding principles of *pari passu* ranking), intentionally targeting those bonds "intended for institutional investors"[5] (*i.e.,* the Transferred Bonds).

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1 *See* http://www.bportugal.pt/en-US/OBancoeoEurosistema/ComunicadoseNotasdeInformacao/Pages/combp20140803.aspx

2 *Id.*

3 *Id.*

4 http://www.bportugal.pt/en-US/OBancoeoEurosistema/ComunicadoseNotasdeInformacao/Documents/Deliberation_11_Aug_2014_5pm.pdf, Annex, para. 2.

5 https://www.bportugal.pt/en-US/OBancoeoEurosistema/ComunicadoseNotasdeInformacao/Pages/combp20151229-2.aspx

As specified in the Banco de Portugal's December 29th press release (the "Press Release"), the below table sets forth the Transferred Bonds, which in the aggregate total €1,941,000,000 in principal amount.

ISIN	Bond	Currency	Type
PTBEQBOM0010	Senior Bond NB 6,875%, maturity July 2016	EUR	Senior
PTBENIOM0016	Senior Bond NB 6,9% maturity June 2024	EUR	Senior
PTBENJOM0015	Senior Bond NB 4,75% maturity January 2018	EUR	Senior
PTBENKOM0012	Senior Bond NB 4,0% maturity January 2019	EUR	Senior
PTBEQKOM0019	Senior Bond NB 2,625% maturity May 2017	EUR	Senior

After the Transfer, the Resolution Authority will ask the European Central Bank to withdraw the authorization of BES, starting a judicial liquidation proceeding.[6]

4. RELEVANT CDS DEFINITIONS

Under Section 4.8 of the Definitions, a Governmental Intervention Credit Event occurs when, "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) …

(ii) …

(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)."

The Definitions do not define "conversion" or "exchange," and thus one needs to discern the meaning of these words from common usage.

The Merriam-Webster Collegiate Dictionary defines "conversion" as "the act of converting," and, in turn, "convert" as "to change from one form or function to another." It defines "exchange" as "the act or process of substituting one thing for another."

"Default Requirement" is defined under section 4.9 (a) of the Definitions as, for these purposes, $10,000,000.

6 *Id.*

Governmental Authority is defined under Section 4.9 (b) of the Definitions and includes, in relevant parts, "any authority or any other entity (private or public) either designated as a resolution authority or charged with the regulation or supervision of the financial markets (including a central bank) of the Reference Entity or some or of all of its obligations."

5. DISCUSSION

Changes to the 2003 Definitions Anticipate Government Intervention

Beginning in 2011, there were a number of governmental interventions with respect to banking institutions, implemented by European governments with direct negative economic effect on unsecured creditors, and in some notable cases, CDS parties. In several instances, the 2003 Credit Derivatives Definitions (the "2003 Definitions"), applicable at the time under Standard European Corporates Transaction Type, did not appropriately address these types of governmental actions, leading to CDS outcomes that did not reflect the economic expectations of the parties and the market. Therefore, work began to fill the gap in the 2003 Definitions by adding a new Credit Event, "Governmental Intervention," to the (2014) Definitions. The intent was to ensure that such governmental interventions in the future would result in outcomes that accurately reflect the expectations of the CDS market that protection buyers of CDS be hedged against these risks. The Transfer is *precisely* the type of government intervention that the newly-created Credit Event was meant to protect against.

Elements of a Governmental Intervention Are Met

The Transfer meets each element of a Governmental Intervention:

First, Banco de Portugal, the central bank of Portugal, is unquestionably a Governmental Authority. Therefore the Transfer is an event "as a result of action taken or announcement made by a Governmental Authority."

Second, the Transfer was sanctioned in the Resolution Measures, which were adopted by Banco de Portugal pursuant to the RGICSF. Relevant articles of the RGICSF govern the resolution of credit institutions in Portugal. The Transfer, therefore, is made "pursuan to … a restructuring and resolution law or regulation."

Third, the Transferred Bonds are in the aggregate amount of €1,941,000,000, well in excess of the Default Requirement.

Fourth, the Transfer is binding.

Fifth, the Transfer is a conversion or exchange, or an event which has an analogous effect.

- The Transfer extinguished the rights of the holders of the Transferred Bond against the Referenced Obligor. In their stead, these holders were given a new set of rights worth dramatically less than the securities they originally held. The Transferred Bonds have therefore been "converted" into something completely different than they once were.

- By the same token, the Transfer also effected an "exchange," or substitution, of the Transferred Bonds for new obligations that are virtually worthless.

- If, notwithstanding the reasoning above, the automatic effectiveness of the Transfer is considered to be a determining factor so that the Transfer did not constitute an exchange, the economic reality of the Transfer is exactly the same as an exchange. The holders of the Transferred Bonds were forced by the Resolution Authority, via governmental intervention, to have their valuable security replaced by a virtually worthless security. This replacement, and therefore the Transfer, is no doubt "analogous" to an exchange because it produces the same economic result.

A No-Governmental Intervention Determination Will Produce an Illogical Outcome

A decision that a Governmental Intervention has not occurred would lead to an illogical outcome where holders of the Transferred Bonds suffer a near complete economic loss for the arbitrary reason that they are institutional investors, but this loss is not mitigated by their CDS protection despite paying a higher premium for protections against the risk of governmental interventions. This outcome will further diminish CDS's efficacy as a tool to hedge credit risk and further erode confidence in the product.

6. CONCLUSION

The actions taken by the Resolution Authority are clearly covered by the Governmental Intervention Credit Event. Each element of that Credit Event has been satisfied squarely and unequivocally. So too is the spirit of the Credit Event. Effected by the Portuguese central bank in connection with its exercise of the resolution authority, the Trasnfer was specifically targeted to protect depositors and a subset of creditors by sacrificing the interest of another subset of creditors whose debt ranked *pari passu*. This action is taken under the "bail in" regime that the European banking regulators seek to implement, and is precisely the type of governmental intervention risk that the Definitions were designed to cover. Protection buyers of CDS under the Definitions have a reasonable expectation that they are hedged against this bail-in risk as a result of the addition of the Governmental Intervention Credit Event in the Definitions. The Definitions should be interpreted in a way that is consistent with those reasonable expectations. Missing the opportunity to do so will further diminish CDS's efficacy as a hedging tool and erode confidence in the product.

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[i] We appreciate that a general interest question regarding a potential succession has also been submitted to the Determinations Committee. In the past, government actions that caused direct creditor losses were not envisioned by the 2003 Definitions and therefore had to be addressed with the only tools at hand – Succession provisions or Restructuring Credit Event provisions. (Notably, the Determinations Committee determined that the 2014 application of Resolution Measures to BES referenced above was a Succession Event, causing the CDS that once referenced BES to reference the Reference Entity.) As discussed above, under the Definitions, a new tool, in the form of the Governmental Intervention Credit Event, is create to better protect creditors against credit risks caused by governmental interventions. The Determinations Committee should utilize the new tool in the context of events of the type that have given rise to the creation of the new tool. If the Determinations Committee decides that a Governmental Intervention Credit Event has not occurred because a succession has, then bondholders with CDS protection will suffer unexpected losses. These losses will be severely exacerbated if the 25% threshold is not met and the CDS stays with the Reference Entity without being triggered.