IN THE MATTER OF AN EXTERNAL REVIEW: NOVO BANCO S.A.

WRITTEN MATERIALS IN SUPPORT OF THE YES POSITION

I. INTRODUCTION & OVERVIEW OF THE YES POSITION[1]

1. These are the Written Materials in support of the Yes Position's case that a Governmental Intervention Credit Event ("GICE"), within Section 4.8(a) of the 2014 ISDA Credit Derivatives Definitions (the "2014 Definitions")[2], *has occurred* with respect to Novo Banco S.A. ("NB") on or about 29 December 2015.

2. For the reasons set out below, it is submitted that the restructuring and resolution action taken with respect to NB by the Bank of Portugal (the "BoP") on 29 December 2015 falls squarely within the definition of "Governmental Intervention".[3] This new[4] Credit Event was introduced into the 2014 Definitions in recognition of the fact that, following the global credit crisis, legislation was enacted in a number of jurisdictions, including in Europe in accordance with the new EU Bank Recovery and Resolution Directive, to enable Governmental Authorities to take action to ensure the continued viability of financial institutions in their jurisdictions, which could result in losses being imposed on creditors of such institutions. As such action could take a number of different forms, the GICE is drafted in very wide terms. Accordingly, as well as referring to various specific events, the GICE includes any event which "has an analogous effect to any of [those] events".

3. The Yes Position submits that, not only does the action taken by the BoP with respect to NB fall within the very broad language of Section 4.8(a) of the 2014 Definitions, but it is

[1] For background information about the credit derivatives market and the 2014 Definitions, see Firth, *Derivatives Law and Practice* (Sweet and Maxwell), Chapter 16.
[2] The 2014 Definitions came into general use on 6 October 2014. Terms defined in the 2014 Definitions have the same meanings when used in these Written Materials, unless the context otherwise requires.
[3] The GICE is designed for use where the Reference Entity is a bank, investment firm or other financial institution and the new Financial Reference Entity Terms are specified in the Confirmation. It is generally not selected for other types of Reference Entity (see the Credit Derivatives Physical Settlement Matrix – Exhibit 1).
[4] 'Governmental Intervention' is the first new Credit Event to be introduced into the ISDA Credit Derivatives Definitions since 1999.

precisely the type of event that the GICE was intended to cover. Indeed, a contrary conclusion would fail to give effect to the underlying purpose of Section 4.8(a) and would result in a situation where the holders of certain senior obligations of NB stand to suffer a substantial credit-related loss as a result of the BoP's action without being able to make a claim on the basis of a GICE under any credit protection they may have purchased. [5]

II. FACTUAL BACKGROUND

(i) The BoP's action on 29 December 2015

4. Prior to 29 December 2015, NB (a specially established bridge bank) was the sole obligor for certain bonds[6] (the "Affected Bonds")[7]. On 29 December 2015 the BoP, in the exercise of its powers as the Portuguese Resolution Authority provided for in a resolution measure adopted pursuant to the applicable Portuguese resolution and recovery law (the "RGICSF"[8]) took action[9], as a result of which NB ceased to be, and Banco Espirito Santo S.A. ("BES") was substituted as and became, the (sole) obligor for the Affected Bonds, and NB ceased to have any continuing obligations in respect thereof.

5. The BoP took this action, in view of significant impairments and negative adjustments to NB's accounts[10], in order to ensure the continuity of the critical functions of NB and

[5] Credit derivatives are transactions which transfer the credit risk – i.e. the risk of a credit-related loss – associated with a third party ("the Reference Entity") from one party ("the Buyer") to the other ("the Seller"), thereby enabling the Buyer to acquire credit protection in respect of the Reference Entity in return for payment of a fee, and enabling the Seller to generate a return for assuming this risk in respect of the Reference Entity.

[6] Five senior bonds governed by Portuguese Law in an aggregate nominal amount of Euro 1.941 billion.

[7] NB had become the issuer and obligor of the Affected Bonds in place of BES, their original issuer, as a result of the BoP's previous decision on 3 August 2014 in the exercise of its resolution and recovery powers whereby a substantial portion of the assets and liabilities of BES became assets and liabilities of NB, following the disclosure of substantial losses, and capital and liquidity shortfalls at BES.

[8] Portuguese General Law on Credit Institutions and Financial Companies – Exhibit 2.

[9] Described as "*extremely urgent, necessary and pressing*" in paragraph 14 of the BoP's decision dated 29 December 2015 – Exhibit 3, page 5.

[10] Paragraphs 10-12 of the BoP's decision dated 29 December 2015 – Exhibit 3, page 4. See also paragraph 2 of the BoP's press release: "*...the economic and financial situation of [NB] has been negatively affected since the date of its setting-up by additional losses which are referable to events predating the resolution date*", Exhibit 4, page 1.

avoid a significant adverse effect on the Portuguese financial system[11]. The BoP also announced at that time that it would take consequent steps to wind-up BES[12].

6. In the period leading up to 29 December 2015, it was open to holders of the Affected Bonds to acquire credit protection in the credit derivative market in respect of NB as the Reference Entity. As a result of the BoP's action on 29 December 2015, substituting BES for NB as the obligor of the Affected Bonds, so that their holders became obligees of BES, the holders of the Affected Bonds have been exposed to a credit-related loss[13]. This is well illustrated by the following table showing the market prices[14] of the Affected Bonds before and after the BoP's action on 29 December 2015.

ISIN	**Price 28/12/15**	**Price 30/12/15**	**Price 12/01/16**
PTBEQBOM0010	99	15	13
PTBENIOM0016	93	14	13
PTBENJOM0015	94	16	12
PTBENKOM0012	92	15	13
PTBEQKOM0019	94	15	12

(ii) Applicable restructuring and resolution legislation

7. The BoP's substitution of BES for NB as the obligor of the Affected Bonds on 29 December 2015 was effected[15] pursuant to its 're-transfer' power provided for in the RGICSF[16], after the initial exercise on 3 August 2014 of its "transfer" power therein[17].

[11] See paragraph 14 of the BoP's decision dated 29 December 2015 – Exhibit 3, pages 4 and 5.
[12] By requesting the European Central Bank to revoke BES' banking licence so as to commence judicial liquidation proceedings. See paragraph 4 of BoP's press release of 29 December 2015 – Exhibit 4, page 2.
[13] Indeed, as is apparent from the BoP's announcement on 29 December 2015 (Exhibit 3), BES is in a financially much weaker position than NB to satisfy such claims and is imminently the subject of judicial liquidation proceedings.
[14] Source: Bloomberg. Where pricing on 12 January 2016 is not available, the nearest prior date is used – Exhibit 5.
[15] See paragraphs 6-7 of the BoP's decision dated 29 December 2015 – Exhibit 3, page 3.
[16] In Chapter III of Title VIII of the RGICSF – Exhibit 2.
[17] See Annex 2, paragraph 2 of the BoP's decision of 3 August 2014 – Exhibit 6, page 17.

8. These statutory powers of the BoP were part of the implementation of the EU Bank Recovery and Resolution Directive 2014/59/EU of 15 May 2014 ("the Directive")[18], which established an EU-wide framework of national laws to facilitate governmental intervention in respect of failing financial institutions. The RGICSF, as amended[19], transposed into Portuguese national law the provisions of the Directive. Specifically, Article 145H(5)[20] of the RGICSF (as amended and renumbered to Article 145-Q(4)) regulated the exercise of the 'transfer'/'re-transfer' powers provided for in the Directive[21].

(iii) EU Bank Recovery and Resolution Directive 2014/59/EU of 15 May 2014

9. As a result of the global financial crisis and its serious effects on the banking industry in the period from 2007/8 onwards, shortcomings had been revealed in the tools available to European regulatory authorities to deal effectively with failing banks and financial institutions and prevent or contain systemic bank failures. It became clear that new 'recovery and resolution' measures were required, in connection with so-called government-initiated "bail-ins"[22] of failing financial institutions, to intervene to protect depositors and safeguard the financial system. Accordingly, the Directive was introduced to establish an EU-wide framework of national legislation for the recovery and resolution[23] of credit institutions and investment firms, under which their creditors and

[18] [2014] O.J. L173/190 – Exhibit 7.
[19] By Law Nº 23-A/2015, 2015-03-26, with effect on 27 March 2015 – Exhibit 8.
[20] Introduced by Decree-Law Nº 31-A/2012, 2012-02-10, with effect on 11 February 2012 – Exhibit 9.
[21] Specifically in Section 3 and Article 40ff of the Directive – Exhibit 7, page 73.
[22] A "bail-in" of a bank or financial institution typically involves its shareholders and/or creditors being exposed to credit-related losses through being required primarily to bear the burden of its losses, as a result of governmental action taking a variety of forms, which negatively affects (in whole or part) their rights and claims against the institution. This may be contrasted with a "bail-out" where the institution is rescued by an injection of new capital from an external source, usually a government or other source of public funds.
[23] Under Article 2(1) of the Directive, the term "resolution" means the application of one or more of the four "resolution tools" (referred to in Article 37(3)) in order to achieve one or more of the five "resolution objectives" (referred to in Article 31(2), and which are of equal significance), namely: (i) to ensure the continuity of the institution's critical functions; (ii) to avoid significant adverse effects on the financial system including preventing contagion and maintaining market discipline; (iii) to protect public funds by minimising reliance on extraordinary public financial support; (iv) to protect insured depositors and investors; (v) to protect client funds and client assets – Exhibit 7, pages 23, 67 and 59.

shareholders could be required to contribute to ("bail in") their losses[24]. Whilst capable of taking many different forms, government-initiated "bail-ins" essentially involve a reduction in the claims of shareholders and/or creditors of the institution on its equity or debt capital, so that such shareholders and/or creditors bear part of the institution's losses.

10. To this end, the Directive required Member States to ensure that their national resolution authorities were empowered to use a suite of new, so-called "resolution tools"[25], available for use singly or in conjunction, and/or sequentially, so as to facilitate a broad spectrum of governmental intervention. The breadth and flexibility of use of these resolution tools reflects the wide variety of different forms that governmental intervention might take[26].

11. In particular, as an integral part of this suite of new tools, the "bridge institution tool" gave a resolution authority the power to transfer assets, rights or liabilities of a financial institution to a bridge institution[27] with a view to maintaining and preserving its critical functions: see Section 3 Article 40 of the Directive. The Directive also specifically contemplated that, following the initial application of the bridge institution tool, the resolution authority might use this tool again to re-transfer some or all such assets, rights or liabilities from the bridge institution back to the financial institution: see Articles 40(6)(a) and 40(7) of the Directive[28].

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[24] Under these new bail-in provisions, Member States may impose on senior as well as subordinated creditors of a financial institution a mandatory write down, conversion or exchange in respect of the principal amount of claims or debt transferred to a bridge institution via the bridge institution tool or via the sale of business or asset separation tools (see footnote 26 below), in order to ensure that creditors contribute to the recapitalisation of the financial institution. Under Article 44(5) of the Directive, a bail-in of at least 8% of a financial institution's liabilities is a prerequisite to a government bail-out (Exhibit 7, page 80). In certain circumstances, this could potentially impact on senior as well as subordinated creditors of a financial institution.

[25] Namely (i) the sale of business tool, (ii) the bridge institution tool, (iii) the asset separation tool, and (iv) the bail-in tool. All of these tools (other than the asset separation tool) can be used individually or in combination.

[26] Indeed, for this reason, at the time of the introduction of the new GICE in the 2014 Definitions, it was not possible to foresee and anticipate in advance, with "crystal-ball" clarity, all the different possible forms and mechanisms under local law which future governmental intervention might assume; thus, a very widely drawn definition of GICE was adopted – as described in section III(i) below.

[27] An entity controlled by the resolution authority and created for the purpose of receiving and holding some or all such assets rights or liabilities.

[28] Similarly, pursuant to Article 42 of the Directive (Exhibit 7, pages 76-78), the new "asset separation" tool could be used by a resolution authority (together with one or more of the other resolution tools, such as the bridge institution tool – see Article 42(8)) in order to pass certain impaired assets rights or liabilities of an

12. Article 145H(5) of the RGICSF (subsequently amended and renumbered to Article 145-Q(4)) is the Portuguese law provision which regulates the use of the bridge institution tool referred to in Section 3, Article 40 of the Directive. The BoP took its action on 29 December 2015 pursuant to its Article 145-Q(4)) power, transposing into Portuguese law Article 40(6) of the Directive, to 're-transfer' assets and liabilities back from NB to BES.

(iv) Introduction of Governmental Intervention Credit Event in 2014 Definitions

13. The adoption and implementation of the Directive in response to global market events in the period from 2007/8 onwards, as referred to above, forms an important part of the context to, and helps to explain the rationale for, the introduction of the new GICE in the 2014 Definitions. This Credit Event was introduced in response to the incidence of government-initiated bank "bail-ins". This is evident from ISDA's official published guidance about the key changes to be introduced by the 2014 Definitions[29]. Further, certain previous instances of governmental intervention had tested and strained the limits

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institution under resolution onto an asset management vehicle for separate management and/or realisation. Again, Article 42(9) of the Directive expressly contemplated the possibility of the use of the asset separation tool more than once in order to re-transfer such assets, rights or liabilities back to the institution under resolution.

[29] By way of example, in ISDA's publication "*Proposed Amendments to the 2003 Credit Derivatives Definitions – Implementation Timing Proposal and List of Key Changes*" published on 15 July 2013, it was stated in relation to the topic "*Bail-in for financial Reference Entities*" (section 1 - Exhibit 10, page 3) that:

> "*For new transactions only on financial Reference Entities (banks): introduction of a new Credit Event triggered by a government initiated bail-in (for example pursuant to EU measures to be introduced in respect of financial institutions resolution and restructuring regimes). …".*

Similarly, in ISDA's 30 June 2014 publication "*Frequently Asked Questions- 2014 Credit Derivatives Definitions and Standard Reference Obligations: September 22, 2014 Go-Live*", under the heading "*What are some of the important changes under the 2014 Definitions?"* (section 4, Exhibit 11, page 4), it was stated:

> *"… The 2014 Credit Derivatives Definitions introduce several new terms, including:*
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> - *Bail-in/financial terms for credit default swap (CDS) contracts on certain financial reference entities: incorporates a new credit event triggered by a government-initiated bail-in and a provision for delivery of the proceeds of bailed-in debt or a restructured reference obligation, and more delineation between senior and subordinated CDS*."

This ISDA publication also stated (section 9, Exhibit 11, page 5) that:

> *New trades on financial Reference Entities in certain regions can be traded from September 22 [2014] using the new financial terms, which include a Governmental Intervention Credit Event, triggered by a government-initiated bail-in…"*

These statements were also substantially repeated in ISDA's 2 October 2014 publication "*Frequently Asked Questions- 2014 Credit Derivatives Definitions and Standard Reference Obligations: October 6, 2014 Go-Live*" (in section 5 and in section 12, respectively - Exhibit 12, pages 7 and 9).

of the 'Restructuring' Credit Event under the predecessor 2003 ISDA Credit Derivatives Definitions[30], and had highlighted the lack of a 'dedicated' Credit Event that was apt to cover the range of possible "bail-in" scenarios. The GICE was introduced to meet this need.

III. THE "YES" POSITION: ANALYSIS OF SECTION 4.8(a)

14. The answer to the Reviewable Question depends on whether, with respect to NB's Obligation(s) as the obligor of the Affected Bonds, one or more events specified in sub-sections (i)-(iv) of Section 4.8(a) has occurred, as a result of the BoP's action announced on 29 December 2015. If so, then it necessarily follows that a GICE has occurred.[31]

15. As set out below, it is submitted that, as a result of the BoP's action announced on 29 December 2015, there has occurred with respect to NB's Obligations:

    (a) a "*mandatory cancellation, conversion or exchange"*, within Section 4.8(a)(iii); or

    (b) an event "*which has an analogous effect to any of the events specified in Section 4.8(a)[...](iii)*", within Section 4.8(a)(iv).

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[30]In both the well-publicised cases of (1) SNS Bank NV and (2) Bankia S.A. in 2013, a Restructuring Credit Event was determined by the EMEA DC to have occurred as a result of government-initiated bail-in action, in circumstances where there was considerable doubt as to whether that Credit Event was validly triggered. The introduction of the new Governmental Intervention Credit Event was intended to remove the need to consider whether bail-in related events fell within the definition of a Restructuring Credit Event and to eliminate such doubt and uncertainty.

(1) In 2013, the Dutch bank SNS Bank NV was nationalised and its subordinated bonds expropriated pursuant to Dutch governmental bail-in legislation. Expropriation was not one of the events expressly contemplated by the definition of 'Restructuring' in the 2003 Definitions. No Failure to Pay or Bankruptcy Credit Events occurred. However, in February 2013 the EMEA DC determined that the expropriation of the subordinated bonds of SNS Bank N.V. constituted a Restructuring Credit Event, on the basis that there had been "*a reduction in the amount of principal or premium payable at maturity*", notwithstanding the fact that the bonds either remained in existence in the Dutch Government's possession, or else, if cancelled , had been cancelled at a time when the Multiple Holder Obligation requirement (referred to in the predecessor to section 4.10 of the 2014 Definitions) was not satisfied.

(2) In April 2013, the Spanish Fund for Orderly Bank Restructuring resolved that the subordinated debt of Bankia S.A. would be exchanged for Bankia shares pursuant to the Spanish bail-in legislation. The EMEA DC determined that this also constituted a Restructuring Credit Event.

[31]This conclusion necessarily follows from the facts and matters agreed in the Statement of Agreed Facts. It has (*inter alia*) been agreed by the Positions that: (i) the BoP is a Governmental Authority; (ii) the Affected Bonds are Obligations; (iii) the aggregate amount of the Affected Bonds is not less than USD 10,000,000 (or, its equivalent in the relevant Obligation Currency, being Euros; (iv) in consequence (and from the date) of the BoP's decision on 29 December 2015, BES was substituted as the issuer of, and became the obligor of, the Affected Bonds, and NB ceased to have any continuing obligations in respect thereof; and (v) such event(s) occurred as a result of action taken or an announcement made by the BoP pursuant to, or by means of, a restructuring and resolution law or regulation (or any other similar law or regulation), applicable to NB in a form which is binding.

(i) Approach to the construction of Section 4.8(a) [32]

16. It is apparent from its terms that the definition of GICE has intentionally been drafted very widely to reflect the wide variety of ways in which governmental resolution and restructuring action may take effect. Broadly speaking:

    (a) Section 4.8(a)(i) addresses various events changing the terms or ranking of the Obligations so as to reduce the amount(s) payable, postpone the payment date(s) or accord them a lower priority in the winding up of the Reference Entity;

    (b) Section 4.8(a)(ii) addresses various events by means of which the beneficial holder – i.e. the *obligee* – of an Obligation may be changed, so as to divest it of its claim under the Obligation against the Reference Entity;

    (c) Section 4.8(a)(iii) addresses various events by means of which the Obligation(s) of the Reference Entity as the *obligor* to holders may be extinguished, or changed into or replaced by different obligation(s)[33]; and

    (d) Section 4.8(a)(iv) is a broad, 'catch all' clause to capture any and every event with an analogous effect to any of the foregoing events[34].

17. The intended broad scope of Section 4.8 is further evidenced by comparison with Section 4.7. While these limbs of Section 4.8(a) substantially overlap with the limbs of the Restructuring Credit Event in Section 4.7(a), Section 4.8 goes further, adding limbs (a)(ii)-(iv) that extend beyond those provided for in Section 4.7(a). In particular, Section 4.8(a)(iv) extends the ambit of the definition of GICE so as to include "any event which has an analogous effect to any of the events specified in Sections 4.8(a)(i)-(iii)". Further,

[32] The general principles of construction to be applied as a matter of English law are well-established and very familiar to the External Reviewers and therefore will not be rehearsed here.

[33] This may occur, for example, in the case of the division of the Obligations of an institution in resolution between a "good bank and a "bad bank": some of the obligations (be they senior or subordinated) of the "bad bank" are replaced by obligations of the "good bank", while others remain obligations of the "bad bank".

[34] Reflecting that, when the GICE definition was drafted, it was not possible to foresee and provide in advance for all the possible forms, under different local laws, which future governmental intervention might take.

in contrast to a Restructuring Credit Event, a GICE may occur notwithstanding the fact that the 'trigger' event is expressly provided for under the terms of the Obligation(s)[35], and does not require that such event should result from any deterioration in the creditworthiness or financial condition of the Reference Entity.

18. According to the opening words of Section 4.8(a), an event specified in any limb of Section 4.8(a) must occur "*with respect to one or more Obligations*"; it is therefore key to the correct interpretation of the GICE to identify the relevant Obligation(s) in question.

19. "Obligation" is defined (in Section 3.1(a)-(b) on page 27 of the 2014 Definitions) to mean:

> "*(a) any obligation of the Reference Entity (either directly or as provider of a Relevant Guarantee) determined pursuant to the method described in Section 3.13 (Method for Determining Obligations); and*
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> *(b) the Reference Obligation*".[36]

20. For the purposes of Section 3.1(a), Section 3.13 (on pages 30-31) provides that the term "Obligation" is defined as each obligation of the Reference Entity described by the "Obligation Category" (and having each of the "Obligation Characteristics", if any[37]) specified in the related Confirmation, immediately prior to the Credit Event in question. For this purpose, "Obligation Category" means one (only) of "Payment", "Borrowed Money", Reference Obligation Only", "Bond", "Loan" or "Bond or Loan". Since an Obligation may be specified within any of these categories, the terms of the various limbs of Section 4.8(a)(i)-(iv), which are in principle of universal application to any such Obligation(s), must be interpreted broadly, and in a general sense that is equally apt to

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[35] Catering for the fact that certain instruments may contain express bail-in provisions.
[36] Provided that it is not an Excluded Obligation (as defined).
[37] "Obligation Characteristics" means any one or more of "Not Subordinated", "Specified Currency", "Not Sovereign Lender", "Not Domestic Currency", "Not Domestic Law", "Listed" and "Not Domestic Issuance": this definition underlines the breadth of the range of possible types of Obligation to which the various limbs of Section 4.8(a) are capable of applying.

apply to any potentially applicable "Obligation Category", not narrowly by reference only to one specific "Obligation Category" (such as, for example, "Bond").

21. For the purpose of Section 3.1(b), "Reference Obligation" is defined (in Section 2.5 on pages 21-22 of the 2014 Definitions) to mean the "Standard Reference Obligation" (save for certain exceptions which are immaterial for present purposes). That is in turn defined (in Section 2.6 on page 22) as "*the obligation of the Reference Entity with the relevant Seniority Level*[38] *which is specified from time to time in the SRO List*[39]".

22. Accordingly, the definition of GICE is predicated on the *substance* of the obligation owed by the Reference Entity – i.e. its liability – under the instrument in question, rather than the particular *form* of the instrument documenting the obligation[40].

23. In this case, the relevant Obligation is the obligation of NB as the obligor of the Affected Bonds, i.e. the liability of NB to holders of the Affected Bonds, not the instrument(s) documenting such liability. Prior to the BoP's substitution of BES for NB as the obligor/issuer for the Affected Bonds on 29 December 2015, NB was the obligor of the Affected Bonds. As a result of the BoP's action, as is common ground, BES became the obligor in place of NB, and NB ceased to have any continuing obligations, in respect of the Affected Bonds. Holders of the Affected Bonds thereby ceased to have any claim against NB and obtained in its place a claim against BES, a new and different obligor.

(ii) Correct construction of Section 4.8(a)(iii)

24. The Yes Position submits that a mandatory "*conversion or exchange*" with respect to the Obligation(s) of NB has occurred within the meaning of Section 4.8(a)(iii):

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[38] i.e. Senior Level or Subordinated Level: see Section 2.17 on page 25 of the 2014 Definitions.

[39] i.e. the list of Standard Reference Obligations published by ISDA on its website from time to time: see Section 2.18 on page 25 of the 2014 Definitions.

[40] Similarly, by virtue of Section 4.8(b), the term "Obligation" for the purposes of Section 4.8(a) is also deemed to include "Underlying Obligations" for which the Reference Entity is acting as provider of a Guarantee. In this context "Underlying Obligation" is (by Section 3.23 on page 36) defined as "*with respect to a guarantee, the obligation which is the subject of the guarantee*" i.e. the guaranteed liability.

(a) According to their natural and ordinary meanings: ‘conversion’ means a change in character, nature, form or function; ‘exchange’ means giving one thing up and receiving another in its place.[41]

(b) As a result of the BoP’s action on 29 December 2015, the obligation of NB as the obligor of the Affected Bonds was mandatorily converted into, or exchanged for, an obligation of BES as the new obligor thereof. Holders of the Affected Bonds thereby acquired a claim against BES in place of a claim against NB – an intrinsically different obligation or liability. The credit risk as against BES, to which holders of the Affected Bonds have thus become exposed, is entirely different from – and materially greater than – the credit risk as against NB to which they were previously exposed. There was clearly a change in the character or nature of the obligation owed to the holders. Further, in consequence, the former obligation of NB to the holders was given up and replaced by a new obligation of BES to the holders.

(c) The mere fact that the *form* of the instruments remained the same, despite the substitution of BES for NB as the obligor, is irrelevant and does not affect this analysis: as a result of this complete change of obligor, the character or nature of the obligation owed before and after it was different in *substance*. The obligation/liability of NB to holders ceased and was replaced by the obligation/liability of BES to holders. The fact that the new obligation of BES was on the same terms and conditions as the former obligation of NB is beside the point.

(d) Therefore, the effect of the BoP’s action in this instance was fundamentally different and distinguishable from, and cannot be equated with, a mere amendment to a term or condition applicable to an Obligation. The latter would not amount to a “conversion” or “exchange” for the purpose of Section 4.8(a)(iii).

[41] Oxford English Dictionary.

(e) Further, as noted above, "conversion" and "exchange" are words of general application to Obligation(s) of widely different kinds (as denoted by the wide range of possible Obligation Categories), and are therefore properly to be interpreted and understood in a broad, general sense, not in any narrow, specialised sense peculiar to any one particular type of instrument or asset class.

(f) There is no justification for reading down the words "conversion or exchange" in Section 4.8(a)(iii) as if they were narrowly confined to a change from one *form* of instrument to another different *form* of instrument (e.g. from a bond to equity), or as if they were limited only to claims against the same original obligor. This phrase is equally apt to apply, for example, to a change from issuer/obligor 'X', to issuer/obligor 'Y', in respect of the same bond[42]. There is no good reason to suppose *a priori* that the draftsman must have intended to exclude altogether from the ambit of Section 4.8(a)(iii) any situations where, as a result of governmental action, an obligation of one obligor ceases and an obligation of the same form of a different obligor (and equally possibly of less value), is put in its place.[43]

(g) The specific and limited usage of "exchange" in the (entirely distinct and different) context of Sections 2.2(d) and 4.7(d) of the 2014 Definitions does not inform, and is not a reliable guide to, the correct interpretation of this word in Section 4.8(a):

(i) Section 2.2(d) is exclusively concerned with the provisions for determining a Successor to the Reference Entity (<u>not</u> with the occurrence of a Credit Event). Those provisions are here irrelevant (see paragraph 24(h) below). Further, the word "exchange" is used there only in a very specific and limited context, viz. of

[42] Once it is accepted that "conversion or exchange" can apply where an obligation owed by X is replaced with an obligation owed by Y, it is immaterial whether this change is documented by the issue of a new instrument.

[43] Similarly, a debt obligation owed by the obligor may, as a result of governmental action, be converted into or exchanged for a monetary claim by the holder against the governmental authority evidenced by the original debt instrument. It is anomalous that such a situation should fall within Section 4.8(a)(iii) but the conversion or exchange of such debt obligation for an obligation of a different third party obligor should not.

"Exchange Bonds or Loans" (as defined), whereas in Section 4.8(a) it is used in a different, more general, context and has a much broader sense;

(ii) Section 4.7(d) is similarly, but even more narrowly, confined to the specific and limited context of an exchange of a Bond only (see Section 4.7(a) lines 6-7)[44]. This is entirely distinct and different from the general context in which the word is used in Section 4.8(a)(iii).

(iii) It therefore does not logically or necessarily follow from either Sections 2.2(d) or 4.7(d) that, in the separate context of Section 4.8(a), the substitution of BES for NB as the obligor for the Affected Bonds does *not* amount to an "exchange".

(h) Indeed, the "Successor" provisions in Section 2.2 are not relevant to, and do not detract from, this analysis of the occurrence of a GICE in the present case[45]: if the BoP's substitution of BES for NB as obligor for the Affected Bonds satisfies the definition of a GICE, then the GICE occurs, irrespective of whether or not BES might also become the Successor of NB in respect of the Affected Bonds. The occurrence of the GICE is determined without reference to the separate question of whether there is any Successor to the Reference Entity. The latter is only relevant to the occurrence of any further Credit Event(s) in future (subsequent to the GICE in question)[46] but is of no consequence to the occurrence of the GICE itself.

(i) In light of the broad and general sense in which the words of Section 4.8(a)(iii) are properly to be interpreted, no particular significance should be attributed to the absence of the word "transfer" from Section 4.8(a)(iii), or by comparison with its

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[44] In that specific context, a comparison is to be made of the terms of the obligations prior to and immediately after such exchange in order to determine whether a Restructuring Credit Event has occurred.

[45] The Successor Provisions cannot be regarded as, and provide no, substitute for the occurrence of a GICE. Indeed, it is not difficult to envisage examples of situations in which the Successor Provisions would not be engaged at all by the occurrence of one or more events which caused the Obligation(s) of a Reference Entity to be exchanged for or converted into obligations of another obligor.

[46] If the DC determines that a GICE has occurred, this will become academic. However, the DC may not have made a determination by the time of the subsequent Credit Event or there may have been no referral to the DC of the question of whether a GICE has occurred.

inclusion in Section 4.8(a)(ii): Section 4.8(a)(ii) is concerned with an entirely different concept and type of situation – namely, a mandatory change in the *beneficial holder* (i.e. the *obligee*) of an Obligation. In that context, it is accurate to refer in general terms to a "transfer": the Obligation subsists, the obligor remains unchanged, and only the ownership of the Obligation changes. However, where (as here) there is a change in the *obligor*, it may be inaccurate to refer loosely to a "transfer" of "the" Obligation.[47] In some jurisdictions the use of this terminology may be accurate under the local law but in others it may not. The draftsman cannot, however, be taken to have intended the occurrence of the GICE to turn on how the substitution of an obligor is described as taking effect under the local law. The inclusion of the word "transfer" in Section 4.8(a)(iii) would therefore have created an ambiguity that was not intended. It cannot therefore be inferred from its absence that Section 4.8(a)(iii) was not intended to cover the type of situation (as here) where the obligor for selected obligations is changed.[48]

(j) For these reasons, the requirements of Section 4.8(a)(iii) are satisfied in this case.

25. Further, or alternatively, it is submitted (insofar as necessary) that a mandatory "*cancellation*" with respect to NB's Obligations has occurred within Section 4.8(a)(iii):

(a) According to its ordinary and natural meaning, "cancellation" means annulling or striking out[49]. By virtue of the mandatory substitution of BES for NB, the former obligations of NB to holders of the Affected Bonds were annulled and struck out – or, in other words, cancelled. Following this substitution, NB's obligations have

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[47] It is not relevant or determinative, that the English translation (which itself is stated to have no legal value) of the BoP's announcement dated 29 December 2015 uses the words "transfer"/"re-transfer" to describe the BoP's actions with respect to the Affected Bonds: the relevant question is whether the event(s) which in fact occurred on 29 December 2015 satisfy the requirements of Section 4.8(a)(iii)-(iv) on their true construction.

[48] Indeed, this would be a rather unlikely result, and represent a surprising lacuna in the definition of a GICE, given that by the time of the introduction of the new GICE in the 2014 Definitions, it was contemplated that governmental resolution and recovery action could take the form of a so-called "good bank"/"bad bank" split, involving the substitution/ re-substitution of a bridge bank (or "good bank") for a financial institution (or "bad bank"), and vice versa, as the obligor for some or all of a Reference Entity's Obligations.

[49] Oxford English Dictionary.

ceased and can no longer be claimed upon by holders of the Affected Bonds. The fact that a new and distinct obligation, owed to holders by a *different* obligor (BES), came into being at that time does not derogate from that position. This is also entirely consistent with the clear contractual focus of Section 4.8(a)(iii) on the effect of the action taken by the BoP on *NB's obligations*.

(b) This analysis would be fortified if (contrary to the preceding submissions) the words "*conversion or exchange"* were to be very narrowly interpreted, so as to apply only where one obligation of the Reference Entity is replaced by a different obligation of *the same* Reference Entity; then "*cancellation*" would be apt to apply in circumstances where (as here) the Reference Entity's obligation ceases and no new obligation at all *on its part* comes into existence in its place.

(c) In any event, the words "cancellation", "conversion" and "exchange" as used in Section 4.8(a)(iii) are not necessarily to be interpreted as entirely mutually exclusive concepts: there is no warrant in the words of the section themselves, or otherwise, for so interpreting them. This can be seen from the fact that the terms "conversion" and "exchange" themselves overlap[50]. In that context, it is no surprise that there is also an overlap with the term "cancellation". The use of such broad and, to some extent, overlapping language demonstrates that the *effect* of the governmental intervention is the focus of the section, regardless of the precise form that it takes.

(iii) Correct construction of Section 4.8(a)(iv)

26. In the alternative, it is submitted that an "*event which has an analogous effect to*" a mandatory cancellation, conversion or exchange with respect to the Obligation(s) of NB has occurred within the meaning of Section 4.8(a)(iv):

[50] 'Conversion' is also defined in the Oxford English Dictionary as "substitution of or exchange for something else", while exchange is defined as "substitution of one person or thing for another".

(a) The draftsman has employed very wide and open-ended language in Section 4.8(a)(iv), enabling a correspondingly broad interpretation and flexible application, given that governmental intervention may take many different forms and may be effected by means of a variety of different resolution actions, tools and mechanisms.

(b) The words of Section 4.8(a)(iv) direct attention to the "*effect*" of any event: the effect must be analogous to that of a mandatory cancellation, conversion or exchange on NB's Obligation (the events *themselves* are not required to be analogous).

(c) Consideration of the "*effect*" of an event clearly, in this context, requires analysis of its economic impact on NB's Obligation (rather than the *form* of the instrument documenting the Obligation(s)). The selection of the phrase "*analogous effect*" makes it plain that this sub-section is not narrowly confined to only events which alter the *form* of the instrument, but is directed to their substantive *effect*.

(d) The mandatory substitution of BES for NB as the obligor for the Affected Bonds has an effect on NB's Obligations that is analogous to that of a mandatory cancellation, conversion or exchange, because the Obligations of NB to, and claims by, holders of the Affected Bonds against NB, thereupon cease; instead BES owes new obligations, and the holders acquire new claims against BES, with respect to the Affected Bonds. Economically this effect is "*analogous to*" (indeed substantially the same as) the effect of an exchange of NB's former obligations for BES' new obligations, or a conversion of the former into the latter, or, so far as NB's obligations themselves are concerned, their cancellation.

(e) This construction of Section 4.8(a)(iv) does not, however, open the door too widely so as to admit any event whatever affecting a Reference Entity's Obligation: for example (as noted above) a simple amendment to a term of an Obligation would not be, or have an effect analogous to, a "cancellation, conversion or exchange". This

would not bring about the cessation of the Obligation, or change it into a fundamentally different liability. The operative words of Sections 4.8(a)(i)-(iii) still apply to govern and limit appropriately the scope of Section 4.8(a)(iv).

(ii) Sensible, commercial result of Yes Position's construction

27. Accordingly, the requirements of Section 4.8(a)(iii)-(iv) are satisfied in the present case. Standing back from the detailed analysis of the terms of those provisions, this produces a sensible and practical commercial result, and is also consistent with the overall structure of the Credit Events in the 2014 Definitions.

28. Where governmental action results in the substitution of a new and different obligor for the former obligor, potentially exposing holders of the obligations to a credit-related loss, it is, and should be, immaterial whether the rights/claims with which the holders end up:

    (a) lie against the Reference Entity itself or against a third party, as in either case they may be of less value than the original Obligations[51]; or

    (b) are represented by the same, or a different form of instrument: the effect on holders may be the same, regardless of how the rights are evidenced or documented[52].

29. It would also be an anomalous and arbitrary result that a GICE should be triggered only by government-initiated "bail-in" action effected by means of *some* of the suite of resolution tools provided for under the Directive, but not *others* – viz. the bridge institution tool (as transposed into Portuguese national law in the RGICSF). This is all the more implausible where all four resolution tools were provided to form an integrated suite of measures which could be used by a governmental authority in combination.

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[51] The contrary conclusion, which flows from the No Position's interpretation, leads to the anomalous and apparently arbitrary consequence that resolution action by a governmental authority will constitute a GICE where the claims of holders of the Obligations are substituted for less valuable claims against the Reference Entity itself, but not where they are substituted for claims against a third party that equally may be of less value.

[52] On the No Position's interpretation, it appears that a GICE will occur if a new instrument is issued by the new obligor on the same terms and conditions as the former instrument, but not if the new obligor is substituted for the old obligor, subject to the same terms and conditions, and it happens that no new instrument is issued.

30. The occurrence of a GICE triggers settlement of relevant credit derivatives contracts. In broad terms, this will generally[53] involve (a) a valuation of any obligations of the Reference Entity that satisfy certain criteria ("Deliverable Obligations")[54] and the payment by the Seller to the Buyer of an amount equal to the difference between the par value of the Deliverable Obligation with the lowest market value following the Credit Event and that market value or (b) the delivery by the Buyer to the Seller of Deliverable Obligations of the Reference Entity, as selected by the Buyer, in return for the payment of their par value. In the latter case, the Buyer will generally choose to deliver the Deliverable Obligation with the lowest market value. This is sometimes referred to as the "cheapest to deliver" obligation. Further, assuming that the Financial Reference Entity Terms are specified, and the GICE occurs, the Asset Package Delivery provisions (Section 8.8) will apply[55].

31. In such circumstances, the interests of holders of Senior Obligations will be protected:

    (a) If, as may well be the case, in a situation of a "good bank"/"bad bank" split[56], not all of the Senior Obligations of the "bad bank" have become obligations of the "good bank", then the occurrence of a GICE will trigger a substantial settlement payment,

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[53] i.e. where "Auction Settlement" is specified and the DC decides to hold an Auction or where Physical Settlement is specified, or applies because the DC has decided not to hold an Auction. Auction Settlement is normally specified: see the Credit Derivatives Physical Settlement Matrix – Exhibit 1.

[54] See Section 3.2 of the 2014 Definitions.

[55] These provisions are designed to protect a Buyer in circumstances where, as a result of a government-initiated "bail-in", the Deliverable Obligation has either been converted into something that does not constitute a Deliverable Obligation, or has been written-down in part (such that it becomes uneconomic to Deliver) or in full (such that there is no obligation which can actually be Delivered). It is intended that the Buyer should be able to Deliver whatever the relevant amount of the Deliverable Obligation has been converted into, against a payment of par by the Seller. Thus, where a GICE has occurred, these provisions operate so that any obligation that would have been a Deliverable Obligation immediately prior to the occurrence of the GICE would continue to be capable of Delivery by the Buyer in satisfaction of its CDS protection, regardless of the form which it took after such Governmental Intervention. This is the so-called "Asset Package" which the Buyer is able to deliver in lieu of that Prior Deliverable Obligation.

[56] As in this case the 'retransfer' by the BoP of the Affected Bonds from NB to BES, following and partly reversing its earlier 'transfer' of assets and liabilities from BES to NB. The BoP's decision of 29 December 2015 (at paragraph 16) (Exhibit 3, page 5) expressly recognised the differentiated treatment in terms of burden-sharing of the holders of the Affected Bonds, as compared with other types of senior creditors of NB, holding unsecured credits which remained obligations of NB. The BoP explained this as necessary to avoid adversely affecting the franchise and stability of NB, and the stability of the Portuguese banking system.

based on the value of the remaining Deliverable Obligations of the "bad bank" (which will presumably be the cheapest to deliver). This payment will protect holders of obligations of the "bad bank" against the credit-related loss they will have suffered as a result of the Governmental Intervention. The outcome therefore makes commercial sense in the circumstances.

(b) If, on the other hand, all the Senior Obligations of the "bad bank" become obligations of the "good bank" and were Deliverable Obligations, then the Asset Package comprising those obligations will be delivered; assuming that the "good bank" has a good credit rating and its obligations are trading at or very close to its par value, the settlement payment triggered by the GICE is likely to be minimal. This outcome also makes commercial sense: no holders of the "bad bank's" former Senior Obligations will have suffered a material credit-related loss as a result of the Governmental Intervention. There is no material downside to settlement occurring in such circumstances (the buyer and seller are released from their obligations[57] and free to buy/sell credit protection at the rate applicable to the "good bank's" obligations)[58].

32. It is true to say that, in the first scenario, holders of Senior Obligations of the "good bank" may not suffer such a loss as a result of the Governmental Intervention. However, this is also a general feature of the structure of the 2014 Definitions (which do not distinguish between different types of Senior Obligations for settlement purposes, upon the occurrence of a Credit Event affecting one type of Senior Obligation).

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[57] The Buyer's obligations typically accrue from day to day, with payments becoming due on a quarterly basis: see Section 12.12 of the 2014 Definitions and the Credit Derivatives Physical Settlement Matrix – Exhibit 1.

[58] Although it is possible that some of the "good bank's" obligations will be trading at less than par, not due to credit concerns but as a result of particular features associated with those obligations (such as a lower than market interest rate), the possibility of this is a general feature of the 2014 Definitions. For example, a Restructuring may solve a Reference Entity's financial problems, so that, by the time its Deliverable Obligations come to be valued, their market value is no longer affected by such credit concerns. The Reference Entity's Deliverable Obligations may, however, be trading at less than par because (for example) they carry a lower than market interest rate.

(a) For example, a Restructuring Credit Event will occur where a company restructures only some of its Senior Obligations but not others (which it continues to perform). Holders of restructured Senior Obligations will suffer a credit-related loss while holders of unrestructured Senior Obligations will not necessarily do so. Nevertheless, the occurrence of such a Credit Event will result in settlement of the transaction on the basis of the value of those restructured obligations.

(b) Similarly, where a Reference Entity pays the amount due under some of its Senior Obligations but defaults in respect of others (a "Failure to Pay"), this will constitute a Credit Event (in the circumstances set out in Section 3.5 of the 2014 Definitions) even though the holders of the first set of Obligations will have received payment in full. In each case, the occurrence of such a Credit Event will result in the transaction being settled (on the basis of the value of the cheapest to deliver obligation).

IV CONCLUSION

33. Accordingly, it is submitted that a GICE, within Section 4.8(a) of the 2014 Definitions, *has occurred* with respect to NB on or about 29 December 2015. The External Reviewers are therefore respectfully invited unanimously to answer the Reviewable Question: "Yes".

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Advocates for the Yes Position

5 February 2016