

## EMEA DC STATEMENT 23 OCTOBER 2017

The DC met on 20 October 2017 to discuss further the Substitute Reference Obligation question posed to the DC in relation to senior Updated 2003 Transactions referencing Novo Banco S.A. (the **Reference Entity** or **NB**) and specifying the bond identified in Annex 1, Part 1 hereto (the **Original Reference Obligation**) as the Reference Obligation (the **Relevant Transactions**).<sup>1</sup>

Capitalised terms otherwise used but not defined in this statement have the meaning given to them in the 2016 Credit Derivatives Determinations Committees Rules (January 20, 2016 version) (including in the Updated 2003 Definitions, as defined therein).

### 1. Summary of DC determinations

The DC Resolved that:

- (a) in accordance with Section 2.30 of the Updated 2003 Definitions, the bond identified in Annex 1, Part 2 hereto (the **New Reference Obligation**) is a Substitute Reference Obligation of NB in respect of the Original Reference Obligation for the purposes of Relevant Transactions which were entered into prior to 29 December 2015 (the **Transfer Date**) only; and
- (b) no Substitute Reference Obligation of NB in respect of the Original Reference Obligation would be applicable for the purposes of Relevant Transactions which were entered into on or after the Transfer Date..

### 2. Background

- (a) On 3 August 2014, the Bank of Portugal ordered the adoption of a resolution measure with respect to Banco Espírito Santo, S.A. (**BES**), pursuant to which a substantial portion of BES's assets, liabilities (including the Original Reference Obligation) and off-market balance sheet items were transferred to NB.
- (b) On 8 August 2014, the DC identified NB as the Successor to BES such that Updated 2003 Transactions referencing BES thenceforth referenced NB as the Reference Entity.
- (c) On the Transfer Date, the Bank of Portugal ordered the transfer of five senior bonds, including the Original Reference Obligation, from NB to BES, such that BES was substituted as the issuer of the bonds and NB ceased to have any continuing obligations in respect thereof (the **Transfer**).
- (d) The DC understands that, on or after the Transfer Date, a number of Relevant Transactions were executed, i.e. trades referencing the Original Reference Obligation notwithstanding the fact that this was no longer an obligation of NB.
- (e) Markit adopted the New Reference Obligation to replace the Original Reference Obligation as the Markit RED Preferred Reference Obligation (the **RED Preferred**) on 12 April 2016, being the day after the DC resolved to publish an SRO Identification Resolution in respect of the New Reference Obligation as the replacement Standard Reference Obligation for the Original Reference Obligation for senior 2014 Transactions referencing NB.
- (f) On 26 May 2016, DTCC facilitated an auto-adherence update run to move Relevant Transactions entered into prior to the Transfer Date from the Original Reference Obligation to the New Reference Obligation. The auto-adherence process did not apply to any Relevant Transactions entered into on or after the Transfer Date.

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<sup>1</sup> See EMEA DC Issue Number 2017100402: <https://dc.isda.org/cds/novo-banco-s-a-4/>

- (g) The final maturity date of the Original Reference Obligation was 8 May 2017, however, no payment was made at such time and therefore this obligation is still outstanding.

### **3. Issues considered by the DC**

The Substitute Reference Obligation questions posed to the DC were as follows:

- (a) whether there is an obligation on the Calculation Agent to identify a Substitute Reference Obligation pursuant to Section 2.30(a)(ii)(C) of the Updated 2003 Definitions to replace the Original Reference Obligation in respect of any Relevant Transactions, irrespective of whether such transactions were entered into before or after the Transfer Date; and
- (b) if so, whether the New Reference Obligation (being the RED Preferred) is the Substitute Reference Obligation for such Relevant Transactions.

### **4. Analysis**

Section 2.30(a)(ii)(C) of the Updated 2003 Definitions provides as follows:

*"In the event that...for any reason other than the existence or occurrence of a Credit Event, any Reference Obligation is no longer an obligation of a Reference Entity, the Calculation Agent shall...identify [a Substitute Reference Obligation] to replace such Reference Obligation."*

The Original Reference Obligation ceased to be an obligation of the Reference Entity on the Transfer Date and so the key question of interpretation for the DC was whether an obligation can be said to be "no longer" an obligation of the Reference Entity, when it was already not an obligation of the Reference Entity on the relevant Trade Date.

The DC was of the view that the natural meaning of the words "no longer" clearly suggested that the obligation to identify a Substitute Reference Obligation should only arise if the relevant event (in this case, the Reference Obligation ceasing to be an obligation of the Reference Entity) happens during the life of the trade, i.e. after the Trade Date. To construe otherwise would mean that a Calculation Agent would be under an obligation to select a Substitute Reference Obligation as soon as the relevant trade is entered into. The DC did not believe that a broader, more purposive construction of the words "no longer" were required in this instance as construing the words in such a way would not make more sense: the narrower and more natural construction of the words was perfectly sensible such that the Calculation Agent's duty to select a Substitute Reference Obligation pursuant to Section 2.30(a)(ii)(C) of the Updated 2003 Definitions only arises if the relevant event occurs after the Trade Date.

In support of this construction, the DC noted that the Transfer itself resulted in a Credit Event question and a Successor question being raised to the DC, albeit in the context of 2014 Transactions referencing NB therefore the fact that the Original Reference Obligation was no longer an obligation of NB was well-publicised in the market.

The DC noted that the consequence of concluding that Section 2.30(a)(ii)(C) of the Updated 2003 Definitions does not apply in respect of Relevant Transactions entered into on or after the Trade Date is that the Original Reference Obligation (which is now a BES obligation) would be a Deliverable Obligation for the purposes of settling these trades. The DC is considering whether to run an Auction for any such triggered trades and will publish an update in due course.

The bifurcated approach taken by the DC in relation to Relevant Transactions arises because the Original Reference Obligation (being a BES obligation) was selected as the Reference Obligation after the Transfer Date and so at a time when it was an obligation of BES. The same issue does not arise in relation to senior 2014 Transactions referencing NB for which Standard Reference Obligation is applicable. These trades

would just follow the published Standard Reference Obligation for the Senior Level and the time a particular trade is entered into is not relevant.

Finally, the DC's determination on the Substitute Reference Obligation questions in respect of Relevant Transactions is without prejudice to the identification of the Reference Obligation under any such trades which were submitted to clearing and therefore subject to the relevant clearing house rules.

**ANNEX 1**

**PART 1**

**ORIGINAL REFERENCE OBLIGATION**

<b>ISIN</b>	<b>Coupon</b>	<b>Final Maturity Date</b>	<b>Currency</b>
PTBEQKOM0019	2.625%	8 May 2017	EUR

**PART 2**

**NEW REFERENCE OBLIGATION**

<b>ISIN</b>	<b>Coupon</b>	<b>Final Maturity Date</b>	<b>Currency</b>	<b>Nominal Amount</b>
XS0772553037	5.00%	23 April 2019	EUR	€750,000,000