Clients&FriendsMemo

Bank Resolutions – Trust the Regulators, but Keep Your Powder Dry

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In times of financial turbulence, politicians, regulators and the media make the case for tighter controls of the markets. However, with new regulatory powers coming in and the resulting extra layer of complexity that their application brings, investors have their reasons not to put their trust in regulators. As seen with recent developments in Portugal and Italy, a number of competing motivations surround the rescue of financial institutions. The old maxim – "Put your trust in God, but keep your powder dry" - may be applied to describe investor sentiment in an environment where treating senior investors equitably has not been a priority for local regulators.

The BRRD

In the European Union, the Bank Recovery and Resolution Directive[1] ("**BRRD**") was implemented to equip national authorities with a new framework for recovery and resolution of EU credit institutions and significant investment firms, providing for harmonised tools and powers to tackle crises at banks in a way that minimises costs for taxpayers. Reflective of those new powers, the credit derivatives market[2] added a new trigger, designed to apply to resolution measures taken with respect to European financials – the "Governmental Intervention" Credit Event ("**GICE**").

BES

The Bank of Portugal ("**BoP**") in its capacity as the Portuguese Resolution Authority with respect to Banco Espirito Santo S.A. ("**BES**" – which was the "bad" bank after the resolution measures taken in 2014) and Novo Banco ("**NB**" – the "good" bank) interrupted many market participants' Christmas break by announcing on 29 December 2015 that five (out of 52) tranches of senior bonds of NB will be retransferred back to BES. The retransfer wiped out the value of some €1.9bn of debt. As a result, the tier-1 capital ratio of NB was improved (from a reported 9.4% to 13%).

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1 2014/59/EU.

2 In its revision of the 2014 ISDA Credit Derivatives Definitions (the "Definitions").

Market reaction

The BoP decision created an uproar – holders of the affected bonds were incensed by the transfer, arguing that: (i) under the BRRD certain conditions have to be met – for example, the bank must be about to fail, not simply breaching its capital ratios and (ii) BoP deliberately selected bonds governed by Portuguese law to avoid challenges in other courts, such as the courts of England and Wales.

Credit default swaps ("CDS")

The related issue for investors that hedged their holdings in NB was whether that transfer triggered their CDS protection. The question was accepted by an ISDA Determination Committee ("**DC**") on 4 January 2016; after deliberation and voting, there was no Supermajority (80% of the vote), which triggered the External Review Process. Briefs were submitted arguing the positive and the negative response to the question of whether a GICE has occurred.[3]

The argument that no GICE occurred[4]

For the "No" position, Robert Miles QC argued that the re-transfer does not affect the rights of bondholders as specified under the relevant section of the Definitions,[5] because holders remain "entitled" to the same rates of interest and the same amount of principal as before, each payable on the same terms as before. Giving words their natural meaning, this view concluded that no "cancellation", "conversion" or "exchange" of the relevant bonds had occurred, because the nature of the securities did not change. The argument was also made that the re-transfer should not be treated as an event with an "analogous effect" (to the more narrowly defined intervention acts) for the sake of certainty in the markets.[6]

The argument that a GICE occurred[7]

The "Yes" position (advocated by Timothy Howe QC) submitted that the definition of GICE has intentionally been drafted widely to reflect the many ways in which governmental resolution and restructuring may take effect. A mandatory "conversion or exchange" with respect of the Obligations of NB occurred, as the affected bonds were converted or exchanged into obligations where the credit risk (as against BES) is entirely different, and materially greater, than that of NB. The mere fact that the form of the instrument remained the same should not affect the analysis of the substance of the obligation, the argument ran. The "Yes" position argued that the catch-all provision in the GICE definition – "analogous effect" – should capture the change of the Obligation into a fundamentally different liability.

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3 Published on ISDA's website.

4 http://dc.isda.org/cds/novo-banco-sa-2/.

5 Section 4.8(a)(i) of the Definitions.

6 And to avoid a problematic outcome where an event can be both a GICE and a succession event.

7 http://dc.isda.org/cds/novo-banco-sa-2/.

The Decision of the External Review Panel[8]

The external reviewers found that the better answer is that a GICE has not occurred. The panel's view was that (1) the exclusion of "transfer" from the relevant limb of the GICE definition (" mandatory cancelation, conversion or exchange") must have been deliberate, and (2) the "analogous" catch-all provision at the end of the GICE definition should be interpreted narrowly, to avoid uncertainty.

Ready to blaze away

Under the new regulatory environment for banks, senior debt has become "bail-inable", but the GICE definition has just been proven not to capture the full suite of resolution tools available under the BRRD. The actions of BoP have demonstrated how the new discretions available to regulators can be used to wipe out the value of some of the debt of a "good" bank, through actions that are seen by many as arbitrary and politically motivated. The recently reported investor concerns[9] that have made European bank shares and bonds issuances difficult in 2016 - are here to stay.

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[8] http://dc.isda.org/cds/novo-banco-sa-2/.

[9] The Euro Stoxx banks index was reported to be down 23 per cent so far this year.