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Nationalisation of SNS REAAL: The CDS Consequences

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On Friday, February 1, the Netherlands nationalised SNS REAAL, the fourth-largest systemically important bank in the Netherlands, at a cost to the Dutch taxpayer of EUR 3.7bn. Unusually, in addition to expropriating SNS REAAL's shares, the Dutch state has also expropriated all subordinated bonds issued by SNS REAAL.

The nationalisation brings into question how a Credit Default Swap (CDS) entered into by any bondholder to provide credit protection will operate in the event those bonds are expropriated.

Has a Credit Event Occurred?

In order to claim credit protection pursuant to a CDS, it is necessary for a Credit Event to have occurred. The determination as to whether or not a Credit Event has occurred will be made by the relevant ISDA Credit Derivatives Determinations Committee (the DC). It is unclear, however, that the nationalisation of the subordinated bonds on February 1 itself comprises a Credit Event under the 2003 ISDA Credit Derivative Definitions. It is possible nevertheless that future events may trigger a Credit Event when they occur.

The Credit Events for standard CDS on European Corporates are set out in the ISDA Physical Settlement Matrix and are Bankruptcy, Failure to Pay and Restructuring. The other Credit Events of Obligation Acceleration, Obligation Default and Repudiation/Moratorium are unlikely to be applicable.

Nevertheless, we comment on each of the possible Credit Events below:

- A Bankruptcy is unlikely to have occurred in respect of SNS REAAL - the bank has not been subjected to an insolvency or similar process. However, 'Bankruptcy' also includes the relevant entity's becoming 'insolvent'. Although the DC may decide otherwise, it is

questionable whether SNS REAAL has become 'insolvent'. The nationalisation was implemented to avoid bankruptcy. It is difficult to identify when exactly insolvency occurs and it is not generally relied upon as a trigger for the Bankruptcy Credit Event.

- Failure to Pay requires there to have been a payment default in respect of relevant bonds. The subordinated bonds have been taken from bondholders but, as of February 1, still exist as obligations of SNS REAAL. Failure to Pay does not appear to have occurred. It is possible, in theory, that a payment default may occur in the future.
- A Restructuring requires one of a number of specified restructuring events to occur. These events comprise: (i) a reduction in interest, (ii) a reduction in principal, (iii) a postponement or deferral, (iv) a change in ranking or (v) a change in currency. As of February 1, the terms of the bonds have not been amended by the nationalisation and it is unlikely that any of these events have occurred. It would appear to be possible, however, that, in the future, the terms of the subordinated bonds may be restructured in such a manner as to constitute a Restructuring.
- Obligation Acceleration and Obligation Default require there to have been an acceleration or default, as the case may be, in respect of relevant bonds. As is the case with Failure to Pay, although the subordinated bonds have been taken from bondholders, there appears to have been no default or acceleration. It is possible these events may occur in the future.
- Repudiation/Moratorium requires there to have been a repudiation (or similar event) in respect of the terms of the relevant obligations or a moratorium (or similar event) (and, also, for a Failure to Pay or a Restructuring) to occur. As of February 1, it does not appear that there has been any such repudiation or moratorium in respect of the bonds. Ownership has simply been transferred to the Dutch state.

Even if a Credit Event Does Occur, How Would a CDS Be Settled?

Settlement of a standard CDS requires either:

- auction settlement, pursuant to which a cash settlement price is determined following an auction involving relevant debt – in this case subordinated bonds – and paid by the protection seller; or
- physical settlement, pursuant to which the bondholder delivers relevant debt to the seller of protection in exchange for an appropriate cash payment.

If auction settlement applies to a standard CDS, physical settlement applies as a fallback procedure in the event auction settlement does not occur.

In the case of a standard CDS purchased by a subordinated bondholder of SNS REAAL, it is unclear how any auction could be carried out as envisaged by the 2003 ISDA Credit Derivative Definitions given the lack of available subordinated bonds with respect to which to conduct an auction.

In addition, the relevant bonds that the bondholder would wish to physically deliver pursuant to physical settlement have been expropriated. It would therefore appear impossible for such a CDS to be physically settled.

Conclusion

Whilst the DC may take a contrary view, it is questionable whether standard CDS purchased by subordinated bondholders of SNS REAAL will provide credit protection to bondholders as a result of the nationalisation itself. The possibility remains that, in the future, a restructuring of the bonds or a default may constitute a Credit Event.

If a Credit Event is determined to have occurred on February 1, or occurs in the future, it is also unclear how such a CDS would be settled pursuant to standard CDS settlement mechanics, in light of the expropriation of the relevant bonds.

The nationalisation of SNS REAAL raises awkward questions as to the efficacy of standard CDS protection. Is this another challenge for ISDA and the market to resolve?

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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