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**The Good, the Bad and the Ugly**  
The fall and resolution of Banco Espírito Santo

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## **Abstract**

This case study – and accompanying teaching note – briefly describes the history of the Espírito Santo family, a banking dynasty who led one of Portugal’s leading economic and financial groups, along with its “crown jewel”, Banco Espírito Santo. It chronicles how the corporate governance issues at BES allowed the family to exploit the bank, its shareholders and its customers, so as to support its unprofitable non-financial businesses. This left the bank in a poor financial situation, which deteriorated beyond control, leaving regulators – whose actions are also analysed here – with no alternative, amidst a severe liquidity crisis, but to apply a resolution measure, pinning large losses on junior bondholders and shareholders before recapitalising the bank.

**Keywords:** Corporate governance; bank regulation; bank resolution

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## The Good, the Bad and the Ugly

The fall and resolution of Banco Espírito Santo

*“We usually say that first comes the interest of our country, second, that of the institution and, only in third, the shareholders”*

*– Ricardo Espírito Santo Silva Salgado, CEO 1992-2014<sup>i</sup>*

It was an unusually bright, sunny morning on Friday, 1<sup>st</sup> August 2014, at least by London standards. George Lemon, a trader working in the fixed income desk at the offices of a Swiss asset manager, had come in a little later than usual that day. He was still waiting for his tea to cool down when a blinking red block on one of his screens startled him. Clicking through, he found that a bond on which he had a small position was freefalling. He got rid of it, but the damage was done. Small as his exposure to those 7.15% junior bonds of *Banco Espírito Santo SA* (BES) may have been, the tumble was huge – the securities dipped as low as 15% of face value. He got out before that, but still, in his head, he could already hear his boss rambling over the losses.

On Sunday night, the Portuguese central bank, Banco de Portugal (BdP), announced the resolution<sup>1</sup> of BES, which had fallen in disgrace after, a few days earlier, posting a €3.6bn loss in 2014Q2. Its shares were finally halted from trading on Friday afternoon, already flatlining after having lost 50% that day and 40% the day before. The size of the losses consumed the existing capital buffer, depriving it from its access to central bank money. Without that vital source of liquidity, the bank had all but failed.

The decision – which had been prepared over the previous days – was to remove BES’ sound assets and place them in a “transition bank”, creatively named *Novo Banco* (NB), “The New Bank”. The decades-old BES was to be liquidated, keeping only those assets deemed “toxic” in its balance sheet. While the shareholders – some of which had poured cash into BES in the rights issue that was held less than a couple of months before – and some junior bondholders were *bailed-in*<sup>2</sup>, depositors and senior bondholders also were safely moved to NB, along with €4.9bn of public funds.

Lemon knew there were serious problems at BES’ parent companies – bad news related to this had even been at the core of a minor sell-off in European equities – but it

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<sup>1</sup> *Resolution* is defined by the European Commission (EC) as “the restructuring of a bank by a resolution authority, through the use of resolution tools, to ensure the continuity of its critical functions, preservation of financial stability and restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings” (EC Memo 14/297). In Portuguese legislation, in line with European guidance, such resolution tools consist of transferring part or all of the bank’s activity either to another bank or to a purpose-built “bridge bank”.

<sup>2</sup> *Bail-in* refers to the write-off of failed banks’ debt, under the notion that the bank’s shareholders and creditors should bear all losses possible before public funds are used for its rescue.

seemed to him that the worst had passed. Even Goldman Sachs had bought into the bank just days before. What would happen to those who did not manage to sell them? And what now: trading at a massive yield of over 50%, should he buy in again? What's more, he also had senior bonds of the bank – what will become of those? With yields at 6%, should he buy more? What about the shareholders? He pondered. How had it all come to this? How could the *Espírito Santos* (ES), the family who had controlled the bank since its foundation in the 1920s, have brought it to its knees?

## **Espírito Santo: the origins<sup>ii</sup>**

José Maria do Espírito Santo e Silva was born in Lisbon on May 13th 1850, to unknown parents. As was commonplace throughout Christian societies, unwanted babies were usually dropped off at the door of the nearest church or convent. In Portugal, it was custom for nuns and priests to name the unfortunate children they raise after Catholic symbols, and so they did with José Maria “of the Holy Spirit”. Whether or not they believed that smart little boy was somehow predestined for greater heights, they could not imagine that, 150 years later, the name they had given him was to become the trademark of one of the richest and most powerful families in Portugal.

It is said that José Maria was actually the son of Simão da Silva Ferraz de Lima Castro, a powerful nobleman. Despite his absence, so goes the legend, he not only funded the boy's education, but also, later, personally provided a loan for him to kick-start his adult life and career. Regardless of who provided the initial capital outlay, it is no legend that by 1869, at 19 years old, José Maria owned a small shop where he dealt in currency exchange and sold lottery tickets. Fittingly, it was located in old Lisbon, just down the street from where he was born, and was no less than the humble beginning of a banking and corporate empire. José Maria quickly outgrew the lottery business, moving on to real estate investments, asset management and commercial banking.

By 1911, already a much respected and influent Lisbon banker, José Maria finally bought out the position of the only remaining associate in their commercial banking and securities trading firm. “Silva, Beirão, Pinto & Cia.” became “J.M. Espírito Santo Silva” – the first firm to bear his “Espírito Santo” name. Two years later, he would bring into the business his first heir, José Ribeiro: José Maria, a diabetic, felt his health was deteriorating, and wanted to leave the groundwork for his offspring to continue his life's enterprise. In 1915, on Christmas night, he finally passed away.

José Ribeiro had recently returned to Lisbon from high school in Scotland, and he immediately took charge of his father's business. In 1920, he oversaw a new transformation, as it became *Banco Espírito Santo SARL*. During World War I, the Portuguese economy struggled. With strong inflation, the Escudo lost value very quickly. Many banks and other financial services firms buckled, but the ES weathered the storm. The bank grew steadily, but after Ricardo, José Ribeiro's younger brother, took over as chairman, it really took off. In 1937, they acquired another bank, which they merged with the existing one, thus creating *Banco Espírito Santo e Comercial de Lisboa* (BESCL), then the leading privately-owned bank in Portugal. Ricardo, by then, was the main economic advisor of Oliveira Salazar, the sombre dictator who had just risen to power and used his influence to grow the bank's business.

During World War II, Portugal maintained a “neutral” status, which made it a safe haven for Europe’s aristocracy and top businessmen to safeguard their assets and, often, their lives. Ricardo was not only a shrewd banker but also, with the help of his Jewish wife, Mary Cohen, a masterful host. He made the most of Portugal’s status, and during the war period, BESCL’s stock quadrupled in value as he welcomed European noblemen to his house and, to his bank, their assets.

Ricardo would eventually die young, in 1955, and was succeeded by another brother, Manuel Ribeiro Espírito Santo. He would continue along the same path, further developing international connections to wealthy families, such as the Rockefellers and Firestones, and to noblemen, like Juan Carlos, who would often seek refuge in Lisbon, at their house, from the troubles in Spain. In the 1960s, a golden era for the Portuguese economy dawned after its entrance in the European Free Trade Agreement. BESCL continued to grow, beginning to channel cash into several different businesses, from textiles to oil and gas. Under the authoritarian regime of Salazar, most business decisions were in one way or another very conditioned by central government power, and assets in all business fields were highly consolidated around a handful of large, well-connected conglomerates. For the large part, these were controlled by three traditional business dynasties: the Mellos, the Sommer-Champalimauds and the ES.

Manuel died in 1973, in what would be the first of a succession of terrible events for the bank and the family. He was succeeded at the helm of the bank by his son Manuel Ricardo, but the oil crash brought a major slump to the world economy and, naturally, to business. The bank would be denied the chance to bounce back: the left-wing military coup that took place in Portugal in April 1974, deposing Salazar’s successor, would bring about chaotic, tense times, with many, if not all, of the country’s capitalists being stripped of their assets and either jailed or forced to flee abroad.

On 11<sup>th</sup> March 1975, it was the ES’ turn. Amid great turmoil, as protesters gathered at the door of the bank’s iconic headquarters at *Avenida da Liberdade*, navy officers, with the help of some unionised bank employees friendly to the communist revolutionaries, took control of the building, barged into a board meeting, held the managers at gunpoint and sent them to jail. The bank, as well as all the major companies owned by the family, would soon be nationalised.

Among the workers who flocked back to business when, a week later, normal activity resumed at the offices, was a young, bright middle manager. Ricardo Salgado, then 29, was asked to continue by the committee who took over.

### **Ricardo Salgado, born to be a banker**

Ricardo Espírito Santo Silva Salgado was born in Cascais, Portugal, 25<sup>th</sup> June 1944, the eldest son of Maria, daughter of Ricardo ES and Mary Cohen, and João Roma Salgado. Cascais, a seaside resort town on the outskirts of Lisbon, had long been the main base for most of the ES, and his childhood was spent there in frolic. As a teenager, however, he moved to Lisbon, having spent most of his time around the upper-class Lapa district, home to embassies and the house of parliament, where he finished both high school and university – where he studied Economics – followed by a year of military

service in the navy.

A cousin of Manuel Ricardo, Salgado was the first male grandson of Ricardo ES and great-grandson of José Maria (see family tree in **Exhibit 1**). Nevertheless, his beginnings at BES were fairly humble, managing the unimportant economic studies team. By then, it was tradition that clan members must prove themselves valid to be able to progress, rather than being promoted solely on the basis of ‘pedigree’.

Ricardo himself, though, quickly rose up the ranks at the bank and by 1973, already led the credit department, where he initially stayed after the uprising. Tolerated by the workers, he stayed, but not for long, as he fled the increasingly hostile environment of post-revolution Portugal, leaving on April 30<sup>th</sup> 1975.

## **Exile and rebirth**

In Switzerland, Ricardo reunited with Mário Mosqueira do Amaral, a board member at BESCL who managed to avert jail: tipped off by a friendly employee, he did not show up at the office that day. The others would only be released on bail in July, then fleeing surreptitiously to Spain through a secondary border post and split up.

As soon as September, however, Manuel Ricardo organized a “family” meeting in London with five other members: his brother António; António Ricciardi; the young Ricardo; Mosqueira and José Roquette. The latter two, though not of direct ES lineage, were regarded as such, having both been loyal employees and partners for a long time. This was the first meeting of what would become the group’s “*Conselho Superior*”, an unofficial institution where strategic decisions were made on a consensus basis, by representatives of the major branches of the family tree.

The plan, then, was to leverage what they had left in order to rebuild their lost empire. They would have little assets of their own to begin with (the official story is they had as little as \$20k in cash), but they benefited from widespread international contacts – the ES were known and respected by the most influential bankers of the world at the time, such as David Rockefeller or Walter Solomon (who provided them with office space in the City) – and the support of former customers and friends who, many having suffered the same fate as them, entrusted the bankers with the management of their remaining assets. One of the first measures was to create a holding company to ultimately centralize all the assets they would build upon, with roughly equal stakes to each of the six: Luxembourg-based *Espírito Santo International* (ESI).

Over the ensuing years, business was based in Switzerland, Brazil and London, mostly around small private banking operations, with one exception. Ricardo and Roquette led a thriving operation in Brazil which had evolved into a retail bank by 1983, with the help of French *Crédit Agricole* (CA), as well as connections in Brazil’s government, who exempted them from paying a \$2m fee for the banking licenses.

Two additional overseas holdings were created: *Espírito Santo Resources* (ESR), to harbour non-financial interests, and *Espírito Santo Financial Group* (ESFG). By 1984, political conditions were ripe for the ES to begin their return to Portugal. Badly in need of capital, after a very tough decade since the revolution – having even twice resorted to the IMF, in 1978 and 1983 –, Portugal’s politicians, led by Socialist prime-minister Mário

Soares, called upon the country's estranged capitalists. In 1985, they purchased a small investment bank and, the year after, they set up *Banco Internacional de Crédito* (BIC), a retail bank, again supported by CA.

A couple of years later, as the first centre-right government took over since the revolution, a wave of reprivatisation operations began. Hand in hand with the French, in 1990 they repurchased their former insurance company, *Tranquilidade*, and, finally, in July 1991, BESCL was back in the family's hands. A large operation, it was significant even for the powerful CA, whose board was reluctant to make such a great investment in a single Portuguese bank. Mário Soares himself intervened, persuading his close friend, President François Mitterrand, to use his influence to get the French on board.

Tragically, Manuel Ricardo would not witness such a triumph: he died in March 1991. The eldest of the group, in accordance with tradition, Ricciardi took the lead. However, next in line of succession to Manuel Ricardo was actually his brother, António. And Ricardo, though the youngest of the pack, was widely recognised as their most capable. Ricciardi came up with a power division agreed upon by everyone: he would become the senior leader (chairing the top holding), Ricardo would manage their interests in financial services and António ES all the others.

Initially, only 40% of BESCL's capital was privatised. Through purpose-built holding BESPARG, 25%-owned by *Crédit Agricole*, and directly through ESFG, the family purchased over half, about 23%. The remainder was sold off early next year. As it was scattered by many different investors (many of which Portuguese capitalists friendly to the ES), the 35% they were finally left with gave them full control over the bank: overall, between the family, their French partners and a Luxembourg bank that also joined them, they spent just under 65bn Escudos (about €650m<sup>iii</sup>, adjusted for inflation) to ensure possession of a majority stake in BES. Ricciardi became chairman, Salgado took over as CEO, with Mosqueira and José Manuel ES (another brother of Manuel Ricardo) joining the executive board.

After 15 years of state ownership, BESCL had 8% of the Portuguese market by assets. Before, it was the largest private lender. At that time, the Portuguese banking sector was dominated by the state, with privately-owned banking groups timidly entering the market, such as *Banco Comercial Português* (BCP) and *Banco Português de Investimento* (BPI). Ricardo's mission was to bring the bank back to the top.

## Growth

By the mid-1990s privatisation of most of the other nationalised banks had taken place, leaving only *Caixa Geral de Depósitos* (CGD), by far the largest, in the hands of the State, as it had been from its foundation. As the Portuguese economy grew steadily, despite the government budget and monetary restrictions imposed by the run-up to the Euro, banks also grew their business (**Exhibit 2**), but BCP was standing out, benefiting from the strong investment BCP's founders had made in densifying its dependency network. Also, consolidation movements would mark the sector throughout these years, and BCP was the most aggressive of the pack. By 1995, with the purchase of *Banco Português do Atlântico*, it had taken first place (bar CGD).



Meanwhile, BESCL grew much more slowly, as the family – the controlling shareholders – focused on also growing other businesses, nationally and abroad, including the investment bank, *BESI*. It refrained from engaging in costly acquisitions, unlike its competitors, as the cash generated by the banking business was used to grow, instead, the ES conglomerate (broadly known as *Grupo Espírito Santo* – GES). Inclusively, BESCL only absorbed BIC by 1999, with the combination being named just *Banco Espírito Santo* (BES).

With the turn of the century, though, a major deal was to be announced: the merger of BES and BPI, which would allow the resulting institution to overtake BCP and take the lead which had eluded the ES for decades. It was ultimately called off due to pressures, on one side, from the ES, who wanted to keep control of the resulting bank, and on the other, from BPI's shareholders and management, who pressed for a governance model that did not allow the family to have that control.

Either way, on one dimension, the ES were second to none: similarly to them, the Mellos and the Champalimauds also tried to rebuild their empires, with a *bancassurance* model at their core, but were ultimately unable to do so: by the early 2000s, the former had sold off their bank to BCP and the latter's financial services assets were divided, in different moments, between Spanish Santander, BCP and CGD.

## **The group**

So, the pattern continued into the 2000s. As Salgado boasted about BES' «organic growth strategy», GES continued to grow around BES towards other business lines, with major investments in several businesses, such as Portugal Telecom (PT) – the major TMT group in Portugal, privatised during the 1990s – but also hotels, real estate, transport, construction and development, among others. It also sought to expand internationally, with investments in the United States, its overseas investment banking arms and, particularly, in one place: by 2002 it had transformed its blooming banking business in Angola – which, with the end of the civil war, was becoming a leading emerging economy – into a full-grown retail bank, Banco Espírito Santo Angola (BESA), the first European bank to be awarded a banking license in post-colonial Angola. The group was involved also in other businesses in Angola, which remained in ESCOM, the local group holding, 33% owned by its native CEO.

In any case, BES sat comfortably in third place throughout the 2000s, as a failed hostile takeover bid by BCP over BPI in 2005, and the ensuing drama, hindered the ability of either to grow. But the sprawl of GES was not devoid of hiccups. In 2002, BES departed with its partner of many years, PWC, opting instead for KPMG as their auditors. The word on the street was that PWC was under pressure to hide problems at the top holdings, namely the leverage of ESI and ES, but nothing ever came to light, apart from minor issues regarding the book values of PT assets.

## **Economic and financial crisis**

The major Portuguese banks managed rather well through the market turmoil of the 2007-8 global financial crisis, for four main reasons. First, curiously, the Portuguese

economy had in 2007 registered 7-year record growth, which only slowed down slightly in 2008 after the Lehman bankruptcy. Second, they had little exposure to the complex credit products affected by the subprime crisis in the USA. Third, in line with European guidance, the Portuguese authorities supported the banking system with a €20bi state guarantee programme, to minimize liquidity issues arising from market tightening, and a €4bi recapitalization programme. This comprehensive response was also intended to contain any shockwaves from the November 2008 nationalisation of *Banco Português de Negócios*, a smaller lender that had failed dramatically amidst an accounting fraud scandal, mostly unrelated to the global crisis. In any case, all in all, banks' financials were not particularly hit (**Exhibit 3**). During 2009, things continued to run more or less smoothly, despite a slight rise in non-performing loans, due to some windfall from export-based firms suffering from lowered external demand.

In September 2009, a shift in corporate structure (**Exhibit 4**) took place with the creation of Rioforte, a new holding that would absorb most of the non-financial assets, replacing ES Resources. Backed by loans from friendly institutional investors, but still wholly owned by ESI, the idea was to open the way to bringing fresh capital into GES' increasingly fragile non-financial subsidiaries, who took a much greater toll during the crisis than the bank itself.

In any case, a turn for the worse would come the following year. The EU/IMF bailout of Greece in May 2010 marked the beginning of the European sovereign debt crisis. Portugal was out in the twin-deficit cold: its government was running a massive deficit and the country's external position was very poor and still worsening. Already hit by faltering external demand from struggling European trade peers, strong austerity measures worsened even further the economic outlook. As sovereign spreads and CDSs spiked (**Exhibit 5**), banks all but lost access to financial markets, becoming increasingly dependent on ECB funding. The Irish government also had to be bailed out in November, after doubling its public debt ratio in a year following a series of rescues amidst a very serious banking crisis.

The shift in external investor sentiment towards "peripheral" countries seemed to be structural, and as sovereign yields stayed high, after much political resistance, in May 2011 it was Portugal's turn, entering a 3-year "adjustment programme", in return for a €78bn bailout from a so-called "troika" of lenders (IMF, ECB and the EU).

Despite its relative easiness through the early stage of the crisis, as was the case of the economy in general, the Portuguese banking system was highly leveraged at the time, with high loan-to-deposit ratios (**Exhibit 6**). A section of the measures in the "programme" targeted banks, forcing them to deleverage and, in some cases, also improve solvency indicators, in accordance with a pre-defined calendar. At the same time, the road to Basel III, and more stringent capital requirements, was paved. Accounting for this, €12bi of the bailout money was earmarked for bank recapitalisation operations. Sooner or later, most banks would surely need it.

And so they did: on the morning of June 4<sup>th</sup> 2012, the government announced it would be providing BPI with €1.2bi of fresh capital, BCP with €3bi and even CGD with

€1.7bi, mostly through CoCos<sup>3</sup>. Of the four largest banks, only BES avoided state aid.

In fact, BES had undertaken a €1bi rights issue scarce months before, allowing it to up its Core Tier One (CTI) ratio to a level close to 11%, above the minimum 10% BdP ruled Portuguese banks should reach by the end of 2012 (**Exhibit 7**). Market conditions were not exactly favourable, for which reason the new shares would be issued at a 41.6% discount against the theoretical ex-rights price (TERP). Even so, it was not an easy sell, but Salgado's team was determined to succeed, meeting over 150 potential buyers in a Europe-wide roadshow. In many of the meetings, Salgado himself would pitch to investors. As was so often the case, he took business in his own hands.

### **Ricardo Salgado, the ugly?**

*“I was among the first to arrive at the bank, and the last to leave. (...) I spent 70% of my weekends at work, to the great sacrifice of my family”*

*– Ricardo Salgado<sup>iv</sup>*

Salgado was, by then, a modern workaholic. He would typically arrive at *Avenida da Liberdade* before 8 a.m. and leave around ten. Such long hours were not for show: over the years, his control and power over not only the bank, but all the branches of GES, became greater and greater. He was not only the CEO of BES: he chaired and/or was executive head at many of its subsidiaries. At BES, he also was the head of the credit committee, the ALCO, and, within the executive committee, he was responsible for the accounting department and investor relations. Outside, he was also executive chairman at ESFG<sup>4</sup>, and board member at ESI and other group entities.

Moreover, the 25-strong board of directors at BES was chaired by Alberto de Oliveira Pinto, a former executive chief at CGD, born in 1932, and at ESI, the chairman was still the same as back in 1991: Ricciardi, currently 96 years old. At the helm of Rioforte was Manuel Fernando, the first son of Manuel Ricardo who was 14 years younger than his cousin Salgado, and his underling at the BES executive committee.

### **Banking Union and Asset Quality Review**

*“We're on the path to Banking Union, and there'll be no room there for family banking groups”*

*– Ricardo Salgado<sup>v</sup>*

The events of 2008 highlighted how problems in large banks can easily trigger market turmoil and systemic troubles. In particular, when issues appeared around Europe after the financial crisis mutated into a sovereign debt crisis, two things became clear:

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<sup>3</sup> Contingent convertible bonds. The use of this instrument (a type of debt instrument which converts into equity in “bad times”, in the terms defined by some triggers) became widespread from 2012 in recapitalisation operations with public funds, as it can be counted as loss-absorbing capital without nationalising banks.

<sup>4</sup> BES' direct parent holding. Through BESPARG (a vehicle which harboured the stakes of the ES and CA in BES), it was considered to control the bank, and was the reference entity under BdP supervision (BES was its controlled subsidiary) and subject to prudential capital ratio rules. In May 2014, BESPARG was extinct – CA and ESFG owned stakes directly in BES instead – and the BdP supervision perimeter was thus restricted to BES.

that the strong link, or “vicious circle”, between banks and sovereigns in Europe left its economy exposed to very strong headwinds in the case of a financial crisis, and that there were no rules or institutions to deal with cross-border banking problems.<sup>5</sup>

So, at a European Council summit in June 2012, European leaders decided to build a “Banking Union”. This would be based on three “pillars”: a “single rulebook”, meaning a unified legal framework for capital requirements, deposit guarantee schemes and other aspects throughout the EU; a “single resolution mechanism” (SRM), whereby the legal framework to address bank failures is the same across member states, and a European fund is created to provide capital to distressed “systemic”, cross-border banks and a “single supervisory mechanism” (SSM), where bank regulation is centralised in the ECB, who supervises major banks directly, only delegating to national central banks for smaller institutions.

After many negotiation rounds and legal groundwork, the so-called SSM Regulation<sup>vi</sup> was released, announcing the ECB would «carry out a comprehensive assessment, including a balance-sheet assessment» of all major banks, in liaison with the national central banks, before taking over their supervision on November 4<sup>th</sup> 2014. This would become known as the Asset Quality Review (AQR).

Discreetly, in preparation for and as part of the AQR, during 2013, BdP began to investigate possible issues hidden away in satellite companies’ balance sheets which could materially affect that of BES. These probes were already taking place due to a series of activities that stemmed from financial sector measures agreed with the “troika”, namely, in a programme named ETRICC2<sup>6</sup>, with the help of auditors *PwC*.

### **“Ring-fencing” around the tip of the iceberg**

*“When (...) I was told [ESI’s debt] was €6bi, I almost died. I had no idea.”*

*– Ricardo Salgado<sup>vii</sup>*

In late September 2013, BdP requested a full audit report on ESI. Preliminary data was made available on November 26<sup>th</sup> 2013: its Q32013 liabilities were in fact about €1.5bn higher than recorded initially. It would soon surface that there was unrecorded debt and that said liabilities had been underestimated since at least 2008, but this was the first time BdP had any indication of such issues.

BdP considered this to cast doubt, to some extent, over any and all exposures of ESFG and BES to the non-financial side of the group, and sought to begin a “ring-fencing” strategy, i.e. to immunize BES and its customers from any group assets. Soon, it would surface that ESI and other subsidiaries’ debt seemed to be everywhere, not only on BES and ESFG’s balance sheets, but also held by customers, sold through BES’ retail channels. In a letter to the board at ESFG, led by Salgado, BdP requested that if a host of measures was not taken within a month, they would have to record a large impairment on

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<sup>5</sup> Belgian bank Dexia, for example, failed mostly due to taking huge losses on its holdings of Greek sovereign debt, in the 2011 “haircut” credit event they suffered.

<sup>6</sup> *Exercício Transversal de Revisão da Imparidade da Carteira de Crédito*, i.e. Comprehensive review of credit book impairments. BdP, in September 2013, began ETRICC2, where it sought to individually audit a sample of major credit clients of major banks, reviewing their business plans and accounts.

their exposure to ESI, asking for their auditors, KPMG, to provide an estimate for that impairment. By then, it had also surfaced that there had been sales of ESI and RioForte debt (commercial paper) sold through BES' retail channels, though the amounts were not clear.

In January, a more complete version of the audit review was sent by KPMG to BdP. It turned out not only there was unrecorded debt, but assets were also grossly overvalued (**Exhibit 8**): as a result, instead of the originally recorded positive €136m, ESI had negative equity of €2.4bn. The report also detailed that of ESI's €6.3bn debt<sup>7</sup>, €4.9bn was held by BES and subsidiaries' customers. Another €1bn was owed to ES Financière and ES Panama (ESFG subsidiaries). It would later surface that most of ES Panama' assets were group entities' notes and bonds, and that it was mostly funded by BES. None of this information was made public at the time. Additionally Rioforte also had about €3.1bn in debt, with a part also held by BES clients.

The board did not comply with the measures requested in December, recording a €700m impairment in its ESFG<sup>8</sup> 2013Q4 accounts, an amount determined by KPMG in February. The resulting loss meant ESFG was then below the regulatory Core Tier 1 minimum (10% + 50 bp as a "buffer" to account for possible write-downs with the completion of the AQR). BdP ordered the board to increase ESFG's solvency levels and that a series of corporate structure changes were to be undertaken. Among these, was a curious ruling: that all non-financial companies must stop bearing the "Espírito Santo" name. Other measures were not fulfilled, with the pressure by BdP mounting. None of this was public at the time, except for some vague rumours. There were only slight indications that the problems in group holdings might be significant: notably, a family feud – in November, José Maria Ricciardi, CEO of BES' investment bank (BESI) and a board member at BES, challenged his cousin's leadership claiming to have «lost trust» in his management, due not only to the shady connections between BES and GES but also, among other things, to a €14m «gift» received by Salgado from a customer, a construction and development tycoon, related to past business in Angola (which was forbidden by bank policy). An additional source of speculation was a *Wall Street Journal* feature in December<sup>viii</sup>, regarding a self-financing scheme during 2012 and 2013, where "low-risk" mutual funds managed by BES' asset management arm and marketed to customers, were at a certain stage, composed in more than 80% by GES debt – those positions had since been wound down, in light of new regulations.

Slightly later, in March, with more and more news starting to trickle down, some customers try to withdraw investments in ESI and Rioforte funds, finding their requests denied. Meanwhile, customers' holdings of GES debt were quickly wound down, but at a cost for BES, which would later become clear.

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<sup>7</sup> This considers not only ESI but also an additional €0.8bn owed by small subsidiaries, such as ES Irmãos, the remainder of ES Resources (which was being wound down at the time), and others.

<sup>8</sup> The provision was only recorded at the ESFG level because this entity issued a guarantee against the risky ESI notes held by BES clients, with its stake in Tranquilidade, the insurance company, as collateral.

## Angola

Meanwhile, problems which had already begun to surface in Angola, had, during 2013, become worse. BESA was a highly leveraged bank, with a LTD ratio of about 220%. It had credit assets of about €5.7bn, of which €3.5bn were funded by loans from its parent, which had grown significantly over the preceding few years. A year earlier, in 2012, Álvaro Sobrinho, the long-time Angolan BES employee who was chosen to lead BESA from its foundation, was replaced as CEO, “moved” to chairman, and then dismissed in the bank’s 2013 shareholders’ meeting, which preceded a USD 500m rights issue. It had surfaced that there had been many problems with the credit function – Sobrinho had named his sister-in-law as chair of the credit committee – including loans made to unknown parties, loans whose documentation had been lost and even loans approved directly by the CEO to firms owned by himself. This had gone, until then, largely unbeknownst to BES headquarters<sup>9</sup>. This information would also not become public until much later. BESA was audited by KPMG’s Angolan office.

Salgado, sometime after said shareholders meeting, met with the Angolan President, who subsequently issued a two-page decree serving as a state guarantee against USD 5.7bn (€4.2bn at the time – about 70%) of BESA’s loan book.

On 14<sup>th</sup> January 2014, a Goldman Sachs research note sets a 12-month target of €1.55 (28% up) for BES stock, with “improving margins in Angola” as a key driver.

### 2014 rights issue

*“Of the ten capital increases<sup>10</sup> we have done since the reprivatisation [of BES], this was the most successful”*

*– Ricardo Salgado<sup>ix</sup>*

On February 13<sup>th</sup>, at the press conference in which BES’ 2014 annual report was presented, Salgado mentioned a capital increase was a possibility in the near future, while rejecting resorting to the €6bn of “Troika” funds still available to banks: “We have been nationalised once, in 1975, and we would not like to go through that again”, he said<sup>x</sup>. BES had recorded a €0.5bn loss, and had a slight capital shortfall according to Basel III rules (in the phasing-in arrangement valid at the time<sup>11</sup>). Moreover, not only was the AQR coming close to its conclusion, but there were stress tests coming soon, also as part of the Banking Union process, for which reason BdP required the major banks to have a certain additional “buffer” to accommodate any unforeseen losses.

So, on 15<sup>th</sup> May, BES announced a €1.045bn rights issue, at a subscription price of €0.65. While its approval by the authorities suggested that any problems were more or less contained, there were still major causes for concern: the 375-page prospectus was

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<sup>9</sup> A large portion of Angolan loans was not recorded in the BES loan book according to the same internal ratings system as all the others, having to rely on aggregate information provided by BESA management.

<sup>10</sup> By then, BES’ equity capital was composed of 4018m shares.

<sup>11</sup> The Basel III agreements (and the CRD III/CRD IV European implementations thereof) foresee a “phasing-in” stage (up to 2019) where its various stipulations enter gradually into force: minimum solvency levels increase in small increments every year, and the same is true for the stringency of capital instrument eligibility and deductions rules. In Portugal, the former were anticipated by BdP; the latter are being *phased-in* more gradually.

only approved by CMVM<sup>12</sup> after many versions were submitted, insisting that information on every possible risk was included. Significantly, the prospectus was the first document where the bank publicly disclosed the existence of accounting issues and a very poor financial situation in general at ESI (**Exhibit 9**).

The press jumped on this information, and in the ensuing days rumours about the issues at ESI grew. Salgado gave an interview a week later, trying to ensure investors that the problems in the non-financial firms were very serious but constrained, and would not affect BES. BES' shares tumbled more than 20% after the issue was announced, but recovered partially over the ensuing couple of weeks. (**Exhibit 10**)

Indeed, supported by an impressive underwriter syndicate (**Exhibit 11**), the offer was very successful, attracting new investors. As in 2012, Salgado himself took to the road, but unlike 2012, most shareholders took significant dilution (**Exhibit 12**).

### **Downfall: chain of events**

By June 9<sup>th</sup>, the rights issue had been all but fully subscribed. Over the next few days, though, reports begin to surface on governance changes to come at BES. BdP had begun to pressure Salgado's team intensively. In this context, shares continue to fall. Sometime during this week Salgado meets with the government and, already under significant stress, requests a state loan for GES, which is denied. Weeks before, he had already asked for the government's blessing for a loan to GES by a syndicate led by CGD and BCP, which was also denied. Government sources would over the next few weeks repeatedly deny the possibility of direct public funding for BES, both in public and in private discussions with BdP. On the 13<sup>th</sup>, Machado da Cruz, a financial officer at ESI, who had been blamed by Salgado for the accounting issues, claims in an interview that he was aware that there had been several operations kept off the balance sheet. A week later, on the 20<sup>th</sup>, Salgado announces the intention to step down. Speculation grows on the problems at ESI, as reports intensify mentioning BdP pressure for any board members and directors related to the family to leave.

On July 3<sup>rd</sup>, ESFG announces that its exposure to GES entities had increased by more than two-thirds, to €2.4bn, over the previous few months, in order «to support the reimbursement of GES group commercial paper held by retail clients»<sup>xi</sup>. A couple of days later, a new fully independent executive committee is announced by the BES board: Vítor Bento, a former BdP director and CEO of SIBS<sup>13</sup>, is named as CEO.

10<sup>th</sup> July is a key date: In the morning, ESFG suspends its own securities' trading due to overwhelming financial stress at ESI, amid reports of it failing payments on commercial paper to private banking customers in Switzerland and more detailed information on the irregularities at ESI and BESA. BES dropped 17% before also being removed from trading. Shares fell all over Europe in a minor sell-off which analysts attributed to market nervousness due to the situation at BES. At night, BES issued a

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<sup>12</sup> CMVM stands for *Comissão do Mercado de Valores Mobiliários*, i.e. the Portuguese Securities Market Commission, comparable to e.g. the American Securities and Exchange Commission.

<sup>13</sup> SIBS is a joint-venture responsible for managing the interbank ATM and card payment system infrastructure ("Multibanco") in Portugal.

statement with details on its exposures to group entities. (**Exhibit 13**)

As the market and news flow pressure did not respite, trying to restore confidence, on Sunday 13<sup>th</sup>, BdP forces the exit of Salgado and Morais Pires. Bento, his deputy and his CFO enter the field (the change was only meant to take place at a shareholders' meeting on 31<sup>st</sup> July), but other board and executive committee members remained in place. On 18<sup>th</sup> and 22<sup>nd</sup>, ESI and Rioforte, respectively, file for creditor protection. The latter had failed to repay a batch of almost €900m of short-term debt held by PT<sup>14</sup>. Curiously, on the 23<sup>rd</sup>, shares climb over 15% as Goldman Sachs and a US hedge fund increase their holdings of BES shares from marginal to over 2% of its equity, even though it was clear by then that a new capital increase would be needed at the soonest. Soon, on Friday, 25<sup>th</sup>, it was ESFG's turn to file for creditor protection, but an even worse development had taken place early in the previous day's morning: Salgado was detained by police at home, for questioning in an unrelated money laundering and tax fraud investigation. He was later released on bail of €3m. Meanwhile, BES' Q2 results' presentation, due that day, was postponed. Shares fell 8%.

## 2014Q2 results

On Monday, 28<sup>th</sup> July, reports surface that losses at BES might be above expected, in the €3bn range. KPMG provides the final Q2 data to BdP in advance, indicating capital ratios were below requirements. BdP gives BES a 48-hour deadline to show proof that it can raise capital to compensate for the shortfall.

On Wednesday night, BES finally posts Q2 results: a loss of €3.58bn, mostly due to impairments on GES and BESA exposures, losses on own bonds repurchase and SPE/SPV operations (**Exhibit 14**). Bento announces a forthcoming capital increase. BdP, at this point, suspends board members responsible for risk, audit and compliance, issuing a statement about “recently discovered (...) gravely damaging management practises in the past few weeks” and replaces the bank's audit committee (**Exhibit 15**).

Unbeknownst to the public for the time being, adding to the issues disclosed in the Q2 report which were more or less foreseen in the July 10<sup>th</sup> communication, already during July BES had repurchased €1.5bn of its own debt instruments from customers, in heavy loss-making operations: these bonds, having originally been issued and sold to customers at a discount, were now being bought back at fair value (and above market value).<sup>15</sup> Similar operations had already taken place during the preceding months, accounting for a part of the provisions in Q2 results). Some deposits (close to €2bn, especially from Spain) also fled, as customers grew wary with all the speculation. Other operations also infected BES further, such as two “comfort letters” (guarantees) sent to Venezuelan state oil funds in the end of June regarding €260m of ESI debt they held.

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<sup>14</sup> The investment accounted for over 50% of PT's current assets (excluding accounts receivable, as per its Q22014 report). Its chairman was Henrique Granadeiro, a childhood friend of the ES. He resigned after these events.

<sup>15</sup> Note that these were zero-coupon bonds with very high maturities (40 years) – thus particularly difficult to accurately value – which had been placed through Eurofin, a small Luxembourg securities trading firm led by a former employee of GES, Alexandre Cadosch. The repurchased bonds were purportedly meant to be traded for assets held by other clients in Switzerland and Luxembourg, specifically, preference shares of SPVs that financed GES entities such as ESI.



All in all, BES had leaked during July about €3.35bn. By then, far exceeding its collateral pool, necessary for repo operations with the ECB, it had been forced to resort to the ELA<sup>16</sup> lifeline to the tune of €3.5bn. That night, the ECB executive committee calls BdP, warning that BES would lose counterparty status<sup>17</sup> the next day. This meant a legal obligation to immediately return any ECB funds loaned to the bank, regardless of their maturity – by then a total of €10bn, up from €8.5bn on June 30<sup>th</sup>. BdP managed to negotiate a slight delay – in a ECB Council conference call, at noon the next day, it was decided that that harsh measure would only take place the following Monday, but BES' fate was, by then, already settled.

## The resolution

In fact, BdP had started making preparations, days before, for an eventual extreme solution. Having in the previous days hired a law firm, to analyse all legislation on bank resolution, and exchanged contacts with the European Competition Authority, who must authorise any state aid to private firms in member states, on Thursday night, after the call from the ECB, the resolution was all but decided. Right after the Council, BdP called the government, letting them know of the decision, but not CMVM. Only later, at 3.12pm, did BdP's Governor call CMVM's head, letting him know there was "material information due to be released soon". Shares finally hit rock bottom (€0.101) at 3.34 pm, before finally being suspended 15 minutes later, at €0.12. On that very same day, changes to the banking legal framework, notably, related to some details with respect to the resolution of banks, were enacted by the government. On Saturday night, a political commentator described the resolution model chosen on his weekly TV show.

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Before and during the 2007-8 financial crisis, bank failures would be solved in one of two ways. Most commonly, banks were "bailed out" i.e. governments would either provide substantial loans or outright buy into banks and provide them with fresh capital. In either case, banks' creditors would not face any losses and existing shareholders might, at worst, suffer short-term losses as the bank's prospects, and therefore share price, deteriorate. The perceived only alternative was to let them fail and enter bankruptcy as a normal company, which in the case of banks with "systemic importance" can have unpredictably problematic effects on the financial system and the economy, of which the failure of Lehman Brothers was an unfortunately acute example.

A strong idea behind the reforms in Europe was basically to reframe the way bank failures are handled around the concepts of *resolution* and *bail-in*. Indeed, the resolution measures applied in the case of BES were only effectively possible due to a newly implemented legal framework, put in place as a stepping stone towards the full implementation of the EU Bank Recovery and Resolution Directive (BRRD)<sup>xiii</sup>. From 1<sup>st</sup> January 2016, when BRRD must be implemented in Member States, shareholders, all bondholders and even unsecured depositors must bear losses before public funds may be

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<sup>16</sup> *Emergency Liquidity Assistance* is defined by the ECB as «the provision by a Eurosystem national central banks of (...) central bank money (...) to solvent [banks] facing temporary liquidity problems, without such operation being part of the single monetary policy». This is generally used when banks run out of eligible collateral.

<sup>17</sup> License to engage in monetary policy operations (repos and longer-term operations)

used. Until then, and since 1<sup>st</sup> August 2013, a new version of the so-called Banking Communication<sup>xiii</sup> applies, requiring some subordinated debt and all of the equity to be bailed-in in order for public rescue funding to be allowed under state aid rules.

So was the case of BES. Junior bondholders and shareholders (**Exhibit 16**) – including those who had just increased their position in the bank, in the May rights issue – were, for the time being, left with nothing but rights to receive some of the proceeds after BES’ liquidation proceedings. These, in turn, relate only to those assets deemed “toxic” in its balance sheet (**Exhibit 17**). Among the biggest losers were, obviously, qualified shareholders: Crédit Agricole, for instance, had to cope with a €0.7bn write-off: 97.5% of its Q2 “would-be” profits.

Most of BES’ sound assets were removed and placed into NB, the “bridge bank”, wholly owned by the Portuguese *resolution fund*<sup>18</sup> (RF), who provided it with €4.9bn in capital, and is liable for all deposits and senior bonds, which were similarly moved. Theoretically, RFs work as insurance systems, funded by regular yearly contributions of all of the country’s banks. In practise, however, the Portuguese one had little capital of its own, as it was only created in 2012. The operation was in fact mostly funded by the government, who provided a loan to the fund. The complete financing structure was negotiated between the government and other banks during August, only being decided by the end of the month (**Exhibit 18**).

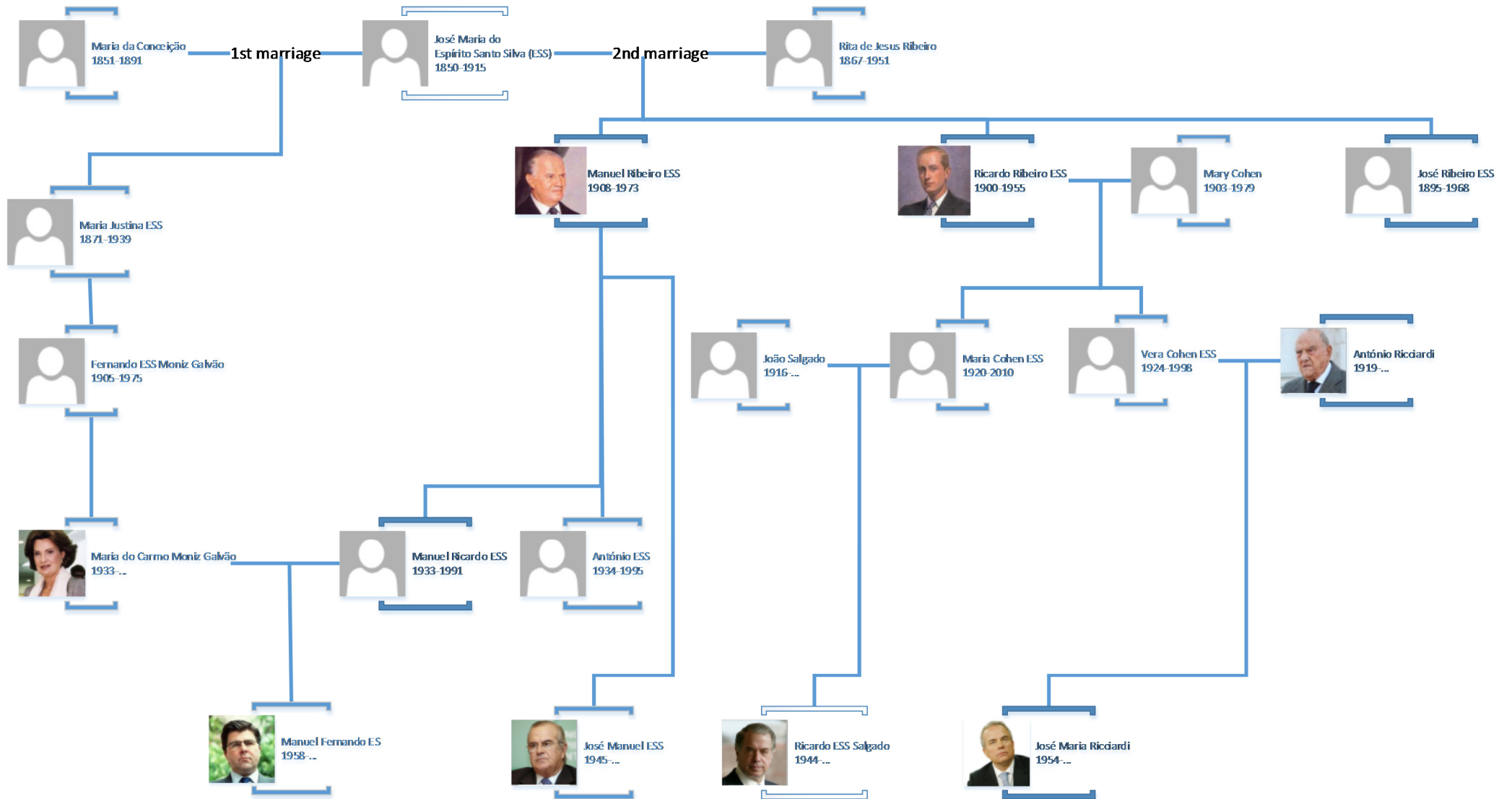
NB is to be sold, with the proceeds going to RF, its 100% owner. If these are insufficient to repay the state loan, other banks would theoretically be liable to repay any shortfall to the government, even if the legal and institutional mechanisms through which that might be enforced remain unclear. In principle, this would be done through some kind of «extraordinary contribution» to the fund, which would be required from participating banks. However, BdP has since admitted that the exact terms would only be defined at the time of a prospective sale, depending on the amount of the shortfall.

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<sup>18</sup> In the preceding years with the progressive implementation of new bank resolution rules, “resolution funds” such as this were created in most Eurozone countries. In Portugal, as in most cases, it is a public entity, managed by BdP.

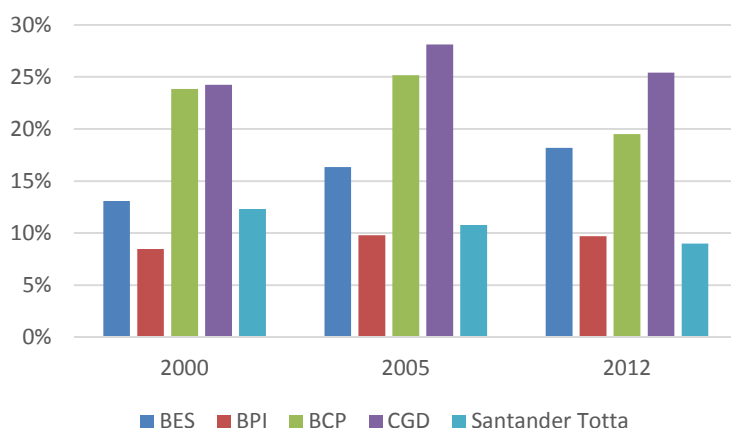
# Exhibits

Exhibit 1. Selected portions of the Espírito Santo family tree



Sources: BES; Geneall; “O Último Banqueiro” (See endnote *i*); Press sources

**Exhibit 2.** Market shares of Portuguese banking sector, 1998(before?)-2014



Sources: Company data/CMVM; Bureau Van Dijk (Bankscope); Banco de Portugal; Own calculations

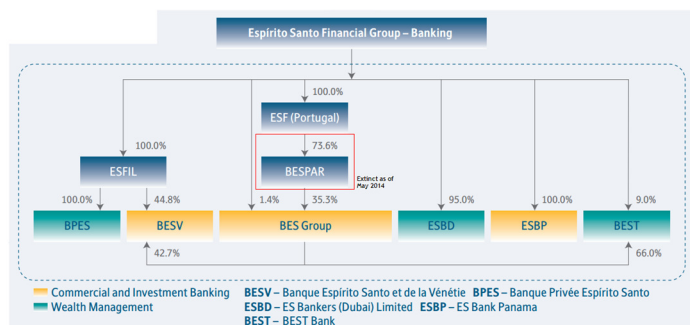
**Exhibit 3.** Portuguese domestic banks consolidated headline financials, 2007-14

	2013	2012	2011	2010	2009	2008	2007
<b>Selected income statement indicators</b>							
Net interest income	3,983	4,970	6,200	6,012	5,969	7,013	6,504
Operating costs	5,314	5,554	5,844	5,921	5,721	5,833	5,647
Impairments	4,985	5,921	5,818	2,878	2,931	3,592	1,419
Net income	-2,733	-1,235	-1,516	917	452	-220	2,511
<b>Selected balance sheet indicators</b>							
Available for sale financial assets	55,206	51,189	44,448	46,616	35,386	21,505	22,640
Gross credit to clients	233,066	248,483	246,496	261,992	270,345	268,200	242,513
<i>Of which: Overdue</i>	16,295	15,179	12,137	9,603	8,915	5,632	4,022
Liabilities to central banks	51,126	56,179	50,723	49,157	19,419	14,407	5,731
Liabilities to other banks	46,883	61,247	74,602	81,125	74,316	74,303	72,362
Deposits and other liabilities to clients	253,164	251,027	244,431	230,558	218,478	217,870	195,604
Debt securities issued	41,184	56,600	75,029	89,061	116,807	94,219	97,333
<b>Solvency indicators</b>							
Regulatory capital ratio	11.9%	11.3%	8.6%	8.3%	7.8%	6.6%	7.0%
Core Tier I (BIS II) ratio	12.3%	11.5%	8.7%	7.4%	N/A	N/A	N/A

Note: N/A = not available.

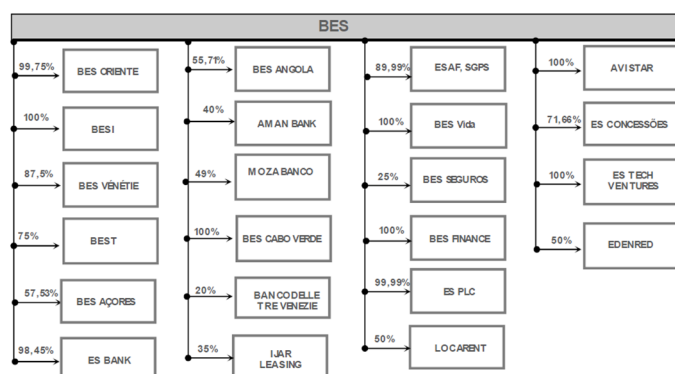
Source: Banco de Portugal

**Exhibit 4a.** ESFG banking subsidiaries, end 2013



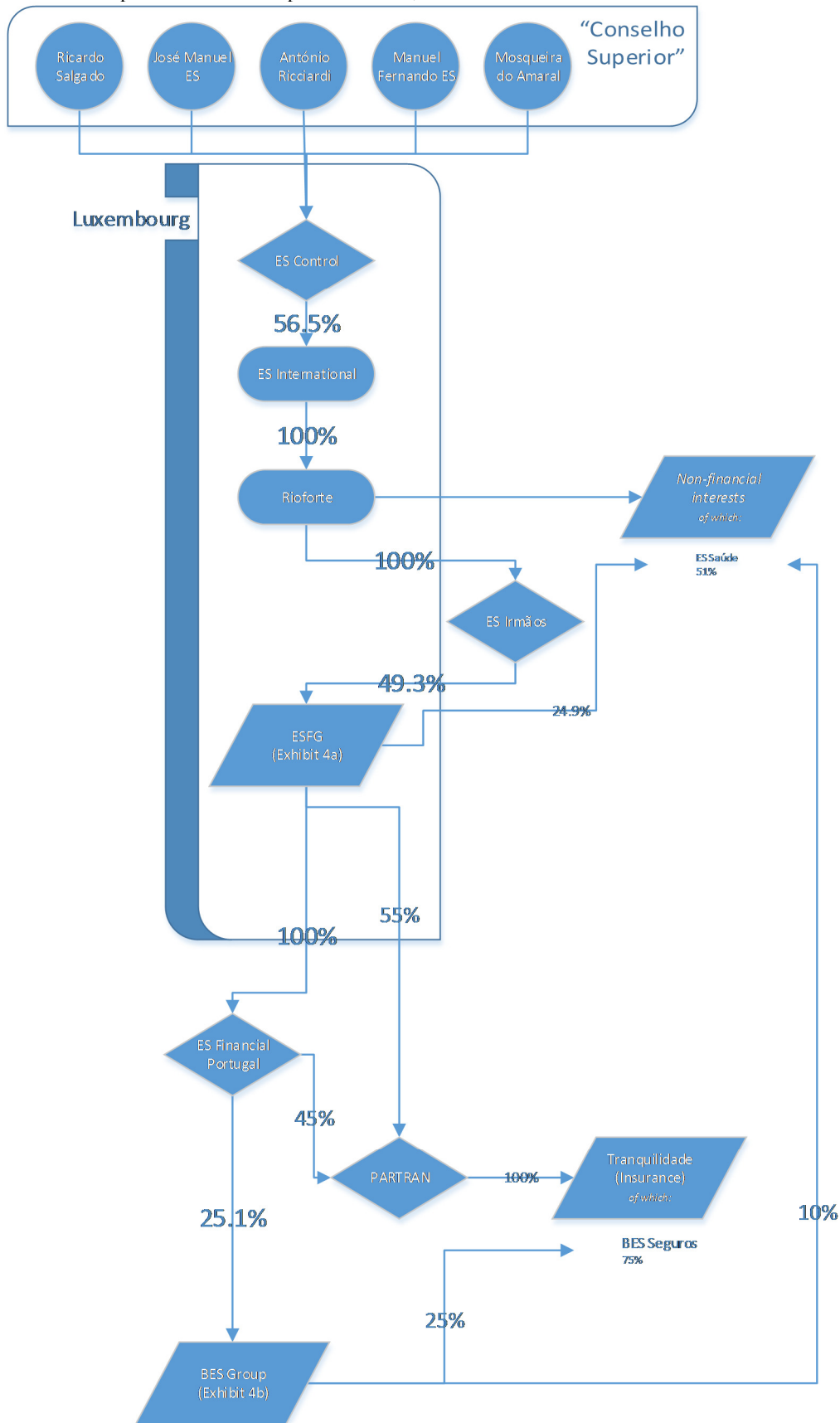
Source: ESFG

**Exhibit 4b.** BES Group subsidiaries, 2014



Source: BES

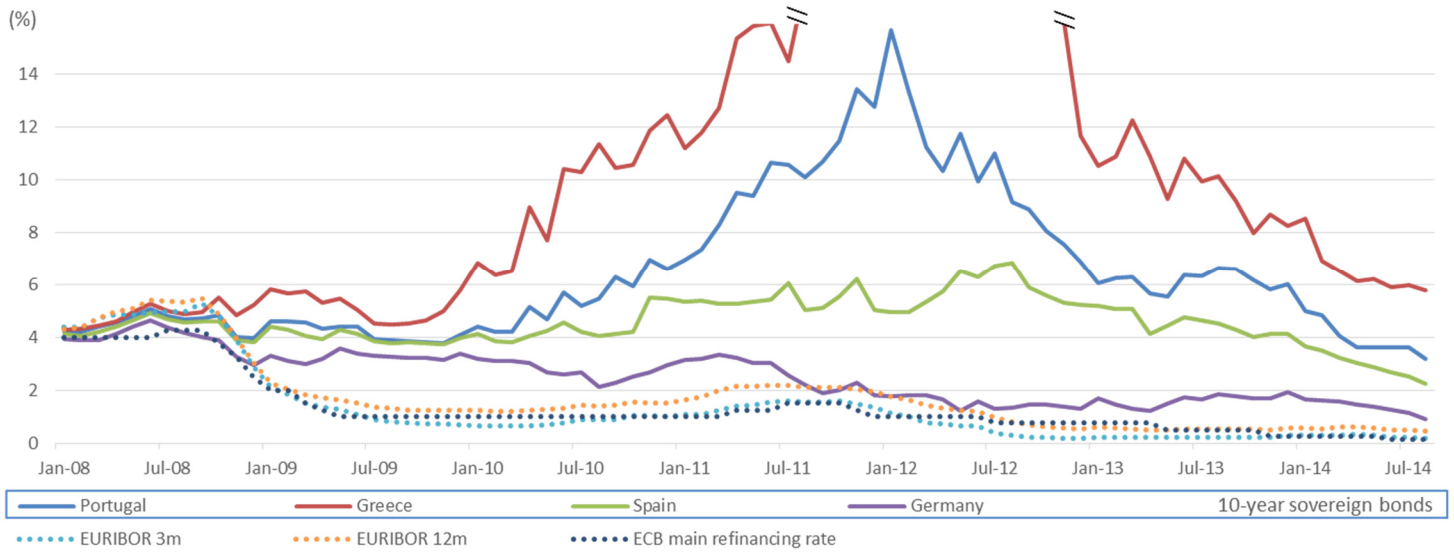
**Exhibit 4. Simplified GES/BES corporate structure, 2014**



Note: "Conselho Superior" members all held similar stakes in ES Control, close to but under 20%; except for the case of Manuel Fernando, who represents his mother's stake, Maria do Carmo Moniz Galvão ES (in fact the largest shareholder with 19.4%).

Sources: BES; ESFG; BPI Equity Research; Press sources

**Exhibit 5. Sovereign yields and money market rates, 2009-14**



Source: Bloomberg

**Exhibit 6. Loan-to-deposit ratio, Portuguese domestic banks vs. BES, 2009-13**



Source: BES; Banco de Portugal

**Exhibit 7. BES selected financial indicators, 2009-14**

	30-06-2014	31-03-2014	31-12-2013	31-12-2012	31-12-2011	31-12-2010	31-12-2009
<b>Key balance sheet indicators</b>							
Total assets*	93,419	96,150	93,342	97,765	98,589	105,540	105,917
Net assets	80,216	82,817	80,608	83,691	80,237	83,655	81,702
Gross credit to clients	51,281	51,001	49,722	50,399	51,211	55,713	50,531
Deposits	35,932	36,242	36,831	34,540	34,206	30,819	25,447
Debt securities issued	11,476	12,666	11,920	15,424	18,452	24,110	33,101
<b>Solvency indicators</b>							
Risk-weighted assets	60,169	62,268	57,332	61,681	65,385	65,097	68,802
CETI/CTI capital**	3036	6079	6084	6471	6020	5416	5232
(Total equity)	4244	7017	7049	7733	6192	6859	6344
CETI/CTI ratio**	5.0%	9.8%	10.6%	10.5%	9.2%	7.9%	8.0%
Tier I ratio	5.0%	9.8%	10.4%	10.4%	9.4%	8.8%	8.3%
Regulatory minimum***	7.0%	7.0%	10.0%	10.0%	9.0%	8.0%	8.0%
<b>Liquidity indicators</b>							
ECB funds (net)	7,432	8,346	5,414	6,897	8,677	3,929	-1,760
Repoable assets	21,593	23,783	20,912	22,256	18,881	10,823	5,553
LTD ratio	126%	129%	121%	137%	141%	165%	192%
<b>Credit quality indicators</b>							
Overdue loans**** / Gross loans	6.4%	6.0%	5.7%	3.9%	2.7%	2.0%	1.6%
Credit provisions / Gross loans	10.5%	7.2%	6.8%	5.3%	4.2%	3.4%	3.1%
Cost of risk	8.3%	2.2%	2.0%	1.6%	1.2%	0.7%	1.1%

	Year-to-date						
	30-06-2014	31-03-2014	31-12-2013	31-12-2012	31-12-2011	31-12-2010	31-12-2009
<b>Summary income statement</b>							
Net interest income	287.0	269.9	1,034.5	1,180.5	1,181.6	1,164.0	1,200.9
+ Fees and commissions	332.9	151.9	693.4	828.4	790.5	806.9	717.9
= Retail banking income	619.9	421.8	1,727.9	2,008.9	1,972.1	1,970.9	1,918.8
+ Trading and other income	-356.0	154.7	172.1	569.5	-21.9	432.9	530.6
= Banking income	263.9	576.5	1,900.0	2,578.4	1,950.2	2,403.8	2,449.4
- Operating costs	594.8	286.4	1,137.0	1,149.1	1,129.2	1,123.1	1,006.1
= Net operating income	-330.9	290.1	763.0	1,429.3	821.0	1,280.7	1,443.3
- Provisions	4,253.5	380.6	1,422.8	1,199.4	848.3	533.6	708.8
= Income before taxes	-4,584.4	-90.5	-659.8	229.9	-27.3	747.1	734.5
- Income tax	-843.5	6.1	-145.2	110.7	-31.1	43.7	109.8
- Minority interests	-163.7	-7.4	2.8	23.7	112.6	146.5	53.0
= Net income	-3,577.3	-89.2	-517.4	95.5	-108.8	556.9	571.7

\*Total assets = Net Assets + Asset Management + Other off-balance sheet assets + Securitised Credit

\*\* Values refer to Common Equity Tier I (CETI) ("phased-in" BIS III) in 2014, Core Tier I (CTI) (BIS II) before

\*\*\* Set in Tier I terms until 2010; CTI until 2013; CETI 2014

\*\*\*\* Loans on which a payment is overdue for more than 90 days

Note: The "fully loaded" BIS III CETI ratio was, as of 31.03.2014, 8% and would be 9.6% post-2014 capital increase. As of 30.06.2014, it was 4.1%.

Values in millions EUR. Source: BES (Prospectus rights issue 2014; Annual report 2011); BPI Equity Research

**Exhibit 8. ESI 2013Q3 headline financials from KPMG Jan14 special report**

	30 Sep 2013	
	First reported	Adjusted
Assets	7,823.3	5,575.7
Liabilities	7,687.3	7,941.6
Equity	136.1	- 2,365.9

Values in millions EUR.

Note: ESI was not independently audited. The special report by KPMG was prepared at the request of BdP for ETRICC2. Source: KPMG/"Expresso"

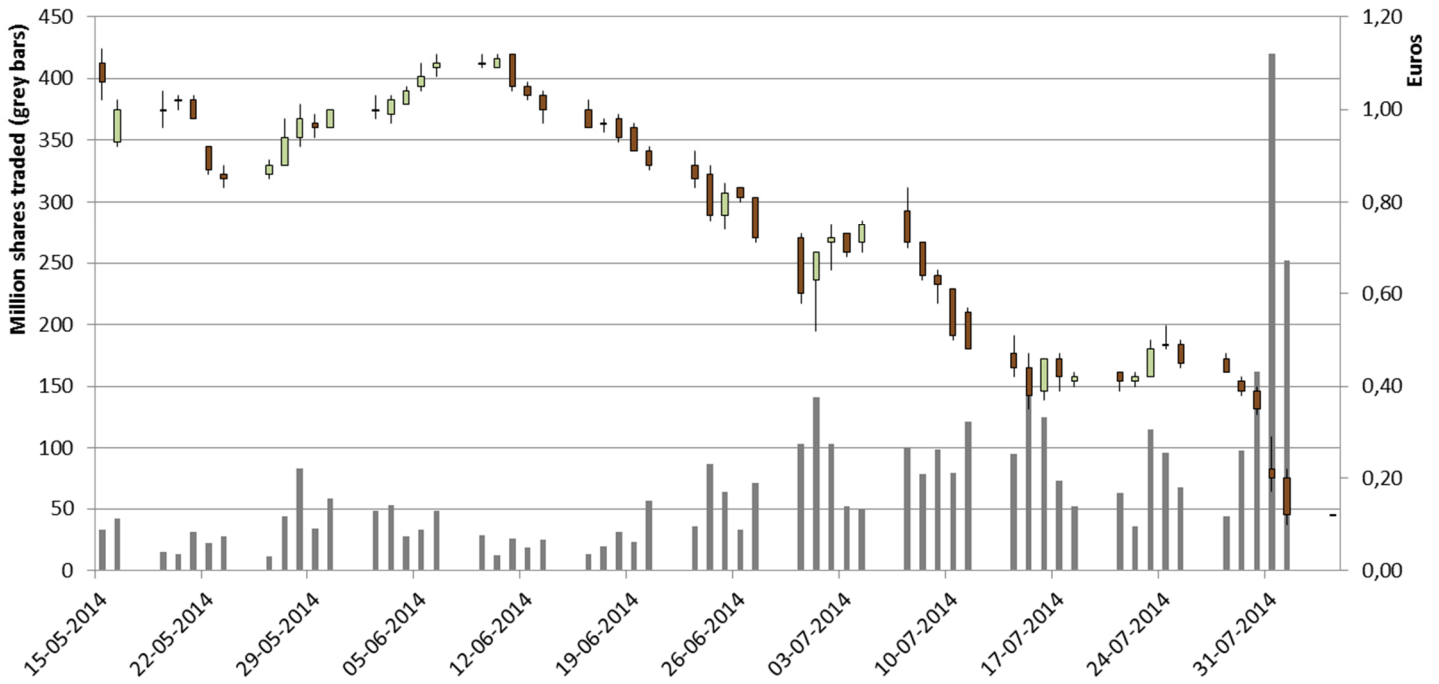
**Exhibit 9. Selected pages of 2014 rights issue prospectus**

Reputational risks for the BES Group associated with a potential deterioration or perceived deterioration of the financial position of Espirito Santo International, S.A. or its subsidiaries:

ESI has started a reorganization and deleveraging programme regarding its group that is aimed at rebalancing its financial position and its accounts have been subject to audits. Certain debt instruments, including commercial paper, issued by ESI and certain of its subsidiaries have been subscribed by BES clients (both institutional and retail investors). At 31 December 2013, the total amount of these debt instruments that remained outstanding was €3,035 million, of which €1,565 million was held by retail investors and €1,470 million was held by institutional investors. As at 30 April 2014, the amount of debt instruments held by retail clients was €516 million, while the amount held by institutional investors was €732 million. As at 19 May 2014, the amount of debt instruments held by retail clients was €395 million, while the amount held by institutional investors was €564 million.

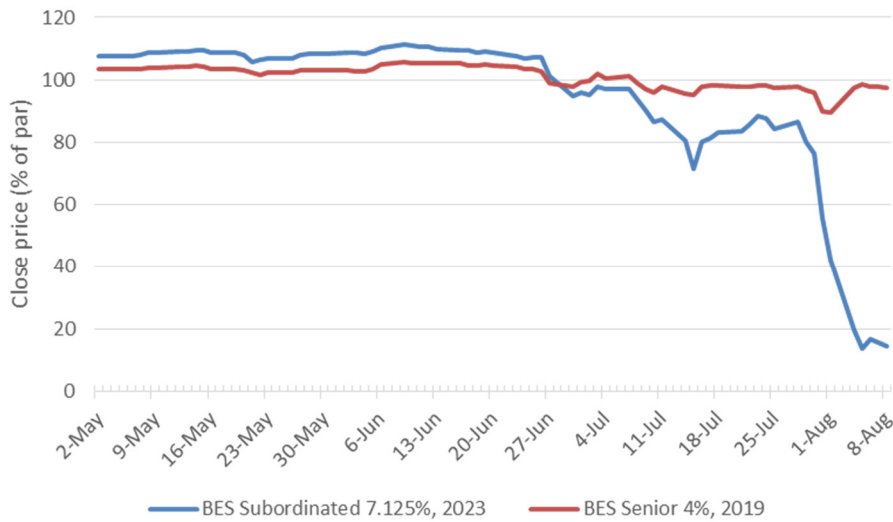
Source: BES

**Exhibit 10. BES.LS stock: daily open, close, maximum and minimum prices; volume traded; May-August 2014**



Source: Yahoo! Finance

**Exhibit 11. BES.LS bond prices, January-August**



Source: Bloomberg



**Exhibit 12.** Syndicate of underwriters in 2014 rights issue

15% each			
Morgan Stanley	JP Morgan		
UBS	Merrill Lynch		
Citigroup	Nomura		

1% each			
Société Générale	Mediobanca	KBC Securities	
Crédit Agricole	Santander	Commerzbank	
Banca IMI	ING	KBW	BBVA

Source: BES (rights issue prospectus)

**Exhibit 13.** BES qualified stakes

	% of BES equity	
	30-06-2014	31-12-2013
BESPAR	-	35.29%
ESFG (Luxembourg)	6.00%	1.38%
ESFG (Portugal)	19.05%	-
Portugal Telecom	2.06%	2.09%
Crédit Agricole (France)	12.19%	10.81%
Silchester (UK)	4.70%	5.67%
BlackRock (US)	4.65%	2.00%
Capital Group (US)	4.23%	4.14%
Bradesco (Brazil)	3.91%	4.83%
Others	43.21%	33.79%

Source: BES (Q22014 report)

**Exhibit 14.** BES exposures to GES 2013-14

Direct exposures*	As reported in			
	10th July		Q2 report	
	30.06.2014	30.06.2014	31.03.2014	31.12.2013
<i>Rioforte and subsidiaries</i>	234.2	270.8	69.6	101.7
<i>ESFG and subsidiaries</i>	934.4	927.6	416.2	301.3
<i>Opway, ESCOM, and others</i>	71.2	373.4	321.5	298.2
Total (excl. insurance)	1239.8	1571.8	807.3	701.2
<i>Tranquilidade and subsidiaries</i>	304.6	226.2	203.8	301.1
Total	1544.4	1798	1011.1	1002.3

Indirect exposures**	As reported in				
	10th July		Q2 report		
	30.06.2014	30.06.2014	30.06.2014	31.03.2014	31.12.2013
Type of client	Total	Total	Institutional	Retail	Retail
<i>ESI and similar</i>	766	766	511	255	1565
<i>Rioforte and subsidiaries</i>	1882	1882	1496	386	544
<i>ESFG and subsidiaries</i>	251	251	0	251	172
<i>ESCOM and ES Tourism</i>	208	208	0	208	206
Total	3107	3107	2007	1100	1684

\* Debt issued by the aforementioned entities and held by BES

\*\* Debt issued by the aforementioned entities and subscribed to by BES clients

Values in millions EUR. Source: BES (Q22014 report)

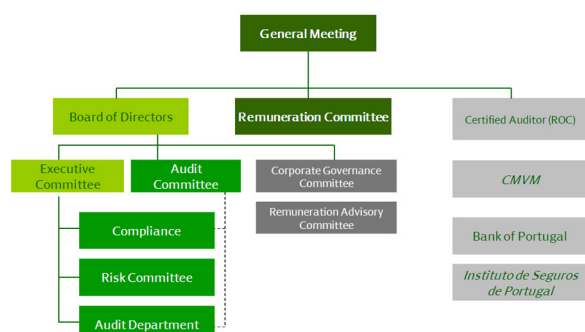
**Exhibit 15.** Breakdown of special events' effects on BES income as reported on Q22014

	Year-to-date 30.06.2014		Special events in 2014				Year-to-date 30.06.2014
	Reported	GES Exposure	Issued bonds and SPE/SPV	BESA	Credit risk adjustments	Other impairments*	Before special events
<b>Summary income statement</b>							
<i>Net interest income</i>	287.0			-247.2			534.2
<i>+ Fees and commissions</i>	332.9						332.9
= Retail banking income	619.9			-247.2			867.1
<i>+ Trading and other income</i>	-356.0	-9.6	-491.0		-75.4	-20.4	240.4
= Banking income	263.9	-9.6	-491.0	-247.2	-75.4	-20.4	1,107.5
<i>- Operating costs</i>	594.8						594.8
= Net operating income	-330.9	-9.6	-491.0	-247.2	-75.4	-20.4	512.7
<i>- Provisions</i>	4,253.5	2,062.3	757.8	3.7	383.6	181.3	864.8
= Income before taxes	-4,584.4	-2,071.9	-1,248.8	-250.9	-459.0	-201.7	-352.2
<i>- Income tax</i>	-843.5	-339.0	-368.4	73.8	-111.0	-22.0	-76.9
<i>- Minority interests</i>	-163.7			-143.8			-19.9
= Net income	-3,577.3	-1,732.9	-880.4	-180.9	-348.0	-179.7	-255.4

\* Impairments refer to stakes in PT (€106.1m); Aman Bank of Libya (€10.2m); Real estate funds (€85.4m)

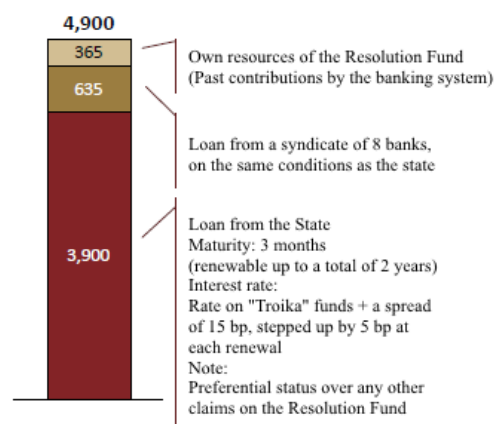
Values in millions EUR. Source: BES (Q22014 report)

**Exhibit 16.** BES Corporate Governance tree



Source: BES (Corporate Governance report 2013)

**Exhibit 17.** Resolution financing structure



Values in millions EUR. Source: Banco de Portugal

**Exhibit 18.** Resolution liability distribution

All liabilities and off-balance-sheet items of BES were transferred to Novo Banco, S.A. except:

- All subordinated debt instruments (€1.1bn)
- Claims (deposits, securities or other) from "related parties", including:
  - Shareholders with controlling stakes i.e.  $\geq 2\%$
  - Board members and auditors, considered responsible for the difficulties at BES by BdP
  - Entities meeting any of the above criteria at any time during the two years before the resolution
  - Family members or proxies of any persons meeting any of the above criteria
- Claims and guarantees related to BES/GES entities (excluding those relative to BES subsidiaries transferred to NB)

Note: all contracts and agreements with workers and external service providers were also transferred to NB.

Source: BdP; NB; BPI Equity Research

**Exhibit 19.** Resolution asset distribution

All assets, rights and licenses of BES were transferred to Novo Banco, S.A. except:

- Loan exposures to GES entities except:
  - Loans to ESFG
  - Loans to BES subsidiaries
  - Loans to Tranquilidade and subsidiaries
- Equity stakes in BESA, Aman Bank (Libya), ES Bank (Miami)
- €10m in cash-equivalents for liquidation procedure expenses (staff, legal duties, etc.)

Note: Assets under the management (AUM) of BES also became managed by NB.

Est. value of NB assets as of Aug. 4<sup>th</sup> 2014: €72,465m.

Source: BdP; NB; BPI Equity Research; Press sources

## Teaching notes

The case of BES is that of the retail and commercial banking front of an extraordinarily intricate corporate structure, the backbone of a group which expanded globally and far beyond financial services, controlled by a traditional, century-old banking dynasty. Losses in the non-financial side of the group (known as GES) mounted during years, but faulty corporate governance allowed the family to use the bank's resources at its own will – and ultimately expropriating the bank's shareholders –, extracting cash from the bank to finance their unsustainable, unrelated businesses. The bank ultimately failed due to taking huge risks in GES (and in its Angolan subsidiary, riddled with bad credit), of which the full extent was only known, in its 2014 Q2 results, which revealed a large capital shortfall. Amidst mounting pressure from regulators, customers and the market, a liquidity crisis escalated until the bank lost access to central bank money and had to be resolved.

The discussion of the case study should cover the corporate governance issues in both the bank and the broader group. It should also approach why it is important that “vanilla” banking firms are as independent as possible from other kinds of business. Students should also analyse the stress period leading to the bank's ultimate failure, the authorities' actions and how investors' interests were or not protected and, finally, the implemented resolution model. Below are proposed possible questions for class discussion and their respective solution topics.

### **1. What is GES and how does it relate to BES?**

GES is the generic designation of the multiple firms and holdings in which the family's interests and non-financial businesses were invested. BES was, in principle, the retail and commercial banking front of the group, in a very complex corporate structure. Downstream from ESFG, the immediate parent to BES, were many subsidiaries in different areas (from asset management to venture capital, among others), but most importantly, upstream, the financial services business served as the backbone of a group which expanded globally in many different industries, but focusing on construction and development.

The Espírito Santos did not have *per se* a controlling stake in the bank but exerted effective control over it, first and foremost due to the strategic partnership with relatively silent Crédit Agricole. In fact, their main stake was held through a waterfall of holdings with ES Control at the top. In the end, they ultimately represented only about 5-6% of BES' equity. BES was strongly connected to GES in multiple, unpredictable ways: through ESFG, BES had a strong exposure to GES entities debt; GES debt instruments were extensively sold at BES counters to customers; mutual funds managed by BES had great exposures to GES; multiple managers and board members at BES had connections to GES.

### **2. How was BES performing before its dramatic fall?**

While not catastrophic, BES performance was deteriorating. Its 2013 results were essentially a prelude to the Q22014 meltdown: a record loss of €500m mostly due to credit provisions, but also a steep fall in trading income. At €255m, BES was on track to perform

just as poorly in 2014, if one excludes the effects of the GES/BESA tragedy – even if trading income was slightly up (but the trading loss in 2014 may have already been related to operations with GES debt), a downward trend in fees and commissions continued from 2013. All in all, performance was fairly poor, even if one takes into account that the very low interest rate environment mattered to the persistence of low NII, and was an additional source of pressure.

### **3. What finally caused the downfall of BES?**

Solvency issues arose at GES and BESA, and as plenty new information was uncovered on the exposures of BES to these entities, doubts began to be raised over the solvency of BES. Despite the success of the rights issue, liquidity problems began to mount in June and July: clients trying to redeem GES debt or fund units at BES, its subsidiaries and ESFG subsidiaries (e.g. Banque Privée Espírito Santo). Deposits, especially in Spain, flying as not only market, but also customer confidence suffered with the successive bouts of bad news.

Any confidence left vanished with the major capital shortfall due to the losses announced in the Q2 results, and the liquidity crisis escalates, culminating with, most importantly of all, the ECB removing BES' counterparty status on Friday (meaning that BES would have to redeem some €10bn of monetary policy loans the next Monday). As there was no immediate solution to provide additional capital, and much-needed cash, in a matter of days, the chain of events had evolved into a solvency crisis at the bank, leading to its fall and resolution.

### **4. What are the main issues you identify with BES corporate governance? How do they affect incentives and value sharing between the main involved parties?**

The very strong linkages between the bank and GES are all revealing of relevant corporate governance faults at BES. The agency problems inherent to the relationship between shareholders and managers of public companies are well-established in academic literature<sup>xiv</sup> These problems tend to be aggravated with the existence of a large, controlling shareholder – as is often the case of founding families, such as the Espírito Santo –, but a multitude of factors contributed to yield them their power over the bank: the bloated size of the bank's board of directors, the fact that the CEO (as well as multiple executive and non-executive board members) were family members; the chairman, though in principle independent, was very old (hardly the best profile to take a thorough, aggressive position in defending minority shareholders' interests); that Salgado, as CEO, was simultaneously a manager of many group companies who owed BES directly and indirectly; among others.

All in all, this was a very favourable context for the expropriation of shareholders by the family, who extracted money from the bank through debt – and even from its clients – to prop up their non-financial businesses on a regular basis, using the bank as a platform for the group to develop on. By lending to GES, both directly and through holdings, or selling GES debt to customers, the bank was financing and increasing its risk exposure to one of its own shareholders. This increased the incentives mismatch between management, GES and other shareholders, which was accentuated by the ultimately small size of their stake in the bank.

Also, regulators' job was purposefully made very difficult: the very intricate and

complex structure of both BES' subsidiary universe and the upstream group made a true real-time assessment of the bank's exposure to the family's non-financial firms extraordinarily hard. Moreover, the fact that most of the holding companies were in different jurisdictions (with possibly more lax regulatory environments), as well as some of BES' subsidiaries used to finance GES, made it very hard to trace back financial flows and assess each component's solvency.

**5. Why did BES undertake a rights issue in 2014, just two years after the last one? Did it seem like a good deal with the information available? What was the implied discount in the offer price assuming all rights were exercised?**

As of March, the solvency level of BES, as measured by the "phasing-in" CETI ratio, was sufficient to comply with the regulatory minimum. However, several potential obstacles loomed in a near future, which would possibly consume some of that capital buffer or otherwise decrease BES' regulatory ratios: as mentioned above, financial performance was fairly poor, with the bank running at a loss; the potential for further provisions, considering the trouble at GES and BESA, was high; as more stringent Basel III rules enter into force regarding the eligibility of CETI capital, the ratio decreases (hence the lower "fully loaded" ratio); the AQR and stress tests would potentially uncover additional necessary write-offs.

For these reasons, a capital infusion was necessary (or would be in a near future). As they had done in 2012 (and 2009...), BES management sought to raise capital in the market. Though better than in 2012, conditions were still unfavourable for such an operation (hence the large discount), but unlike all the other major Portuguese banks, it insisted in not resorting to public recapitalisation funds. This could eventually be considered to have historical reasons, namely that the ES family, out of "pride" or "trauma" regarding the bank's nationalisation forty years earlier, would not allow that to happen again. A more serious assumption, though, is that they needed to avert not only the possibility that state aid might entail an unprecedentedly thorough due diligence process on BES books and more importantly, that a state loan would come with covenants limiting their ability to control the bank and use it to finance GES at will. Moreover, they pushed the operation through sooner than later, as in a stress situation – as would later materialise – there is often no time for a private capital increase, leaving public funding as the only viable solution.

It should be noted that this insistence was detrimental to the interests of shareholders – due to what they stood to lose directly from the successive rights issues, through dilution and underwriting fees, but also, simply, because the cost of capital of (new) equity was much higher than the interest rate the bank would have paid on government funding (likely through CoCos).

At €0.65, the rights issue implied a 39% discount to the closing price on May 15<sup>th</sup> (€1.06), and 32% to the theoretical ex-rights price (TERP) – ignoring underwriting costs:  $€1,045m/€0.65 = 1,607m$  new shares;  $1,607m/4,018m = 40\%$  additional shares;  $€1.06*(1/1.4)+€0.65*(0.4/1.4) = €0.96 = \text{TERP}$ ;  $1-(€0.96/€1.06) = 32\%$  discount.

This extremely low and dilutive issue price was chosen to ensure the success of the operation: on the one hand, to attract strong interest from new investors and incentivize the existing shareholders to either acquire additional shares or sell their rights;

on the other hand, it must have been a necessary condition to get the underwriters on board – they would need to be sure that the post-operation price would be significantly higher than the issue price (as seen by the large discount to TERP), as it actually did, during about one month.

In any case, from the perspective of a new investor, with the information available, the rights issue would have likely appeared to be a great deal, considering the huge discount, and that a syndicate of many of the world's leading investment banks made themselves available to purchase the new stock if necessary. There were, however, some *bad* signs, namely the fact that most existing shareholders took significant dilution and the extensive warnings, in the prospectus, about the potential effects of issues at GES and BESA– even if the extent of these was by no measure fully public at the time.

#### **6. How did the insolvency of GES affect BES? How did BES management decisions during July contribute to the bank's debacle?**

BES' direct holdings of ESFG and especially Rioforte debt were already indeed in immediate risk of default, and ultimately all had to be impaired. In addition, BdP ruled that, at least for retail clients, BES was liable for all its indirect exposures – provisions also were created for those. All this created a huge pressure on BES' Q2 results and contributed to the major capital shortfall. Also, the operations made before June 30<sup>th</sup> (reflected in Exhibit 15) and especially afterwards, using SPV/SPEs to pull money from BES to Rioforte and ESI, to allow them to meet immediate obligations, as were the operations at ESFG subsidiaries other than BES – and BES as well –, where clients were allowed to redeem GES debt instruments at the bank, as well as other bond repurchases, completely drained the bank's liquidity, forcing it to resort to ELA, having far exceeded its ability to borrow from the ECB.

#### **7. What was the main issue with Angola and BESA?**

While its high leverage was cause for concern, it was not necessarily a problem: it was merely a subsidiary of BES, and while it was desirable that the Angola business contributed with more deposits, the LTD ratio of BES was at a reasonable level and so as long as there was enough capital at the BES level, commensurate with the risks taken in Angola, there should not be a problem. The aggressive position at BESA might have been justified for competitive reasons, or for an optimistic view of growth prospects in an emerging market.

Having said that, adequate information on credit assets is key for the successful management of any banking firm: on the one hand, the predictability of its cash flows is essential for adequate asset-liability management to be possible, and on the other hand, precise information on risk is necessary for the right amount of capital to be kept against those assets: neither more – affecting profitability – nor less – jeopardising solvency – than necessary.

The issue, then, was the existence of huge risks in BESA's loan book which had gone unnoticed – including a considerable sum, over €3bn, of probably unrecoverable loans – and, therefore, their write-off entailed a capital shortfall, as would become clear in BES' 2014Q2 results. That any loans were extended without adequate information on

the risks involved (and even to whom they were extended) would not have been possible without the failure of multiple elements in the BES/BESA corporate governance.

## **8. What checks and balances were in place to protect investors' interests? Could they have done so better?**

Internally, BES' corporate governance model had structures that theoretically were in place to control the executive committee's actions, namely: independent board members; audit committee in the board; compliance and risk functions; among others. While some of the problems may only have occurred in the context of illegal, deceptive actions, which compliance and risk officers may not have been expected to be able to uncover on their own, issues such as the large-scale, disproportionate sale of GES debt instruments or loss-making buybacks thereof should have raised flags in BES internal control mechanisms.

There are many external observers who, by following and researching the bank's activity, might exert limited pressure and control over the management, such as rating agencies, equity research analysts, the press, academia, and so on – even if largely limited to public information. However, two main external entities are essential to controlling the bank' management and protect investors' interests: auditors and supervisors.

Issues such as hidden exposures of BES and ESFG to GES and the worthlessness of some €3bn of credit at BESA probably should have been detected and brought to light much sooner by the auditors. While assessing the auditors' performance is beyond the scope of this case, several problems can be generally identified in association with the auditor's important role. While this role is precisely to reduce the agency costs arising from the conflict of interest between management and (in this case, non-controlling) shareholders, another conflict may also arise in the relationship between the auditor and its customer.

Auditors provide an assurance that the firm's financial statements are true, precise and complete, which benefits shareholders and also other stakeholders, such as creditors, depositors and even the market in general – a “public good” of sorts –, while their fees are paid for by the firm – a cost for shareholders in general. However, choosing (and dismissing) the auditor is largely at the management's discretion, even if often auditors must be approved by a shareholder majority. Obviously, this conflict seems particularly strong in the case of BES, where the incentives of the management (and controlling shareholder) are particularly misaligned with those of the other shareholders. Moreover, KPMG was the auditor of many if not all of ESFG and BES subsidiaries, accentuating the relative importance of the group as a revenue stream for the firm. The case of BESA is particularly remarkable how such a large amount of poorly accounted for credit could have gone unnoticed.

The case of BES also raises questions about the role of supervisors. First, BdP in its role as prudential regulator: could it have insisted that more information was provided on BES' exposures to GES earlier? Could it have forced changes in BES' faulty corporate governance earlier? Did it monitor closely enough (within its powers) the functioning of BES existing structures, such as the audit committees, accounting, risk and other functions? Second, BdP in its role as behavioural supervisor: Were sales practises

at BES, namely placing GES debt with clients, legal and adequately monitored? Was all information was provided to customers buying securities of a separate but related party to the bank? Third, the role of CMVM, the market regulator: Were the warnings in the 2014 rights issue prospectus “too little, too late”? Within its powers, could it have prevented the rights issue from being completed, at least unless even more information was provided in the prospectus? Should it have suspended trading on BES shares earlier?

Also note that this case highlights the importance of good coordination between the banking supervisor and the market regulator (see also question 14). For example, with better cooperation, CMVM might have suspended trading sooner if it had known earlier about the resolution, and more might have been done, during the critical months of June of July, to get all the relevant information out at the same time, rather than a successive collection of bad news dripping through, fostering speculation and undermining market confidence.

**9. What different solutions were available to the authorities on the last week of July 2014? Why might have this resolution model been chosen?**

Once BES’ capital was below the regulatory minimum, from a theoretical standpoint BdP had four options; a) a new private capital increase, b) a government-funded capital increase and c) full liquidation. d) a resolution measure.

a) Market confidence was shattered. Moreover, the size of the shortfall, made it very hard to gather enough investor interest at the required scale. In any case, BES needed an immediate cash infusion, and a new rights issue would take at least a couple of months.

b) Similar to d), without splitting the bank. The same bail-in measures would necessarily be applied. Regarding the losses arising from toxic/uncertain assets, on a good scenario, shareholders/junior creditors would lose less; on a bad scenario, the same, and government would likely be called upon to provide additional capital. Would require significant political backing which might not be available.

c) Due to the size of the bank would severely affect the financial system and possibly the greater economy, therefore was not viable.

d) a) and c) were seemingly impossible from a practical point of view. D) seems more favourable than b) to the interests of government, depositors and senior bondholders, as it contains the problems that may arise from the toxic assets that remain in “bad bank”-BES, not allowing as yet unknown further impairments to contaminate the bank (NB)<sup>19</sup>. For the “bailed-in” parties, this solution is worse.

**10. Was the resolution of BES a *bail-out* or a *bail-in*? How would your answer differ if the resolution fund was fully capitalised?**

The measures adopted are particularly interesting as they do not necessarily fit the description of either a typical bail-out or a fully-fledged bail-in resolution. There is a bail-out component, as public money was used, even if the banking system is, via RF, theoretically liable to repay the amount to the state, even if the legal-institutional

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<sup>19</sup> It should be noted however that this might not be the case if an interested party (e.g. a vulture fund holding BES subordinated debt) is able to successfully challenge BdP’s resolution decision (or a part of it) in court. In the case of BESI, which was separated from NB and already sold to a Chinese group, the sale contract stipulates that any costs arising from litigation regarding the resolution will impend on BdP/the government, with the bank being sold “litigation-free”. This will likely also be the case when NB is resold.



mechanisms through which that can be enforced remain somewhat unclear. At the same time, shareholders and junior creditors bear losses – are “bailed-in” – even if the bail-in is only partial, as other uninsured creditors and depositors were spared. If the resolution fund had enough available own resources (i.e. contributions from banks), there would be no bail-out component, as the funds used for the recap would not originate in general taxes (despite technically being considered public funds, as the resolution fund is part of general government for legal and statistical purposes). It is interesting to note, however, that if contributions were provided a similar rate as thus far (365m€ over two years), RF would only be able to fund an operation of the size of BES’ recap on its own after more than 25 years, assuming it would not be called upon until then.

**11. Assess the resolution financing structure. Why did the banks prefer to finance a larger part of the recap upfront? Why do the loans’ spreads increase with time?**

A plausible interpretation is that the impact on banks’ income statements of a loan (neutral or positive) was completely different from that of a special contribution (negative, would be considered an expense). For these reasons they acceded to financing a much larger part of the operation upfront. As for the loan spreads, they are intended to incentivize a quick sale of NB, in order for the government to be repaid sooner.

**12. Why only junior bondholders? What is the *rationale* for the criteria used to discriminate creditor classes?**

State aid rules in place (see endnote *n*) at the time did not allow for public funds to be used without bailing-in junior bondholders and shareholders.

The idea is that creditors who took riskier positions, with better returns, should be first to bear losses. Junior bondholders will receive, eventually, liquidation proceeds from the bad bank. The way BES’ assets were split means there may be some recovery eventually (hence the non-zero price they traded for even after the resolution), but likely not much – especially since BdP seems to be legally allowed to rearrange assets and liabilities between the bad bank and NB at any given time according to its interpretation of resolution legislation (as it did in December 2013 with debt owed by BES to a Goldman Sachs SPV) casting great uncertainty over the recovery rates.

**13. Why are authorities so keen to promote *bail-ins* and not commit public funds? Are there other issues that might surface like this? In this case, who pays the €4.9bn bill?**

Many European countries’ governments were forced to provide significant amounts of cash to recapitalise banks during the financial crisis, leading to intensified political pressure in order to create mechanisms to prevent tax proceeds to be used, in a large scale, for bank rescue. Moreover, one of the major causes identified by economists in academia and government for the European sovereign debt crisis was the so-called «bank-sovereign loop»: doubts on banks’ solvency lead to potential government bailouts, which in turn jeopardise government solvency and increase potential taxes, which negatively affect the economic outlook, in turn further damaging banks’ prospects, and so on. Banking Union reforms, including rules on resolution and bail-out, have «breaking the loop» as one of their main objectives.

However, there are other issues that might surface. It is clear, for one, that by

increasing their risk, the cost of funding for European banks will rise. (Some argue that this might be appropriate, as the possibility of bailouts represented an implicit subsidy from government to banks – add reference). Also, the contributions to resolution funds – especially large, “extraordinary” ones when a negative event occurs and the fund is undercapitalised, as happened in Spain – impose an additional cost on banks. It is likely that not only bank shareholders, but also consumers will be affected, through bank commissions, fees, and interest. This is the case here, where the €4.9 will be paid by banks to RF over years to come.

Another problem is the unpredictable consequences if there is a problem in a large, multinational bank – almost 40% of securities other than shares issued by banks in Europe are held by other banks (ECB data). So if a big, systemic bank goes bust (or a subsidiary thereof) and its bondholders are bailed in (especially once senior bonds are also affected), this could cause significant problems for all the country’s (or Eurozone) banks, which have to write that bank’s debt down, bear losses, and maybe require additional capital. Note that even in the case of BES, Crédit Agricole’s Q2 profits were wiped out because of the resolution.

#### **14. How do you explain the behaviour of share and bond prices in July? What might have gone wrong?**

Stock and sub bond prices follow very similar patterns: they begin to fall steeply on June 30th, when the first major signs of stress became public, falling even more a few days later, as more information was released (such as the Q2 report) – 10 p.p. of par in the most panicky market days –, seems to demonstrate that the market was fairly aware there was a risk of “bail-in”. With the news of the rights issue’s success, they recovered slightly, to almost 90% of par, until, in the last couple of trading days before the resolution, they completely crash (the biggest sell-offs occur on Thursday).

It is difficult to justify the dimension of this crash without considering that some market participants must have been aware that the resolution was taking place the ensuing weekend. Those participants would be at an unfair advantage over the others, as they already knew that the shares – and to a lesser extent, the sub bonds – would become worthless over the weekend. At the same time, at least earlier that week and the week before – and perhaps until the very end – many investors surely must have seen an opportunity in BES stocks at such a low price, especially considering the news of strong purchases by Goldman Sachs on behalf of its clients: “This purchase passes on some security to the market and can open the door for other institutional investors”, a trader said at the time<sup>xv</sup>. If CMVM, the market regulator, had been informed sooner – as soon as plans for the resolution began to be made, at least on July 30th – it might have suspended trading at that time.

Senior bonds also suffer in the crisis period (July), also trading below par, but to a much smaller degree. After the resolution, they recover as its holders became the creditors of a newly solid, toxic assets-free, bank. It is interesting to note that up until the last days of June, the price of sub bonds was still above that of senior securities, implying that the market, until that time, considered the risk premium they offered (about 4%) was still enough to account for the additional risk they entailed.

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## Endnotes and references

- <sup>i</sup> Gago, Maria João and Maria João Babo (2014). *O Último Banqueiro*. Lisbon: Lua de Papel. (p.82)
- <sup>ii</sup> Main references: “Espírito Santo: A história de um império familiar”, *Diário Económico* newspaper, 15<sup>th</sup> November 2013; Damas, Carlos Alberto (2002). “José Maria do Espírito Santo e Silva, de cambista a banqueiro, 1869-1915”. *Análise Social*, vol. xxxvn (164), pg. 851-878.
- <sup>iii</sup> (p. 29 *O Último Banqueiro* and D. Económico July 2014); value is inflation-adjusted (source: PORDATA/Statistics Portugal).
- <sup>iv</sup> Ricardo Salgado at a parliamentary hearing on December 9<sup>th</sup> 2014
- <sup>v</sup> “BESgate. Como Ricardo Salgado adivinhou o fim” *i* newspaper.
- <sup>vi</sup> The legal document, released by the European Council, laying down the implementation framework for the SSM (Council Regulation no. 1024/2013, of 15<sup>th</sup> October 2013).
- <sup>vii</sup> “Salgado tentou envolver família na ocultação do passivo do GES” *i* newspaper.
- <sup>viii</sup> “Espírito Santo Engages in Financial Gymnastics to Survive Crisis”, *Wall Street Journal*, 12<sup>th</sup> December 2013.
- <sup>ix</sup> “Ricardo Salgado: «Foi o aumento de capital com mais sucesso desde 1992»”, *Jornal de Negócios* newspaper, 11<sup>th</sup> June 2014
- <sup>x</sup> «Não queremos ser nacionalizados outra vez», *Lusa* press agency, 13<sup>th</sup> February 2014
- <sup>xi</sup> ESFG communication to the market, 3<sup>rd</sup> July 2014
- <sup>xii</sup> Directive 2014/59/EU adopted by the European Parliament on 15 May 2014, provides essentially uniform EU-wide rules for bank resolution, in which the aforementioned SRM will function.
- <sup>xiii</sup> Communication 2013/C 216/01 adopted by the European Commission on 30<sup>th</sup> July 2013. Replaces the “2008 Banking Communication” i.e. Communication 2008/C 270/02 of 25<sup>th</sup> October 2008. These are part of a group of several rulings by the Commission, broadly known as the “Crisis Communications”, regarding state aid in the EU in the context of policy responses during the financial crisis of 2008 and the ensuing Eurozone economic and financial crisis.
- <sup>xiv</sup> See e.g. the seminal article by Fama, Eugene F. (1980), “Agency Problems and the Theory of the Firm”, *Journal of Political Economy*, 88, issue 2, p. 288-307. Chicago: University of Chicago Press.
- <sup>xv</sup> “BES Rises as Goldman Sachs and D.E. Shaw Disclose Stakes”, *Bloomberg News*, July 23<sup>rd</sup> 2014.