BANCO ESPÍRITO SANTO:

ANATOMY OF A BANKING SCANDAL IN PORTUGAL

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Summary

I. FROM CRADLE TO GRAVE: 150 YEARS OF BANKING HISTORY

1. The *Banco Espírito Santo* (BES) was the oldest and one of the largest Portuguese banks. It was created in 1869, precisely at the same year that Goldman Sachs was founded, and it was resolved in 2014.

A. The origins

2. The BES's origins began with a small currency exchange and securities business ('Caza de Cambio') run by José Maria do Espírito Santo e Silva, then only 19 years old, in the centre of Lisbon in 1869. Since then, and until 1920, he founded several banking institutions, such as 'Beirão, Silva Pinto & Cª' (1884–1887), 'Silva, Beirão, Pinto & Cª' (1897–1911), and 'J.M. Espírito Santo Silva & Cª' (1915). After World War I, it was transformed into a public limited liability company in 1920 under the name *Banco Espírito Santo, SARL*, managing to consolidate its position within the context of national

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banking by opening agencies and using a renewed management model. In 1937, after merging with another bank (Banco Comercial de Lisboa), it became the *Banco Espírito Santo e Comercial de Lisboa* (BESCL): the BESCL soon developed into the leading privately owned bank in Portugal, succeeding to quadruple the value of its stock even during World War II, due to the reinforcement of its international presence, business expansion, and connections with wealthy families (Rockefellers, Firestones) and aristocracy (e.g. the King of Spain, Juan Carlos).

3. After the revolution of 1974, the bank, as well as all the major affiliated companies, were *nationalized* and the Espírito Santo family was prevented from doing business in Portugal. The exiled family, however, swiftly reorganized its business and financial interests abroad, in countries such as Switzerland, France, Luxemburg, Brazil, and the United States. In the end, with the wave of *reprivatization* of the major banks and enterprises during the 90's, the BESCL was partially back under family control (due to the creation of a holding company in association with the French 'Credit Agricole') and Ricardo Salgado, one of the youngest members of the Espírito Santo dynasty, took over as CEO of the bank. In 1999, the bank was renamed *'Banco Espírito Santo'.*

B. The growth

4. Since the 90's, after being reprivatized, the BES underwent a major expansion, becoming a major institution in Portugal, both as a bank, as the head of an economic group, and an economic player.

5. The BES was the *second major private bank* in Portugal, operating in twenty-five countries, with net assets estimated at 80 billion euros, with more than 650 branches, more than two million clients, and more than seven thousand employees, and with an average market share of 20.3 per cent. It was also the second largest listed Portuguese bank, the ninth largest contributor to the NYSE Euronext Lisbon (the main Portuguese stock index), and the most internationally reputed of the Portuguese banks (being nominated as the 'Best Trade Financial Bank' for five consecutive years by the Global Finance magazine and the sole Portuguese bank to be included on the sustainability FTSE4Good Index).

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6. The BES also became the axis of *one of the largest Portuguese corporate groups*: the Grupo Espírito Santo (GES). Following a strategy of organic growth, the cash generated by the banking business was used to form a major conglomerate or corporate group with significant investments in diversified businesses (including real estate, construction, transport, agriculture, hotels, energy, and development, among others), and geographical areas (such as Switzerland, Luxemburg, Libya, Angola, Panama, and the United States). The GES group was a large and international corporate group, with hundreds of companies located in different countries, both in financial and non-financial areas, with a complex internal network. In 2014, the head of the GES group was Espírito Santo Control (ESC), ultimately owned by the Espírito Santo family, which controlled the intermediate holding, Espírito Santo International (ESI), which in turn owned, both directly and indirectly, two major subholdings: Rioforte, a holding in the non-financial area of the group, owning and controlling dozens of commercial companies (e.g. real estate, transport, hotels, mining, and energy); and Espírito Santo Financial Group (ESFG), a holding in the financial area, which controlled the BES, as well as more than a dozen financial companies (e.g. insurance, investment services, and brokerage).

7. In addition, it is worth mentioning that the BES also became *a key player in the Portuguese economy*. In 2013, it held 25.5 per cent of the market share in the enterprise segment, being considered the financial motor for Portuguese small and medium enterprises, while at the same time having important interests in the Portuguese larger non-financial companies (namely, 'Portugal Telecom'). In 2011, the leader of the BES, Ricardo Salgado, was nominated as the most powerful businessman in Portuguese economy by the financial magazine Jornal de Negócios—earning him the nickname 'lord of all this' ('dono disto tudo').

C. The downfall

8. After decades of 'annus mirabilis', where the BES became the pivot in the formation of a large, internationally based conglomerate, a long and intricate chain of events occurred during 2013 and 2014—truly 'annus horribilis'—eventually bringing the BES down.

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9. In May 2011, in the wake of the *global financial crisis,* Portugal entered into a three-year 'program of economic adjustment' (2011–2014) in return for bailout assistance of 78 billion euros from a so-called 'troika' of official lenders (the International Monetary Fund (IMF), the European Union (EU), and the European Central Bank (ECB)). During 2013, the first signs of instability appeared. In March 2013, rumours about *financing difficulties at some of GES's holdings* began to circulate, revealing an off-balance sheet exposure of BES clients to the GES group in excess of 1.8 billion euros. In September 2013, the Bank of Portugal, in its supervisory authority capacity, ordered a *full forensic audit on Espírito Santo International* (ESI), a top holding company of GES: it soon transpired that the group's debt had been underestimated since at least 2008, with a negative equity of 2.4 billion euros and a total unrecorded debt of 6.3 billion euros, almost 80 per cent of which was held by the BES and its customers (4.9 billion euros). In November 2013, the *race to succession* in the group leadership within the Espírito Santo family began: José Maria Ricciardi, CEO of an investment bank of the BES (BESI), challenged the leadership of his cousin, Ricardo Salgado, claiming loss of trust in his management and conduct. In January 2014, a *huge financial hole in the BESA*, the Angolan subsidiary of the BES, was exposed, revealing that it had unrecorded and uncovered credit exposures of up to 5.7 billion euros (equivalent to 220 per cent of the subsidiary's deposits), more than 60 per cent of which were funded by loans from its parent company, the BES (3.5. billion euros). In February 2014, during the presentation of the BES's annual report, the BES's CEO announced a loss of 0.5 billion euros and, while rejecting the Troika bailout funds still available to Portuguese banks, mentioned a future increase of capital. In May, the BES announced a *stock capital increase* of approximately one billion euros, at a price of 0.65 euros, at a time when the stock was trading at 1.06 euros: the prospectus was the first document that publicly disclosed the existence a very poor financial situation at the top of the GES group.

10. In spite of the success of the capital increase (supported by a strong underwriter syndicate), *events accelerated in the opposite direction* over the following two months, sealing the fate of the BES. By the end of May, only a few days after the BES capital increase, rumours grew about the delicate financial situation of the group holding ESI and the BES share prices tumbled. On 20 June, Ricardo Salgado, the bank's CEO, announced he was leaving the BES administration. On 3 July, the group financial holding ESFG

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announced that its exposure to the GES group had increased by almost 70 per cent (2.4 billion euros) due to the reimbursement of GES commercial paper sold to the BES's retail clients. On 10 July, the Portuguese securities exchange commission (CMVM) suspended trading on ESFG's shares due to overwhelming selling pressure. On 13 July, in order to restore confidence to markets and the public, the Portuguese central bank (BdP) forced the exit of Ricardo Salgado, the bank's CEO, and Amílcar Salgado, the bank's CFO. On 14 July, with the support of the BdP, a new executive committee for the management of the BES is announced, lead by Victor Bento, a former BdP director, as the new bank's CEO. On 18, 22, and 25 July, respectively, the group holdings ESI, Rioforte, and ESFG filed for creditor protection in Luxemburg after defaulting on their obligations. On 26 July, Ricardo Salgado was detained for questioning by police officers in an unrelated tax fraud and money laundering investigation. He was later released on bail for 3 million euros. On July 30, the BES's new executive committee presented the results of the second quarter of 2014, announcing record losses of 3.5 billion euros (mostly due to impairment of GES exposure, SPV operations, and bond losses issues). These losses reflected seriously detrimental acts of mismanagement, as well as intragroup exposures issuing from the violation of previous determinations of the Portuguese supervisory authority establishing ring-fencing prohibitions amongst entities of the GES group. On 1 August, the CMVM suspended trading of the BES's shares, as they were falling to about 50 per cent of their value (being traded at 0.12 euros), while customer panic caused a withdrawing of bank deposits to the value of two billion euros.

D. The funeral

11. On 3 August 2014, the Portuguese central bank (Banco de Portugal (BdP)) proposed the *resolution of the BES*. This decision, which sentenced to death an institution with one and a half centuries of history, was the pinnacle of the above-mentioned long and intricate chain of events.

12. Facing the imminent suspension of its counterparty status with the ECB, and given the systemic risks involved to the overall banking system, the Portuguese resolution authority (BdP) decided to apply to the BES a resolution measure in the form of the *bridge institution tool*, which was speedily approved by the European Commission and which essentially split the bank in two. On the one hand, the BES was left behind as a *'bad*

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bank', with the equity (3.7 billion euros) and liabilities to subordinated creditors (927 million euros), as well as other toxic assets, contingent liabilities, and claims of related parties. On the other hand, a new *'good bank'* was formed, incorporating all the staff, branches, deposits, and credit customers of the BES and assuming the rest of its balance sheet, including deposits, senior debt obligations, and healthy assets: this newly created bridge institution was named Novo Banco (NB), whose share capital of 4.9 billion euros was fully subscribed and held by the 'Portuguese Resolution Fund'. The resolution measure was taken with the goal of ensuring the continuity of the services provided by the resolved bank BES (which is now under liquidation) while preparing its future sale to private parties: in October 2017, the NB was acquired by the American private equity firm, Lone Start Fund, who purchased 75 per cent of its share capital in return for a capital injection of one billion euros. Aside from the case of an improbable resurrection, the *BES was dead*.

II. THE BES'S AUTOPSY: ON THE CAUSES OF DEATH

13. The BES was a Portuguese institution with one and a half centuries of history. It survived to two world wars, it prevailed over different political regimes (a monarchy, a republic, and a revolution), and it endured diverse economic regimes (nationalization and reprivatization, public and private ownership). What reasons might then explain the abrupt end of such an apparently solid institution?

14. While the story of the BES collapse has yet to be fully unveiled, there is a *set of plausible causes of death* which, at least in abstract, may be considered here. Was the BES's collapse a by-product of the global financial crisis of 2007-2008? Was it a result of failures of banking supervisors or regulators? Was it due to the organic growth of the BES leading to a conglomerate with a dangerous mix of financial and commercial activities? Or was it instead a result of family quarrels at the heart of a family-based business? Finally, was the bank's collapse caused by unethical leadership?

A. The usual suspect: the global financial crisis

15. A first possible cause of the BES collapse is the *global economic and financial crisis of 2007–2008*. In fact, this crisis brought to light some hidden vulnerabilities of the

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Portuguese banks, including over-reliance on wholesale funding resulting in low levels of liquidity (with one of the highest loan-to-deposit ratios in the euro area, increasing from 100 per cent in 1999 to 172 per cent in 2008) and credit concentration and misallocation (which was heavily concentrated in the real estate and construction sectors, rocketing from 8.4 billion euros in 1999 to 26.1 billion euros in 2008, accounting for 70 per cent of the total credit portfolio by 2008, exposing them to the crash in those industries).

16. On top of this, the financial crisis quickly evolved into a *sovereign debt crisis*, with large feedback repercussions in the banking system. Unable to repay or refinance its debts, Portugal entered a three-year 'program of economic adjustment' (2011–2014) in return for bailout assistance of 78 billion euros from a so-called 'troika' of official lenders (IMF, the European Union, and the ECB).

17. While the market turmoil and the country bailout certainly accelerated the BES collapse, it was not its cause. As had happened with most of the other Portuguese banks, the BES had a little exposure to toxic financial instruments related with the American subprime credit crisis. Of the largest Portuguese banks, the BES was the only one who rejected resorting to taking the 12 billion euros of Troika bailout funds made available to the Portuguese banking industry: instead of state aid, the BES undertook a succeeded capital increase of one billion euros by mid 2012, thereby rising its Core Tier 1 ratio to around 11 per cent (above the minimum fixed by Portuguese bank supervision authorities). Above all, the history of the BES proves its resilience to extremely adverse environmental conditions: a bank institution that survived the Great Recession of 1929 and World War I and II, while quadruplicating its worth in the process, has unequivocally proven to be prepared *to pass any stress test*.

B. The supervisory prop: 'laissez-faire' and other stories

18. Another usual suspect for the banking crisis is banking supervision: although it is not a supervisor's role to prevent bank failures, *supervisory oversight* is crucial to reduce both the probability and impact of such failures.

19. At this point, one should underline that the BES collapse was not an isolated case: as a matter of fact, before and after the BES downfall, a good deal of Portuguese banks

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underwent various forms of crisis, including ‘Banco Português de Negócios’ (which was nationalized in 2008), ‘Banco Privado Português’ (whose liquidation was ordered in 2010), and ‘Banco Internacional do Funchal’ (which was bailed-in in 2015). It is now increasingly clear that the crisis of the Portuguese banking system *could never have reached such a scope and dimension* unless the Portuguese central bank, as the national supervision and resolution authority, had failed to perform its basic prudential mission. To put it bluntly, according to some viewers, during the first decade of the twenty-first century, the Portuguese central bank (BdP), lead by a former general-secretary of the Socialist Party, had been little more than a mere decorative piece installed in its ivory tower, remaining oblivious to the significant macro and microeconomic changes then occurring at the level of the banking system that it was supposed to oversee.

20. No wonder that the measures to prevent the BES collapse undertook by the BdP from 2010 onwards, already under the leadership of a new Governor, Carlos Costa, were doomed to fiasco. In 2013, somehow anticipating the Asset Quality Review strategy of the ECB, the BdP ordered a *full forensic audit* of the GES in order to identify possible hidden debts in other group holdings and subsidiaries that could materially affect the BES: as a result, a total unrecorded debt of 6.3 billion euros was disclosed, almost 80 per cent of which was held by the BES and its costumers (4.9 billion euros). As many of those group members, due to their non-financial nature and foreign registered offices, were not subjected to its prudential supervision, the BdP sought to implement a *‘ring-fencing’ strategy* aimed at immunizing the BES and its customers from the credit exposure to GES. During the first half of 2014, the supervising authority also undertook other measures, such as, for instance, imposing on the ESFG, the holding company of the BES, the liability to redeem the BES retail clients who acquired commercial paper issued by GES (in the amount of some 700 million euros) and to increase its solvency ratios. *But it was just too late.*

C. The explosive blend: banking and commerce

21. As mentioned earlier (see Section I.B), contrary to other Portuguese banks, the BES sought to undergo a strategy of *organic growth*, thus becoming the financial key to the formation of the Grupo Espírito Santo (GES), an international and diversified corporate group composed of both financial and non-financial companies located in different

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countries. One may thus wonder whether there were also structural factors concerning group organization to be considered when assessing the causes of the BES collapse.

20. There is an old debate on the *separation between commercial banking and investment banking*, as well as, more broadly, between banking and commerce. The recent crisis revived this debate as concerns about the negative effects of the lack of such separation in Europe have become increasingly intense: an example is the so-called 'Liikanen Report' (Report of the European Commission's High-Level Expert Group on Bank Structural Reform of 2012), proposing a separation or ring-fencing of high-risk and third-party trading by universal banks.

22. *The integration of the BES within the perimeter of a broader economic group, the GES, seems to confirm those concerns*. For years, the cash generated by the banking business was used to develop a conglomerate composed of commercial companies operating in diversified businesses (e.g. real estate, construction, transport, agriculture, hotels, energy, and development, among others). This group ownership structure is also likely to have induced credit misallocation in commercial and industrial sectors of the group, exposing them to the crash in those sectors, with the subsequent climb of non-performing loans resulting in huge impairment losses. On top of this, as large parts of the GES were not subjected to any prudential supervision, regulators and supervisors faced difficulties seeing the boomerang dangers lurking beneath the surface of the BES organization, namely the exposure of the bank to the risk of refinancing the debts of other group members.

D. The War of the Roses: the race for succession

23. One of the main reasons for the BES's longevity was undoubtedly its *ownership model*: family businesses usually out-perform non-family owned firms over a long period of time, and the BES is a good example of that. Since its creation in 1869 by José Maria do Espírito Santo e Silva, and safe for the short period of time after its nationalization in 1974, the history of the BES has been always inextricably linked with the history of the family Espírito Santo—which thus also became the oldest banking dynasty in Portugal.

24. Family-owned firms, especially big ones, face, however, a major challenge: how to manage succession from one generation of leaders to the next while avoiding the

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destructive force of family quarrels and disputes. It is clear that, after more than a century of successfully dealing with such challenges, *the family went through a 'War of the Roses' that eventually advanced the BES's collapse*. As a matter of fact, the entire GES was governed and overseen by an unofficial board, named Top Council ('Conselho Superior'): this council, composed of representatives of the major branches of the family tree, was actually above the group formal structure and took the most strategic decisions concerning any relevant group matter on a consensual basis. From 1991, when he became CEO of the BES (then BESCL), Ricardo Salgado was the undisputed leader of the group, being the mentor of its strategic development for two decades. However, during 2013, rumours about a race for succession within the group started to circulate. In November 2013, José Maria Ricciardi, cousin of Ricardo Salgado and son of António Ricciardi (the eldest of the members of the Top Council), challenged Salgado's leadership, claiming loss of trust in his management both at a professional and personal level. Other members of the family, like Ricardo Abecassis Espírito Santo (another cousin of Salgado's and chairman of BES Investimento in Brazil), apparently also entered the race for succession.

25. In its capacity as supervisor authority, the BdP forced an armistice agreement between the contenders in order to ensure the stability of the BES in that delicate moment of its life, with the Top Council expressing a unanimous vote of confidence in Salgado's leadership. But the *poison* of the hidden 'War of the Roses' had already corroded the foundations of the family's unity, at precisely the time it was most needed, thus sealing its fate.

E. At the penthouse: unethical leadership

26. The *importance of ethics on business*, and the disruptive impact of unethical behaviour of CEOs and top management in the value and future of firms, is a matter on the agenda. To be true, this is nothing new: already in 1494, the Italian Medici Bank, owned by the Medici family, went bankrupt after running up large debts due to the family's reckless spending, extravagant lifestyle, and failure to control their managers. But recent scandals bringing down large publicly held companies, at the turn of the second millennium, such as Worldcom (2000), Enron (2001), Parmalat (2003), Madoff (2008), and others, pushed it again to the forefront of public attention, media debate, and scientific research.

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27. Ricardo Salgado was the *undisputed mentor and head of the BES and of the GES for more than twenty years*. He was the acknowledged leader of the BES: notwithstanding that the bank was governed by a large board of directors including several family members, representatives of other major shareholders, and independent directors, board meetings were often said to be a mere formality for the approval of the CEO business policies and decisions. Salgado was also the indisputable frontrunner of GES, responsible for the strategy of rebuilding and developing one of the largest Portuguese business conglomerates, with significant investments and interests both internationally and internally (including, in some larger Portuguese non-financial companies, such as Portugal Telecom). Finally, pursuing a tradition of banking dynasties, he was able to maintain ties with successive governments and exert influence in major areas of the Portuguese corporate sector. It is thus no wonder that in 2011 Salgado was nominated *the most powerful businessman in Portugal* by the financial magazine Jornal de Negócios, earning him the nickname 'lord of all this'.

28. However, *leadership is a double-edge sword*: leaders may go from genius to dunce in a heartbeat. It is a fact that the misuse of the BES lending money to its own shareholders, the exposure of the bank and of its clients to ruinous businesses from the GES, the uncontrolled default bank loans to BESA, the accounting concealment of the real financial situation of the group holdings, and other similar harmful events that dug the bank's grave, occurred under the kingship of Salgado. On top of this, he was involved in a number of criminal proceedings, including unrelated proceedings of tax fraud and money laundering ('Operação Monte Branco'): in 2016 he was fined by the BdP up to 4 million euros and banned from any banking activity (a final decision is still pending); and in 2017 he was also indicted in a vast criminal proceeding involving a former Portuguese Prime-Minister, José Sócrates (who was in charge from 2005 until 2011, shortly before the country's bailout), along with a long list of other well-known Portuguese politicians and businessmen ('Operação Marquês'). The 14 million euro alleged 'gift' received by Salgado from a bank customer, who's lawfulness was certified by the legal opinion issued by law professors of the University of Coimbra, became also another burlesque episode in this respect. It is thus no wonder that, in 2014, he was nominated *the worst CEO of the world* by the 'Finkelstein' ranking.

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III. EPITAPH

29. In the most famous Portuguese book ever written—the epic poem 'Os Lusíadas' (1572)—Luís Vaz de Camões sung that *'a weak king makes weak strong people'* ('Que um fraco Rei faz fraca a forte gente': Canto III, verse 138). In this verse, the greatest Portuguese poet alludes to King Fernando I, later surnamed 'The Inconstant', who, thanks to his feeble and erratic governance, turned Portugal into a weak and submissive country steeped in futile palace intrigue and frivolous wars with the Kingdom of Castil, paving the way to a broad political and social crisis arising immediately after his death.

30. Once again, in a single stanza, the inspired pen of the poet immortalized a *recurrent governance feature* of a country, with an almost millenarian history, capable of the best and the worst—where great and memorable leaders, responsible for major achievements (e.g. Prince Henrique, mentor of the Portuguese Discoveries of the fifteenth and sixteenth centuries, that gave new worlds to the world) have perplexingly coexisted and alternated with trivial, disruptive leaders who swiftly fade into oblivion.

31. *The downfall and subsequent death of the BES shall remain in future as a symptom and a symbol of the ongoing crisis of the III Portuguese Republic*. Of course, as previously discussed, the bank's autopsy may suggest a number of other possible causes of death, ranging from macroeconomic and external factors (global financial crisis, soft supervision) to microeconomic or internal ones (group structure, family battles, unethical leadership). However, in this author's opinion, the decisive reason for the collapse of such a long-established institution—which survived two World Wars, one Great Depression, a Revolution and a Nationalization—lies elsewhere. It is simply the by-product of the subliminal collapse of an entire political regime currently underway, induced by a blatant absence of qualified leaderships during the last decades (with only a few exceptions), who have caused some of the main political, economic and cultural institutions of the country, both public and private, to fall one after the other before our own eyes.

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