



Why Do Banks Collapse? The Cautionary Tale of Banco Espírito Santo

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Abstract

In 2014, the Banco Espírito Santo (BES) conglomerate collapsed, marking the first bank resolution inspired by the European Union's Bank Recovery and Resolution Directive (BRRD). Explanations for these events range from the aftermath of the 2008 financial meltdown to last-minute regulatory failures or capture. In this article, we offer empirical findings supporting a different perspective. The 2014 debacle stemmed from structural issues dating back to the Espírito Santo family's reacquisition of BES in the early 1990s and the business strategy pursued over the subsequent two decades. While the financial meltdown post-2008 may have accelerated the events of 2014, it was not the root cause but rather an immediate trigger. Regulatory failures were evident but began well before the 2010s. This case carries broader implications for banking regulation in the European Union and beyond.

Keywords Banking collapse · Supervision · Capital ratio · Financial conglomerate · Hubris · Growth strategy

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1 Introduction

Events of bank insolvency, leading to closure, merger, takeover, large-scale government assistance or other forms of reorganization, have been common over time.¹ A considerable body of literature has developed offering a wide spectrum of explanatory frameworks for the origin, nature, and outcome of bank collapses. Among them, macroeconomic factors, financial liberalization, various regulatory and banking idiosyncratic managerial factors, and political connections are frequently mentioned.² However, recent cases of bank failure in the European Union and the United States, such as Silicon Valley Bank (SVB), Credit Suisse, Northern Rock, Royal Bank of Scotland, HBOS, Bear Stearns, and Lehman Brothers, persist in challenging those explanations.³

This prompts a central question: why do banks fail? As argued by different scholars,⁴ banks can fail for two main reasons at a conceptual level: either due to a bank run, or as a consequence of the deterioration of business model fundamentals. Such deterioration is often linked to the aftermath of periods of rapid asset growth and is characterized by ‘realized losses, deteriorating solvency, and unviable business models’.⁵

Banco Espírito Santo (BES) collapsed on 3 August 2014, under a resolution measure, the first ever executed under the mechanism called the European Single Supervisory Mechanism (SSM).⁶ According to prosecutors’ (‘Ministério Público’ in Portuguese) estimations, this crisis left losses to be paid by taxpayers of more than 18 billion euros, approximately 10% of Portugal’s 2014 GDP.⁷ Yet, despite the

¹ For example, Correia et al. (2024a), p 1, report: ‘In the United States, 20.4% of all national banks in existence from 1863 to 1934 and around 13% of all commercial banks in existence from 1935 to 2023 failed at some point during these periods’. Caprio and Klingebiel (1996, 1997) presented and analyzed data on episodes of bank insolvency since the late 1970s. In this study, however, the word ‘collapse’ is used interchangeably with insolvency and failure. World Bank Group (2016) described several case studies of failing European banks. More recently, the Federal Deposit Insurance Company (FDIC) reported that ‘there were 567 bank failures from 2001 through 2024’ in the United States (U.S.) banking markets (<https://www.fdic.gov/resources/resolutions/bank-failures/in-brief/index.html> (accessed 10 January 2025)). Furthermore, Jiang et al. (2023), p 1, computed that, in the U.S., ‘almost 190 banks are at a potential risk of impairment to insured depositors, with potentially \$300 billion of insured deposits at risk.’ See also Acharya et al. (2023a), Roach (2023) and Jonsson (2019).

² See, among many others, Abdelsalam et al. (2024), Blau et al. (2013), Reinhart and Rogoff (2009), Rochet (2008), Allen and Gale (2007) and Office of the Comptroller of the Currency (1988).

³ See, for a broader discussion, Metrick (2024), The Swiss Parliament. (2024), Acharya et al. (2023b), Broughman (2023), Bank of England, Prudential Regulation Authority (2015), McConnell (2012), Financial Services Authority (2011), McDonald and Robinson (2009) and Shin (2009).

⁴ See, for example, Correia et al. (2024a).

⁵ As suggested by Correia et al. (2024b).

⁶ Strictly speaking, the resolution was based on the 2012 Portuguese legislation. The European Directive (Directive 2014/59/EU) was enacted in May 2014, that is, before the BES resolution measure, but transposed to Portuguese law in March 2015, that is, after the BES resolution measure. For a more detailed overview see, e.g., Ferreira (2016) and Garcia (2016), and references cited therein.

⁷ Data on Portuguese GDP from <https://www.pordata.pt/pt/estatisticas/economia/crescimento-e-produtividade/produto-interno-bruto-pib> (accessed 4 November 2024). Data on banking losses from <https://dciap.ministeriopublico.pt/pagina/universo-espirito-santo-acusacoes-0> (accessed 4 November 2024).

political scrutiny carried out by the 2014 Parliamentary Inquiry Commission (PIC), we still have a limited understanding of what the main drivers of the BES collapse were.

The more popular literature, in Portugal and the European Union, has suggested some explanations for the dramatic BES debacle. These narratives range from basically bad luck (a consequence of the global financial crisis in 2008 that, unfortunately, undermined a generally prestigious bank) to some sort of last-minute regulatory failure and/or capture.⁸

Our empirical findings suggest a significantly different explanation – the debacle of 2014 was driven by more structural factors that trace back to the reacquisition of BES by the Espírito Santo family in the early 1990s (the privatization arrangement after the 1989 constitutional amendment), and their business strategy in the subsequent twenty years. To be sure, there were plenty of regulatory failures, but these did not start in the 2010s. According to our understanding, the financial meltdown after 2008 may have precipitated the unfolding events in 2014, but it was not the cause, most likely merely an immediate trigger.⁹

In this article, broadly speaking, we aim to enlighten the generic research question: *how did BES get to the verge of collapse?* To that end, we explore various conceptual economics frameworks to shed light on some still unanswered questions regarding BES's road to financial and economic insolvency, and ultimately to its failure.¹⁰ Among them, we include the universal banking business model, supervisory forbearance, managerial hubristic strategic behavior, and political economy. Arguably, all these aspects may have contributed more directly to BES's collapse. Although we do not examine the effectiveness of BES's resolution measure administration after August 2014, some of our findings are relevant in understanding the financial context of the resolution.¹¹

Our qualitative and quantitative analysis of the BES case leads to two principal claims. First, we contend that extensive regulatory failures over a prolonged period preceding 2014 played a central role in the bank's collapse. Second, in consequence, we suggest that strengthening the European Single Supervisory Mechanism (SSM) would have significantly enhanced the preparedness and effectiveness of pre-resolution supervision and regulation of BES before 2014. Both claims are interwoven with and supported by the examination of idiosyncratic issues within the Portuguese political and institutional environment, such as the government's industrial policies.

Section 2 provides a summary of the relevant literature that helps to contextualize the collapse of BES. Specifically, we examine whether a malfunctioning

⁸ See Garoupa (2016) for a discussion and references to local media coverage, and Antunes (2018) for a summary of this literature.

⁹ For a detailed description of these unfolding events in the English language, see Shein and Hawbecker (2016), and references cited therein.

¹⁰ Coutinho dos Santos and Garoupa (2015), p 50, raise some questions about the institutional, organizational, and governmental design of banking resolution mechanisms in general, and specifically about the BES resolution.

¹¹ See Gortsos (2025) for an overview of the post-2014 period in the European Union concerning the Bank Recovery and Resolution Directive.

universal banking system may have contributed to the bank's breakdown. In Sect. 3, the empirical methodology and findings are discussed. In this context, we explore whether the supervisory discipline failed to perform, or whether its early warning systems did not function. Subsequently, we probe whether strategic misfortune or mismanagement contributed to the final debacle; we also discuss regulatory forbearance. Section 4 provides a more general framing of BES's road to collapse by making use of political economy principles. Our main argument is that BES's growth strategies and the idiosyncratic hubris of the conglomerate leadership cannot be fully understood without looking at institutional and contextual factors. Section 5 provides general implications beyond Portugal, focusing on the European Union as well as the financial law and economics literature. Section 6 concludes with final remarks.

2 Background of the Conceptual Framework

This section provides an overview of the relevant literature and discusses various conceptual frameworks potentially useful in conceptualizing BES's road to collapse. Among them, we include managerial hubristic strategic behavior, rent protection associated with excess control rights, capitalization, financial reporting, quality of internal control mechanisms and external auditing, and supervisory forbearance.

2.1 The Universal Banking Business Model

The Second Council Directive of 15 December 1989 (89/646/EEC) institutionalized the removal of the legal segmentation barriers to the financial intermediation activities authorized for banks in the European Economic Community. This led to the broadening of the universal banking model and the proliferation of financial conglomerates.¹² Over the last few decades, universal banking activity has expanded significantly. Financial conglomerates have grown larger and become more complex business organizations, driven primarily by the objective of reaping economies of scope and scale associated with the potential synergies induced by the increased diversification of their financial intermediation activity portfolios.¹³

Despite the significant increase in scale and scope of universal banks, the evidence from extant banking literature seems ambivalent about the dominance of either the universal or the specialized banking model when it comes to economic performance. Scholars have offered arguments explaining this empirical question. For example, in a universal banking framework, if the governmental safety net is

¹² In the United States, the 1999 Gramm-Leach-Bliley Act eliminated the legal segmentation of banks' authorized activities that had previously been enacted by the 1933 Glass-Steagall Act. For a broad discussion see Morrison (2010), Goddard et al. (2007), Vennet (2002) and Tilly (1998).

¹³ See, among others, Freixas et al. (2007) and Mälkönen (2004). According to Wilmarth (2009), the sizable amount of credit granted by U.S.-based universal banking conglomerates to households, non-financial businesses, and financial institutions between 1991 and 2007 was a key trigger of the subprime financial crisis.

extended too broadly, moral hazard behavior may spill over beyond the boundaries of financial conglomerates.¹⁴

Current banking literature differs on banks' valuation effects following the adoption of the universal banking and conglomeration models. On one side, some authors expressed the view that financial conglomerates 'are more revenue efficient than their specialized competitors and that the degree of both cost and profit efficiency is higher in universal banks than in nonuniversal banks'.¹⁵ On the other side, different scholars argued that the economies of scope (generated by the productive activities in which financial conglomerates are engaged) are insufficient to offset their associated costly agency problems.¹⁶

On the 'plus side' of this literature, it has been claimed that universal banking may be advantageous for clients and for the stability of the financial system.¹⁷ Some scholars examined a sample of listed banks from 17 European countries over the period 1989–2004 and found a 'strongly positive relationship between franchise value and the degree of functional diversification.' Additionally, they also reported that universal banks might be able to lower revenue risk.¹⁸

On the 'minus side' of this literature, it has been suggested that a banking safety net may be extended 'far too broadly, that moral hazard problems could be exacerbated as a consequence, and that they could potentially be transmitted beyond the financial sector'.¹⁹ Moreover, the organizational structure of a prototypical universal bank is a complex network that draws on a set of centralized financial, informational, human, and organizational resources – a profile that tends to be extraordinarily difficult to manage in a way that achieves an optimum use of invested capital.²⁰

In the words of an important scholar, 'from the viewpoint of banks, it cannot be stated, in a vacuum, that universal banks are superior to specialized banks, or vice versa. It all depends on the banks' people, resources, skills, and management quality'.²¹

2.2 Organic Growth Strategies

The literature on real-world banks' managerial practice suggests that bankers do care about the growth of the volume of assets carried on their balance sheets. Perhaps this stems from the conjecture that asset growth may drive market power and ultimately profitability, implying a positive relationship between market power, bank

¹⁴ See Boyd et al. (1998).

¹⁵ See Vennet (2002), p 254.

¹⁶ See Laeven and Levine (2007).

¹⁷ See Schildbach (2012).

¹⁸ See Baele et al. (2007), p 2001.

¹⁹ See Boyd et al. (1998), p 427.

²⁰ A good source is Walter (1997), p 344.

²¹ See Canals (1997), p 132.

size, and earnings.²² Yet, in an examination of a sample of 12,799 banks, including 21 Portuguese, over the period 1997–2007, the authors found that ‘abnormal loan growth is [...] significantly negatively associated with bank profitability and solvency’.²³ Others found that ‘excessive current growth can have damaging implications for future profit, due to a managerial constraint on the rate at which a bank can grow without causing its profitability to deteriorate’.²⁴

Existing evidence on the direct relationship between bank profitability and capitalization suggests an empirical link between asset growth and capitalization via retained earnings.²⁵ In a sample of 524 European Union banks, a study found that the distance to distress is a decreasing function of bank size, implying that banks’ total net assets growth may be inversely related to economic performance, potentially shortening the distance to distress.²⁶

Overly aggressive growth strategies may risk putting considerable strain on bank resources.²⁷ Therefore, caution is in order when committing to a specific asset growth strategy. It is prudent to ensure that a bank’s growth objectives take into account not only the pool of internal resources available to support growth, but also those that may be sustainably mobilized in the long run.²⁸

Typically, banks may choose between two mutually exclusive growth strategies: acquiring growth externally or growing organically.²⁹ A branch of the literature examines the performance implications of these growth strategies.³⁰ However, a growth strategy based on ‘serial acquisition isn’t just a business strategy. It can be a

²² See, e.g., Bikker et al. (2006) and Barla (2000).

²³ See Foos et al. (2010), p 2930.

²⁴ After an examination of 583 French, German, Italian, Spanish and British banks over the 1992–1998 period. See Goddard et al. (2004), p 1086.

²⁵ For example, Goddard et al. (2004) and Demirgüç-Kunt and Huizinga (1999). Based on balance sheet information for a sample of U.S. failing banks from 1863 to 2023, these authors estimated that the probability of failure, measured by banks’ insolvency risk and proxied by bank capitalization, income, or non-performing loans indicators, was 82–89% before the enactment of the deposit insurance system and 90–95 percent afterward. In a comprehensive study of a sample of more than 5000 U.S. bank failures spanning the 1865–2023 period, Correia et al. (2024b) found that ‘problems in failing banks are often the consequence of rapid asset growth in the preceding decade.’

²⁶ See Marques and Alves (2021).

²⁷ See, e.g., Adams and Driscoll (2018).

²⁸ Brian Moynihan, Chairman and CEO of Bank of America (BofA), in Written Statement Before the Committee on Banking, Housing & Urban Affairs of the United States Senate (2022), testified that BofA’s ‘Responsible Growth’ (strategy) has four straightforward tenets: ‘We must grow and win in the market; We must grow with a customer focus; We must grow within our risk framework; We must grow in a sustainable manner’.

²⁹ See, e.g., Deloitte (2015) and Lockett et al. (2011).

³⁰ For instance, Cyree et al. (2000) analyzed a sample of publicly traded U.S. banks utilizing market and growth data from 1987 to 1991 and market-based performance metrics. They found that banks employing external growth strategies significantly outperformed their peers after the sample period. More recently, Fahlenbrach et al. (2018), p 2016, conducted a study on a sample of banks from 1973 to 2014. The authors discovered that banks in the top quartile of credit asset growth underperformed in terms of common stock price. They concluded that ‘high credit growth at the bank level compared to other banks leads to poor performance.’ This suggests that banks and market participants may have been overly optimistic or overconfident in their risk assessments.

sign of CEO hubris.³¹ Still, evidence that hubristic behavior shapes organic growth strategies is not uncontroversial.³²

2.3 Capitalization and Ownership Control Rights

Our article also talks to the vast literature on capitalization and ownership control rights. As commonly known in the finance literature, the equity capital carried on banks' balance sheets plays several pivotal roles, for example, protecting claimholders, taxpayers, deposit insurance funds, and uninsured depositors in insolvency and liquidation states; cushioning unanticipated losses in adverse states of nature; strengthening market participants' going-concern confidence; funding bank growth strategy; and assisting the supervisory jurisdiction in restraining excessive asset growth.³³

In the presence of adjustment transaction costs and regulatory discipline, banks voluntarily readjust their book capital ratios toward their preferred targets in order to comply with the binding requirements regarding regulatory capital ratio.³⁴ Recent research suggests that it may be beneficial for banks to use the liability side of their balance sheets to adjust capital ratios.³⁵ However, banks have also employed on-balance sheet asset bases, risk reduction techniques, and capital-raising strategies to manage their capitalization levels.³⁶

Under concentrated ownership, controlling shareholders have an incentive to reap private rents from ownership control rights.³⁷ In this framework, bank capital

³¹ Sonnenfeld (2011), last para. Dennis Stevenson, Chairman of HBOS plc, acknowledged this in the Halifax Bank of Scotland plc Annual Report and Accounts 2007, see Halifax Bank of Scotland plc (2007), p 5, stating 'in the eye of the storm, nemesis followed hubris.' According to Jonsson (2019), p 2, 'Royal Bank of Scotland failed on the basis of hubris as its leaders thought they could do no wrong' (see also Perman (2012)).

³² Adams and Driscoll (2018) documented that the four largest U.S. banks by total assets in 2012 grew an astonishing 1,220 percent from 1990 to 2016, with this growth divided almost evenly between organic and external strategies. These four banks are JP Morgan, Bank of America, Citigroup, and Wells Fargo (Adams and Driscoll (2018)), footnote #3.

³³ See Elizalde and Repullo (2007).

³⁴ See, e.g., Bakkar et al. (2019). Flannery and Rangan (2008) documented that by the end of the 1986–2001 period, a sample of U.S. large banks held, on average, 75% more book capital than the regulatory capital minima. According to Gropp and Heider (2010), bank regulatory capital is second in order of importance to economic capital (see also Elizalde and Repullo (2007)).

³⁵ See, e.g., de-Ramon et al. (2022) and Abbas et al. (2021).

³⁶ Banks operating under mandatory capital adequacy regimes make both voluntary and involuntary capital structure adjustments. Voluntary adjustments reflect discretionary managerial choices, whereas involuntary adjustments arise when institutions alter their capital positions to satisfy binding regulatory capital requirements. Abbas and Masood (2020) found that well-capitalized banks primarily use on-balance sheet assets to readjust towards their preferred or required capital ratios. Conversely, under-capitalized banks use external and internal equity to revert to target leverage. Further, too-big-to-fail banks tend to readjust regulatory capital ratios at a slower pace than well-capitalized and adequately capitalized banks. See, e.g., Gropp et al. (2019).

³⁷ See, e.g., Belcredi and Caprio (2004). Blockholders in control may benefit from excess control rights over cash flow rights 'through the use of stock pyramids, cross-holdings, and dual-class stock' (Bebchuk (1999), p 2).

structure becomes a trade-off between the dilution of ownership control rights and the benefits associated with security issuance choices.³⁸

In line with our discussion about BES, prior research has documented that excess control rights are inversely related to bank profitability and value, while being positively associated with insolvency risk.³⁹ Further, in the presence of excess control rights, banks tend to adjust their market and regulatory capital ratios by downsizing their on-balance sheet assets rather than issuing new equity capital. This empirical regularity is more common in ‘countries with weak shareholder protection or for family-controlled banks’, which directly relates to the case of BES.⁴⁰

2.4 Managerial Hubristic Strategic Behavior

The literature has identified some commonalities between hubris and personality traits and temperaments, such as overconfidence, excessive self-belief, and a propensity for risk-taking, which may lead ‘hubristic CEOs (to) overestimate their own problem-solving capabilities and their company’s resource capabilities’.⁴¹ In this framework, managerial hubristic behavior ‘has become a popular explanation for all kinds of business failure’,⁴² including in banking.⁴³

2.5 Supervisory and Regulatory Framework

The relevance of banking economic functions in most economies is a substantive motivation for extensive regulation and supervision of the banking industry. Therefore, supervisory watchdogs engage in intensive bank surveillance to mitigate potential informational deficiencies and promote the safety, soundness, and stability of the overall financial system.⁴⁴ However, the frequency and severity of banking crises in recent decades worldwide indicate that the banking supervisory framework appears far from being a completed endeavor, in terms of its main architecture and governance features, including scope, independence, and accountability.⁴⁵

Supervisory and regulatory discipline is instrumental at both *ex ante* and *ex post* stages of a resolution process and is thus exercised to protect the public interest and promote financial stability. Notably, regarding the valuation of banks in failing states, the goal is to determine ‘whether the conditions for resolution or the write-down or conversion of capital instruments are met’; ‘the choice resolution action to be

³⁸ See, among others, Boot and Thakor (2011) and Cronqvist and Nilsson (2005).

³⁹ See, e.g., Saghi-Zedek and Tarazi (2015) and Azofra and Santamaría (2011).

⁴⁰ See, among others, Lepetit et al. (2015), p 574, as well as Bechuk (1999).

⁴¹ There is a vast literature: see Owen (2016), p xi, as well as Loia et al. (2022), Sadler-Smith (2016), Brennan and Conroy (2013), Lawrence et al. (2011) and Farrell (2010).

⁴² See Tourish (2020), p 88.

⁴³ See also Hollow (2014) and Picone et al. (2014).

⁴⁴ For a broader discussion, see Freixas and Rochet (2008). See European Systemic Risk Board (2022) for an institutional overview of the macroprudential regulatory and supervisory framework for the EU banking sector.

⁴⁵ See, among others, Masciandaro et al. (2013) and Barth et al. (2003).

adopted, and other decisions on the implementation of resolution tools’; and, ex post resolution, ‘whether an entity’s shareholders and/or creditors would have received better treatment if the entity had entered into normal insolvency proceedings’.⁴⁶

Under this framework, the resolution arrangements of complex, interconnected, and relatively informationally opaque banks may damage the market’s perception of trust in regulatory and supervisory practices regarding their resolution functions. Therefore, this undermines the ‘confidence in the banking regulator’s competence, and, hence, in other banks chartered by the same regulator’.⁴⁷ In this framework, rational regulators may, for example, in anticipation of potential reputational damage, recalibrate their forbearing behavior.

3 Empirical Findings

3.1 The Case of BES

Banco Espírito Santo & Comercial de Lisboa (BESCL) was founded in October 1937 through the merger of Banco Espírito Santo (incorporated in April 1920) and Banco Comercial de Lisboa (incorporated in February 1875). In 1999, BESCL was renamed Banco Espírito Santo.

Before its nationalization in March 1975, BESCL was the largest Portuguese commercial bank.⁴⁸ When it was nationalized, the universal banking model had already been adopted in several European countries. By that time, BES was one of the largest undiversified providers of commercial banking products and services operating in Portugal.⁴⁹ BESCL was reprivatized through public offers in two tranches, the first in July 1991 and the second in February 1992. After its reprivatization, BES adopted an organic diversification business strategy, ultimately becoming a holding-company conglomerate (Grupo Espírito Santo – GES). By year-end 2013, the commercial and investment banking arms of the BES conglomerate were operating in multiple jurisdictions.⁵⁰

3.2 BES’s Growth Strategy: Empirical Estimations

In several instances, BES publicly reiterated its commitment to an organic growth strategy. For example, at a conference with financial analysts, BES revealed that

⁴⁶ See European Banking Authority (2017), p 3; see also World Bank Group (2016).

⁴⁷ See Morrison and White (2013), p 642.

⁴⁸ <https://www.bportugal.pt/arquivo/details?id=18293> (accessed 10 January 2025). For more details, see Antunes (2018).

⁴⁹ See discussion by, e.g., Amaral (2015).

⁵⁰ Namely, Angola, Brazil, Cape Verde, China, France, India, Libya, Luxembourg, Mexico, Mozambique, Poland, Spain, United Kingdom, United States of America, and Venezuela (Banco Espírito Santo Group (2013), pp 49–52).

its strategic business model was based on organic growth.⁵¹ In a video interview, Ricardo Salgado, CEO of BES from 1992 to 2014, stated: ‘[O]rganic growth is a winning strategy’.⁵²

According to a statement from the BES Annual Report, since the bank’s reprivatization in the early 1990s, the organic growth strategy pursued (which leveraged the BES brand) resulted in a two-fold increase in market share, rising from 8.5% in 2002 to 18% in 2005.⁵³

According to the literature,⁵⁴ the sustainable rate at which a bank can increase its asset base (hereafter: SGR) is the maximum annual rate at which its total on-balance sheet assets can increase, supported by internally generated equity capital.⁵⁵ Focusing on BES’s performance regarding its organic growth strategy from 1992 to 2013, we estimated the difference between the annual SGR and the effective annual growth rate of net total assets; the annual SGR is given by:

$$\frac{ROA(1 - d)}{\left(\frac{1}{LM}\right) - [ROA(1 - d)]}$$

where ROA denotes the return-on-assets ratio; d the retention rate; and LM the leverage multiplier ratio.

Our findings are reported in Table 1. We found that during 1992–2013, the cumulative difference between the annual SGR and the effective growth rate of net total assets was 136.8%. This indicates that BES’s on-balance sheet net total assets grew approximately 137% beyond the maximum growth rate of total net assets (without resorting to incremental external funding). Stated differently, to achieve this 137% growth over the cumulative SGR during the sampling period, BES financed the ‘excess growth’ by raising debt and equity funding in external capital markets.

However, as documented in Table 2, this result underestimates the ‘true’ cumulative difference in the sample’s SGR and effective growth rates, because after BES’s reprivatization in 1991–1992, it issued an additional 13,860 million euros in external equity capital.

This evidence indicates that the estimated 137% differential in cumulative growth rates, reflecting the difference between the annual SGR and the effective growth rate of net total assets, was funded with incremental debt. Yet, as posited by experts, bank failures may also be driven by ‘vulnerabilities’ in bank funding structures linked to excessive reliance on inefficient liability funding instruments.⁵⁶ Moreover, while investigating a sample of approximately 11,000 U.S. and European banks

⁵¹ https://www.jornaldenegocios.pt/mercados/bolsa/research/detalhe/bes_estabelece_crescimento_organico_como_principal_objetivo (accessed 10 January 2025).

⁵² https://www.jornaldenegocios.pt/mercados/detalhe/video_crescimento_organico_e_uma_estrategia_vencedora (accessed 10 January 2025).

⁵³ See Banco Espírito Santo (2005), p 34.

⁵⁴ See Vasiliou and Karkazis (2002).

⁵⁵ See further Moynihan (2022) and Zheng and Escalante (2020).

⁵⁶ See Correia et al. (2024a), p 3.

Table 1 Sustainable growth (SGR) and effective growth rates

	ROA (%)	Retention rate (%)	Capital ratio (%)	SGR (%)	Effective growth rate (%)	Δ
1992	1.01	44.8	6.24	7.8	24.2	16.4
1993	0.98	45.1	5.77	8.3	18.1	9.8
1994	0.81	43.8	5.61	6.7	6.0	-0.7
1995	0.63	46.6	4.91	6.3	34.2	27.9
1996	0.62	46.3	4.31	7.1	18.7	11.6
1997	0.57	46.0	3.84	7.4	21.8	14.4
1998	0.53	45.0	4.38	5.9	19.4	13.5
1999	0.55	49.4	3.93	7.5	16.5	9.0
2000	0.67	62.1	4.24	10.9	15.5	4.6
2001	0.51	62.0	3.64	9.6	13.5	3.9
2002	0.54	61.3	4.85	7.3	7.0	-0.3
2003	0.58	60.4	4.84	7.8	5.0	-2.8
2004	0.60	59.9	4.91	7.9	6.0	-1.9
2005	0.56	57.2	6.03	5.6	9.4	3.8
2006	0.71	52.5	8.15	4.8	17.8	13.0
2007	0.89	60.5	7.92	7.3	15.6	8.3
2008	0.54	80.1	6.19	7.4	10.0	2.6
2009	0.63	68.7	8.43	5.5	9.5	4.0
2010	0.67	73.6	8.94	5.8	1.7	-4.1
2011	-0.14	100.0	7.72	-1.7	-4.1	-2.4
2012	0.11	100.0	9.24	1.3	4.3	3.0
2013	-0.64	100.0	8.75	-6.8	-3.7	3.1
					Σ	136.8

Source: Authors' estimations using data from annual reports

The table reports the annual estimates of the SGR rate and its drivers, the annual effective growth rate of the net total (on-balance-sheet) assets, and the difference between the two growth rates. 'Leverage Multiplier' (LM) is net total assets divided by equity capital; 'Return on Assets' (ROA) was computed as the quotient between net income and net total assets; 'Retention Rate' was calculated as 1 minus the dividend payout ratio.

Table 2 BES's new stock issues after reprivatization in 1992 (unit: 10⁶ euros)

1995	8145
2002	550
2006	1380
2009	1200
2010	530
2012	1010
2014	1045
Total	13,860

Source: The Portuguese Securities Market Commission's (CMVM) information disclosure system

spanning the 2001–2009 period, scholars provided evidence that ‘large cross-border (global) banks were more vulnerable to solvency risk due to excessive leverage’.⁵⁷

Overall, our ‘excess growth’ finding may be interpreted as a manifestation of hubristic behavior in terms of growth and funding strategies, as it significantly exceeded the asset growth rate that BES could have sustained during the 1992–2013 period.

3.3 BES’s Capitalization: Additional Empirical Estimations

After the endorsement of the 1988 Basel Accord, banks across the world significantly improved their capitalization.⁵⁸ In contrast, using data from the OECD banking database, spanning the 1992–2009 period, a previous study found that after a slight decline from 1993 to 1995, mean (median) book capital ratios rose steadily until 2005, then oscillated until 2009.⁵⁹

Prior research documented that, after the enforcement of the 1988 Basel Accord in 1992, banks held capital-to-assets book ratios in excess of the capital adequacy regulatory requirements.⁶⁰ In contrast, another analysis showed that regulatory capital ratios were higher than book capital ratios.⁶¹

Other research on bank privatization events has documented that, on average, leverage ratios tend to decrease significantly after state ownership divestiture events.⁶² Using financial statement data published by the Associação Portuguesa de Bancos (APB), our analysis revealed that during the 1989–1991 pre-privatization period, BES’s average book capital ratio was 21 basis points higher than the 8.0% average capital ratio for the sample of banks reporting financial statements to the APB. In contrast, during the 1992–1998 post-privatization period, BES’s average book capital ratio was 28 basis points lower than the 5.06% industry average.

This finding indicates that, contrary to prior evidence, BES transitioned from being overcapitalized relative to its peers before privatization to undercapitalized post-privatization. Additionally, the average book capital ratio of the overall Portuguese banking sector dropped by 36.8% between BES’s pre- and post-privatization periods.⁶³ Further, since its reprivatization in 1992, BES’s annual book capital ratio exhibited a clear downward trend until 2004, despite a significant stock issue of 8145 million euros in 1995 (see Table 3 and Figure 1).

This finding is consistent with the debt funding strategy, which shows a 137% cumulative excess of net total asset growth over BES’s sustainable asset growth rate

⁵⁷ See Vazquez and Federico (2015), p 1.

⁵⁸ For example, Berger et al. (2008) and Flannery and Rangan (2008).

⁵⁹ See Coutinho dos Santos (2021), p 130, analyzing the OECD database ‘Bank Profitability: Financial Statements of Banks’.

⁶⁰ See, e.g., Harding et al. (2013).

⁶¹ Tables 11 and 12 in Coutinho dos Santos (2021), p 130.

⁶² See, among others, Boubakri et al. (2005) and Megginson (2005).

⁶³ Extant capital structure literature documents that the industry’s median leverage ratio is typically used as a surrogate for the target capital structure, e.g., D’Mello and Farhat (2008).

Table 3 BES's book capital ratio 1992–2013

1992	6.24%
1993	5.77%
1994	5.61%
1995	4.91%
1996	4.31%
1997	3.84%
1998	4.38%
1999	3.93%
2000	4.24%
2001	3.64%
2002	4.85%
2003	4.84%
2004	4.91%
2005	6.03%
2006	8.15%
2007	7.92%
2008	6.19%
2009	8.43%
2010	8.94%
2011	7.72%
2012	9.24%
2013	8.75%

The book capital ratio is computed as the quotient between the book value of equity and the total net on-balance sheet assets.

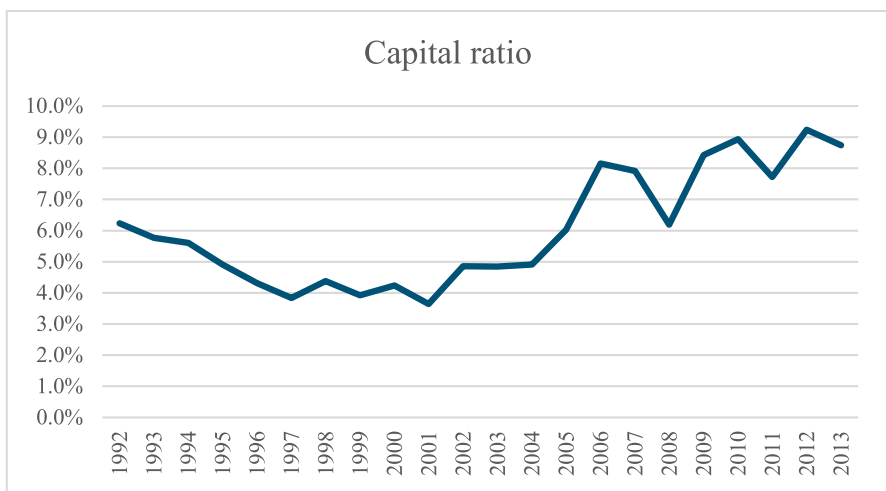


Fig. 1 BES's book capital ratio 1992–2013

from 1992 to 2013 (see Table 1). According to experts,⁶⁴ banks may collapse during periods of excessive reliance on non-core funding such as on- and off-balance sheet liabilities, which are ‘different from the typical bank deposits’,⁶⁵ and are typically more sensitive to interest rate risk and therefore more expensive.⁶⁶ Moreover, the issuance of asset-backed instruments, such as securitized assets, may have provided ‘opportunities for banks to reduce substantially their regulatory capital requirements with little or no corresponding reduction in their overall economic risks.’⁶⁷ Earlier research documents this phenomenon using data from OECD bank statistics for the sampling period,⁶⁸ indicating that financial innovations, such as securitization and other off-balance sheet activities, may have been employed for regulatory capital arbitrage in the Portuguese banking system from 1993 to 2009.⁶⁹

3.4 Contextualizing Empirical Findings with Qualitative Evidence

3.4.1 BES’s Governance

The governance of BES as well as GES was largely shaped by the Espírito Santo family. As postulated by an important scholar: ‘[T]he extreme concentration of corporate control rights in the hands of tiny elites observed in many countries raises concerns about corporate governance in those economies’.⁷⁰ This leads to important questions about the allocative efficiency of corporate control as discussed in the corporate governance literature.⁷¹ For example, contests for corporate control in firms with concentrated ownership structures, such as family-owned businesses, are particularly susceptible to various types of governance-related conflicts of interest. These conflicts often arise between family and non-family shareholders, between family controlling blockholders and non-controlling shareholders, and between large family blockholders and minority blockholders.⁷²

In addition to those standard agency problems, shareholders of family firms such as BES may also appoint representatives ‘to extend their influence within their firms’,⁷³ and ‘for preserving and enhancing the family legacy’.⁷⁴ Unsurprisingly, BES’s governance was deeply rooted in these family values and structures.

Arrangements such as family assemblies, councils or shareholders’ agreements can be designed to mitigate the potential problems associated with such agency

⁶⁴ See Correia et al. (2024a).

⁶⁵ See Barattieri et al. (2021), p 148.

⁶⁶ BES annual reports documented that BES was involved in off-balance asset securitization transactions during 1999–2013.

⁶⁷ As suggested by Jones (2000), p 35.

⁶⁸ See Coutinho dos Santos (2021).

⁶⁹ See also Pinto and Coutinho dos Santos (2024) and Seidman (2000).

⁷⁰ See Morck et al. (2005), pp 656–7.

⁷¹ See, e.g., Morck et al. (2000).

⁷² See, e.g., Sacristán-Navarro et al. (2015), Villalonga et al. (2015) and Jara-Bertin et al. (2008).

⁷³ See Chen et al. (2013), p 242.

⁷⁴ See Villalonga et al. (2015), p 644.

relationships. However, it is doubtful whether these mechanisms could have effectively constrained BES's controlling shareholders' hubristic behavior. They certainly did not serve as a constraint on the overall executive strategy until it was too late, in 2014.

3.4.2 Supervisory Behavior

Past banking crises have demonstrated that effective *ex ante* macroprudential supervision can mitigate adverse consequences. They have also shown that *ex post* regulatory and supervisory strengthening is typically necessary to restore safety and functionality to distressed banking organizations. However, Banco Espírito Santo (BES) apparently went unnoticed by the Portuguese banking industry watchdogs prior to its resolution in 2014.

The Economic Adjustment Program agreed between Portugal, the European Council and the International Monetary Fund (IMF) for the period 2011–2014 allocated up to 12 billion euros to support the stability, deleveraging, and capitalization of the banking system.⁷⁵ Despite this provision, BES's Board of Directors chose not to utilize the available support facility, citing business rationale as the reason for their decision.

According to available data, 114 banks received financial assistance from the European Union, totaling 1249 billion euros in asset/liability support or direct capital injections.⁷⁶ In contrast, the BES Board's decision to forgo this support may have been influenced by concerns over the potential market stigma associated with accepting governmental financial assistance, thus invoking business rationale.⁷⁷ By the end of the Economic Adjustment Program, only 5.6 billion euros of the allocated funds had been used, leaving 6.4 billion euros in the Bank Solvency Support Facility (BSSF). Ironically, 3.9 billion euros of this remaining amount were eventually lent to the Resolution Fund and used to finance the capitalization of Novo Banco in August 2014, following the resolution measure applied to BES.⁷⁸

This decision potentially reflects managerial hubris, where the decision to reject EU financial assistance was driven by concerns about market perception and the associated stigma. Studies suggest that such behavior is not uncommon among banking executives who prioritize short-term reputational considerations over long-term stability.⁷⁹ The BES case underscores the critical need for balanced decision-making that takes into account both immediate market reactions and the enduring health of the financial institution.

⁷⁵ See European Commission (2011).

⁷⁶ See Gerhardt and Vennet (2017).

⁷⁷ Hearing of Ricardo Salgado (the last BES CEO) at the Parliamentary Inquiry Commission on 9 December 2014, <https://www.dailymotion.com/video/x2cbu1e> (accessed 10 January 2025). See also https://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/bes_evitou_troika_por_decisao_racional_e_nao_por_qualquer_fuga_ou_temor (accessed 10 January 2025).

⁷⁸ See European Commission (2016).

⁷⁹ See Abad and Garcia Pascual (2022).

Effective *ex ante* measures can prevent crises, but *ex post* interventions are often necessary to address the fallout. The reluctance of BES's management to utilize available support underscores the complex interplay between managerial decisions, regulatory frameworks, and market perceptions. This case serves as a cautionary tale about the dangers of allowing short-term reputational concerns to outweigh prudent financial management practices.

3.4.3 Financial Reporting, Internal Control Mechanisms, and External Auditing

According to a local expert,⁸⁰ the earnings management hypothesis for the three largest Portuguese listed commercial banks, including BES, during the period from 2002 to 2012, cannot be rejected.⁸¹ Another local expert noted that BES's interim financial statements for the first semester of 2014 reported consolidated losses of 3.6 billion euros, which included over 1.5 billion euros of unexpected losses from operations conducted primarily in the first half of 2014, unbeknownst to the external auditor.⁸²

On 20 May 2014, in compliance with the Portuguese Securities Code, BES disclosed in a prospectus for a common stock public offering that the financial condition of Espírito Santo International, S.A. (ESI) could impact the price of BES shares.⁸³ Testimony at the Parliamentary Inquiry Commission (PIC) revealed that the external auditor, KPMG, during a limited review requested by the Bank of Portugal (BdP), identified a concealment of liabilities amounting to 1331 million euros in ESI's 2012 accounts.⁸⁴

4 Explaining BES's Road to Collapse

In this section, we offer a comprehensive explanation to contextualize how our findings present a different perspective on BES's situation compared to that of regulators and governmental authorities. In our view, an explanation based solely on organic growth strategies and the idiosyncratic hubris of conglomerate leadership is insufficient to fully understand BES's road to collapse. These organic banking growth strategies and the specific traits of leadership were sustained, if not induced, for over two decades by the contextual and institutional aspects of the Portuguese political economy.

⁸⁰ See Santos Maia (2014).

⁸¹ Montenegro and Brás (2022), using data drawn from the Bankscope database, did not find evidence of income smoothing via loan loss provisions (LLP) for BES within a sample of Portuguese banks during 1992–2013.

⁸² See Garcia (2016), p 52.

⁸³ As discussed by Coutinho dos Santos and Garoupa (2015).

⁸⁴ See Saraiva (2015), pp 29–30, paras. 646–717.

4.1 Political and Social Background: Conglomerates Are Good for the Portuguese Economy

An economic historian provided a detailed descriptive historical background, highlighting the ideological context underpinning the actions of Portuguese governments, regardless of their political alignment.⁸⁵ According to him, the prevailing ideology among policymakers in the 1990s and 2000s was to protect and promote local conglomerates. This perspective was shaped by the challenges posed by the small size of the Portuguese economy and the competitive pressures of the Common Market, later the European Union. Policymakers widely believed that large conglomerates, bolstered by banking and other financial services, were essential for the country's economic stability and growth.

The reacquisition of BES by the Espírito Santo family in the early 1990s exemplified this broader policy strategy. From the outset, BES was intended to serve as the banking arm of a larger, more powerful conglomerate, reflecting the strategic economic policies of the time. This approach mirrored, but did not precisely replicate, the conglomerates that existed prior to the 1974 revolution, as explained by historians.⁸⁶ The alignment of BES with these overarching economic strategies underscores a deep-seated belief in the necessity of powerful conglomerates to navigate the complexities of the Portuguese and European markets.

4.2 The Role of Supervision When Conglomerates Are Good for the Economy

Inspired by the prevailing theory in certain sectors of Portuguese society that conglomerates were beneficial to the economy, regulators adapted European Union laws to fit local interpretations.⁸⁷ This approach likely ignored the balanced consideration of costs and benefits typically emphasized in standard economic literature. Instead, regulators focused on potential benefits while downplaying significant costs, aligning their actions with narratives promoted by the political branches of government. The European Union's slow implementation of regulatory and supervisory changes in Portugal, as noted by a recent study,⁸⁸ often resulted in ineffective measures. This ineffectiveness helps to explain why regulators systematically ignored many warning signs that were present well before 2008, as evidenced by our findings in Tables 1 and 2.

The collapse of two other banks in the early 2000s – Banco Português de Negócios (BPN), nationalized in 2008, and Banco Popular Português (BPP), liquidated in 2010 – significantly influenced the regulator's perception of the challenges faced by BES after 2008, as explained in a different article.⁸⁹ Rather than prompting stricter regulatory and supervisory interventions to prevent further banking failures, these

⁸⁵ See Amaral (2015).

⁸⁶ Ibid.

⁸⁷ For a general overview, see Lourenço et al. (2022).

⁸⁸ Ibid.

⁸⁹ See Garoupa (2016).

events revealed a mixture of behavioral biases, including overconfidence, cognitive biases, and excessive reliance on past performance. Supervisory forbearance became more acceptable, particularly when state interventions in BPN, BPP, and later Banco Português do Funchal (BANIF), bailed in in 2015, were generally unpopular with voters.⁹⁰

The political branches of government faced growing media scrutiny due to controversial decisions involving the state-owned bank Caixa Geral de Depósitos and the involvement of ruling party members in Millennium Banco Comercial Português during 2008–2010. The criminal prosecution related to some of these decisions and involvements is, for the most part, still ongoing more than a decade later.⁹¹ This environment of political and media pressure further complicated the regulatory landscape, contributing to a reluctance to take decisive action.

These successive banking failures shaped the actions of Portuguese regulators before 2014, with the regulatory perimeter becoming endogenous to local conditions. The cases of BPN and BPP, along with the political storm surrounding Millennium between 2008 and 2010, were widely regarded as regulatory mistakes that resulted in a chilling inaction by supervisors. This inaction persisted until changes were made to the Bank of Portugal's board in 2010. Different authors suggested that the new board's prudential actions were too little, too late to effectively address the existing regulatory shortcomings.⁹²

The combination of political influence, behavioral biases, and previous banking crises created an environment where regulatory prudence was overshadowed by a reluctance to intervene. This context helps to explain why regulators ignored multiple warning signals leading up to BES's collapse in 2014. The broader implications for banking regulation underscore the need for a more balanced and proactive approach, one that takes into account both local conditions and the broader economic context to prevent similar failures in the future.

4.3 Endogenous Rent-Seeking

A third aspect of this story is the significant moral hazard effect stemming from the small size of the economic and political elites and overly centralized policy decision-making processes in Portugal. As the Espírito Santo conglomerate expanded, its influence and power grew correspondingly.⁹³ This created a feedback loop in which the government and local supervisors, who were proponents of pro-conglomerate policies, became increasingly invested in the conglomerate's continued growth. The defense of these policies thus became endogenous to the conglomerate's expansion, fostering an environment where regulatory actions were heavily influenced by the conglomerate's interests rather than by objective economic considerations.

⁹⁰ As discussed by Vilela (2023).

⁹¹ See outline by Braga de Macedo et al. (2020).

⁹² See, for different views, Antunes (2018) and Rosa (2022).

⁹³ For a general discussion, see Antunes (2018). Ricardo Salgado (the last BES CEO) was known in the Portuguese media as 'DDT' (*dono disto tudo*, owner of everything), see Amaral (2015).

Economic literature acknowledges that lobbying and political influence often compete with, and can overshadow, business rationales in explaining corporate behavior.⁹⁴ In the case of the Espírito Santo conglomerate, over time, lobbying and political influence may have supplanted sound business judgment. This shift likely contributed to the conglomerate's risky business practices and the eventual regulatory failures that led to its collapse. The case of the Espírito Santo conglomerate illustrates how entrenched political and economic interests can create a moral hazard, whereby the conglomerate's growth and influence perpetuate a cycle of regulatory leniency and inadequate oversight, ultimately undermining the stability and integrity of the financial system.

4.4 A Structural Explanation of BES's Collapse

Considering all these aspects, we observe a narrative of misaligned incentives within a framework of misguided policy and regulatory goals — specifically, the protection of Portuguese conglomerates within the European Union. This scenario aligns with the model proposed by academic experts, where political and economic dynamics foster environments conducive to financial instability.⁹⁵ The collapse of the Espírito Santo conglomerate became inevitable when financial and economic conditions deteriorated post-2008.⁹⁶ The failure of the government and regulators was not solely due to technical incompetence or direct private capture but was significantly influenced by the prevailing ideology favoring large conglomerates. This ideology, which continues to be influential in policy discourse today, created an environment where regulatory oversight was compromised by the desire to protect and promote national conglomerates (the so-called national economic champions).

BES thrived in a highly favorable institutional context, responding rationally to the incentives it encountered. The conglomerate's expansion was driven not merely by business or financial goals but also by a strategic investment in maintaining a dominant position in the arenas of lobbying and policy influence. This approach enabled BES to secure regulatory leniency and continued support from policymakers, even as its business practices grew increasingly risky. The case of BES illustrates how entrenched ideological and institutional factors can create an environment where regulatory goals are subordinated to the interests of powerful economic actors, ultimately leading to systemic failures. It emphasizes the need for a more balanced and objective regulatory framework that prioritizes financial stability over the protection of entrenched economic interests.

⁹⁴ See, for example, Tollison (2012).

⁹⁵ See Calomiris and Haber (2014).

⁹⁶ See Shein and Hawbecker (2016).

5 General Implications

The collapse of Banco Espírito Santo (BES) serves as a critical case study, offering lessons in banking regulation and supervision that extend well beyond the Portuguese financial sector. It underscores the importance of a more nuanced and comprehensive approach to regulatory and supervisory frameworks, highlighting both technical and contextual dimensions.

5.1 Explaining Banking Failure

In Sect. 3, we presented three key quantitative observations. Despite BES's ostensibly organic growth strategy, the bank expanded well beyond sustainable levels without resorting to external funding. This expansion was largely financed through incremental debt, creating significant vulnerabilities. Additionally, we observe a striking shift in the bank's capitalization: BES transitioned from being overcapitalized relative to its peers before 1994 to becoming undercapitalized in the subsequent years. This trend was primarily driven by the hubristic behavior of the bank's leadership, compounded by a lack of opposition from shareholders and other members of the Espírito Santo family, who prioritized short-term returns, and the social prestige associated with the bank's growth.

While these three empirical regularities shed light on the internal dynamics of BES, they alone are insufficient to construct an entirely new narrative of the bank's collapse. These findings must be understood within the broader contextual and institutional framework that shaped the bank's operations. The hubristic behavior of BES's leadership and the passivity of its shareholders were exacerbated by external factors, including a regulatory and institutional setup that fostered such behaviors.

This context included an industrial policy that favored the establishment and expansion of conglomerates, coupled with supervisory forbearance and regulatory practices that, while not always failures in themselves, often misapplied competitive industrial policies. The institutional environment also tolerated extensive rent-seeking, which further entrenched structural vulnerabilities. Although these factors are not unique to Portugal, they were undeniably critical in shaping the long-term structural dynamics that contributed to the collapse of BES.

In summary, the collapse of BES reflects a confluence of factors, including the hubristic behavior of its leadership, the inaction and complacency of shareholders and other members of the Espírito Santo family (characterized by ineffective internal governance mechanisms and an overreliance on prestige and political influence), and the misguided objectives of government and regulators shaped by the broader contextual and institutional framework.

5.2 Literature on Organic Growth Strategy

Beyond the immediate general implications, our findings contribute to current debates in financial law and economics, namely regarding different views on organic growth strategies. It is clear that our empirical findings and observations about

organic growth strategies are not unique to the specifics of BES and align with the general literature in financial economics. Our analysis supports the view that hubristic behavior plays a significant role in organic growth strategies, indicating that the case of BES is not unique or particular to a specific context in time and space.

5.3 Literature on Financial Reporting, Internal Control, and External Auditing

Reliable and traceable information systems, internal control procedures, and high-quality external auditing are key elements for proper risk management and control, as well as for ensuring the integrity of financial reporting. However, current academic literature provides abundant evidence of financial misreporting, poor external auditor independence, and substandard audit quality, which typically heightens litigation risk. In this framework, successful lawsuits carry the risk of potential substantial financial and reputational penalties. Prior research indicates that banks' accounting and financial reporting practices may have been prone to managerial discretion in earnings reporting.⁹⁷ Managerial discretion in banking accounting and reporting allows insiders to manipulate financial reporting, often misrepresenting the true economic and financial condition of the disclosing organizations.⁹⁸ For example, this may include postponing the acknowledgment of loan losses or anticipating gains from operations.⁹⁹ However, the likelihood of managerial financial misreporting may be curtailed by the reputation and industry specialization of external auditor.¹⁰⁰

Typically, bank managers are vested with significant discretionary power in setting loan loss provisions (LLPs). As a result, they may use this prerogative opportunistically, notably, for income smoothing, risk management, and regulatory capital management.¹⁰¹

Findings from prior research on European banks indicate that LLPs may have been utilized for earnings and capital management purposes.¹⁰² Therefore, many of the shortcomings we have identified with BES regarding systematic failures in financial reporting, internal control, and external auditing are unsurprising in light of the financial law and economics literature.

⁹⁷ For a broader discussion, see Ceccobelli and Giosi (2019), Cornett et al. (2009), and Shen and Chih (2005).

⁹⁸ See, e.g., Goel and Thakor (2003).

⁹⁹ See, e.g., Wall and Koch (2000).

¹⁰⁰ See, for example, DeBoskey and Jiang (2012) and Kanagaretnam et al. (2010).

¹⁰¹ See, e.g., Anandarajan et al. (2003).

¹⁰² For example, Bouvatier et al. (2014) found evidence of income smoothing behavior using discretionary LLPs in a sample of European commercial banks exhibiting more concentrated ownership. This effect is smaller in high-powered regulatory regimes or with higher external audit quality. Leventis et al. (2011), p 103, using a sample of 91 EU-listed commercial banks from 18 European countries from 1999 to 2008, found that 'for risky banks, earnings management behavior is more pronounced when compared to the less risky banks.' Further, Anandarajan et al. (2003) documented that LLPs were used for earnings capital management by Spanish depository institutions from 1986 to 1995.

5.4 Implications for the Regulation and Supervision of Financial Conglomerates

Larger and increasingly interconnected financial conglomerates pose significant challenges to effective consolidated regulation and supervision. Several factors contribute to concerns regarding the efficacy of such oversight.¹⁰³ Among these is the fragmented nature of the regulatory and supervisory framework for diversified conglomerates, which often include a mix of regulated, partially regulated, and unregulated entities or activities.¹⁰⁴ Moral hazard behavior by large banks within financial conglomerates can also exacerbate risks, as regulatory and supervisory authorities may view them as ‘too big to fail’.¹⁰⁵ Additionally, non-bank divisions of financial conglomerates might engage in excessive risk-taking, leveraging the benefits of deposit insurance in ways they would not if they were standalone entities.¹⁰⁶ Another concern is the potential inadequacy of capital adequacy regulations to address the complexities of ‘large financial institutions combining several activities under common control’.¹⁰⁷ Effective oversight also requires assessing ‘the fitness and propriety of managers, directors, and major shareholders’ of these conglomerates, as well as ensuring ‘the prudent management and control of risk concentrations and intra-group transactions and exposures’.¹⁰⁸ This interconnectedness and diversity of operations within financial conglomerates demand a more robust, harmonized approach to regulation and supervision.

Overall, as argued by some scholars,¹⁰⁹ financial stability in banking is contingent on sound regulation and effective supervision ‘particularly where most of the problems begin in the banks, i.e. weaknesses in risk culture, governance and business models’. The case of BES just confirms these concerns and provides qualitative evidence that inadequate regulation and supervision of financial conglomerates undermine the effective enforcement of banking law.

5.5 Implications for the Preparation and Implementation of a Resolution Measure

Despite having been used several times since its inception, the EU bank resolution framework still appears to suffer from both conceptual and implementation shortcomings. Notably, it falls short in mitigating market distortions, addressing moral hazard problems, enhancing supranational governance of adopted resolution measures, securing resolution financing, and improving coordination during the preparation and implementation phases of the resolution process.¹¹⁰

¹⁰³ See, e.g., Menand (2018) and Gruson (2008).

¹⁰⁴ For example, the Joint Forum (2001, 2010, 2012).

¹⁰⁵ See, e.g., Barth et al. (2012) and Morrison (2010).

¹⁰⁶ See, e.g., Freixas et al. (2007).

¹⁰⁷ See Mälkönen (2004), p 33.

¹⁰⁸ See the Joint Forum (2012), p 1.

¹⁰⁹ See Walter (2024), p 2.

¹¹⁰ For a general discussion see, among others, Gortsos (2025), Restoy et al. (2020), Philippon and Salord (2017), World Bank Group (2016), and Dewatripont and Freixas (2011).

Main bank resolution frameworks – such as the Bank Recovery and Resolution Directive in the European Union, and Title II of the Dodd-Frank Act in the United States – were designed to ‘minimize the systemic distress costs of the failure of a large financial institution’;¹¹¹ to mitigate banking systemic risk; to promote financial system stability; and to improve the effectiveness of resolution measures in terms of welfare costs to society.¹¹² However, in the case of the resolution measures applied to BES, it is yet to be demonstrated that the good governance principles of resolution measures – which recommend not to bail out distressed banks, imposing disproportionate burdens on taxpayers and other negative externalities – were consistently followed.¹¹³ In itself, this serves as a cautionary tale about the importance of appropriate design and enforcement of banking resolution measures.

Our empirical analysis of the BES case suggests that strengthening the European Single Supervisory Mechanism’s preparedness level would have been beneficial for pre-resolution supervision and regulation. Enhanced preparedness could have mitigated the eventual collapse of BES by curbing excessive forbearance, improving the design and planning of resolution strategies, and promoting the predictability of these measures, thereby reducing post-resolution litigation.

5.6 More General Policy Implications

Understanding BES’s collapse has important policy implications within the European Union and beyond. Firstly, integrating behavioral insights into the consolidated regulatory and supervisory practices of financial conglomerates is paramount. Traditional regulatory approaches often focus on structural and procedural aspects while overlooking the human and institutional behaviors that drive decision-making within financial entities. By embedding behavioral considerations, regulators can better anticipate and mitigate risks arising from cognitive biases, organizational culture, and group dynamics.

Secondly, a robust public choice analysis of institutional and social norms is indispensable for understanding the efficacy and limitations of regulatory frameworks. Political and cultural contexts play a pivotal role in shaping how regulations are implemented and enforced. Ignoring these factors leads to a disconnect between formal rules and their practical application. Transplanting regulatory norms from one jurisdiction to another without considering local determinants – such as political processes, social ideologies, and institutional incentives – can render even the most sophisticated frameworks ineffective.

BES’s collapse vividly illustrates how local determinants can undermine best practices. Factors such as the concentration of power, tolerance for rent-seeking behavior, regulatory incompetence, and deeply ingrained political dynamics significantly weakened the resilience of the Portuguese banking system. These contextual

¹¹¹ See Gordon and Ringe (2015), p 1297.

¹¹² See, e.g., Souza et al. (2019), and Gerhardt and Vennet (2017).

¹¹³ See also, e.g., Bolton and Oehmke (2019) and Avgouleas et al. (2013).

elements not only hindered effective oversight but also facilitated the conditions for systemic failure.

Ultimately, the lessons from the BES case emphasize the need for a paradigm shift in banking regulation – one that acknowledges the interplay between global best practices and local realities. A holistic approach that balances technical rigor with contextual sensitivity is essential for fostering resilient financial systems capable of withstanding complex and evolving challenges.

6 Concluding Remarks

Following prolonged supervisory and regulatory constraints, along with a clear disregard for fundamental principles of regulatory prudence, transparency, and rigor, the intervention in 2014 has sparked significant doubts and concerns regarding the maturity and technical robustness of the resolution measures employed. These concerns call into question whether the procedures in place were sufficiently developed to ensure coherent and effective resolution strategies.¹¹⁴

The collapse of BES unequivocally underscores substantial regulatory failures spanning a significant period, rather than being a mere last-minute lapse in prudent supervision in 2014. Our findings indicate that the structural overextension of the conglomerate was apparent from its early stages, an issue that was overlooked by governments and supervisors for decades. We attribute this oversight to a combination of prevailing ideologies (such as the belief in the economic benefits of conglomerates), behavioral biases, and the endogenous growth of conglomerates aimed at policy capture, all of which align with our observations.

From the downfall of BES, we can derive three critical lessons. Firstly, echoing previous scholarship,¹¹⁵ behavioral insights must be integrated into the consolidated regulatory and supervisory practices of financial conglomerates. Secondly, regulatory frameworks cannot be fully understood or anticipated without a robust public choice analysis of institutional and social norms. The political and cultural contexts are crucial and should not be ignored. Transplanting regulatory norms without considering practical aspects and contextual determinants is inappropriate. The BES case illustrates how local determinants – such as political processes, prevailing ideologies, tolerance of rent-seeking, regulatory incompetence, and power concentration – can easily undermine best practices.

Finally, regulatory failures do not always result in immediate consequences. The downfall of BES is attributable to structural factors that have persisted for decades, rather than merely bad luck or complex business cycles.

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¹¹⁴ For more details on BES's resolution measure see, e.g., Garoupa (2016) and references cited therein.

¹¹⁵ See Khan (2018).

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Declarations

Conflict of interest The authors declare that they have no known competing financial interests or personal relationships that could have appeared to influence the work reported in this paper.

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