

Carlos da Silva Costa: The application of a resolution measure to Banco Espírito Santo

Address by Mr Carlos da Silva Costa, Governor of Banco de Portugal, on the decision to apply a resolution measure to Banco Espírito Santo, Lisbon, 3 August 2014.

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Good evening. Thank you for your presence.

The Board of Directors of Banco de Portugal decided today to apply a resolution measure to Banco Espírito Santo, S.A. The general activity and assets of Banco Espírito Santo, S.A. are transferred to a new bank, called Novo Banco, duly capitalised and clean of problem assets.

I will start by explaining what has brought us to this point. Then I will point out some of the main aspects of this measure and its implications, and finally conclude.

1. Background

- ***It is public knowledge that Banco Espírito Santo, S.A. is facing a serious financial imbalance situation.***

On 30 July 2014, Banco Espírito Santo, S.A. published its results for the 1st half of 2014, with losses attaining €3,577 million, almost entirely (€3,488 million) relating to the 2nd quarter of 2014.

These losses largely exceed the foreseeable values in the light of information disclosed until then by Banco Espírito Santo, S.A. and its external auditor. I would like to recall that, on 10 July, Banco Espírito Santo, S.A. released information on the Bank's exposure to entities in Grupo Espírito Santo as at 30 June 2014, amounting to approximately €1,240 million. Based on this information, Banco de Portugal confirmed, in its press release of 11 July, that the capital buffer of Banco Espírito Santo, S.A. – amounting to €2,100 million – was sufficient to accommodate possible negative impacts arising from its exposure to the non-financial arm of Grupo Espírito Santo, without jeopardising its compliance with the required minimum capital ratios.

The deterioration of the results of Banco Espírito Santo, S.A. versus the figure foreseeable about two weeks ago derives from the practice of a series of management acts – that occurred before the appointment of the new members of the Executive Board – seriously detrimental to the interests of Banco Espírito Santo, S.A. and overtly non-compliant with the determinations issued by Banco de Portugal.

In the second fortnight of July, the external auditor identified the following operations:

- (a) The issue of two comfort letters addressed to non-resident institutional investors, in breach of the internal procedures for the approval of this type of operation, which led to the recognition of a loss in the accounts of Banco Espírito Santo, S.A. amounting to €267 million, as at 30 June 2014;
- (b) The placement of securities, involving Banco Espírito Santo, S.A., Grupo Espírito Santo and Eurofin Securities, which led to losses in the accounts of Banco Espírito Santo, S.A. amounting to €1,249 million, as at 30 June 2014.

These operations had a negative impact of approximately €1,500 million in the profit and loss account for the 1st half year. I would like to stress that the acts in question were not reported to Banco de Portugal by any member of the management or supervisory boards of Banco Espírito Santo, S.A. on the date they occurred.

As already published by Banco de Portugal, the assessment of individual responsibilities, including those of the former Chief Executive Officer, the former Chief Financial Officer and other members of the Executive Board who have resigned in the interim from their posts, will take place in the context of the on-going forensic audit commissioned by Banco de Portugal. Should the practice of illicit acts be confirmed, the relevant administrative and criminal actions will be pursued.

- ***In this context, in the last few days, the situation of Banco Espírito Santo, S.A. deteriorated rapidly and significantly***

The magnitude of the losses and their nature had several adverse consequences:

- (i) Banco Espírito Santo, S.A. ceased to comply with the minimum capital ratios in force, with a 5% CET1 ratio, i.e. 3 percentage points below the regulatory minimum.
- (ii) On 1 August, the Governing Council of the European Central Bank decided to suspend access by Banco Espírito Santo, S.A. to monetary policy operations, with effect from 4 August.
- (iii) Public perception regarding the bank deteriorated markedly, leading to a very significant fall in the quotation of its shares to around 12 cents, culminating in the suspension of transactions by the Portuguese Securities Market Commission on Friday afternoon, 1 August.
- (iv) Also on Friday 1 August the Canadian rating agency DBRS cut the rating of Banco Espírito Santo, S.A. and indicated the possibility of further rating cuts;
- (v) The evidence of control failure and harmful mismanagement in the Bank has aggravated uncertainty about the balance sheet of Banco Espírito Santo, S.A., making unfeasible a private capitalisation solution in the short run.
- These facts placed Banco Espírito Santo, S.A. in a situation of serious and severe risk of not meeting, in the short run, its commitments and, as a result, its authorisation requirements.
- Considering the importance of Banco Espírito Santo, S.A. in the banking system and in the financing to the Portuguese economy, the risk of cessation of payments or failure to meet its obligations carries high risk of contagion, compromising the stability of the national financial system.
- ***It is therefore imperative and urgent to adopt a solution that simultaneously: 1) guarantees deposit protection; and 2) ensures financial system stability.***

2. Resolution measure applied to Banco Espírito Santo, S.A.

- Banco de Portugal, in articulation with the European authorities and taking into account the legal framework in force, decided to apply a resolution measure to Banco Espírito Santo, S.A., which translates into the creation of a new bank to which the essential part of the activity carried on until now by Banco Espírito Santo S.A. is transferred.
- ***Hence, by decision of the Board of Directors of Banco de Portugal, a new bank was created, called Novo Banco, to which most assets and liabilities of Banco Espírito Santo, S.A. are immediately and definitively transferred, as well as its collaborators and other material resources.***
- ***Novo Banco will continue to ensure the activity carried on until now by Banco Espírito Santo, S.A. and by its subsidiaries, in Portugal and abroad, thereby protecting its customers and depositors.***

From the point of view of the customers of Banco Espírito Santo S.A. and of its subsidiaries' customers, this transfer does not affect in any way the relationship with the bank. The new bank's branches, which for the time being will maintain the brand name and logo of BES, as well as the other telephone and online banking services, will continue their normal operation. Customers will be able to carry out all usual operations under normal conditions, no changes being required.

- Thus, and as a consequence of the decision adopted, potential losses for depositors are completely and unequivocally ruled out.
- ***The equity capital of Novo Banco, to the amount of 4,900 million euros, is fully held by the Resolution Fund.***

I would like to note that the Resolution Fund's financial resources do not include public funds. The Fund's sources of funding are the initial and periodic contributions of financial institutions and the proceeds from the levy over the banking sector. It is important to stress that the Resolution Fund is an integral part of the European financial stability model.

As the Resolution Fund was only created in 2012, it has not available sufficient financial resources to finance the resolution measure applied to Banco Espírito Santo S.A.. For that reason, the Fund had to take out a temporary loan from the Portuguese State. The loan granted by the State to the Resolution Fund will be temporary, remunerated and substitutable for loans granted by credit institutions.

This means that the resolution measure now decided by Banco de Portugal, contrasting with other solutions adopted in the past, will have no costs for public funds and taxpayers.

The equity capital of Novo Banco will enable a CET1 ratio of 8.5% to be reached at consolidated level, envisaging a margin compared with the minimum capital ratios in force.

- ***The Novo Banco, S.A. is an institution with full access to the liquidity facilities provided by Banco de Portugal***, under the Eurosystem framework, having the same funding conditions of the remaining national credit institutions.
 - ***Problem assets or assets to be discontinued are not transferred***, notably the liabilities of other Grupo Espírito Santo entities that led to the recently disclosed losses.
 - This measure therefore ***constituted a new level of the ring-fencing process***, which has been promoted by Banco de Portugal since the end of 2013, isolating the new bank from the risks associated with Grupo Espírito Santo. ***These risks remain in the balance sheet of Banco Espírito Santo, S.A. and the current shareholders of Banco Espírito Santo S.A. and its subordinate creditors will be accountable for them.***
 - ***By designation of Banco de Portugal, the current members of the board of Banco Espírito Santo S.A. will retain their positions in the new bank and will ensure business continuity. Banco de Portugal considers that this team will guarantee that Novo Banco will be a reference institution at national level and will restore depositors and investors' confidence.***
 - The board of Novo Banco will promote within an appropriate timeframe and depending on market conditions, the acquisition of significant holdings in the bank by private investors. Banco de Portugal deems that the removal of uncertainty regarding the soundness of the new institution's balance sheet is the most adequate solution to keep the interest that has been shown by investors.

3. Conclusion

During the last week there was a significant deterioration of Banco Espírito Santo, S.A. financial situation and of the uncertainty surrounding it. Due to this situation, a capitalisation solution through private funds became unfeasible.

Under these conditions and given the imminent risk of failure of Banco Espírito Santo S.A. to meet its obligations, Banco de Portugal decided to apply a resolution measure to Banco Espírito Santo S.A., transferring the essential part of its activity to a new bank, duly capitalized and with conditions to carry on its activity without disruption.

The solution adopted by Banco de Portugal had as major concern the preservation of financial system stability and the protection of depositors' interest. The solution adopted is also the best safeguard for the interests of taxpayers and public funds and ensures the maximum accountability of the institution's shareholders.

The new bank has a significant share in the Portuguese financial market. Furthermore, as the risks that led to the recently announced losses have been removed, it has conditions to continue to establish itself successfully in the market and to create value, being an attractive asset for private investors in the near future.

I would like to make a final point, which I consider important to understand the developments of Banco Espírito Santo S.A. during the last year. Grupo Espírito Santo, through the non-financial entities that are not subject to Banco de Portugal supervision, developed a fraudulent funding scheme between the companies belonging to the group. International experience shows that these frauds are very difficult to detect before they collapse, in particular when activities are carried out in various jurisdictions. Banco de Portugal was able to identify a tip of the problem as it conducted an inspection beyond the normal perimeter of supervision, involving an audit to the non-financial companies that are the main customers of the banks – this exercise is known as ETRICC2 (Horizontal Review of Credit Portfolio Impairment). When this tip of the problem was identified, in September de 2013, Banco de Portugal started a ring-fencing policy of Banco Espírito Santo regarding the other companies in the Group. This policy was progressively reinforced over the course of 2013 and due to its tightening Grupo Espírito Santo companies started to default.

Thank you.