Carlos da Silva Costa: Increasing the resilience of the Portuguese financial system

Opening address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, to the COFAP committee regarding Banco Espírito Santo, Lisbon, 18 July 2014.

* * *

I. Background on supervisory activity since 2011

To increase the resilience of the Portuguese financial system, Banco de Portugal designed an action plan which began before the Economic and Financial Assistance Programme and continued under that programme and thereafter, involving the following horizontal exercises:

- The Special Inspections Programme (SIP), launched in 2011, which aimed at validating the key components for calculating institutions' solvency levels by analysing three aspects (review of impairment, RWA calculation and stress test methodology);
- The On-site Inspections Programme (OIP), conducted in 2012, which aimed at validating impairment levels for exposures in specific sectors deemed high-risk;
- The Horizontal Review of Credit Portfolio Impairment (ETRICC) in 2013, which assessed individual impairment in the credit portfolio, and was followed by a second phase (ETRICC 2), which assessed impairment from exposures to 12 economic groups selected using risk criteria;
- Finally, also in 2013, the Special Assessment Programme (SAP), which assessed the institutions' procedures and processes in managing distressed credit.

  The results of the SIP were disclosed in a press release on 16 December 2011. The credit assessment estimated that EUR 838 million was needed to reach robust impairment levels for the set of eight banking groups as at 30 June 2011. This corresponded to 9.1% of total impairment constituted for credit covered by the inspection work and 0.3% of the overall amount of this credit. All the banking groups strengthened their impairment levels in accordance with Banco de Portugal's request.

The SIP followed an innovative methodology in terms of supervision, simultaneously covering the eight major banking groups (over 80% of the assets and credit in the financial system) and used independent audit firms that assessed the credit portfolio against benchmarks defined by Banco de Portugal. Despite the complexity and wide scope of the exercise, which involved a significant number of human resources (350 people, including auditors, consultants and Banco de Portugal staff) and a very demanding timeframe, the internal governance mechanisms adopted by Banco de Portugal led to timeliness, quality and consistency in the results.

A Steering Committee was set up to monitor execution of the programme, chaired by Banco de Portugal and comprised of experts designated by the International Monetary Fund, the European Commission, the European Central Bank, three European Union supervisory authorities – Banco de España, Autorité de Contrôle Prudentiel (France) and Banque Nationale de Belgique – and also by Banco de Portugal.

Following this exercise, Banco de Portugal decided to include horizontal periodic inspections of the overall credit portfolio or of asset classes most exposed to macroeconomic or market developments as part of regular banking system supervision.

In this context, Banco de Portugal ran new checks and assessments in 2012 under the OIP on the credit portfolios serving the construction and real estate promotion sectors, using independent auditors. The results were disclosed in a press release on 3 December 2012.

The total exposure of the eight banking groups assessed together came to EUR 69 billion (61% corresponding to the construction and real estate promotion sectors, 39% to other related entities). This total represented about 40% of the companies segment. For the purposes of analysing the impairment amounts recorded, a sample of 2,856 entities was taken from that universe, with an aggregate exposure of EUR 39 billion, representing 56% of the total.

The impairment levels recorded for the sample's exposure were assessed using conservative criteria, with an emphasis on treating all those participating in the OIP in a homogeneous way. For the eight banking groups as a whole, reinforcement of EUR 861 million was estimated as necessary for the value of impairments recorded for the exposures analysed as at 30 June 2012, in order to reach robust provisioning levels (about 2.2% of the overall amount of the exposures assessed).

All the banking groups strengthened their impairment levels in line with the conclusions of the exercise.

In the first half of 2013, Banco de Portugal conducted a new horizontal assessment of impairment levels for the credit portfolio, resulting in an effective strengthening of impairments that has already been recognised in the consolidated accounts of June 2013. The results of the exercise were disclosed in a press release on 2 August 2013.

Total credit for the eight banking groups as a whole under this exercise reached EUR 92.6 billion, which also included off-balance-sheet exposures such as guarantees conceded and irrevocable credit lines. For the purposes of analysing the impairment amounts recorded, a sample of 2,206 entities was taken from that universe, with an on-balance-sheet exposure of EUR 44.2 billion, and an off-balance-sheet exposure of EUR 8.9 billion.

Using particularly conservative assessment criteria, a EUR 1.1 billion impairment reinforcement was estimated as necessary for the exposures analysed among the eight banking groups as a whole as at 30 April 2013, in order to reach robust provisioning levels (about 2.1% of the overall amount of the exposures assessed). This level was set in a context of very unfavourable economic developments and took into account the events taking place up to the present.

The impairment reinforcements made in the interim by the banking groups as at 30 June 2013 covered all the reinforcement needs for impairment identified in this exercise.

While the two first exercises were conducted by independent auditors, this horizontal operation was carried out by each banking group's external auditor, based on benchmarks and guidance adopted by Banco de Portugal. In parallel, the exercise made use of an independent external auditor, which, jointly with Banco de Portugal, was responsible for horizontal consistency, through the harmonised application of the benchmarks and guidance, thereby minimising the risk of divergent conclusions.

In September 2013, Banco de Portugal decided to deepen its assessment of the criteria used to calculate impairments for a set of Portuguese and foreign economic groups, for whom the capacity to recover credit granted depended on their medium-term business plans creating sufficient cashflow for debt repayment. Therefore, an independent auditor assessed how conservative the economic and financial models used by the banks were, and looked at the robustness and adequacy of the support information for these models and the reasonableness of the main assumptions used. Further, sensitivity testing was carried out on the results, using where necessary alternative assumptions to those used by the banking groups.

As a result of this exercise, a €1 billion overall reinforcement of the impairment and provisions levels was estimated as necessary as at 30 September 2013. This amount, already reflected in the institutions' accounts, aims to ensure that the risks associated with the economic groups involved are adequately addressed. The exercise confirmed the soundness of the national banking system at 30 September 2013. ETRICC 2 brought to a close a series of horizontal inspections carried out by Banco de Portugal since 2011 which have contributed to making the Portuguese banking system more solid.

The results of these exercises were duly incorporated into the institutions' financial statements. At the same time, recommendations were issued to correct insufficiencies found in the internal procedures and processes of the institutions in these areas.

The extension of the measures taken and the adoption of additional supervisory instruments further advanced the intrusive and forward-looking approach to supervision.

Banco de Portugal deems it necessary to ensure that Portugal's banking institutions continue their efforts to adapt their balance sheet structures, their business and internal governance models and necessarily their risk management processes, while ensuring adequate solvency levels that incorporate all the relevant risks to which they are or may be exposed.

Among other measures, the situation has led to various initiatives from the Bank recently, including the publication in May of a circular-letter with guidance on capital planning, designed to strengthen levels of own funds in all their forms (Core Tier 1, Tier 1 and total), above the minimum regulatory ratios in force, in order to create capital buffers that can withstand unforeseen events.

Banco Espírito Santo Group

1. Banco Espírito Santo Group structure and activity

Banco Espírito Santo, S.A. (BES) is the third largest banking group in Portugal, with assets of EUR 76.6 billion as at March 2014, deposits of EUR 37.3 billion, liabilities of EUR 13.7 billion in the form of securities, and funds from other credit institutions of EUR 4.2 billion.

The Common Equity Tier 1 ratio (CET1) (phasing-in) in March 2014, with the effect of the capital increase of June included, came to 11.3% (CET1 capital reaching EUR 7.1 billion). It was thus 434 basis points above the regulatory minimum (which corresponds to a EUR 2.1 billion capital buffer). BES Group's total capital ratio is 12.8% under the same assumptions.

BES Group's activity covers the most important business segments, such as retail, corporate and institutional clients, offering a variety of financial products and services through a diversified distribution network. BES Group is present on four continents and in 25 countries, and employs around 10,000 staff. In Portugal, BES Group has around 650 branches and a network of 22 Private Banking centres. In the corporate segment, BES has a domestic market share of 25.5% and operates through a network of 25 Corporate Centres, that serve the medium-sized enterprises subsegment and a group of teams split between Lisbon and Porto dedicated to the large enterprises subsegment.

Most of BES Group's international activity is carried out directly by BES and comes from Angola (with BES Angola – BESA), Spain (where BES has a network of 20 branches), the United Kingdom, Brazil, the USA, Macao, Poland, Cape Verde and Ireland. All the banking subsidiaries held directly by ESFG are located in countries outside the European Union: Dubai (ES Bankers Dubai), Panama (ES Bank Panama) and Switzerland (Banque Privée Espirito Santo).

2. Overview of recent supervisory activity regarding BES Group

Based on the permanent risk profile assessment of this banking group, Banco de Portugal identified certain vulnerabilities that led to the implementation of various prudential measures. These measures were designed to: (i) effectively reduce the (direct and indirect) exposure to the non-financial arm of GES, (ii) increase own funds to create a capital buffer with regard to the regulatory minimum (8% Common Equity Tier 1, phasing-in), and (iii) strengthen governance and internal control procedures and processes. In order to ensure an appropriate and timely adoption of these corrective measures, Banco de Portugal has monitored their execution and has met the institution's management and the audit committee regularly, along with BES's external auditor.

In the light of the conclusions reached in Banco de Portugal's horizontal supervisory initiatives, namely the Horizontal Review of Credit Portfolio Impairment (ETRICC) of the main Portuguese banking groups, Banco de Portugal decided to deepen its assessment of a set of economic groups where the capacity to recover their debt and the inherent impairment are analysed through the creation of financial flows (ETRICC 2).

The sample of entities to be assessed included in a first stage, the non-financial GES companies, the analysis extending thereafter to financial entities too. Given the nature of this assessment, PricewaterhouseCoopers & Associados – Sociedade de Revisores de Contas, Lda (PwC) was invited to undertake it under Article 116 of the Legal Framework of Credit Institutions and Financial Companies (Regime Geral das Instituições de Crédito e Sociedades Financeiras). In parallel, Banco de Portugal formulated a comprehensive set of information requests, with a view to deepening its assessment of the financial position of GES's non-financial companies.

As a result of these initiatives promoted by Banco de Portugal, a serious situation was identified in the ESI's individual accounts at the end of November 2013, caused by an unusual and extremely significant increase in its financial liabilities. Banco de Portugal thus requested ESI to prepare proforma consolidated accounts immediately with reference to 30 September 2013, accompanied by an external auditor's opinion. The audit work to issue this opinion was awarded to KPMG & Associados – Sociedade de Revisores Oficiais de Contas, S.A (KPMG).

In parallel, as the developments affecting ESI's financial position took on a considerable scale with potentially serious reputational risks for the banking group, on 3 December 2013, Banco de Portugal requested the implementation of the measures needed to ensure an appropriate segregation of BES Group from the risks arising from GES's non-financial arm, so-called "ring-fencing". In particular, Banco de Portugal determined (i) the elimination of ESFG Group's exposure to Espirito Santo International not covered by contractual obligations and guarantees assessed conservatively and (ii) the creation of an escrow account with a minimum reserve equalling the remainder of the debt issued by Espírito Santo International and placed with BES customers, to be supported by cashflows from entities outside the ESFG Group perimeter.

Banco de Portugal also announced that failure to implement these measures would lead to the compulsory constitution of a provision with reference to 31 December 2013, which reflected the conclusions of the external auditor.

Since the measures in question were not implemented in the terms specified by Banco de Portugal, a provision of EUR 700 million was recognised in ESFG's consolidated accounts for the 2013 fiscal year. The level of this provision was determined by KPMG and confirmed by PwC, after taking into account the economic assessment of ESI's business plan and the identified execution risks.

The level of this provision was based on a deleveraging plan for ESI, involving the sale of assets and holdings, which presented high execution risks. Consequently, Banco de Portugal imposed a successive strengthening of the ring-fencing measures between the banking group and GES's non-financial arm, to mitigate risks of contagion between GES's two arms.

Given the adverse developments in the capital markets resulting from uncertainty over BES's financial position, Banco de Portugal asked BES to disclose its overall exposure to all GES entities. According to the information disclosed by BES on 10 July 2014, BES Group's direct exposure to other GES entities as at 30 June 2014 amounted to EUR 1.2 billion, of which

EUR 927 million related to loans extended to ESFG and its financial subsidiaries. Furthermore, BES reported a total of EUR 853 million of debt securities issued by GES entities and held directly by BES retail customers, as well as a total of EUR 2 billion held by institutional clients, considered qualified investors. ESFG issued an unconditional and irrevocable guarantee of EUR 700 million to ensure the fulfilment of the obligations related to the debt instruments issued by various non-financial GES entities and placed by BES Group among its retail customers. Detailed information on these exposures was released to the market on 10 July and is available on the CMVM website (http://web3.cmvm.pt/sdi2004/emitentes/docs/FR51235.pdf).

In this context, Banco de Portugal requested BES to prepare a contingency plan based on three pillars (liquidity, capital and communication), with a view to mitigating risks arising from a scenario of default in GES's non-financial entities. In particular, Banco de Portugal asked BES to identify and duly quantify the various contagion channels to BES Group based on multiple contingency scenarios and including any impact arising from customers common to the two arms of GES (BES and GES's non-financial arm). Banco de Portugal also requested the analysis of any losses and other possible effects arising from reputational risk, as a result of a default event in GES's non-financial arm. A quantification was also requested of the impact foreseen on the liquidity and capital position of BES Group, as well as the measures to be adopted to reduce the risks arising from the materialisation of the risks identified.

3. BES Group's capital and liquidity position

Based on the information disclosed and the impact quantified by the institution and the external auditor, BES has an adequate capital buffer to accommodate possible negative impacts arising from exposure to GES's non-financial arm, without compromising fulfilment of minimum capital ratios (8% CET1 phasing-in).

Banco de Portugal does not foresee a significant negative impact on BES's capital position resulting from the financial situation of its subsidiary BES Angola (BESA). Given that the Guarantee from the Angolan State covers a substantial part of the credit portfolio and that there is close collaboration between the Authorities of both countries, Banco de Portugal hopes that this subsidiary's position is clarified in the near future and without material impact on BES.

Nevertheless, Banco de Portugal ordered BES to present additional recapitalisation measures, namely measures to accommodate any insufficiency arising from the Comprehensive Assessment that ECB is currently undertaking. In order to assuage doubts and ensure the review of BES Group's accounts is complete and clear, Banco de Portugal also ordered that an independent audit be conducted in addition to the credit portfolio review being carried out under the Comprehensive Assessment. In addition, Banco de Portugal requested a forensic audit to confirm full compliance with all the prudential ring-fencing orders issued regarding GES's non-financial entities.

The preliminary interactions between BES and international investment banks, as well as the interest shown by various entities (investment funds and European banks) in taking up reference holdings in BES, showed that a private solution to strengthen its capital is feasible.

However, if necessary, EUR 6.4 billion are available from the public recapitalisation line, created under the Economic and Financial Assistance Programme, and may be used to support any capital need of a Portuguese bank, under the relevant legal framework and State aid rules.

Despite having solvency levels above the regulatory minimum, the media impact of the GES situation, BES's rating downgrade and the performance of the CDS spread have put BES's shares under great pressure and high volatility. In terms of liquidity, Banco de Portugal will remain available to support any needs should its liquidity position deteriorate.

4. *Changes to internal governance and restructuring of senior management*

As mentioned above, hand-in-hand with successive requests to ring-fence BES from the non-financial arm of GES, and more recently from ESFG and its subsidiaries, Banco de Portugal ordered BES to strengthen its internal governance model, with particular regard to independence and prevention of conflict of interests, and to restructure its management body to eliminate situations in which management roles in other GES entities accumulate and lead to harm to BES Group.

The restructuring of BES's management body began shortly after the end of the capital increase, with the resignation of the board members that also had senior roles in ESFG and/or entities of the non-financial arm. Following that, Banco de Portugal recommended that the dialogue between shareholders, above all between the two principal qualified shareholders, was broadened to include presentation of a consensual proposal on replacing the resigning board members. Banco de Portugal led this process in accordance with the principle that the new board members be independent, credible and the result of consensus of at least the two principal reference shareholders (ESFG and Crédit Agricole), and also that the members of the Espírito Santo family – due to their accumulation of roles – resign immediately upon appointment of the new board members.

On 5 July, a consensual proposal was reached between ESFG and Crédit Agricole over the decision to co-opt the new CEO and CFO. This decision was later complemented on 11 July with a proposal from both shareholders to choose a new Deputy CEO for the Executive Board. Based on the shareholders' consensus, on 13 July Banco de Portugal ordered that the co-optation process be accelerated, and on the same day, the new members be co-opted, replacing the members of the Espírito Santo family. A new Chairman of the Board of Directors, also proposed through shareholder consensus, will be chosen by the Extraordinary General Meeting to be held on 31 July.

The shareholder consensus reached in the meantime also allowed proposals for statutory amendments to be submitted at the next Extraordinary General Meeting, designed to strengthen BES's internal governance. These proposals address Banco de Portugal's concern that credit institutions' senior management is independent and acts in strict compliance with sound and prudent management criteria, safeguarding in particular the funds entrusted to the institutions and ensuring that institutions have internal governance models conducive to sound and prudent management.

5. *Perimeter of supervision*

On 30 June 2014, Banco de Portugal was the supervisory authority of Espírito Santo Group on a consolidated basis, based on the consolidated position of Espírito Santo Financial Group, S.A. (ESFG), the holding company with head office in Luxembourg, which took the role of parent undertaking as defined under the legal framework in force.

Recently, as a result of various events that led to the reduction of ESFG's stake in BES and the changes to the bank's internal governance structure and above all the announcement on 20 June 2014 of the resignation of the board members designated by ESFG, Banco de Portugal deems that the requirements needed for BES to qualify as a subsidiary of ESFG within the meaning of Article 4 (1) (16) of Regulation (EU) No 575/2013 are no longer met, leading to a change to the perimeter of supervision on a consolidated basis, which will now only include BES, effective 30 June 2014.

For supervisory purposes, the change to the consolidation perimeter has marginal impact. Indeed, ESFG's banking activity was focused on BES and its subsidiaries: BES Group represents around 96% of ESFG's banking assets, 95% of the regulatory capital requirements, 96% of the banking turnover and 92% of the operating expenses. Furthermore, ESFG does not make use of any Eurosystem refinancing operation, except the operations to provide liquidity to BES Group.