Resolving Banco Espírito Santo: An Overview of the Application of Recovery and Resolution Measures in Portugal

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Abstract

A recovery and resolution framework for banks was central to the EU response to the 2007–2008 financial crisis. In 2014, the Bank of Portugal applied a resolution measure to Banco Espírito Santo SA (BES) by creating a bridge bank in order to mitigate the impact of BES's failure in the Portuguese economy and financial system resulting in a two-year process, still ongoing.

> "It is the innate conservation of the people that has kept our money good in spite of the fantastic tricks which financiers play—and which they cover up with high technical terms. The people are on the side of sound money. They are so unalterably on the side of sound money that it is a serious question how they would regard the system under which they live, if they once knew what the initiate can do with it."
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> Henry Ford, My Life and Work (1922)

Introduction

While financial and economic crises tend to present themselves cyclically, the 2007–08 crisis was pivotal in driving the focus of attention of academics and legislators to the many risks of the banking and financial services sector and to the realisation of the shortcomings of the then applicable regulation and supervision of banks. Among other concerns, the need to approve laws and regulations aimed at equipping countries with tools to prevent bank default and failure, or, if necessary, to deal with the failing of significant or systemically important banks and other financial institutions became rather uncontested and the emphasis then shifted to the implementation of mechanisms enabling (should the situation so require) *sustainable bank failures*, whilst ensuring minimal or mitigating the impact of the same in the real economy, the financial system and without costs to taxpayers.

Traditional insolvency procedures were recognised as being unsuitable to deal with bank failure in a way that protected public interest and, at the same time, public outrage against successive bail-outs aligned politicians' views to the notion that banks should be allowed to fail in an orderly manner, thus preventing moral hazard from public bail-outs that ultimately shifted the burden and risk of bank failure to taxpayers.

Together with crisis management (e.g. liquidity support or guarantees on bank liabilities) and resolution measures (e.g. capital injections and asset purchases) which focused on ex post intervention, ex ante measures such as recovery and resolution planning (or "living wills") were seen as being able to make banks more robust. These measures aimed at allowing a financially troubled bank's speedily return to health or facilitating its failure in a more streamline manner whilst guaranteeing the access to and the continuation of bank's critical services, preventing the dissipation of its balance sheet value and mitigating the impact of failure to the rest of the economy.

In the pursuit to create a safer and sounder financial system within the single market, EU legislators undertook a massive legislative endeavour for the approval of extensive reforms that culminated in the envisioned European Banking Union, underpinned by the single resolution mechanism, the single supervisory system and the deposit guarantee system. Notwithstanding, a more granular approach was also sought, through the approval and implementation of a directive on bank recovery and resolution—Directive 2014/59 (BRRD)[1]—which first, procured the harmonisation of rules and practices regarding bank recovery and resolution and introduced common resolution tools and powers across the EU.

The BRRD entered into force on 4 June 2014.[2] Coincidently, two months later the Portuguese authority for supervision and regulation of banks and financial institutions, *Banco de Portugal* (Bank of Portugal), applied its first resolution measure to one of Portugal's most important banks—BES. The application of the resolution measure was facilitated by the fact that Portugal had introduced, since 2012, significant amendments to its Legal Framework for Credit Institutions and Financial Firms (enacted by Decree-Law 298/92 of 31 December)

[1] Directive 2014/59 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Directive 82/891, and Directives 2001/24, 2002/47, 2004/25, 2005/56, 2007/36, 2011/35, 2012/30 and 2013/36, and Regulations 1093/2010 and 648/2012 [2014] OJ L173/190.
[2] The European Commission first adopted a legislative proposal for bank recovery and resolution in 2012 that was later adopted by the European Parliament on 15 April 2014.

by establishing a regime for bank recovery and resolution granting powers to the Bank of Portugal to apply resolution measures (and had also partially implemented the BRRD by 1 August 2014).

BES: the fall from grace

BES belonged to one of the largest Portuguese privately owned banking groups with the origin of the family-named franchise tracing back to the 19th century (more precisely 1864). The bank was nationalised from 1975–91 following the nationalisation of the entire Portuguese banking sector, but apart from that the Espírito Santo family closely controlled it through its presence in the board of directors of BES and through the controlling interests held in BES via its affiliates, known in a broad sense as the family group: Espírito Santo Group (ESG or GES[3]).[4]

In March 2014, BES was reported to be the third largest Portuguese banking group with €76,600 million assets and €37,300 million in retail deposits. As a universal bank, BES focused on all segments of clients: retail, corporate and institutional. The BES franchise was the result of a Portuguese family's perseverance and ambition, especially as it was able to regain control of the bank after the unwarranted nationalisation, and it was very much regarded as a history of success: being present in 25 countries and in four continents, employing roughly 10,000 people and being considered the second-largest Portuguese banking private group by total reported net assets.

However, throughout mid-2014, the centennial second-largest private Portuguese banking group faced its doom amidst suspicion of fraudulent intercompany funding schemes and high levels of exposure to the debt of GES. On 30 July 2014, pursuant to its reporting obligations, BES informed the Portuguese securities regulator (*Comissão do Mercado de Valores Mobiliários*, CMVM) and the market, in CMVM's website, of its half-yearly reports which recorded a shortfall of €3,577.3 million. The capital situation of BES and its subsidiaries had been negatively affected by high impairment and contingency costs related to GES and to possible illegal intragroup transactions identified by an external auditor. The reported losses largely surpassed BES's capital buffer resulting in a CET ratio of 5.1% and a total capital ratio of 6.5%, both on a consolidated basis, largely below the respective legally required CET ratio of 7% and 8%. Just a day after this announcement, BES reported to the Bank of Portugal that it was unable to promote any recapitalisation solution.

Surprisingly, these results came just after BES had successfully undertaken a share capital increase on 20 May 2014. At the time, BES had already announced that the Bank of Portugal had undertaken an audit to Espírito Santo International (which was the controlling shareholder in the Espírito Santo Financial Group) and found that it was in a critical financial condition and several news centres had reported that there were financial problems with some of the holding companies belonging to GES, including Espírito Santo International, Espírito Santo Financial Group and Espírito Santo Control. However, the belief that BES was properly ring-fenced and the reputational capital it had acquired in the market throughout the years contributed to the success of the share capital increase and the belief in the institution's financial resilience.

Notwithstanding, following the publication of its half-yearly results, the bank's liquidity situation plummeted with BES having to make use of the emergency liquidity assistance credit line which, on 1 August, already amounted to €3,500 million. On that same day, the European Central Bank (ECB) decided to suspend BES's classification as counterparty with effects starting on 4 August and with the simultaneous obligation to repay €10 milllion to the Eurosystem. This sealed BES's fate: with a run on deposits and without access to funding, BES was pulled into an unsustainable liquidity situation and in the eminency of being incapable of honouring its short-term payment obligations.[5] With the bank's default as a near certainty, on 3 August 2014, the Bank of Portugal applied the first resolution measure to a Portuguese bank in order to protect depositors and mitigate the adverse effects of the bank's failure to the Portuguese economy and financial system.

The Bank of Portugal later attributed these results to the mismanagement of BES and to the violation of specific determinations made by the Bank of Portugal that had prohibited BES from increasing its exposure to certain companies within GES.

Thus, the financial problems of BES were not considered to be created by systemic events but were rather idiosyncratic and rooted in significant financial exposures to several companies within GES. These issues were augmented by the fact that the shareholding structure of GES was rather complex and opaque which hindered its prudential supervision and ultimately led to BES being vulnerable to the liabilities of other companies in the group as it was inadequately ring-fenced. In this regard, several news centres reported that BES was "victim" to and part of a funding scheme of its parent undertakings which had been struggling for financing since the 2007–08 crisis and that were mainly staying afloat through debt rollover. These reports were later corroborated by the conclusions of the final report of the parliamentary committee of inquiry of BES published in the Portuguese language on 28 April 2015.

[3] To clarify, references to GES or ESG in this article shall include all affiliates of BES and not only BES's subsidiaries.

[4] In the 1990s, the recovery of a controlling interest in BES by the Espírito Santo family entailed a joint venture with Crédit Agricole which remained until the present as one of BES's main shareholders.

[5] During the month of July alone, the bank lost 11–17% of its deposits (not considering the ECB/Bank of Portugal deposits).

Resolutions of the Bank of Portugal: the creation of Novo Banco

Given BES's critical liquidity condition, the Bank of Portugal applied the resolution measure in an urgent administrative procedure which, simply put, created a transitional company vehicle equipped with a banking licence—a bridge bank, to which it transferred the "healthy" part of the assets, liabilities, off-balance-sheet items and assets under management of BES. In total, the value of the assets transferred to this new entity amounted to €64,007.6 million.

As rationale for its decision, the Bank of Portugal detailed the need to safeguard depositors and the stability of the Portuguese financial sector combined with the impossibility of arranging the sale of BES to another authorised credit institution in the immediate future.

Although there was no direct bail-out per se of BES, Novo Banco's entire share capital in the amount of €4,900 million was fully subscribed and paid for by the Resolution Fund (a public entity which is privately financed by the Portuguese banking system)[6] which at the time only held €90.4 million. Hence, these funds were not sufficient to meet the regulatory capital needs of the bridge bank thus requiring additional contributions from the Portuguese banking system in the amount of €286 million and a loan from the Republic of Portugal in the amount of €4,500 million financed from the Portuguese state budget. Since all the funds from the Resolution Fund used for the subscription of Novo Banco shares could be attributed to the Portuguese State, the capitalisation of the bridge bank was deemed (compatible) State aid by the Directorate-General for Competition in the European Commission's decision of 3 August 2014 regarding State aid No.SA.39250 (2014/N).

This newly created entity was named Novo Banco SA (literally New Bank) and as it was initially envisaged it should function only as an intermediary transferee to allow the future sale of the viable parts of BES to another bank, allowing for the reimbursement of the contributions made by the Portuguese banks and the Portuguese State, in both cases via the Resolution Fund. Additionally, the Commission's decision established a time limit for the existence and sale of Novo Banco to be attained within a 24-month period, after which any unsold assets of Novo Banco should be wound down in the subsequent month to the end of the two-year period through resolution. Later on, after some significant amendments to the Portuguese legal framework, the possibility of Novo Banco remaining on a standalone basis was presented by the Bank of Portugal in its second attempt to sale Novo Banco via its "market" recapitalisation (in case a direct sale is not possible to obtain) by a twofold offering of the shares of Novo Banco directed at cornerstone investors (i.e. institutional investors), after which a public offer of shares would ensue.

BES remained with a total amount of €1,000 million net assets (including its more toxic assets and troublesome subsidiaries, such as Banco Espírito Santo Angola (BESA), Espírito Santo Bank and Aman Bank) and its baking licence—to be revoked either after the 24-month period or the sale of Novo Banco, depending on whichever occurred first—but stripped of the ability to accept deposits and provide credit. This asset division allowed BES to be resolved by being wound up under normal insolvency judicial proceedings, after the sale process of the bridge bank had been completed.

According to the Commission's decision, the existence of the bridge bank and the orderly winding-down of the bad bank should result in lower losses, capital needs and other related costs to the Portuguese State, as it noted that no additional capital injection could be provided to Novo Banco in the future. As it was, estimates made by the Bank of Portugal of the cost of immediate liquidation of BES forecasted increased resolution costs somewhere between €16,000 million and €28,000 million, as well as a disbursement of up to €18,000 million to cover "insured" deposits from the Deposit Guarantee Fund. Therefore, the separation of the viable parts of BES through the creation of the bridge bank and the orderly resolution of BES was considered to be the least costly option.

The asset-split was publicised through the antagonist notions of "good" bank and "bad" bank, reflecting the objectives of the split and cutting with the past by signalling Novo Banco as a stealth institution ring-fenced and unaffected by the exposures to GES that had tainted BES's balance sheet, thus attempting to maintain the value of the newly created bank's assets closer to (as much as possible) their fundamental value by avoiding additional runs on deposits and fire sales.

Due to the urgency of the entire procedure, the resolution of the Bank of Portugal determined the perimeter of assets to be transferred from BES to Novo Banco based on unaudited figures and a preliminary balance sheet for the newly created entity with figures adjusted by the Bank of Portugal.

Through the resolution measure, the Bank of Portugal carved out several assets and liabilities from the perimeter that should remain with BES, including, inter alia:

- short-term liabilities vis-à-vis BES's shareholders, directors and other related parties;
- other assets and liabilities entwined with the exposures to GES;
- liabilities in relation to subordinated debt which was used to calculate BES's own funds;

[6] The Resolution Fund is a public entity, created in 2012 through Decree-Law No.31-A/2012, of 10 February, with the intent to provide financial assistance to the resolution measures applied by the Bank of Portugal.

- liabilities or contingencies in relation to civil, penal or administrative responsibilities resulting from wilful misconduct, fraud and breach of regulatory dispositions;
- liabilities related to any responsibility arising from any share or subordinated debt issuance; and
- liabilities and contingencies resulting from the commercialisation, intermediation and distribution of GES debt instruments.

In this manner, by also establishing that all shareholders, subordinated creditors and related parties' non-contractual claims should remain in the bad bank, the resolution measure maximised the contribution from shareholders and subordinated creditors in line with the principles established in the BRRD.

The creation of Novo Banco ensured the continuation of BES's core activities, notably its commercial and retail segment and payment services, mitigating the impact of BES's failure to depositors and enterprises and limiting any contagion effects to the Portuguese economy and financial system. With lighter colours and a new brand, Novo Banco seemed fit for business and remained as one of Portugal's most significant banks from a balance sheet and market share perspective although otherwise disenfranchised.

However, not surprisingly, several additional resolutions from the Bank of Portugal followed the 3 August resolution that incorporated Novo Banco and established the perimeter of "good" assets, either rearranging it or clarifying its content. This occurred through the following resolutions by the Bank of Portugal: 11 August 2015, 13 May 2015 and 29 December 2019.

In addition, not a year and half had passed and gloom set on the newly created bank. Through the stress tests conducted under the comprehensive assessment made by the ECB in the context of the Single Supervisory Mechanism, Novo Banco failed its adverse stress test scenario with an anticipated shortfall amount of €1,398 million for 2017. This led to the need to implement strategic measures that mainly focused on a divestment policy of the non-core activities of Novo Banco and the revaluation of Novo Banco's balance sheet with focus on the perimeter of assets and liabilities that had been transferred from BES to Novo Banco. Concerns relating to the capital needs of Novo Banco had been raised during the first sale attempt, as denoted in the Bank of Portugal's announcement of 15 September 2015, when it suspended the first sale process due to the belief that the price offers had factored in the uncertainty regarding the capitalisation of Novo Banco, and were discounted accordingly.

From the above-mentioned subsequent resolutions, the most contentious were the 29 December ones as they determined the retransfer to BES of senior bonds tranches that wiped out the value of part of the debt of Novo Banco. In determining this retransfer, the Bank of Portugal was able to improve Novo Banco's capital situation as the CET1 of Novo Banco improved from 9.4% to 13% and it did so by, in a certain way, making this senior debt "bail-inable".

The power to rearrange the scope of assets in applying resolution measures is foreseen in the BRRD and was thus one of the resolution tools used by the Bank of Portugal to assist the value of Novo Banco and to maximise the prospective outcome of its sale process after the more negative outlook from the results of the stress test conducted by the ECB. However, creditors that had been affected by the measure immediately contested it by arguing its illegality since the power to retransfer assets under the BRRD had to fulfil certain specific conditions that were not met in this situation (e.g. the bank should be about to fail and not merely undercapitalised). In addition, it was argued that there were signs evidencing that the Bank of Portugal had chosen those bonds that were governed by Portuguese law so as to avoid possible litigation in other jurisdictions, such as the courts of England and Wales.

The power of the Bank of Portugal to, at any time, transfer and retransfer assets and liabilities between BES and Novo Banco was determined in the text of the resolution that resolved BES and it is an important tool to secure the success of the sale of Novo Banco and the maximisation of its balance sheet value. However, it may be seen as a "two-edged sword" contributing to uncertainty surrounding the application of resolution measures across the EU as it creates room for investors' doubt for fear that a certain degree of "cherry picking" may occur since the regulator's decision-making process is discretionary and difficult to control. This may also raise questions as to the possibility of such decisions being arbitrary and politically motivated which contravenes the need for a single levelled playing field market.

Theory meets practice

Goals and implications of the resolution measure

Traditional insolvency proceedings are considered to be inadequate to deal with the particularities of bank failure. In a company's insolvency, shareholders' losses will be limited to their residual claims in the company and the insolvency estate will be managed in order to pay creditors pro rata and in accordance with their contractual or legal ranking priorities. In most cases, in a company's insolvency procedure, all losses will be borne by these two categories and any public intervention is contained to existing legal provisions establishing legal priorities in the order of payments for certain stakeholders (e.g. giving preference to the claims of public authorities, such as tax authorities, and to the claims of the employees of the company). However, this is not the case for bank failure as evidenced throughout the several bailouts that occurred after the 2007–08 crisis. Since bank failure may potentially contaminate the financial and economic

system, public interest justifies public intervention in order to secure that the supply of credit and certain critical services provided by banks to retail customers are not affected and to maintain the stability of the financial market. Assisting failing banks by injecting public money may be paramount to halt further deterioration of financial and economic conditions when no other resources are at hand,[7] but it will have a moral hazard effect to shareholders' and creditors' incentives to properly monitor the bank while it is a going concern and translates into a form of subsidy from taxpayers to the banking industry, as the cost of increased risk-taking and probability of failure will not be correctly priced. Thus, policies regarding bank resolution should ensure minimal external impact from bank failure while, at the same time, preventing that taxpayers will be burdened with the costs of bank failure as these should be borne by shareholders and creditors (with the exception of depositors). This is the rationale behind legislative reforms and legitimises the public expropriation of shareholders and the harm to creditors' claims that is undertaken through the application of resolution measures. From a theoretical legal perspective, there is a collision of rights of public and private nature to be resolved by the preponderance of the public interest at stake.

The BRRD clearly adheres to these principles and reasoning as it establishes that the goals of bank resolution should be, in equal setting, the maintenance of a bank's critical functions, the avoidance of negative impacts to financial stability, the prevention of contagion, the maintenance of market discipline and, finally, the protection of public finances (by preventing further public funds expenditure) and of depositors, investors and clients' assets. In seeking to ensure these goals, the recovery and resolution legal framework dictates that the resolution authority must mitigate the cost of resolution and avoid the destruction of value. Additionally, in procuring that a bank's stakeholders have their interests aligned, the framework establishes as its core principles that shareholders should be the first to suffer losses from failure, after which creditors will bear losses pro rata pursuant to their legal and contractual ranking priorities (as if in the context of insolvency laws) and asserts that "insured" deposits should be wholly protected. The BRRD further echoes the long-established principle that creditors of the same category should be treated equally, but it adds a "no creditor worse off" principle to be considered in light of the overall impact of the resolution measure that is not as easily interpreted. The latter principle determines that no creditor should bear higher losses through resolution than those that it would have suffered should the institution have been liquidated through normal insolvency proceedings. The application of this principle in practice may be rather intricate: how are courts to determine the value of a creditor's loss based on a hypothetical liquidation that will not take place? Taking into consideration what was said about how a bank's value easily disappears after the bank has signalled that it may be financially troubled and the fact that a bank's balance sheet poses particular challenges in terms of valuation—since not all of its assets have the necessary liquidity to be fungible in the market, mark-to-market valuations may lead to significant impairments being recorded and thus lead to extensive write-offs from the bank's balance sheet value—it seems virtually impossible to determine the measure of a creditor's "no worse off" loss, especially when the insolvency estate from which such creditor would have been allowed to claim payment is either qualitatively or quantitatively reduced (e.g. through the transfer of a resolving bank's "good parts" into a bridge bank or instead its "bad parts" into an asset management vehicle).

Policy goals with regard to bank recovery and resolution were further achieved in the BRRD by a dualistic approach through the introduction of:

- mechanisms enabling the recovery of an institution which is financially struggling with the objective of reorganising such institution into financial health; and
- mechanisms allowing for an orderly resolution of an institution when it has reached the point of non-viability.

The resolution instruments and mechanisms implemented by the BRRD consist of sale of business, creation of a bridge bank, creation of an asset management vehicle and bail-in debt. These can be used on a standalone basis or combined, subject to certain requirements being meet. Through these mechanisms, the BRRD tries to achieve a flexible regime capable of easily adapting to different situations and attributes to the resolution authorities the necessary powers to implement the same unilaterally, without the consent from the institution's shareholders or from its creditors.

When the Bank of Portugal applied the resolution measure to BES, the BRRD had barely just come into force and there were no precedents the Portuguese regulator could use as reference.[8] Nonetheless, the Bank of Portugal opted to create a bridge bank by using its power to transfer the viable parts of BES to Novo Banco with the objective of liquidating the remaining part of the failing institution.[9] In line with its provisional nature and the BRRD's objective, the bridge bank is intended to enable the transfer of the assets and liabilities of the institution which was the object of the resolution measure in order to guarantee the continuance of critical functions,

[7] In this regard, it is still contentious whether the US Government should have bailed-out Lehman Brothers on the basis that this would have prevented the intensification of the economic crisis.

[8] Portugal had, however, dealt with two previous bank failures in the cases of Banco Português de Negócios, which was bailed-out through nationalisation and later sold to a third-party investor, and Banco Privado Português, which received a guarantee from the State in the amount of €450 million to aid its financial situation but which fell, in any case, into insolvency proceedings.

[9] The "bridge bank" instrument is said to have been modelled on the US's and UK's concept of "receivership". In Portugal, the closest to this concept is the judicial administrator figure applicable in the context of insolvency.

to facilitate the access to deposits and to enable the transfer of the same to another institution. In addition, for the purpose of making the creation of the bridge bank and the transfer of the assets, rights and liabilities as streamline as possible, the legal requirements and procedures that would otherwise have been applicable to the incorporation of the new entity and to the transfer of assets, rights and liabilities are derogated by the regulator's authority. Finally, in order to ensure that there is no financial imbalance from applying this measure, the resolution authority must ensure that the value of the liabilities transferred to the bridge bank does not surpass the value of the assets. Although seemingly evident, this may be difficult to attain in practice when, such as in the case of BES, regulators will have to apply this within an urgent procedure precluding a thorough audit to the bank's accounts and expert validation of the figures presented in its financial statements and balance sheet. This may explain why the legislator has opted to grant resolution authorities with a certain degree of flexibility by establishing the power of the resolution authority to retransfer the assets, rights and liabilities to and from the original bank, at any time after the resolution measure has been applied, if certain conditions are met.

The sale process of Novo Banco

The creation of a bridge bank is temporary as the name clearly indicates and it introduces an intermediary step between the sale and purchase that should help maintain the value of the bank. For this reason, Novo Banco was created with a limited time frame with the objective to secure its sale to a third party.

As made public in the several announcements of the Bank of Portugal in relation to the sale of Novo Banco, the sale process of the bridge bank was initiated on December 2014, with seven non-disclosed entities presenting their non-binding offers on 24 March 2015 from 15 initial contenders that had been validated by the Bank of Portugal to participate in Novo Banco's due diligence. However, by the binding offer's deadline of 30 June, only three offers were made. After the selection of the potential buyer's offer to acquire Novo Banco, a negotiation phase followed between the Bank of Portugal and the selected investor which ended on 1 September as the Bank of Portugal decided to stop negotiations with such investor and initiated discussions with the investor whose offer had been second ranked. Notwithstanding, by 15 September these negotiations were also led to an abrupt end when the Bank of Portugal decided to interrupt the sale process altogether in anticipation of the results of the Supervisory Review and Evaluation Process (SREP) undertaken under the comprehensive assessment being made by the ECB (which had in the meantime become the direct supervisory authority of Novo Banco). The assessment was contributing to a degree of uncertainty in the context of the sale as investors were concerned about the possible capital needs of Novo Banco and factored this into their offer prices. The results indeed found that Novo Banco had a capital shortfall of €1,398 million in an adverse stress test scenario for 2017 which meant that it required capital in excess of the regulatory minimum.

Hence, the Bank of Portugal decided to temporarily stop the sale process in order to address some of the exogenous issues that were hampering negotiations with Novo Banco's prospective buyers. The latter's valuation of the bank and price at which they were willing to acquire Novo Banco, as well as the risk they were willing to assume, were not aligned with the former's views and objectives for the sale. The interruption of the sale process aimed to achieve a better outlook for the sale by allowing the Bank of Portugal to articulate the implementation of a management strategy with Novo Banco's management in order to address the capital needs of Novo Banco. Moreover, macroeconomic events also played a part in the Bank of Portugal's decision since the Greek sovereign debt crisis had intensified—creating uncertainties as to its impact to the euro—and Asian markets were evidencing signs of economic slowdown (the Bank of Portugal had noted that major investors in Novo Banco were international investors, with focus on investors based in Asia).

In relation to Novo Banco's management strategy, the Bank of Portugal announced that the bank's performance had been negatively affected by recording high levels of impairment and provisions which were not related to its core business. As a matter of fact, Novo Banco's performance had been positively valued in its core business as the bank achieved a degree of stability and repositioning in the market, together with an overall deleveraging effort. Therefore, in order to obtain a solution for Novo Banco's capital needs, the board of directors of Novo Banco was tasked with achieving a strategic and operational plan to deal with Novo Banco's capital needs.

To achieve the goal of maximising the sale value of Novo Banco, the Bank of Portugal requested an extension of Novo Banco's sale deadline to the Commission, which was later granted on December 2015 after the Commission had analysed the strategic plan presented by Novo Banco's board of directors. In order to agree to the extension of the sale period, the Commission set additional commitments to the activity of Novo Banco by determining that it should focus only on its core business and initiate a divestment strategy of all its non-core operations and markets (e.g. through sale or winding-up of subsidiaries and closing branches). Also, the Commission approved the extension of the Portuguese State guarantee over the €3,500 million bonds that had been transferred from BES to Novo Banco.

Finally, the Bank of Portugal produced three resolutions on 29 December 2015 relating to the final adjustments and clarification to the perimeter of assets of Novo Banco. These decisions were underpinned by the fact that Novo Banco had been negatively affected by losses that could be imputed to BES and therefore such liabilities should be primarily borne by BES's

shareholders and creditors and not by the Portuguese banking system and taxpayers. As such, the Bank of Portugal resolved on the retransfer of non-subordinated bonds that had been subscribed by and placed with institutional investors in the amount of €1,941 million corresponding to a balance sheet value of €1,985 million, thus positively affecting Novo Banco's capital situation. Pursuant to the Bank of Portugal's resolutions, these decisions definitively established and crystallised Novo Banco's perimeter of assets, which justified presenting a request to the ECB for the revocation of BES's banking licence and for the initiation of judicial proceedings for its liquidation.

These circumstances largely assisted in overcoming a lot of the negative conditions that had affected Novo Banco's performance and enabled the Bank of Portugal to initiate the second attempt to sale Novo Banco, starting on January 2016.

In the second sale attempt, the Bank of Portugal opted for a different strategy by determining two different parallel processes:

- a strategic sale process; and
- a market sale process.

The strategic sale process was in line with what had been previously done through the first sale attempt, but the market sale process introduced some novelty as it foresaw the possibility of a sale of Novo Banco's shares to institutional investors and possibly a public offering of shares, combined with the selection and possible commitment of cornerstone investors to acquire a certain percentage of Novo Banco's share capital.

Through this renewed sale process, the Bank of Portugal received four binding offers on 30 June 2016 to be analysed by it (which is ongoing at the moment) in order to decide if a strategic sale approach or a market sale approach should then be followed. However, if as previously noted by the bank of Portugal, macroeconomic conditions negatively impacted the first sale attempt, it may be safe to assume that, with Asian markets still on the downturn and with the EU having to deal with the aftermath of the UK's referendum "leave" results, conditions for the sale of Novo Banco are no more favourable than the previous ones in a manner that safeguards the interests of the Resolution Fund. Additionally, fear that BES may still have hidden far-reaching effects on Novo Banco's balance sheet and concerns relating to the effects of the outcome of litigation surrounding the resolution of BES may also be contributing to deter investors from offering a price for Novo Banco that is close to the Bank of Portugal's expectations. It is not expected that Novo Banco would go into a third round sale attempt in case the offers received by the Bank of Portugal are not as appealing as the Bank of Portugal would wish, so Novo Banco will have to be sold either way or, in case the sale does not succeed, it will have to go into liquidation as foreseen in the Commission's decision on the resolution of BES and the State aid from Portugal. Further prolongation of Novo Banco's life expectancy may also be contributing to its losing value, as the bank's activities and risk-taking policies are severely restricted, preventing its business growth and limiting its returns.

Although the BRRD establishes that any return on the sale of the bridge bank should, in the case of the transfer of assets, rights and liabilities, benefit the institution that was object to the resolution (i.e. BES), subject to the Resolution Fund being first reimbursed of its "reasonable" expenses from the application of the resolution measure, it is not likely that BES's shareholders and creditors will receive any returns from the sale of Novo Banco since the Resolution Fund fully subscribed Novo Banco's share capital by injecting €4,900 million into the bridge bank, which was raised from the Portuguese banking system and from the Portuguese State.

Regulator's lax screening?

As part of a reassessment procedure, the Bank of Portugal nominated an independent commission to undertake an evaluation of the decisions and the behaviour of the Bank of Portugal in the supervision of BES in the three years prior to the resolution measure applied to BES. This commission produced a 600-page report which identified at least two problems in the supervision of BES, with news reporting the Bank of Portugal's regulatory oversight by failing to use the full array of regulatory powers to obtain further information and clarifications pursuant to information it already had in relation to the relationship of BES with GES and to BES operations in Angola. Although the report is still confidential, the commission's recommendations were made public. In total, there were 19 recommendations relating to the supervision of mixed financial conglomerates, risk exposure of credit institutions to shareholders and to subsidiaries, conflicts of interest, financial intragroup exposures and terms and conditions of the issuance of commercial paper, as well as concerning the monitoring of the sale of financial instruments by banks, the relationship and supervisory model of financial regulatory authorities, the requirements for external auditors and the exercise of prudential supervision vis-à-vis supervised entities.

Conclusion

As already mentioned, the externalities of bank failure are different from those of commercial companies. The value of a bank quickly disappears as soon as any concern arises in relation to its financial stability, affecting, on the one hand, its business as enterprises will be keen to request financing elsewhere, and, on the other hand, its ability to obtain liquidity and financing as depositors (short-term lenders) will want to move their deposits from the bank and the bank's financial counterparties will raise the price on short-term debt financing and raise haircuts on collateral, cutting the oxygen from the institution. In addition, as institutions' balance sheets are often

intertwined, the negative impacts of bank failure are very significant due to potential domino effects in the solvency of other banks, contributing to the deterioration of the macroeconomic set as multiple institutions' failing will lead to loss of access to payment systems and to a constriction of lending impacting households and businesses as the supply of credit shrinks (credit crunch).

Through the resolution measure applied to BES and the creation of Novo Banco, the Bank of Portugal succeeded in securing depositors' interests and mitigating the impact of BES' failure and its contagion to the Portuguese economic and financial system. Shareholders and subordinated creditors were wiped out of their claims maximising the value of their contribution to the resolution of BES. Also, the immediate and automatic legal transfer of the bank's contracts, rights, liabilities and security, by overriding contractual terms and general legislation which was facilitated by the legal framework, helped to secure the swift transition and the continuation of the bank's business and the provision of its critical services.

However, the resolution measure entailed an indirect funding from the Portuguese State through the loan provided to the Resolution Fund and through the contributions from the Portuguese banking system via the capitalisation of the Resolution Fund, which may not be completely recovered and thus taxpayers may not have been fully cushioned against the cost of BES's failure.

Additionally, there are still some problems arising from the application of the resolution measure and the creation of the bridge bank which are not in line with the recovery and resolution policy goals. As evidenced by Novo Banco's two-year sale attempt, the structure and size of the bridge bank was maybe too complicated for speedy resolution, as assets and liabilities were not easy to evaluate and concerns on the capital needs of the institution were raised. Finding potential purchasers was obtained in the first and second sale attempts, but the offers received by the Bank of Portugal did not reflect its valuation of Novo Banco and sale objective. Moreover, the perimeter of assets and liabilities of Novo Banco was subject to more than one adjustment in order to maintain the capital requirements of Novo Banco. Although the power to rearrange the perimeter is an important resolution tool, it creates room for risk of arbitrary treatment of creditors.

At the moment, the sale process of Novo Banco is ongoing as the Bank of Portugal is currently evaluating the offers received by investors and thus no forecast can be made on the sale price of Novo Banco and on the amount to be recovered by the Resolution Fund. In any case, the resolution measure applied to BES ensured that depositors suffered no loss and that the viable parts of the bank were saved as they were transferred to Novo Banco.