

Suddenly last Summer... The good bank/bad bank dichotomy in Portugal

From the rushed partial enactment of the EU directive to the untested application of a “resolution action”, Nuno Líbano Monteiro discusses the Good Bank/Bad Bank dichotomy as a supposed safeguard for the legitimate interests of customers



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Factual and legal background – the need for intervention by Banco de Portugal

On 11 July 2014, *Banco de Portugal* announced publicly, in light of the information reported the previous day by *Banco Espírito Santo, S.A.* (“BES”) and by its external auditor, KPMG, that BES held sufficient equity to bear any negative impact arising from its exposure to the non-financial arm of *Grupo Espírito Santo* (“GES”) without compromising compliance with the minimum ratios in force. *Banco de Portugal* made the announcement because, a few days earlier, it had learnt of the high-value default by a GES holding, for the Portuguese economy of commercial paper (notes).

According to the information disclosed by BES on 30 July 2014, the losses resulting from the exposure to GES, determined and recognised in the financial statements as at 30 June, had remained within the expected limits and in compliance with the provision of €2 billion that *Banco de Portugal* had required BES to constitute for this exposure.

However, and surprisingly, in the second half of July, the

external auditor identified situations that increased the value of the losses to be recognised in the profit and loss accounts for the first half of the year by around €1.5 billion, calling into question compliance with the applicable minimum solvency ratios.

According to *Banco de Portugal*, these actions, taken between June and July 2014, prior to the appointment of new members on BES’s executive committee, triggered the following consequences:

- 1) placing BES in a position of non-compliance with the applicable minimum solvency ratios;
- 2) *Banco de Portugal*’s decision to suspend BES’s access to monetary policy operations and, therefore, to Eurosystem liquidity;
- 3) increasing pressure on BES’s cash flow;
- 4) damaged public perception of BES, demonstrated by the very negative performance of the respective securities, a situation that harmed depositor confidence¹; and,
- 5) increased uncertainty about BES’s balance, making a private capitalisation solution in a short space of time unviable.

Against good legislative practice and faced with an imminent need to intervene in the management of BES, the Portuguese Government published Decree-Law 114-A/2014 of 1 August, which made certain amendments to Chapter VIII of the General Regime of Credit Institutions and Financial Companies.

The new Decree-Law introduced the clarifications and adjustments necessary to partially enact Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 in the Portuguese legal system. The EU Directive establishes a framework for the recovery and resolution of credit institutions and investment firms and the Decree-Law enacts one of its guiding principles into Portuguese law. This principle, to safeguard the legitimate interests of creditors affected by resolution actions, provides that no creditor should be worse off under resolution than it would have been had the bank been wound up under applicable insolvency law. Besides this, it clarifies the means for making the resources of the Resolution Fund available, specifically the possibility of the Fund providing guarantees in the context a resolution action.



The application of the resolution action by Banco de Portugal – the good bank/bad bank separation

According to *Banco de Portugal*, BES's capital cushion was not sufficient to accommodate the losses of the first half of 2014. Having (hastily!) created the legal conditions for its intervention, on a Sunday night last summer, 3 August, at a press conference, the Governor of *Banco de Portugal* announced the decision to apply a resolution action to BES. It was undoubtedly an original way to determine intervention in one of Portugal's largest banks: in front

of television cameras, after the 8 o'clock news.

Faced with the alleged financial difficulties of a credit institution and the fact that it was impossible to find a private solution with the required speed, *Banco de Portugal* used this regulatory instrument, on the one hand, in order to isolate BES's problem assets which were to be subsequently liquidated and, on the other, to concentrate its core business in a capitalised entity to be sold post-haste.

As such, the resolution actions included the creation of a bridge bank to which the core business would be transferred. In the opinion of *Banco de Portugal*,

this solution is a fast way to ensure (i) the protection of deposits and customers, (ii) the continuity of the financial services provided by BES, and (iii) the maintenance of stability and confidence in the Portuguese financial system.

The bridge bank was given the name *Novo Banco*. Most of the business and assets of BES were transferred to it and business continued to be carried on as usual. However, this made BES into the bad bank, as opposed to the good bank, which was to be the *Novo Banco*.

Besides this, *Banco de Portugal* intervened in BES, by taking the following steps and corrective intervention measures:



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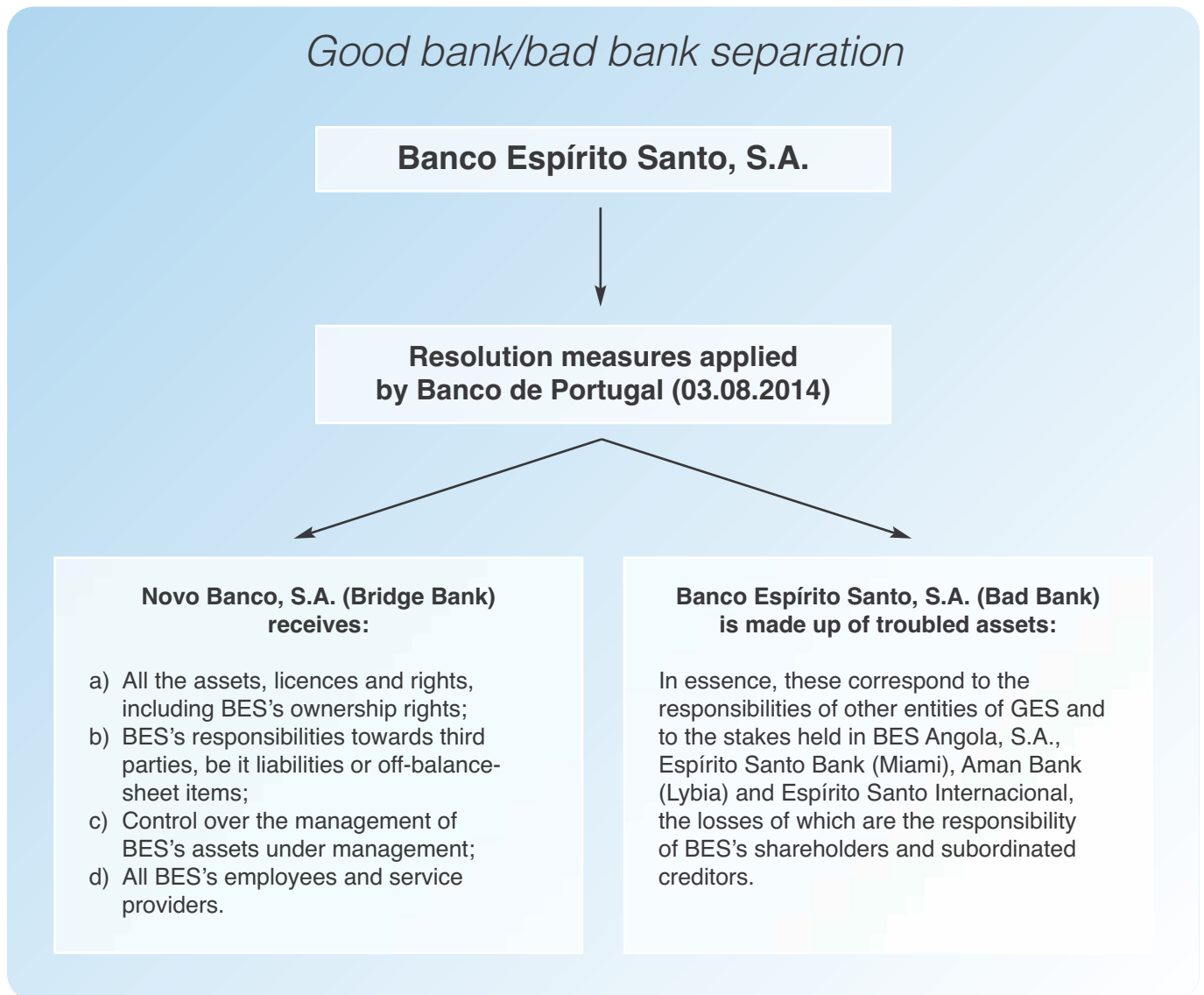
- a) the prohibition to grant credits and apply funds to any types of assets, except to the extent that the application of funds is necessary to preserve or increase the value of its assets;
- b) the prohibition to take deposits; and,
- c) a waiver, for one year, of the requirement to comply with the applicable prudential rules and with timely compliance with previously contracted obligations, except if this compliance is crucial to preserving or increasing the value of its assets. In this case, *Banco de Portugal* may authorise the operations necessary.

As a result of this intervention, BES is not carrying on its banking activity and *Banco de Portugal* will end up by revoking its authorisation to do it. This decision will have the effect of a statement of insolvency, which in turn will lead to BES's liquidation. The liquidation process will only apply to the liabilities and assets that were not transferred to *Novo Banco*, and the costs associated with this process will be similar to those arising from any insolvency process and will be borne by the insolvent estate.

In turn, *Novo Banco*, as a bridge bank, is a credit institution in the form of a public limited company. It has been incorporated specifically to receive

and manage the assets, the liabilities, the assets under management and off-balance-sheet items transferred from a credit institution in a situation of financial imbalance. As it is a bank, it can carry on all the activities permitted for credit institutions under the management mandate put in place by *Banco de Portugal*. It is also subject to all the applicable rules, including the prudential requirements imposed on banks operating in the market.

The 'good bank/bad bank' distinction becomes clearer if we look at the diagram below.



Costs of application of the resolution action – the importance of the Resolution Fund and the impact on public funds.

Allegedly and according to *Banco de Portugal*, one of the main objectives behind the creation of the resolution framework was to minimise the impact on public funds resulting from the situation of financial imbalance of a credit institution.

In the case of BES, the costs of the resolution were, in the first place, borne by the shareholders and subordinated creditors of the institution. In the second place, and because the final costs of the resolution action are greater than the amount covered by the shareholders and subordinated creditors, it was necessary for the Resolution Fund to intervene. It did so as a public-law, legal entity whose main object is to provide financial support for the application of resolution actions imposed by *Banco de Portugal*.

As a result of this intervention, the share capital of Novo Banco is €4.9 billion, fully subscribed by the Resolution Fund. The resources of this fund come from the contributions paid by member institutions and from the banking sector levies which, under the applicable rules, are charged without compromising solvency ratios.

This means that ideally, public funds will not have to make any contribution. However, the Resolution Fund only came into being in 2012, thus it does not yet have sufficient financial resources to finance the resolution action applied to BES. For this reason, the Fund, using the option established by law, had to take out a loan from the Portuguese State, the Fund's intention being to substitute this loan with financing from credit institutions. In any case, the amounts lent from the public purse plus the applicable interest will be paid back in the future, as and when the Resolution Fund accumulates revenue.

Finally, at the end of the operation, the State should not have to bear any costs related to the resolution of BES. Time will tell, but it is very unlikely that *Novo Banco's* sale price will be enough to repay the State the amount it lent to the Resolution Fund. If that turns out to be the case, only two possibilities remain. Either the members of the Resolution Fund, in other words, most of the banks operating in Portugal, provide the Fund with the amounts necessary to pay the State's loan, or the State forgives part of the amount it lent, meaning the public will bear the cost of the intervention in BES.

It is important to remember that the resolution action has been legally challenged by a number of entities and all the cases are now before courts.

Consequences of the resolution action for customers and shareholders – the particular concern to protect the interests of customers

According to *Banco de Portugal*, the resolution action it applied is intended to guarantee the security of deposits made in BES and to maintain the contractual conditions of the credits granted by that bank. *Banco de Portugal* holds that there have been no effects on the legal or contractual rights of depositors. The deposits are transferred in full to *Novo Banco*, except for deposits made by persons having a special relationship with BES. Despite this show of intent by Banco de Portugal, reality has shown that the application of the measure has indeed affected the bank's customers, resulting in intense litigation before the Portuguese courts.

The deposits transferred to *Novo Banco* and not subject to any dispute are available for immediate use by customers, without any restrictions (except those that already existed with BES). These customer deposits in *Novo Banco* have exactly the

same characteristics they had in BES: namely, the same balance, term and conditions of operation of the deposit. These deposits also continue to benefit from the guarantee offered by the Deposit Guarantee Fund.

In contrast with the outcome described above, the shareholders of BES, now transformed into a bad bank, have seen primary responsibility for the debts resulting from the financial imbalance of BES moved into the sphere of the company they hold.

Under the applicable legal rules, the fact that the set of assets with the greatest value were transferred to *Novo Banco* (the good bank), leaving behind the toxic assets, does not, in itself, give the shareholders any right to compensation. As the part of BES's business that was not transferred to *Novo Banco* will be subject to a liquidation process, any rights the shareholders may have will have to be exercised in the context of that process, under the applicable law.

Final considerations

Having reached the end of our story, we have also reached the conclusion that the resolution action applied to BES by *Banco de Portugal* is an innovative solution in the context of the European Central Bank's protection mechanisms. As such, the 'good bank/bad bank' solution will have to pass under the scrutiny of the courts in the pending legal proceedings before it is considered stabilised.

Furthermore, the resolution action may violate principles of distributive justice.

Time and the courts will tell whether the action taken by Banco de Portugal stands. ■

Footnotes:

- 1 This negative public perception led to the suspension of transactions on the afternoon of Friday, 1 August 2014, with the risk of contaminating the perception of all the other institutions in the Portuguese banking system.



THE 'GOOD BANK/BAD BANK' SOLUTION WILL HAVE TO PASS UNDER THE SCRUTINY OF THE COURTS IN THE PENDING LEGAL PROCEEDINGS BEFORE IT IS CONSIDERED STABILISED



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