Lessons from the collapse of two banks in Portugal: implications for banking management and regulation

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Lessons from the collapse of two banks in Portugal: implications for banking management and regulation[1]

ABSTRACT

It is almost 10 years since one of Portugal's five largest banks, BES, was subject to a bank resolution measure. In 2015, another large bank, BANIF, followed the same path. Now that some time has passed and the full consequences of the resolutions materialised, it is time to reflect on the causes of the crises at these two banks and to draw lessons for the future. In addition to looking into the relevant literature, official company reports, parliamentary inquiries, newspapers and other public information, we examine whether key financial ratios could have raised a red flag. We conclude that the collapses were explained by a mixture of macrostructural causes and above all bank-specific factors. The two cases are good illustrations of the negative effects of financialisation in the Portuguese economy. The key profitability and risk indicators provided some timely indications of the problems facing the two banks.

Keywords: banking crises, risk management, banking regulation, Portugal, financialisation.

1. Introduction

If the banking system is to work as an engine of economic development, risk management must be at its heart, as the subprime crisis shows. This article analyses the risk management of BES (Banco Espírito Santo) and BANIF (Banco Internacional do Funchal), two Portuguese banks that were subject to a resolution in 2014 and 2015, respectively. These cases clearly exemplify the severe banking crisis in Portugal between 2008 and 2015 (Cardão-Pita and Batista, 2016). Non-academic works on this matter include bank reports, supervisory reports, parliamentary enquires, and newspapers; among the academic papers addressing this subject, notably those of Chiang et al. (2015), Cardão-Pita and Batista (2016), Teixeira (2017), Antunes (2018), Silva and Pereira (2020), and Coutinho dos Santos and Garoupa (2023), some have taken a more macroeconomic perspective, while others focus only on BES. We add to the literature by analysing the two banks in light of the academic and non-academic literature within the context of the financialisation

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process of the Portuguese economy, and explore key financial ratios to determine whether it would have been possible to anticipate the downfall of the two banks. Our goal is to understand what went wrong in bank management and supervision so that lessons can be drawn for the future.

The literature identifies the bank characteristics that foster a better performance, especially in crises. Beltratti and Stulz (2011) conclude that good governance, lower risk propensity, more Tier 1 capital, more deposits, and more stringent supervision help explain the good financial performance of banks in the 2008 crisis. Similarly, Le Quang and Scialom (2021) and Cao and Chou (2022) show that the capital buffers built before the Covid-19 shock helped limit its impact on the banking system and assured a stronger lending supply.

Klein and Turk-Ariss (2022) conclude that higher capital ratios promote financial stability and GDP growth. In a study of 50 Luxembourg banks, Giordana and Schumacher (2017) find that Basel III liquidity provisions contribute to lowering the probability of bank default. In emerging economies, the impact of bank capitalisation and liquidity on profitability is positive, but that of non-performing loans (NPLs) is negative (Albulescu, 2015). Mota et al. (2019) conclude for Portuguese banks in the period from 2006 to 2016 that profitability is negatively affected by higher financial leverage and higher credit risk.

Building on the literature, we will examine the evolution of financial ratios (capital, return, non-performing loans, and leverage) as predictors of the resolution of BES and BANIF, and make a qualitative analysis of both risk governance and the macroeconomic environment.

The paper proceeds as follows. Section 2 provides an overview of the Portuguese banking system in the crisis period from 2008 to 2013. Section 3 describes the collapse of BES while Section 4 explains the downfall of BANIF. Section 5 presents an analysis of how financial ratios could have been used to anticipate the collapse of the two banks. Finally, Section 6 concludes.

2. Performance of Portuguese banks during the subprime and the sovereign debt crises

Following Portugal's accession to the European Union (EU) in 1986, the privatisation, liberalisation, and deregulation of the financial system together with a favourable macroeconomic environment with lower interest rates led to high growth in both credit and banking activity from the late 1990s to 2008. Moreover, with the elimination of the exchange rate risk after the introduction of the euro, the Portuguese banking system was able to provide credit domestically as it could obtain financing abroad at a lower cost.

The context began to change with the international financial crisis of 2008, which started in the US before spreading to Europe. Exports fell, European banks made losses due to toxic financial products (although Portuguese banks were not affected significantly), and there was a lower appetite for risk, greater difficulties in financing banks and rising risk premiums on public debt, especially for the most indebted countries.

Although Portugal did not experience the same subprime lending as the US or a real estate bubble (Lagoa et al., 2013), there were other specific problems. The financialisation process of the Portuguese economy from the mid-1990s made the economy more vulnerable to external shocks (Barradas et al., 2018) due to greater risk-taking by financial institutions; this was reflected in weaknesses in capital (lower solvency) and liquidity (lower deposit base), a growth in private debt (firms and households) and public debt, and a concentration of credit in the construction and real estate sectors.

Cardão-Pito and Batista (2016) add that other problems in the banking system may have led to the credit boom-bust cycle: the strong link between politicians and banks, and the poor preparation of bank management to work under the euro. There were also problems at the European level, with a lack of institutions and regulations to deal with the consequences of euro integration for financial systems.

The problems in peripheral countries, including Portugal, in conjunction with increased risk aversion led to a transfer of capital from the periphery to the centre of the euro area. As Portuguese banks were heavily dependent on financial market funding, their main difficulty became obtaining funding from international financial markets; this was offset by the issuance of bank bonds with a state guarantee, the injection of liquidity and cuts in interest rates by the European Central Bank (ECB) (Lagoa et al. 2013).

The financial markets eventually cut off funding to southern European countries and Ireland, which were facing the most serious problems, exacerbated by higher debt levels and weaker economic growth potential. Portugal and the other countries that were unable to finance themselves on the markets resorted to "troika" financing. Between 2011 and 2014, Portugal faced a severe economic crisis and the implementation of an Economic and Financial Adjustment Programme (EFAP - 2011-2014) for the recovery of the economy.

As a result of the subprime and sovereign debt crises, the growth trend of the banking sector was reversed, with a reduction in the volume of credit, banks' profitability and the deterioration of their risk profile, triggering enormous difficulties for several banks (Mota et al. 2019). Excessive concentration in real estate and construction proved costly when these sectors entered into crisis.

The construction and real estate sectors were among the hardest hit by the crisis, even though their output had been falling from 2002 according to Eurostat; this was partly due to oversupply as a result of easier credit for companies in the sector. Under the troika, the EFAP required austerity policies to be implemented that had a particular impact on the construction sector due to the reduction in public and private investment and credit supply. The overdue credit ratio in the construction sector remained much higher than in other sectors, reaching a peak in December 2016 (Figure 1).

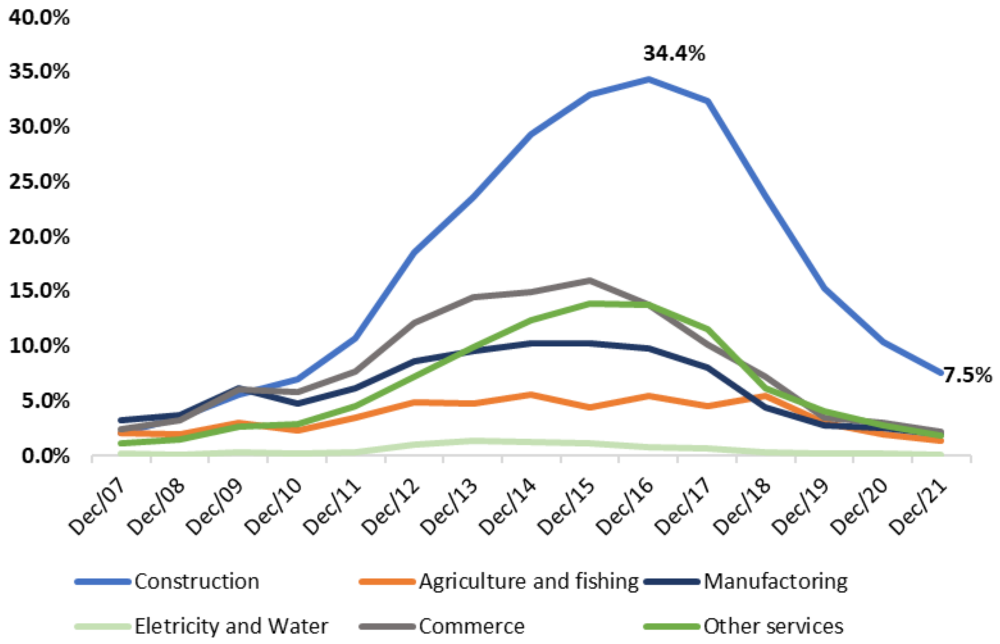

Figure 1. Overdue Loans Ratio[2] by sector

(Source: BoP, 2012 and 2022)

Among the main objectives of the EFAP were the deleveraging, capitalisation, restructuring and cost reduction of banks. The programme dedicated 12 billion euros to boost the capitalisation of the banking system and advocated the strengthening of the supervisory role of the Bank of Portugal (more human resources for supervision and more on-site inspections of banks) – Coutinho dos Santos e Garoupa (2023). Using financial resources from the Troika, public funds were injected into the major banks, namely Banco BPI, CGD, Millenium BCP and BANIF; however, BES and Santander did not use public money (Cardao-Pito & Baptista 2017). Thus, the EFAP led to a process of bank capitalisation and deleveraging, with the transformation ratio (net

2 Non-performing loans between 2007 and 2009 and overdue loans between 2010 and 2021.

loans to customers/customers' funds) accentuating the downward trend that had been in place since 2009 - Figure 2.

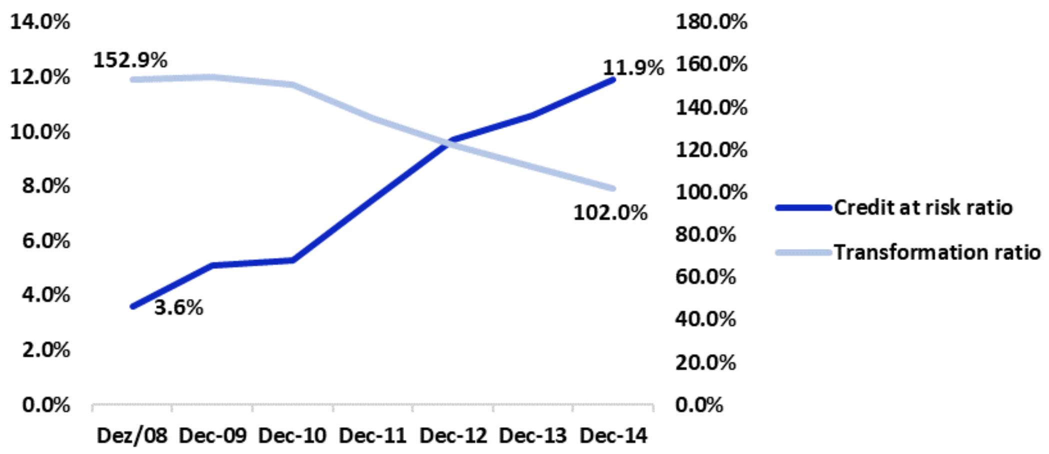

Figure 2. Credit at risk ratio and transformation ratio of the Portuguese Banking Sector (PBS)

(Source: BoP, 2022b)

After the first banking crises with BPN and BPP in 2008 and 2010, the most severe phase of the banking crisis in Portugal unfolded with the resolutions of BES in 2014 and BANIF in 2015; this phase only began a few years after the onset of the economic crisis and after non-performing loans had increased sharply, reaching a peak in 2015.

Financial stability was restored through the recapitalisation of the banking sector and the reduction of both the transformation ratio and non-performing loans (Weise & Economy 2020). The implementation of Basel III in the European Union in 2013 and in Portugal in 2014 also contributed to this. BES was not managed under Basel III regulations and BANIF was only affected by them from 2014. However, both banks felt the impact of higher capital requirements from 2011 in anticipation of the implementation of the Accord.

3. The collapse of BES and the Group Espírito Santo

3.1. Group Espírito Santo – Constitution, characteristics and composition

Credit institutions in Portugal were nationalised in 1975 and subsequently reprivatised in the 1980s. The Group Espírito Santo (GES) regained control of BES in 1986, initiating a series of projects to reorganise the administration, modernise technology and improve service quality.

The GES adopted an organic growth strategy that greatly increased its size, obtaining interests in both the financial and non-financial sectors (Coutinho dos Santos and Garoupa, 2023). According to these authors, in addition to business objectives, this growth sought to increase political capture, which may explain the regulatory failures regarding the bank. In booms, it is common for the financial sector to grow and to become more profitable and influential, and consequently its regulation becomes less strict (Reinhart and Rogoff, 2011). The growth in business conglomerates, such as GES, was supported by an ideology that defended Portuguese conglomerates were good for the economy.

The GES became a highly complex structure, comprising around 300 financial and non-financial companies located in almost 50 countries. As presented in the final report of the Parliamentary Commission of Enquiry on the management of BES and GES – herein Saraiva (2015), the Luxembourg-based Espírito Santo Control (ES Control) and Espírito Santo Internacional (ESI) (controlled by ES Control) represented the non-operational holdings that controlled the financial and non-financial branches. In the financial branch, the banking, insurance and financial activities, including Group BES (GBES) and, within it, BES, were held by GES through a holding company (Espírito Santo Financial Group - ESFG, based in Luxembourg).

In the non-financial sector, the most important structure was the holding company Rioforte, also based in Luxembourg. Rioforte and other companies were active in sectors as diverse as health, tourism, property development and management, construction, agriculture and livestock, industry, mining and energy. BES accounts (by volume of assets) at the end of 2013 showed a value of €80,608 million, representing 95% of the consolidated value of ESFG's assets (€84,850 million) - GBES (2013). This compares with an asset value of 4,350 million euros for Rioforte (the holding company for the non-financial branch). Here we see that GES was completely dominated by BES in terms of assets value. This is common for banking groups in Portugal as the commercial bank dominates the financial group due to its size. The money of BES and its clients was used by GES to invest in the most diverse sectors, creating additional potential risks for the bank.

BES was a systematically important bank as it was one of the largest private banks in Portugal (the third largest) with a market share of 11.5% in domestic deposits, 31% in financing financial and insurance activities, and 19% in loans to non-financial companies (Saraiva 2015).

3.2. Main causes of the BES collapse

Banks in general, and BES in particular, faced difficult times following the subprime crisis of 2007-2009 and the subsequent sovereign debt crisis (2010-2013). More specifically, the devaluation of real estate implied losses resulting from GBES's exposure to this sector. The crisis also had a strong negative impact on the various sectors of activity in the non-financial branch of GES, making it more difficult to access financing outside GBES. At this point, it became clear that the GES conglomerate was oversized (Coutinho dos Santos and Garoupa, 2023).

However, unlike other national banks, BES did not take advantage of the recapitalisation available under the EFAP for Portugal. Instead, it opted for three capital increases to meet the Portuguese Central Bank's (Bank of Portugal, BoP) requirements for higher core Tier 1 capital for all banks in the context of the financial crises and the future adoption of Basel III.

The financing of the non-financial branch of GES

It is generally agreed that the collapse of BES was caused primarily by the excessive indebtedness of the non-financial branch to the financial branch of the group. There are several historical examples where the inclusion of banks in conglomerates led to bad debt problems, such as in Korea and Japan (Lemieux, 1999).

The exposure of GBES to the non-financial branch of GES exceeded EUR 5,000 million and represented almost 70% of ESI's debt as of 31 December 2013. Analysing BES in particular, its total exposure (assets, including loans and securities held) to its subsidiaries (financial and non-financial) amounted to EUR 8,832 million in December 2013 (the largest being to BES Angola); in addition, there were guarantees of EUR 7,238 million *vis-a-vis* a core Tier 1 capital of EUR 6,081 million (GBES, 2013), demonstrating the bank's vulnerability to losses in the GES universe.

Exposure to the non-financial sector of the group was both direct (debt held by BES) and indirect, through commercial paper of the non-financial branch purchased by BES's retail and institutional clients and other banks controlled by the group. Initially, one of the funding strategies used the Espírito Santo Liquidity Fund, marketed at BES branches, which invested almost all of its funds in GES debt (Garrido, 2016) However, following changes to the legislation made by

CMVM in 2013, it was necessary to reduce this concentration, so GES debt started to be sold directly at BES branches. As regulators created more obstacles to the sale of commercial paper to BES clients, it was the bank itself that was increasingly called upon to make loans to GES.

Another regulatory measure was the BoP's decision in July 2013 to ring-fence ESFG's exposure to ESI but this was only observed in retail banking (the bank was prohibited from selling commercial paper in its branches) and did not significantly reduce the overall exposure. As a result of the commercial paper of non-financial companies of the Group sold at BES branches, ESFG was required to make a provision of EUR 700 million.

In response, BES became more creative in order to continue funding through its retail clients, creating a range of financial products for its clients, such as preferred shares, which are in effect GES debt (Garrido, 2016). Thus, BES did not respect the BoP ring-fencing requirement.

Portugal Telecom (PT) (of which BES was a shareholder) was another major buyer of GES commercial paper, investing 90% of its cash in these securities (totalling EUR 900 million). The insurance company Tranquilidade was also used to finance the group (Garrido, 2016). Large companies such as PT also contributed to the financing of GES through dividend payments (Campos and Vicente, 2017). This is one of the reasons why dividends paid by non-financial corporations increased in Portugal in the period before 2008 (Barradas et al., 2018).

The uncovering of serious problems

As doubts about the link between GES and BES grew in 2013, the BoP requested several reports on the impairment of the loan portfolio, on loans granted by ESFC group to GES from KPMG and PwC, as well as two limited audits of ESI's accounts (Saraiva, 2015). Several accounting irregularities were found at ESI.

The main problem was ESI's debt to GBES as the audit conducted by PwC (*Exercício Transversal de Revisão da Imparidade da Carteira de Crédito 2* - ETRICC2) in November 2013 found an understatement of ESI's financial liabilities of €1.33 million as of 31 December 2012. However, the distortion of the accounts went back to the onset of the Subprime crisis in 2008, which triggered the abovementioned problems for GES; according to Saraiva, 2015, this was the first key moment in the fall of BES, to be followed by a further three. In addition, the KPMG audit of January 2014 reports overvalued assets and underestimated provisions, and ESI therefore began to register negative equity of 2.4 million euros (Morais, 2014; Chiang et al., 2015). This is evidence of what Silva and Pereira (2019) call a carousel scheme within GES to improve the financial statements of BES. Distressed banks usually try to hide negative information from the public to maintain their funding capacity (Reinhart and Rogoff, 2011).

BES used either its bank in Panama to lend to itself, or BESA – BES Angola (based in a less regulated country) to lend millions to unknown entities. The BES case illustrates the difficulty of tracing funds across borders as a result of failures in the international regulatory system, particularly in the detailed disclosure of information about transactions between subsidiaries in different countries of the same parent company (Sharife, 2016).

The Espírito Santo family dominated the GES shareholder structure, which eventually made it difficult to control and to oppose harmful management practices that often sought to protect the family universe. Notwithstanding, it was a family member who disclosed the concealment of debt at ESI to the BoP in May 2014.

Ricardo Salgado was the head of the family, the CEO of BES and the head of GES and had determined decisively the group's strategy for over 20 years. Although the board of BES had members from outside the family, it is said that their meetings were a formality to approve what was decided by the Chief Executive Officer (CEO) (Antunes, 2018) and that many directors felt pressured by his power (Simo, 2017). The centralisation of power in the CEO, the control over who was nominated director by him and his family, the lack of independence of some directors, the oversized board of directors, and the lack of protection of minority interests were important failures in BES corporate governance. Had they have been addressed, the failure of the bank might have been prevented (Gomes, 2017).

In May 2014, ESFG issued a statement announcing that irregularities had been found in ESI's financial statements. The information that came to light created a crisis of confidence in BES and aggravated the liquidity problems it was already facing due to its high transformation ratio. Deposits decreased in the second quarter of 2014, and this decline was even more pronounced in July 2014. Due to lack of liquidity, BES was forced to resort to the Emergency Liquidity Assistance (ELA) facility managed by the Bank of Portugal, which had already lent it €3.5 billion by 1 August 2014.

The last month and a half of Ricardo Salgado's leadership was a time of ruinous operations consisting of the issuance of bonds by BES, which were then used by a GES company (Eurofin) through a complex scheme to acquire GES debt and pay off some customers, leaving BES with a hole of 750 million euros (Garrido, 2016). Letters of comfort were also issued to Venezuelan investors. These two operations led to a high volume of provisions (see below). This also shows that the risk of losses increases as the collapse of a financial institution approaches.

Nevertheless, the BoP informed the market on 11 July 2014 that BES had sufficient equity to cover the exposure to the non-financial branch of GES (BoP, 2014), probably in an attempt to calm the market.

In July 2014, BES registered a provision amount of approximately EUR 4,253 million. This was largely explained by the provision of EUR 2,000 million required by the supervisor (BoP) on 23 July 2014 derived from GBES's exposure to the non-financial branch of GES, as well as the EUR 1,500 million provision determined by KPMG as a result of specific financial operations (repurchase operations of GES bonds held by retail customers) and the issuance of two comfort letters to Venezuelan institutional investors in GES debt (according to Saraiva, 2015, the constitution of these two provisions were two other key moments in the bank's fall).

As a result of the additional provisions, BES published negative results of EUR 3.57 billion in the first half of 2014. The BoP then issued a statement declaring that the facts "indicate the practice of management acts seriously detrimental to the interests of BES and a clear non-compliance with the determinations issued by the BoP" (BoP, 2014) - see also Silva and Pereira (2019). It ordered BES to make a capital increase, disqualified ESFG and ESF (another holding of the group) from voting, suspended some members of the management and supervisory bodies and appointed a supervisory committee. However, the BoP also argued that BES still met the conditions for the normal functioning of the bank and the full protection of depositors.

Whereas the solvency ratio and CET 1/ Core Tier 1 ratio were 11.8% and 10.6% respectively as of 31 December 2013, six months later these indicators were 6.5% and 5.1% respectively, below the regulatory limits of 8% and 7% respectively.

The final collapse

Already at the end of 2013, the first difficulties at BES Angola (BESA) (GBES held 55.7% of BESA) became known. BES exposure to this was €3,880 million and there were doubts as to whether BES would be able to recover this amount (in fact, BES recorded losses of €2,750 million with BESA at the end of August 2014). The problems at BESA stemmed from the granting of unsecured loans, in many cases with no known beneficiary. At the end of July 2014, it was announced that Angola's sovereign guarantee for loans granted by BESA would be withdrawn (this happened on 4 August 2014). According to Saraiva (2015), this was the fourth and final key moment in the collapse of BES.

Public capitalisation with Troika funds, which had been on the table, was eventually ruled out by the government, mainly to prevent the state from losing money (Garrido, 2016). On 3 August 2014, the governor of the BoP announced the resolution measure, under which 'most activities and assets of BES will be transferred to a new bank called "Novo Banco", which would be duly capitalised and purged of problematic assets. The State and the banks would inject €4.9 billion into BES (€3.9 billion through a State loan to the Resolution Fund and €1 billion from the

Resolution Fund on the grounds that the banks would pay the cost of the resolution). To protect the good assets and depositors, the bank was split in two: the bad bank remained for the shareholders, who lost almost all the money they had invested, and the good bank - Novo Banco (NB) - integrated the healthy assets of the former BES (Jornal de Negócios 2014).

The resolution of BES took place at a time of transition when the ECB took over the supervision of large financial institutions in the euro area. It has been suggested that the Bank of Portugal's performance as a supervisor had been failing over a long period of time (and not just in the last years of BES), and that it had been slow to recognise BES's problems and also excessively tolerant of the bank's behaviour (Antunes, 2018; Coutinho dos Santos and Garoupa, 2023). A journalistic investigation by a leading television channel (SIC) concluded that the BoP had been aware of serious irregularities at BES since late 2013 (Silva and Pereira, 2019). DECO (one of the main Portuguese consumer associations), cited by Sharife (2016), argues that there was a complete failure on the part of the supervisory authorities. The removal of the fit and proper status of the CEO of BES was another issue that could have been addressed further and earlier, and which was being investigated (Garrido, 2016). The supervisor placed too much trust in the suitability of the bankers in general (Campos and Vicente, 2017).

As a rule, regulation tends to be pro-cyclical towards the end of booms even though the opposite would be preferable (Reinhart and Rogoff, 2011); this is perhaps explained by overconfidence and a desire to forget past crises (Minsky, 1982).

In the supervisor's favour, it should be noted that as the non-financial arm of GES was not under its regulatory purview, it was more difficult to detect the problems that germinated within it (Antunes, 2018). The regulator's work was hampered because audit firms failed to detect accounting fraud. There was no rotation of firms and many of the firms had conflicts of interest because they also offered consultancy services that they wanted to favour (Campos and Vicente, 2017).

The resolution of BES did not have a major impact on the banking system (BANIF was one of the banks that lost the most) because the problems were anticipated and many banks had recovered their money in time (Garrido, 2016).

Novo Banco (NB) was kept under public management for some time but was privatised in October 2017 when 75% of the capital was sold to an investment fund (Lone Star) for one thousand million euros. To reassure investors, the sale contract provided that the Resolution Fund would reimburse NB for losses on the loan portfolio inherited from BES (the contingent capitalisation mechanism provided for a maximum transfer limit of €3.885 billion). The expected losses materialised: between 2018 and 2021, total losses on BES's problematic assets were €4367 million, with the Resolution Fund transferring €3.4 billion to NB (Tavares, 2021). This demonstrates that credit risk was a serious issue at BES and that it was undervalued even after all the audits that had taken place.

As in other Portuguese banks, there were failures in credit risk management at BES and loans were granted to large counterparties without sufficient analysis and guarantees; there were various cases of the predominance of personal criteria, proximity to the CEO, exchange of favours, loans to businessmen to buy shares in a competing bank, and political criteria (Campos and Vicente, 2017). In 2016, the published list of the 21 largest debtors of what is now NB corresponded to a total of €6.6 billion (of course, not all of this debt was in default) - Jornal de Negócios (2016).

Synthesis of the main causes of the downfall

The main causes leading to the liquidation of BES are summarised below.

- The international financial crisis (2007-2009) and the sovereign debt crisis (2010-2013) made it difficult for GES to obtain financing outside its universe, caused heavy losses in several of its businesses and also led to an increase in non-performing loans at BES. With the crisis, GES's expansion into various businesses proved to be excessive and misjudged investments may have been made.
- Excessive indebtedness of the financial branch (GBES) to the non-financial branch of GES (direct and indirect exposure), leading to a provision of €2bn.
- Lending to large customers without adequate risk analysis and collateral requirements.
- Concealment of liabilities in ESI's accounts in 2012 and overvaluation of ESI's assets. In times of crisis, there is a tendency for some banks to hide losses by manipulating their accounts, which justifies the intensification of audits in these periods. The distorted financial reporting played an important role in concealing the difficulties of GES and preventing the adoption of corrective measures that could have avoided the resolution. Accounting irregularities were facilitated by subsidiaries located in tax havens and countries with weaker regulation. A corporate governance structure with an emphasis on integrity in financial reporting would have been a key element in avoiding the failure of BES (Simo, 2017).
- Management practices of senior administration were detrimental to the interests of BES - in the granting of credit, including in BESA, in accounting, and in last minute ruinous operations (BoP, 2014; Saraiva, 2015) and did not comply with Bank of Portugal guidelines (BoP, 2014).

- Failures in corporate governance, mainly due to the power of the CEO and the Espírito Santo family over shareholders, which made it difficult to control and counteract management measures that proved to be harmful.
- The Bank's crisis since 2013 created a vicious circle. The structurally high liquidity risk was exacerbated in 2014 by the flight of deposits caused by the crisis of confidence in the bank. The various provisions made by the bank eroded its capital, which in June 2014 was below the level required by the supervisor.
- Possible supervisory failures by the BoP, together with failures by audit firms and in the international regulatory system of banks located in different geographies. The complex ownership structure of GES spanning across different geographies, some of them offshores, made it difficult to control the flow of financial operations.

4. The collapse of BANIF

4.1. BANIF: constitution and characteristics

Banco Internacional do Funchal (BANIF) was founded in 1988 by Horácio Roque (Chairman of the Board of Directors until 2010, when he died), among others through the incorporation of Caixa Económica do Funchal, an institution that was going through difficulties (Teixeira 2017). BANIF began its activities on the island of Madeira and later expanded to the Portuguese mainland and other countries (it was present in 17 countries), such as Brazil, Malta and Cape Verde. In 1996, the Group acquired Banco Comercial dos Açores, which owned 100% of Companhia de Seguros Açoreana. In 1999, BANIF took its first step towards internationalisation by acquiring a position in BANIF Primus (an investment bank in the Brazilian market) and later, in 2000, the BANIF Financial Group created BANIF - Banco de Investimento. The expansion to Malta in 2008 and Spain in 2010 took place after the 2008 crisis in what was a clearly counter-cyclical move (Garrido, 2016).

As a medium-sized financial group (the seventh largest Portuguese banking group) with a presence in the insurance market, BANIF was the market leader in the Portuguese Autonomous Regions of Madeira and the Azores. BANIF's shareholder structure in 2013 was heavily influenced by the founder's family: 54% of the shares were held by Rentipar Financeira SGPS SA, owned by Horácio Roque's family (BANIF, 2013).

4.2. Main causes of the collapse of BANIF

Structural problems and the state capitalisation of the bank

The main cause of BANIF's demise indicated in the literature is the granting of excessive and poor-quality credit, particularly to the real estate and construction sectors at a time of their exponential growth. BANIF had a slightly above average exposure to construction and real estate in 2014 (33% and 31.1%, respectively); the problem was not so much quantitative, but more of the poor quality of credit to these sectors. With the subprime crisis, the devaluation of the property market impaired the ability of construction and real estate companies to pay off their bank liabilities, and as a result, BANIF suffered from high levels of default in those sectors.

The bank also had a high exposure to the small and medium-sized enterprise (SME) segment, in which non-performing loans reached five times that of large companies during the crisis in Portugal (2011-13). BANIF's credit growth above the sector average between 2008 and 2011 and countercyclical to the economy (see Parliamentary Commission of Inquiry to BANIF - Dias, 2016, and Figure 6) contributed to higher default levels This was compounded by the death of the founder, Horácio Roque, in 2010.

The high level of non-performing loans from 2011 onwards demonstrated poor credit risk analysis, particularly in the assessment and monitoring of loans and in the valuation of collateral - overvalued properties due to the ineffective work of property valuers (Dias, 2016). The forensic audit of BANIF in 2011 and 2012 found that half of the exposures analysed were approved by the Executive Committee without justification and with an unfavourable opinion from the Global Risk Directorate; that some proposals lacked risk analysis; and that financing was approved in the knowledge that the customer was unable to pay (Dias, 2016). Computer fraud was used to ensure that loans were not declared in default. One of BANIF's most serious problems, which was discovered in 2012, involved illegal behaviour and very poor credit risk analysis in Brazil (Garrido, 2016), resulting in losses of €267 million.

Under the EFAP, in 2012 inspections were carried out particularly of the methodologies and parameters used by the eight largest Portuguese banks to assess their risk and solvency. The institution that received the worst rating was BANIF, due to its exposure to real estate and construction (Dinheiro Vivo, 2012) and to small and medium-sized enterprises (Madeira, 2015).

In general, the economic crisis in Portugal between 2010 and 2013, the increase in funding costs, low interest rates (which prevented high margins) and the unfavourable international environment prevented the strengthening of capital by internal means at a time when capital requirements increased. The economic crises also hampered access to funding on international markets, leading to a lack of liquidity. Overall, the bank's profitability was low from 2011 onwards (Figure 4).

Audit firms did not do a good job of detecting problems at the bank (Garrido, 2016; Dias, 2016). For example, there were gaps in BANIF's information systems and property classification, and the bank did not know exactly which properties it owned (DN, 2016).

With the temporary approval of the European Commission (European Commission, 2015), BANIF received state capitalisation of €1.1 billion In January 2013 with the aim of ensuring compliance with minimum regulatory capital requirements (Azevedo, 2014). The bank was recognised as being of systemic importance and therefore the concern was to maintain confidence in the banking system. The recapitalisation was very large relative to that of other supported banks. Moreover, whereas the recapitalisation of other private banks was only convertible bonds (CoCo loans), in the case of BANIF the State injected capital (700 million euros, and the remaining 400 in CoCo loans). State support strengthened customers' confidence in the bank (Garrido, 2016).

In return, the bank had to implement a restructuring plan, selling non-core and unprofitable businesses, and repurchasing the convertible bonds acquired by the state. The state aid had to be approved by the European Commission (EC) to ensure that it was not illegal (Teixeira 2017). However, the BoP and BANIF disagreed with the EC on the restructuring plan, so successive versions (eight in total) were submitted between 2013 and 2015. The Commission rejected all of them as it did not agree that the bank's long-term viability was guaranteed due to the lack of a good corporate strategy and a very dispersed geographical presence and product range; it argued that the bank should reduce its geographical focus (Dias, 2016).

The public recapitalisation plan envisaged that the shareholders would increase the capital by June 2013, reducing the public aid to €950 million. The capital increase did not take place until May 2014, which caused mistrust, especially in the EC, and showed that BANIF's shareholder structure was incapable of supporting it in a time of crisis (DN, 2016). Basel III was implemented in Portugal in 2014, but with an anticipated increase in regulatory capital in 2010 and 2011, which BANIF had difficulty in ensuring.

The problems of the final phase

Just when it seemed that BANIF was taking a turn for the better, BES collapsed in August 2014. Cross-lending with this bank led to losses of €120 million for BANIF and demonstrates the contagion effect of BES due to the institutions' interdependence. There was a circular lending arrangement between BES and BANIF whereby each lent to companies owned by the other's shareholders or to companies in the other's group, to avoid the restrictions imposed by the regulator. Although the regulator detected this situation and decides that the operations reduced the banks' capital, it did not vigorously prohibit them (Garrido, 2016). Even without these operations, BANIF's exposure to its own group amounted to 200 million euros in 2012, with a core Tier I of 72 million euros (Dias, 2016). In addition, as in BES, debt securities of a related party (Rentipar) were sold at BANIF counters using marketing approaches where the product sold did not always fit the customer risk profile (Dias, 2016).

Due to the BES losses and other impairments, BANIF was unable to pay the €125 million it owed to the state (a very similar figure to that applied in BES) in December 2014, (Madeira, 2015).

In the absence of an approved restructuring plan, the EC opened an investigation into state aid to BANIF in July 2015. In October 2015, a change of government led to an exchange of political accusations and BANIF was perceived in public opinion as a problem, thus leading to a run on deposits. In December 2015, the media reported the bank's imminent collapse, which resulted in a €1 billion run on the bank's deposits. That same month, the administration made an unsuccessful attempt to sell the bank, which therefore had to rely on emergency liquidity funding from the BoP.

On 18 December 2015, the EC declared that it had doubts that the aid to BANIF was compatible with Single Market rules. From that date onwards, the EC could declare the state support to BANIF illegal, which would have resulted in the bank returning the amount to the state (Azevedo 2014).

Like BES, BANIF, became subject to resolution as a result of all these developments. On 20 December 2015, the BoP applied two types of resolution measures to BANIF (partial sale of the business and separation of assets) (Azevedo 2014), announcing that same day the sale of BANIF to Banco Santander Totta for €150 million and the transfer of the troubled assets to an asset management vehicle (Naviget, S.A., later renamed Oitante, S.A.). The resolution was supported by the state (€1,766 million) and the Resolution Fund (€489 million), totalling €2,255 million for Oitante's capital to cover future losses, and it requested an Amending State budget at the Parliament (Mendes 2016). In addition to taxpayers, losses were also made by small investors in shares, in BANIF's subordinated bonds and in bonds of related parties.

Synthesis of the main causes of the downfall

The main causes of BANIF's collapse can be summarised as follows:

- The death of the founder, Horácio Roque, in 2010 triggered a leadership crisis.
- Limited risk and collateral assessment methods, high exposure to the real estate and construction sectors and the Small-Medium Enterprises (SME) segment, and counter-cyclical credit growth after the 2008 crisis, which together led to a high level of non-performing loans when the crisis hit the bank. Audit firms were unable to detect problems in the bank's information system and in the valuation of collaterals.
- Cross-operation with BES produced a loss of €120 million, coupled with BANIF's considerable exposure to its own group.
- Deterioration of equity as a result of excessive losses due to increased credit impairments and funding costs, which led to non-compliance with prudential capital requirements, forcing public capitalisation, and making it difficult to build up capital by retaining earnings. This was compounded by the absence of a shareholder structure capable of capitalising the bank when it was in difficulty.
- Absence of a restructuring plan unconditionally approved by the EC and non-compliance with the agreed temporary plan. After the public capitalisation in 2013, the restructuring plan was not approved and the bank's situation remained unresolved; it was hoped the bank would be sold (Garrido, 2016). The European authorities, in particular the European Competition Directorate General (DG Com), created obstacles in the process and acted contradictorily (Dias, 2016); there were also disagreements on the restructuring plan (even between the DG Com and the Troika team). In addition, the DG Com had a bias towards nationalisation and there was the idea of consolidating European banking. The delay in finding a solution for the bank created mistrust among depositors and led to a run on deposits. The lesson from this case is that when a bank is in difficulty and can be rescued, the authorities must resolve the problem quickly; otherwise, the situation tends to get worse over time.

Teixeira (2017) highlights several similarities in the fall of these Portuguese banks, notably in relation to the unsustainable business models both in macroeconomic and business terms. Firstly, the banks had high external indebtedness due to the limited domestic deposits base. Secondly, not only was there excessive trust in collateral rather than in borrowers' paying capacity, but the collateral was often real estate, the price of which fell sharply with the crisis. In the same vein, the governance model of the banks was often not compatible with the guidelines of authorities, leading to unsound management practices.

5. Forecasting problems in the two banks using financial ratios

In this section, we analyse the main BES and BANIF indicators of profitability, solvency and risk and compare them with the Portuguese Banking Sector (PBS) and GCA (Group Crédito Agrícola), which is considered here as a success case. GCA was chosen for comparison not only because of its good stability and profitability indicators, but also because it was not recapitalised with public funds during the financial crisis, and it follows a cooperative banking model. Our aim is to understand whether this analysis could have served as a warning of the banks' problems. The data used to assess the banks' indicators were obtained from the BoP, Eurostat and the reports and accounts of the respective banks on a consolidated basis.[3]

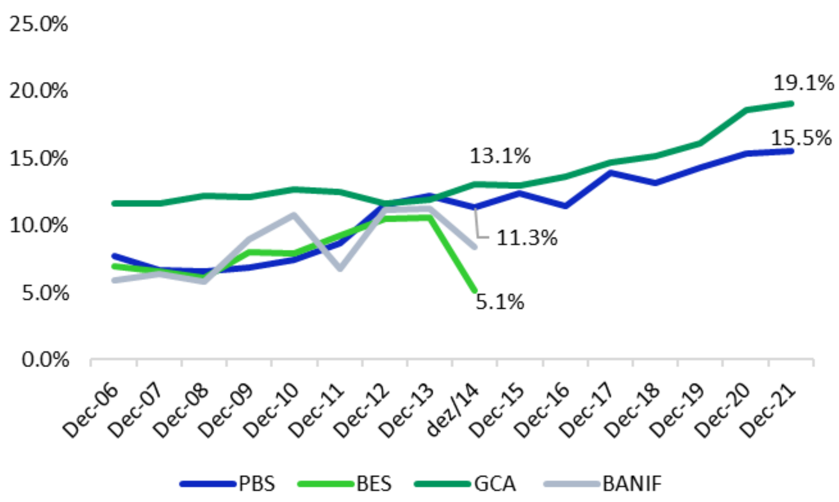

Figure 3. Core Tier 1/ CET1 ratio

(Source: Individual banks: reports and accounts of the respective banks, PBS: Financial stability reports of BoP (2006 and 2007), Portuguese banking sector: long series of BoP (2008-2021))

Under the EFAP, the BoP issued Notice 3/2011 which set minimum core Tier 1 (best quality capital) requirements of no less than 9% and 10% until the end of 2011 and 2012, respectively. Analysing Figure 3, BES's core tier 1 ratio was significantly lower than that of GCA but was in line with the sector average until 2011 and well above the minimum of 4.5% applicable before 2011. This was achieved through three capital increases (in 2009, 2011 and 2012), as the institution did not resort to public recapitalisation. It has been argued that BES did not resort to

3 Data for BES in 2014 refers to July.

public recapitalisation in order to avoid further scrutiny. The fact that it did not need state aid seemed to indicate that the bank was robust and sound, but perhaps the opposite was true.

The evidence analysed in Section 3.2 shows that BES accounts were distorted, at least in 2012 and 2013 (notably by the concealment of ESI's liabilities and the overvaluation of assets), and consequently it was likely that the bank had been compromising actual solvency indicators for some time. Even with the manipulation of accounts, BES deviated from the sector average in 2012 and 2013, suggesting underlying problems. Nevertheless, BES only failed to meet the required capital ratios in June 2014, and the resolution measure was applied in August 2014.

Regarding BANIF, notwithstanding the public capitalisation, the bank had had below sector Common Equity Tier 1 (CET1) capital ratios since 2011, after which this ratio declined sharply. In 2014, it was already showing a significant gap with other banks.

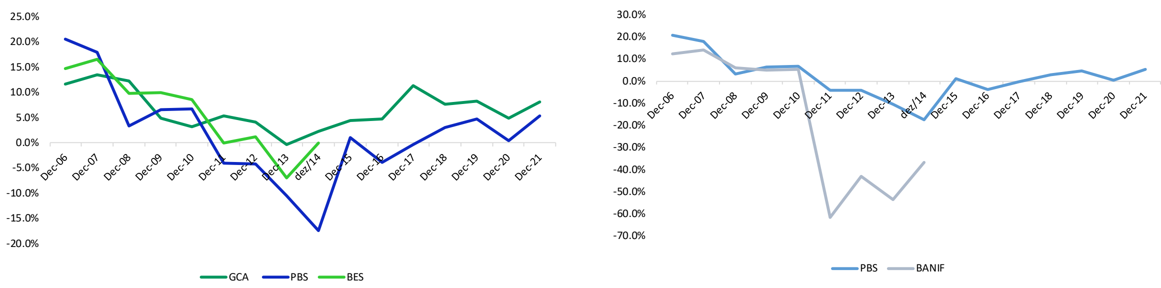

Figure 4. ROE

(Source: Individual banks: Reports and accounts of the respective banks, PBS: BoP Annual Reports 2006 and 2007, and Portuguese banking system: recent developments (Q1 2022), BoP).

BES's ROE (Return-on-Equity) was above the PBS average in the years before its decline, but below that of the GCA in 2011-13 (Figure *4*). On the other hand, BANIF's ROE started to fall significantly in 2011 and, unlike the banking sector, showed very negative values in the following years, which is indicative of an unprofitable business model in these years.

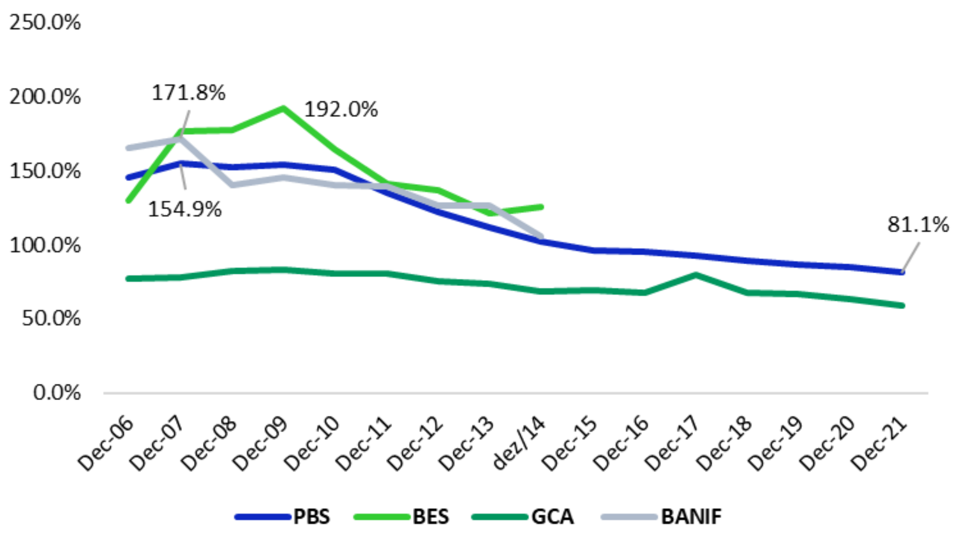

Figure 5. Transformation ratio

(Source: see Figure 4)

The transformation ratio relates loans to customers with deposits from customers and is a relevant indicator for assessing banks' liquidity risk. Between December 07 and December 09, BES's transformation ratio increased in contrast with that of the PBS (Figure *5*). According to Portuguese Banking Association (PBA) (2018), under the EFAP, the BoP recommended that the eight largest banking groups reduced the transformation ratio to 120% by the end of 2014; however the BES ratio was always higher than both the average and the 120% limit even though the deleveraging plan (implemented in 2010) helped reduce the transformation ratio to 121% until 2013. In 2014, transformation ratio of all banks except BES was below 120%. BANIF did not have excessive average transformation levels for the 2007 to 2014 period.

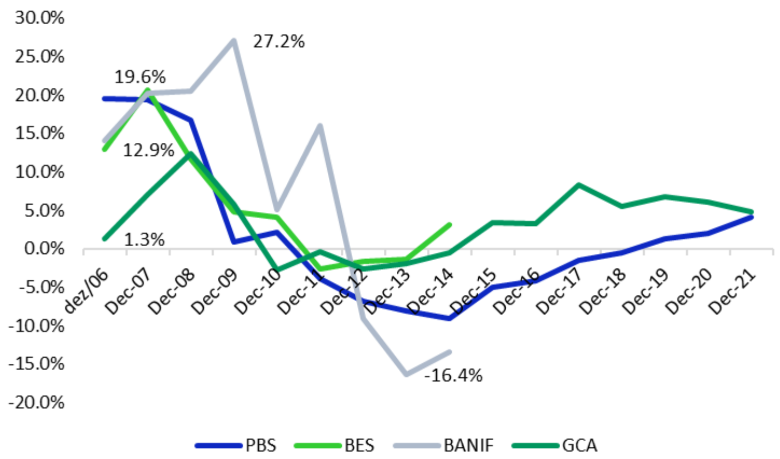

Figure 6. Change in loans and advances to customers.

Note: BES growth in 2014 only refers to the first semester. (Source: Individual banks: Reports and accounts of the respective banks, PBS: 2005-2007: BoP Financial Stability Reports (2006 to 2008), 2008-2021: Sistema Bancário Português Séries Longas: 1990-2021, BoP).

In terms of loans to customers, BES's credit growth from 2006 to 2008 was in line with the sector average and above that of GCA (Figure *6*). From 2009 to 2014, this growth was much more marked than the sector average despite the deleveraging efforts undertaken (less loans and more deposits). Note that during the sovereign debt crisis from 2011 to 2014, the behaviour of BES was similar to that of GCA, which tended to have a less procyclical credit supply due to its cooperative nature. On the other hand, as mentioned in the previous section, BANIF's credit growth was much higher than that of GCA and PBS between 2008 and 2011 but afterwards was much lower than the average, already reflecting the problems that the bank was experiencing.

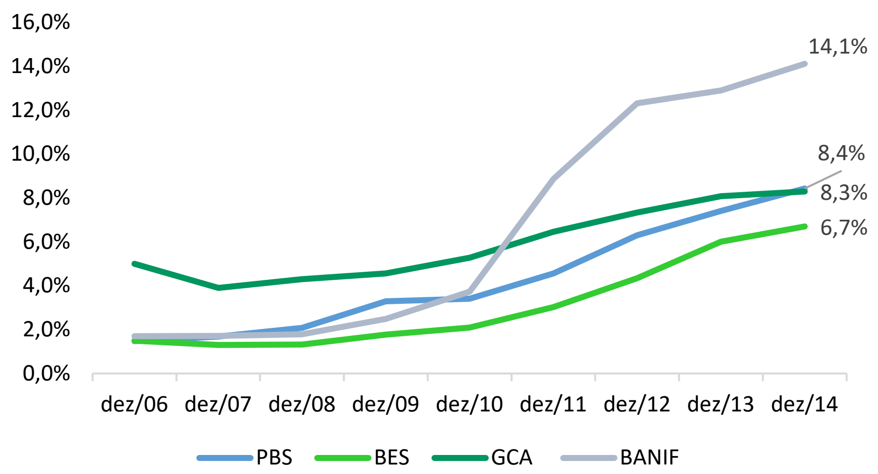

Figure 7. Overdue credit ratio (Source: Individual banks: reports and accounts of the respective banks, PBS: Financial Stability Reports of BoP).

With regard to the overdue credit ratio (OC ratio: OC / gross loans to customers), BES levels were lower than the PBS and GCA between 2006 and 2014. In this period, there was an increase in the OC ratio due to the economic crisis, with BES's ratio rising from 1% in 2007 to 6.7% in June 2014 (Figure *7*). This increase exceeded that of the GCA but was no more marked than that of the PBS. Relative to the largest banks in the market, the situation of BES in 2013 was similar to that of CGD and BCP but worse than the most efficient banks (Santander Totta and BPI), which had ratios of around 3.35%.

On the other hand, although BANIF had an average OC ratio until 2010, it then rose very rapidly to a level above that of the sector and the GCA. Thus, the various indicators examined confirm that BANIF's decline began in a decisive manner in 2011.

In conclusion, this chapter shows that there were indicators that could have anticipated BES's decline. For example, the CET1 ratio started to diverge from that of the GCA and the banking sector in 2012, although this divergence could have started before and would have been stronger if the accounts had reflected the losses discovered later. Similarly, BANIF registered a sharp decline in the CET1 ratio from 2011 onwards.

BES's the transformation ratio was also higher than that of the GCA and the sector throughout the period, increasing countercyclically between 2007 and 2009 and decreasing less than that of the PBS from 2009. BANIF did not register excessive transformation levels.

The two banks' credit growth had some peculiarity during the crisis. While BES had above-average growth on the crisis years (since 2009), this was only the case for BANIF in the first years of the crisis (2008-11).

Other indicators such as ROE, ROA (Return-on-Assets) and overdue loans did not indicate problems at BES. In contrast, BANIF's profitability and overdue loans indicators were out of line with the sector from 2011 onwards.

6. Conclusion

The Subprime crisis and the Sovereign Debt crisis in the euro area had adverse effects on the Portuguese economy, leading to the collapse of BES in 2014 and BANIF in 2015. Nevertheless, the fall of these banks cannot be attributed simply to macroeconomic factors as there were also key bank-specific factors. One of the main factors was the high propensity to risk and the failures of risk management, notably in the identification and assessment of credit risk, the definition of risk limits (e.g., concentration of credit in real estate and construction), and underestimation of impairments in the most acute phase of the collapse. Other key factors were excessive financial leverage, particularly in the run-up to the financial crisis, which made it difficult to obtain liquidity in a period of greater instability; excessive exposure to the own economic group (especially at BES), poor governance models that allowed mismanagement and accounting frauds, difficulty in raising capital in the face of increased regulatory requirements, and less stringent supervision and prudential regulation.

The supervisors' role was to check that banks performed the risk management function in an appropriate manner. Prior to 2007, a low-interventionist approach had generally been taken to supervision, with excessive reliance on banks' self-regulation and on capital to absorb losses (Sabato, 2009). Under Basel Pillar 2, supervisors could have exercised greater control over both the risk management function and risk dimensions that are not easily quantifiable under Pillar 1, rather than relying excessively on capital (Hellwig, 2009).

The key profitability and risk indicators of the two collapsed banks shows that there were indications of problems, namely declining capital levels, a high transformation ratio at BES, high credit growth in crisis periods, and high levels of non-performing loans and low ROE at BANIF. There were clearer indications that something could go wrong at BANIF than at BES from 2011 onwards. Particularly in the case of BES, this analysis shows that the use of quantitative indicators alone is not sufficient to detect banking problems in a timely fashion. On the other hand, the BES resolution measure demonstrates that the credit risk present in the ratios may have been underestimated, given that the good bank, Novo Banco, under the resolution then recorded very considerable losses in its loan portfolio.

Moreover, the BES is a good example of the effects of financialisation in the Portuguese economy, as described by Barradas et al. (2018): the growth of banks in both size and influence over the non-financial sector and politicians; the penetration of the bank in the non-financial sector through GES and public-private partnerships; and the promotion of shareholder value orientation in non-financial companies with increasing dividend payments to shareholders. The cases of BES and BANIF also show the vulnerabilities brought by financialisation to Portuguese banks: high transformation ratio, concentration of credit in real estate and construction, and misallocation of credit.

This study suffered from some opacity of information on the banks analysed. Nevertheless, the study allows us to conclude that failures in prudential supervision and especially poor risk management by some banks can jeopardise financial stability. Improvements in the banking institutions' process of granting credit should be prioritised (quality of borrowers, sectoral concentration and intra-economic group credit granting), and regarding supervision, it is again stressed that this should be strengthened systematically.

Basel III, published in 2010 and mandatory in Portugal from 2014, aims to strengthen banks' capital and liquidity. The new agreement could have helped avoid the banking crisis in Portugal due to the higher quality of capital requirements and a more reliable risk management framework. Although the macroprudential approach adopted by regulators from the 2008 crisis onwards could also have helped identify problems of solidity in the financial system as a whole (Balogh 2012), the collapse of the two analysed banks was caused by a mix of macrostructural causes and bank-specific factors, highlighting the need also for a microprudential approach. Future work could examine whether regulatory changes are having the desired effect on bank behaviour to ensure there is no recurrence of the banking problems experienced by BES and BANIF.

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