Global Counsel

Novo Banco: Made in Brussels

07 August 2014

Summary

At the start of this week the Portuguese authorities announced plans to resolve the failing Banco Espírito Santo. The approach taken – bailing in shareholders and junior bondholders, splitting off problem assets, and creating Novo Banco, a bridge bank, to operate as a going concern – provides a case study for the operation of the new European rulebook on bank resolution, even though it is not yet in force. The approach appears to have been successful, with losses borne where intended, no signs of contagion, and a positive impact on incentives that will help contain moral hazard in future. It will likely embolden the ECB which takes over responsibility for the supervision and resolution of Eurozone banks from November.

On Sunday 3 August the Banco de Portugal announced plans to break up the troubled Banco Espírito Santo (BES). This followed the disclosure the previous week of first half losses at BES of €3.6bn due to €4.2bn of impairments on the value of its Angolan subsidiary and exposures to other parts of Grupo Espírito Santo. These losses were sufficient to overwhelm the bank's €2.1bn capital buffer and push its core tier 1 capital ratio down to 5%, well below the minimum level of 7% required by the Banco de Portugal. This made the resolution of BES inevitable.

Problems in Grupo Espírito Santo had been brewing for months following the discovery of accounting irregularities. The Portuguese media has suggested the Banco de Portugal was aware of these problems – and their potential implications for BES – as early as September 2013. The collapse of BES was nevertheless a shock to both the Portuguese financial system and business establishment. As of 30 June 2014 BES was the third largest Portuguese banking group with operations in 25 countries, €80bn in assets and €37bn in deposits.

Once it became clear the Banco de Portugal had to act, it acted quickly and was in a position to announce the resolution plan for BES before the markets opened on Monday morning. The intervention is a case study for how the new European rulebook on resolving banks will work in practice. This is set out in the Banking Resolution and Recovery Directive (BRRD), which was agreed last year. The directive is not required to become law until 1 January 2016, but even so it has provided the template used by the authorities in this case. The experience provides us with some useful pointers to the future conduct of bank resolutions across Europe.

Made in Brussels, Tested in Lisbon

The BRRD sets out the approach resolution authorities should take to ensure the continuity of a failed bank's critical economic functions, while minimising the impact on the economy and financial system. The tools to be deployed under the directive include "the sale of the business or shares of the institution under resolution, the setting up of a bridge institution, the separation of the performing assets from the impaired or under-performing assets of the failing institution, and the bail-in of the shareholders and creditors of the failing institution." These tools are to be applied before any public sector financial support, which should be fiscally neutral in the medium term.

The approach taken by the Portuguese authorities largely conforms to the Brussels model. It involves splitting off the problem assets into a "bad bank", which will be wound down, with the losses borne by the shareholders and subordinated creditors of BES. The remaining assets, along with funding from senior bondholders and depositors, together form a "bridge bank" under the name of Novo Banco. This going concern will receive €4.9bn in new capital from Portugal's bank Resolution Fund. The intention is for Novo Banco to be sold on, in due course, to private investors. A number of Spanish banks are already said to be interested, according to the Portuguese media. The Portuguese Finance Ministry has said Novo Banco will safeguard all deposits, banking services, jobs and commercial relations formerly operated by BES.

The Portuguese Resolution Fund is financed by contributions from Portugal's banks, but is underfunded as it was only set up in 2012. It will therefore receive a €4.4bn loan from the Portuguese state to finance the capital injection, at an interest rate of 2.95%, slightly higher than the 2.8% rate at which the Portuguese government has been borrowing from the troika under the programme it exited in May this year. The European Commission has already concluded that this public support conforms to existing state aid rules, although they have also said that "in order to limit distortions of competition, the new business by [Novo Banco] will be limited and a prudent pricing policy will be implemented." In practice this is likely to mean Novo Banco will be required to charge interest rates at or above the Portuguese market average until it is sold on. Although somewhat vague, this looks like a relatively light touch approach by DG Competition, most likely reflecting satisfaction in Brussels that the Portuguese authorities are playing by the new rules.

The market reaction

When serious speculation about the viability of BES emerged in mid-July we saw a 40 basis point spike in the yield on sovereign Portuguese debt. However, since then yields have fallen back to near post-crisis record lows (Figure 1).

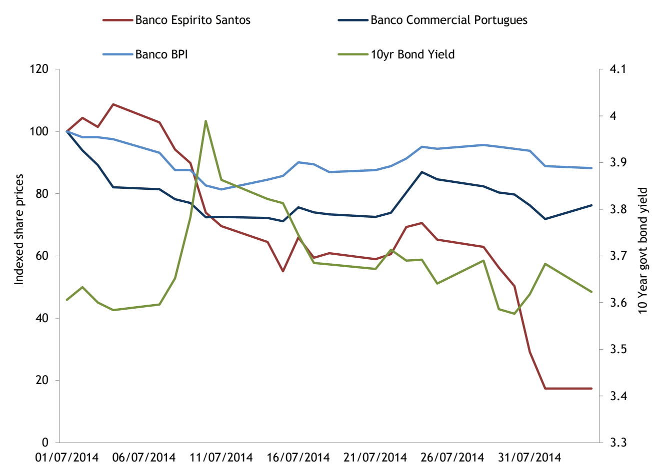

Fig 1: Impact on government bonds and company shares
Source: Reuters, Investing.com

BES shareholders have been wiped out. The French bank Crédit Agricole is among the shareholders affected and reported a loss of €700m on its 14.6% stake this week.

There has also been some impact on the share prices of other large banks in Portugal, but ultimately the spill-overs have been modest, despite their exposure through the Resolution Fund. Indeed, there are reports in the Portuguese press suggesting that the banks may seek to provide more up-front funding through the Resolution Fund in order to reduce the amount (and the cost) of borrowing from the Portuguese authorities. This signals their confidence in the approach taken.

There has been a marked divergence in the price of BES debt held by senior and subordinated bondholders. On Monday the €750m of 7.125% percent subordinated bonds fell to 23 cents on the euro, to yield 37%, while senior unsecured 4% debt rose to 99 cents on the euro, to yield 4.2%.

Novo Modelo

The new European resolution framework has arrived earlier than expected. No member state is obliged to follow the BRRD before 1 January 2016, but if called upon others are now more likely to follow the lead of Portugal and operate largely within the new framework before that date. This may be significant if, as expected, more banks need recapitalising – and possibly public support - when the ECB concludes its comprehensive assessment of banks later this year.

The new resolution framework has worked well, at least in this case, and at least for now. There has been no contagion, to banks or sovereigns, in Portugal or further afield. This is despite the underlying vulnerabilities that remain in Portugal, which only recently exited from its troika programme. This partly reflects the idiosyncratic nature of the problems at BES, rooted in accounting and financial irregularities in the wider group. It also shows that some lessons from previous interventions have been well learnt, such as the need to implement a solution quickly and cleanly. In the case of BES the split into two institutions, the burden sharing, the level and form of public support, and the state aid approval were all agreed over the course of a weekend. Even so, the absence of a durable impact on Portuguese sovereign yields is striking, given that an alleged flaw of the new European model is a lack of burden sharing across member states.

The new system could end up doing more to contain moral hazard than originally expected. There are three indications of this. The first is the nasty shock received by junior bondholders. This will give unsecured creditors at other banks reason to scrutinise more closely the financial health of the institutions to which they are lending. The intervention has been criticised for letting senior bond-holders off lightly, but this is economically justifiable if there is sufficient value in the assets transferred to Novo Banco.

Second, is the fact that other Portuguese banks are on the hook before the Portuguese taxpayer, which may provide incentives for stronger peer review. In this case the share prices of the other banks do not appear to be suffering – but their involvement through the Resolution Fund, and their apparent desire to reduce the loan from the Portuguese government, shows that their fortunes are intertwined.

Third, some of the politics has been taken out of the process. The BRRD model removes much of the considerable room for discretion enjoyed by the relevant authorities in previous cases, enabling them to make political choices about who bears the losses and creating opportunities for abuse. The press and political reaction in Lisbon to the BES resolution has been overwhelmingly positive, with commentators on the left and right describing it as a defeat for traditional crony capitalism. The fact that international investors, such as Crédit Agricole, have also taken a hit, suggests that the opportunities for powerful European capitals to intervene to protect their interests may also be diminishing.

The Portuguese authorities have been criticised for being too slow to expose the full scale of the problems as BES. That may change when the ECB takes over responsibility for the supervision and resolution of large banks in the Eurozone from November this year. The ECB will have less incentive to hold back. The BES case study gives us a good indication of what to expect when they do step in to resolve a failing institution.

This Global Counsel Insight note was written by Gregor Irwin, Chief Economist at Global Counsel. To contact the author, please email g.irwin@global-counsel.co.uk.

The views expressed in this note can be attributed to the named authors only.

5 Welbeck Street
London
W1G 9YQ
info@global-counsel.co.uk
+44 (0)203 667 6500