

PORTUGAL



UNDER PRESSURE: Ricardo Salgado, here at a news conference in early 2012, led the family empire for decades. REUTERS/JOSE MANUEL RIBEIRO

The billion-dollar fall of the house of Espírito Santo

Was there unlawful activity behind the spectacular collapse of the Espírito Santo empire?

BY SERGIO GONCALVES, LAURA NOONAN, ANDREI KHALIP



CLEAN UP: Banco Espirito Santo had grown to become the second biggest lender in Portugal. **REUTERS/HUGO CORREIA**

LISBON, AUGUST 29, 2014

On June 9, with his 150-year-old Portuguese corporate dynasty close to collapse, patriarch Ricardo Espirito Santo Salgado made a desperate attempt to save it.

Salgado signed two letters to Venezuela's state oil company, which had bought \$365 million in bonds from his family's holding company. The holding company was in financial trouble. But the letters, according to copies seen by Reuters, assured the Venezuelans that their investment was safe.

The "cartas-conforto" – letters of comfort – were written on the letterhead of Banco Espirito Santo, a large lender controlled by the family. They were co-signed by Salgado, who was both the bank's chief executive and head of the family holding company.

"Banco Espirito Santo guarantees ... it will provide the necessary funds to allow reimbursement at maturity," said the letters.

There were problems, though: By promising that the bank stood behind the holding company's debt, the letters ignored a

directive from Portugal's central bank that Salgado stop mixing the lender's affairs with the family business. The guarantees were also not recorded in the bank's accounts at the time, which is required by Portuguese law.

The following week, after intense pressure from regulators, Salgado resigned. Within a month, the holding company, Espirito Santo International, filed for bankruptcy, crumbling under 6.4 billion euros (\$8.4 billion) in debt. In August, Banco Espirito Santo was rescued by the Portuguese state, after reporting 3.6 billion euros in losses.

87%

Collapse in value of Banco Espirito Santo shares between May and August

Source: Thomson Reuters

The two letters, whose existence was made public last month but whose details are revealed here for the first time, are a key part of an investigation into the spectacular fall of one of Europe's most prominent family businesses. Portuguese regulators and prosecutors are examining them along with the bank's accounts and other evidence to determine whether there was unlawful activity behind the fall of the Espirito Santo empire.

So far, shareholders and investors in the family companies and Banco Espirito Santo have lost more than 10 billion euros, making this one of Europe's biggest corporate collapses ever.

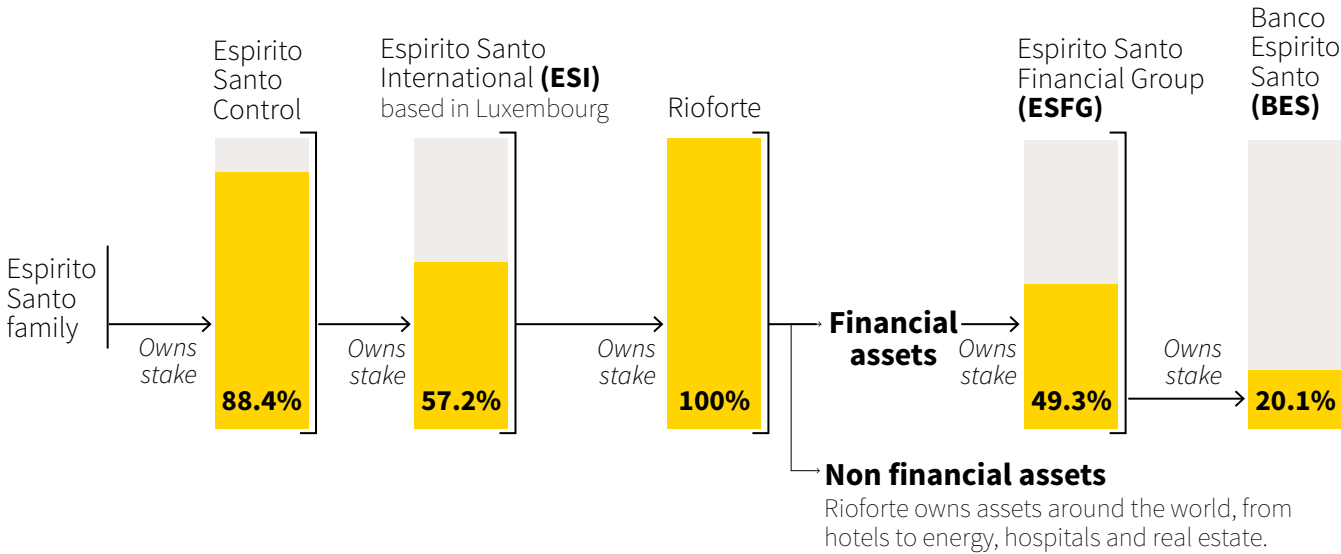
The letters offer a glimpse into how Salgado ran the Espirito Santo empire and its crown jewel, the bank, virtually unhindered. In addition, interviews with family members, company officials and Portuguese regulators, as well as financial documents, show how the 70-year-old patriarch consistently blurred the lines between the bank's interests and those of his

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The Family Businesses

The collapse of the Espirito Santo empire shines a light on the gaps that can open up when companies span different jurisdictions. The Espirito Santo family companies were mostly registered in Luxembourg, while their main asset – Banco Espirito Santo – was in Lisbon.

Main players: who owns what



Market cap of bank and its main owner



Sources: Thomson Reuters; Rioforte; Banco Espirito Santo

M. Ulmanu/Reuters Graphics

family and even his country.

Around the time he signed the letters, Salgado sought public funds to save the family empire, arguing that it was important for Portugal.

“This is not just my problem, it’s a national problem,” he told officials at Portugal’s central bank, according to people at a meeting they held.

Salgado declined to comment for this story. One person close to him said Salgado had asked Portuguese authorities to help him fix the family business in 2013. The bank’s collapse, the source said, could have been avoided.

The corporate meltdown also shines a light on Portuguese and Luxembourg regulators and the gaps that can open up when companies span different jurisdictions. The Espirito Santo family companies were mostly registered in Luxembourg, while their main asset – Banco Espirito Santo – was in Lisbon. Little information was exchanged between regulators in the two countries. That helped hide the true state of the family companies’ affairs.

Portuguese financial regulators knew in January about deep financial problems at Espirito Santo International, the family’s Luxembourg-based umbrella holding. ESI, though, continued to borrow heavily in the months that followed, with deepening consequences for the Lisbon-based bank.

Luxembourg’s regulator CSSF said it did not supervise any holding companies of the Espirito Santo family, while the country’s central bank said it had no responsibility for supervising Espirito Santo entities.

Portugal’s central bank and its markets watchdog CMVM both say they acted promptly and efficiently. Portugal’s central bank says Banco Espirito Santo former managers repeatedly violated its directives. CMVM chief Carlos Tavares told a parliamentary committee earlier this year that the watchdog had examined Espirito Santo companies various times over the past six years and alerted prosecutors about possible



HEADLINES: News of the collapse of Espirito Santo empire rattled markets in Portugal, and around Europe. **REUTERS/HUGO CORREIA**

wrongdoing after finding “signs of abuse of insider information” and a “possible crime of abuse of confidence.”

Portugal’s prosecutor general says there are now several investigations under way regarding the Espirito Santo empire, but has given no details.

Antonio Roldan, an analyst for Portugal and Spain at Eurasia Group in London, says the European Union, the European Central Bank and the International Monetary Fund, who arranged the 78 billion euro bailout of the Portuguese state in 2011, should also have spotted problems.

“Portugal was supposed to be under very close supervision” by international authorities as a condition of the bailout, he said.

A EUROPEAN TALE

In many ways, the rise of the Espirito Santo empire is a quintessentially European tale. Family dynasties such as the Agnellis in Italy or Germany’s Quandts have helped define the continent’s corporate history using their

stable shareholder base and long-term planning as a recipe for growth. But Europe’s debt and financial crisis, which has left one in five out of work across the continent’s southern rim, has changed things.

The Espirito Santo business was founded in 1869 by lottery dealer and currency exchange broker Jose Maria do Espirito Santo e Silva. The family guided its banking empire through World War Two by helping finance Europe’s trade in tungsten, a crucial ore found in Portugal and used to make weapons.

By the early 1970s, Portugal was in the last years of the Antonio Salazar regime, a dictatorship that looked favourably upon the Espirito Santos and their glamorous connections. After 1974’s peaceful “Carnation” revolution, the country’s left-wing government nationalised the banks and the Espirito Santo clan lost the business.

The following year members from the family’s five branches decided to rebuild their empire with \$20,000 (around \$90,000

at today's value) of their own money and loans from several international banks.

The move offered a chance to shine for Ricardo Espirito Santo Salgado, great-grandson of the bank's founder. He had joined the family business a few years earlier as a mild-mannered 31-year-old to head Banco Espirito Santo's economic studies unit. Once the family set out to rebuild he opened a bank in Brazil, together with French lender Credit Agricole. In the mid-1980s, when Portugal began to encourage private investment again, Salgado returned to Lisbon and set up a new bank, again with Credit Agricole. He bought back an insurance firm, called Tranquilidade, that the family had once owned.

The family business grew. So did its ownership structure. At the top was Espirito Santo Control, a non-listed holding company that owned Espirito Santo International, the umbrella for businesses spanning hotels, property and finance. Luxembourg-registered ESI was 57 per cent owned by the family, with the rest held by friends and Portuguese executives who wanted "a seat at the Espirito Santo table," according to a person close to the family. Through an intermediary company, ESI owned Espirito Santo Financial Group (ESFG) which in turn owned Banco Espirito Santo.

A family council, with representatives of the five branches, ran the shop.

Salgado's big break came in 1991 when the Portuguese state sold Banco Espirito Santo back to the family and Credit Agricole. Salgado became chief executive. Under his leadership the bank more than doubled its share of the Portuguese lending market to 20 percent in 2013, becoming Portugal's second-largest lender after a state-run bank.

According to people who worked with him, Salgado was courteous but distant. Every year, at a meeting with senior staff in a Lisbon hotel, he would sit in the middle of the room, shooting detailed questions to



HISTORY: Bank of Portugal Governor Carlos Costa on August 3, the day he announced the central bank would rescue Banco Espirito Santo in a 4.9 billion euro recapitalisation. **REUTERS/HUGO CORREIA**

“This is not just my problem, it's a national problem

Ricardo Salgado

Espirito Santo patriarch

department bosses. At family company board meetings, he rarely faced dissent. "People never turned around and said, 'no, you can't'," said a person who attended the meetings.

The Espirito Santos lived in style. Isabel de Melo, matriarch of one family branch, hosted grand parties in her country estate outside Lisbon, a mansion whose dining room comfortably seats 75. On her piano sat silver-framed photos of the family with Richard Nixon, the Rockefellers and the King and Queen of Spain.

Salgado himself built a holiday home in the coastal estate of Comporta, a sprawling estate larger than Lisbon that the family has been developing into an up-market tourist spot. Every Christmas Eve he gathers 50 family members for lunch at Visconde da

Luz, a traditional wood-panelled restaurant near Lisbon.

FAMILY TENSIONS

Portugal fell into recession after seeking its international bailout in 2011. As part of the bailout terms, Banco Espirito Santo, like other Portuguese banks, was no longer allowed to pay dividends to its shareholders, including the Espirito Santo clan, who at that time owned a majority stake in the lender. That meant a big source of the family's income was gone.

The stock market value of Banco Espirito Santo fell to 1.97 billion euros at the beginning of 2012 from 3.5 billion a year earlier – costing the family 420 million euros on paper. Most banks sought state-backed loans. Banco Espirito Santo did not. Salgado boasted the bank had maintained "strategic independence."

Turnover at the family's hotel, property and other businesses suffered. To avoid selling assets or losing their controlling stake in the

bank, the family companies, led by Salgado, simply borrowed more – including from the bank, and from the bank's customers.

For the first time, though, not everyone agreed with the patriarch's approach. Among the dissenters was Jose Maria Ricciardi, a cousin of Salgado's who headed the bank's investment arm. In early November of 2013, Ricciardi organised a small gathering of family members at his father's house.

According to a source with knowledge of the meeting, Ricciardi said he was worried about the family empire's debt. In particular, Ricciardi was concerned about the way the empire was financing itself by selling bonds of the family businesses to clients of Banco Espirito Santo. He argued that Salgado should step down.

Ricciardi went public with his criticism of "practices" at the group but did not give details. He urged Portuguese financial regulators to order an overhaul.

But at another family meeting on November 7, he was overruled. Even his own father voted to keep Salgado on. "I did not support my son ... to avoid an immediate institutional break" within the family, said Ricciardi's father, Antonio Ricciardi, in an email to Reuters at the time.

The reason for the family tensions soon became clear to Portuguese regulators. The Bank of Portugal had earlier reviewed the top borrowers at the country's largest banks and discovered Banco Espirito Santo's heavy loans to Espirito Santo family companies. The central bank asked auditors KPMG to go through ESI's accounts and the results were shocking: ESI's accounting had "materially relevant" irregularities that put into question the "veracity and completeness of accounting records," according to a copy of the KPMG report seen by Reuters. The report's contents have not been detailed before.

KPMG found that ESI had either not recorded or had under-reported financial liabilities and risks, had grossly overvalued

its assets, and had scant evidence for its reported transactions. The 6.4 billion euros of debt it held at the end of September 2013 was an "atomic bomb," according to a person close to ESI, because most of it had to be paid back within one year.

KPMG would not comment for this story.

After the audit, the Bank of Portugal moved to protect Banco Espirito Santo from its founding family.

It ordered the bank to make sure any loans it had made or would make to family businesses were secured by assets, in case the family could not repay its debts. The central bank also ordered that any of the bank's retail clients who had bought bonds from the family business be given guarantees that their money was safe.

€10 billion

Estimated total losses in Espirito Santo family companies and Banco Espirito Santo

Source: Reuters

The existence of the audit was not made public at the time. But Reuters has learned that four months later, in April, the board of ESFG – the family company that owned a 27.4 percent stake in Banco Espirito Santo – was alerted to the problems at its parent company ESI.

During a teleconference meeting, some directors argued that they should publicly disclose the problems, because ESFG's other shareholders and creditors had a right to know. But Salgado, who was both CEO of ESI and ESFG chairman, argued for silence. "He recommended the board let him deal with the situation. The board believed in him and that his recommendations were the right things to follow," said a person with knowledge of the board meeting.

Salgado decided that ESFG would provide guarantees to Banco Espirito Santo's retail clients who had invested in family bonds, according to a person familiar with the decision. Salgado had previously argued within ESFG that it was in ESFG's interest to guarantee bank clients, because the lender was its most valuable asset.

Some at ESFG, however, thought this was unfair to the company's other shareholders and creditors, the person with knowledge of the board meeting said.

Parent company ESI set out to repay the bonds it had sold to Banco Espirito Santo retail clients. There was a problem, though: The reimbursements didn't come from new revenue. Instead, ESI and other family companies issued even more debt.

The companies issued bonds through an opaque transatlantic ping pong, involving an ESFG holding company in Panama and another family-linked firm, according to people familiar with the family company accounts. Many of the bonds – whose value could reach five billion euros – ended up back in the hands of Banco Espirito Santo clients. That opened up the prospect that the bank would have to compensate clients in the event that the holding company could not repay the bonds.

The problems at ESI were publicly disclosed on May 20, as Banco Espirito Santo told investors that it would raise more capital. The empire kept up a brave face. Earlier that month, the bank had prepared a slide show for investors titled "Wisdomland," playing up the family's history and reputation. "Wisdom is something that needs time to grow."

Now, though, in addition to disclosing the financial problems at ESI, the bank told investors that it had sold debt in family parent company ESI to its customers. It said this posed a "reputational risk" for the bank. If ESI defaulted, customers could start asking questions about how the debt was sold, and the bank's brand could suffer, especially if there was any

hint it knew the bonds were risky.

Salgado told a Portuguese business newspaper that the extent of ESI's problems hadn't previously been known. "We didn't know that there was such sickness as we have subsequently found inside ESI," said Salgado, ESI's chief executive at the time. "There was serious negligence. I don't think there was wilful misconduct."

These assurances helped the bank complete its one billion euro capital increase.

In the weeks that followed, the true extent of the bank's links with its troubled founding family began to emerge. Investors panicked. Shares in Banco Espirito Santo would dive 87 percent in the following two and a half months.

In early June, Salgado made his move to save the business, and his name.

He first visited members of the Portuguese government and central bank governor Carlos Costa. Salgado asked both for loans worth 2.5 billion euros to avoid the collapse of the family company. He said an implosion of the Espirito Santo group would reverberate throughout the economy.

The officials refused. "We will not use public instruments to solve problems of a private nature," Prime Minister Pedro Passos Coelho said. "When private companies do bad business they have to bear the costs."

Salgado and his cousin, Jose Manuel Espirito Santo, signed the letters for the bank to guarantee the family debt bought by PDVSA, Venezuela's state oil company. PDVSA and a Venezuelan state-owned fund, to whom one of the letters was addressed as a proxy of the state oil firm, declined to comment on the correspondence. It is unclear whether PDVSA will get its money back.

The letters were not shown to the bank's internal audit committee and were not recorded at the time in the bank's accounts. The Bank of Portugal later said this violated the law.



ANGER: Protesters hold up posters with the image of Salgado during an August demonstration outside Banco Espirito Santo's headquarters in Lisbon. **REUTERS/HUGO CORREIA**

In late June, Portugal's central bank chief organised a meeting with representatives of the five Espirito Santo family branches. At the meeting, Costa ordered family members, including Salgado, to step down from top management of the bank. New executives would be named.

Weeks later, Espirito Santo International filed for creditor protection in Luxembourg, and most of the other family firms followed suit. Salgado presided over a July 18 meeting to discuss the bankruptcies. "He was cerebral and polite, but imperial as always," said a person who saw him at that time.

A few days after Banco Espirito Santo reported a record loss of 3.6 billion euros for the first half of 2014, Portugal bailed it out. The state formed a new bank, called Novo Banco from the healthy parts of the old lender.

Salgado has now set up an office at a high-end hotel in the coastal resort town of Estoril. He has mostly stayed silent throughout the affair. In a brief interview with a local newspaper, he said: "I will

fight for honour and dignity, mine and my family's."

Quoting Pope Francis, he added: "Don't cry for what you have lost; fight for what you have."

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