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Portugal Can Surmount Espírito Santo Crisis

■ **Dennis Shen**
Economic Associate—Global Economic Research, + 44 (020) 7173 9270
■ **Darren Williams**
Senior European Economist—Global Economic Research, + 44 (020) 7959 4543

A domestic financial crisis within the Espírito Santo Group has dominated the Portuguese headlines in recent weeks. In our view, Portugal is now much better placed to respond to such a shock than in the past, and we do not expect the crisis to have a material impact on the government's credit profile.

In recent weeks, a major corporate scandal in Portugal has shaken local and international financial markets. Several entities within the Espírito Santo Group—a network of companies owned by one of Portugal's longest-lasting family empires—fell into serious financial difficulty. With a complex web of intra-group exposures, Banco Espírito Santo (BES), the group's main bank, faced heavy losses. This crisis raised new questions about Portugal's financial stability, just three months after the country exited a European Union (EU) and International Monetary Fund bailout.

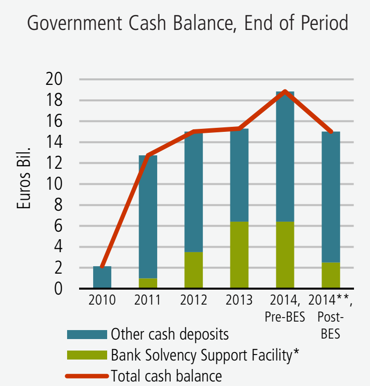
State Intervenes in BES

Last Sunday, the Bank of Portugal intervened in the crisis. The resolution of BES, formerly the country's second-largest lender, will split the bank up into two entities. The first, "Novo Banco," will receive the old bank's clean assets, while the second, a bad bank, will retain the problem assets. As part of the burden-sharing required under the EU's new state aid rules, subordinated bondholders and shareholders of BES will stay at the bad bank and be subject to losses. Depositors and senior bondholders will move to the new bank.

To meet Portugal's minimum capital requirements, Novo Banco will receive a capital injection of €4.9 billion (or 2.9% of gross domestic product) from the nation's bank resolution fund. This fund was created in 2012, and has resources of just €367 million so far, funded by the nation's banks.

With limited resources at present, the resolution fund will receive a temporary loan from the state (of €3.9 billion*) to carry out the immediate recapitalization of BES. The fund's own resources and additional contributions from Portuguese banks will contribute the remaining €1 billion* of the €4.9 billion capital injection.

Display 1
Overall Cash Position Still Comfortable



*Cash reserves earmarked for public recapitalization of banks.
**Total cash balance of €15.0 billion is an estimate after the public injection of capital into BES; €5.3 billion of this will be needed to repay an October 2014 maturing bond.
Source: Bank of Portugal, Portugal Ministry of Finance and Public Administration, Portuguese Treasury and Debt Management Agency and AllianceBernstein

Over time, the government expects Portuguese banks to step in with their own loans to the resolution fund, which would provide the fund with capital to repay the government in full before the eventual sale of Novo Banco back to private investors.

Comfortable Liquidity Cushion

At present, we believe the government of Portugal has sufficient resources to deal with the crisis at BES. The €3.9 billion state loan will be sourced from a special cash

* Note that original plans were for a larger state loan of €4.4 billion. This was reduced to €3.9 billion, after a proposal from the Portuguese Banking Association to increase the private contribution by an additional €500 million. This takes the total contribution to €1 billion from the resolution fund's own resources and Portuguese banks.

balance earmarked for state aid to the banks, built up over the last few years as part of the terms of the troika bailout. Since this contingency facility had a residual €6.4 billion available before the BES recapitalization, the €3.9 billion state loan will draw down most of the remaining balance (leaving €2.5 billion in the fund). However, we estimate that the country's overall cash position—including the €2.5 billion—still stands at a fairly comfortable €15.0 billion after the bailout** **(Display 1, previous page)**.

So there are still resources to deal with any additional contingencies that may arise. Note that the buildup of Portugal's cash balance for such events was a core precondition for its clean exit from the troika bailout just this May (see "The Road to Portugal's Bailout Exit," *European Perspectives*, March 28, 2014).

Fiscal Impact to Be Limited

As the initial state loan is lent from cash, it will have no impact on Portugal's public debt. However, the government will probably want to issue bonds later in 2014 to rebuild its cash cushion, especially in light of substantive financing requirements over the next few years.

Next, how the capital injection is recorded in the fiscal balance will depend on whether Eurostat, the EU's statistics agency, sees it as a financial investment with no impact on the deficit or as a subsidy to the bank, which would be included in the headline deficit. In other cases, Eurostat has tended to include loans/capital injections to banks in the fiscal balance and we would expect the same treatment here. However, we do not expect this to have an impact on Portugal's compliance with the EU's fiscal rules or with credit-rating assessments. These evaluations have generally focused on a country's "underlying fiscal balance," which excludes one-off actions like bank recapitalization costs and, as such, are not affected by the BES support.

Severing Sovereign from Bank

In the end, the speedy resolution of BES may well serve as a template for the application of the EU's state aid rules—which favor purely private solutions to such problems and foresee government intervention (with private burden-sharing) only as a last resort. These rules are still in a period of transition (having come into force in Portugal earlier this year), and seek to sever the links between sovereigns and banks. To this end, regulators can take some comfort from the response within Portuguese sovereign markets since the Espírito Santo crisis started, as there has been a visible divergence between sovereign and bank yields **(Display 2)**.

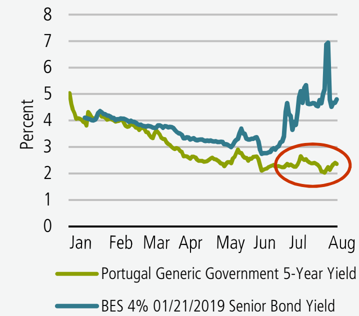
This divergence was partly fostered by the sovereign's liquidity position and new institutions for private burden-sharing, but it was certainly also helped by a favorable market environment and a broader view that the issues at BES have been idiosyncratic in this instance (rather than systemic to the whole of the Portuguese banking system).

Return to Investment Grade?

In coming months, regulators in Portugal will have to answer difficult questions relating to accounting irregularities and possible fraud within the Espírito Santo Group. In a relatively small country like Portugal, the state's reputation is intricately linked to the reputation of its largest institutions, like BES. As such, the reputational cost to Portugal may be more important in the near term than the economic impact (though a modest hit to economic activity in the third quarter is probable).

Display 2
Sovereign and Bank Yields Diverge

Portugal Sovereign and Banco Espírito Santo, 5-Year Yields



As of August 8, 2014
Source: Bloomberg

Over the medium term, we expect Portugal to recover from this crisis. The economy is on a firmer foundation than it was several years ago, and should therefore be able to better cope with such a shock. We do not think the BES crisis will have a material impact on the government's credit profile, which we believe remains on a favorable trajectory. This was highlighted by Moody's in its recent upgrade of Portugal to Ba1, from Ba2 in late July—which came as a surprise to many market participants and underlined diverging trends between the sovereign and Banco Espírito Santo.

In the medium term, we hold a view that Portugal has a material chance to secure an upgrade to an investment grade rating (though this is more likely to occur after general elections in the second half of 2015). In the near term, however, there is still much to be done to stabilize the financial sector and reclaim the market's confidence. ■

** Note that this estimate of the cash position includes funds from the expected repayment of €1.85 billion of state loans by Banco Comercial Português back to the government in the near term.