

Banco Espirito Santo Scandal

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Executive Summary

Banco Espirito Santo is a practical example of what the lack of proper audit oversight and the mismanagement from the owner can do. The company that has survived two world wars, political upheaval, economic transitions could not survive under the leadership of an autocratic business leader. Banco Espirito Santo went from being the second-biggest bank in Portugal to a victim of mismanagement and fraudulent activities. The report shows the complex company structure which made the overall fraud process feasible for the company and how they have been doing it for many years. Espirito Santo Family started business in the financial sector, but they branched out in real estate, tourism, agriculture and many other fields. The overall form and the company structure is so complicated that even in simple words it takes a lot of time to understand the overall company structure. On top of that, their listing in many countries made it difficult to keep them under observation as they fall under a different jurisdiction. Banco Espirito Santo has been under the leadership of Sagaldo who has been working as the CEO since 1991. The parent company was highly leveraged, money was taken out of the bank using complex financial tools and special purpose vehicles. They used their offshore banks and special purpose vehicles in order to bring out more money as debt. However, the revenues from other business tanked and they could not keep up paying the interest on the loans they have taken. The Espirito Santo family sold their parent company loans to the retail customers of the bank as commercial paper. However, the situation deteriorated and they no longer have the ability to pay back their loans and filed for bankruptcy. The case of BES showed how the lack of proper audit created the chance for fraud.

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Introduction

The report is made keeping on the audit perspective in a business. Banco Espirito Santo (BES) was the second wealthiest bank in Portugal. But the poor management and the fraud of the parent company made the company a financial disaster. As we know, the audit procedure makes the company safe, secure and transparent to everyone. However, in this particular case, we see how the close relationship between the management and the auditor has failed the whole company. The auditor was appointed in 2002 and heavily criticised for its role. The report shows the overall company structure. The fraud process has been given the most important due to the complex nature of the fraud. The role of the auditor and the management has been discussed in great detail. The report also shows the current status of the company after the fraud came to light.

Chapter I: Company Overview

Banco Espirito Santo history goes as long as 150 years. The Espirito Santo family business can be traced back to 1869 when the founder of the Espirito Santo family, Jose Maria do Espirito Santo e Silva, started trading lottery tickets and currency exchange (Coppola, 2014). According to Portuguese historians and legends, Espirito Santo was a child abandoned at the gate of a church by a destitute mother. In Spanish, the surname Espirito Santo means ‘Holy Ghost’ in Portugal. The business helped to build Portugal, survived two world wars, went through political turmoil and financed in building the country.

Over the years, the family business has become so big that the Banco Espirito Santo was the second biggest bank in Portugal. The business ranged from fancy condominiums in Miami to Banks all over Europe. In Portugal, the Patriarch leader Mr Sagaldo was known as ‘Dono Disto Tudo’ or the ‘Owner of All this’.

However, the journey of the Espirito Santo family was a roller coaster ride. They faced many challenges in their business. In 1974, there was a revolution in Portugal known as ‘Carnation’. After that revolution, the left-wing party grabbed the power and institutionalized all the banks. In this process, the Espirito Santo family lost all their banks and financial institution in Portugal. After this incident, the major branches of the Espirito Santo family took out all their wealth that valued at that time \$20,000 and took loans from other financial institutions and bank abroad.

This exile brought a great opportunity for Riccardo Espirito Santo Sagaldo under whose leadership the business saw the highs and the bankruptcy of the company. Mr Salgado, then 31 years old, started leading the business. Espirito Santo, along with French lender Credit Agricole, opened a bank in Brazil. The business took off, the company opened a new business in Switzerland and other countries. After 1991, the Portugal government opened doors for foreign direct investment and invited the Espirito Santo family to buy back stakes at Banco Espirito Santo (BES) for the privatization of the bank.

This is the turning period for the business. The family used a very small fortune of their family to gain a stake in the bank and instead took a large amount of debt to buy the bank. In the coming years, the bank used a complex financial structure, used the bank's retail customers to bring out more loans and expand its business. After coming to Lisbon, Mr Sagaldo bought a financial firm named Tranquilidade. The family shelled out money out of the banks, often using offshore banks, and complex financial structure to expand its business.

BES has become one of the major game players in the Economy of Portugal. This bank had major and vast institutions and branches in Portugal. BES was the 2nd major private bank in Portugal. BES has operated and expanding Branches over 25 countries. This bank has a great Asset about 80 Billion Euros. Their total Branches were more than 650. Their total employees were about 7000. They had clients and customers of more than 2 million. This Bank had an average market share of about 20.3%. BES had been awarded for the “Best Trade Financial Bank’ for five consecutive years by the Global Finance magazine and the sole Portuguese bank. In 2011, the leader of the BES, Ricardo Salgado, was nominated as the most powerful businessman in the Portuguese economy by the financial magazine Journal de Negocios.

	1992	2013
N. Counters	240	643
N. Employees	6426	7371
N. customers	1,4 millions €	2,2 millions €
Market share	8,5%	19,7%
Liquid asset	1,742 mil millions €	80,608 mil millions €
Growth rate credit	743 millions €	49,722 mil millions €
Growth rate deposits	1,1 mil millions €	36,8 mil millions €

Figure 1: BES Growth (Kowsmann, 2014)

BES had tried to earn a lot of profit and keep it to make a group of companies, this may be for financial and non-financial companies. At the end of the day, they had started their group of business in the field of agriculture, hotels, energy, real estate, construction, transport. They had expanded their business over some countries around the world like Switzerland, Luxemburg, Libya, Angola, Panama, and the United States. Espírito Santo International (ESI) their group of companies had been turned into two-sided. Rioforte, a holding in the non-financial area of the group had owned and controlled some commercial companies (e.g. real estate, transport, hotels, mining, and energy); and Espírito Santo Financial Group (ESFG), a holding in the financial area had controlled the BES, as well as more than 14 financial companies (e.g. insurance, investment services, and brokerage).

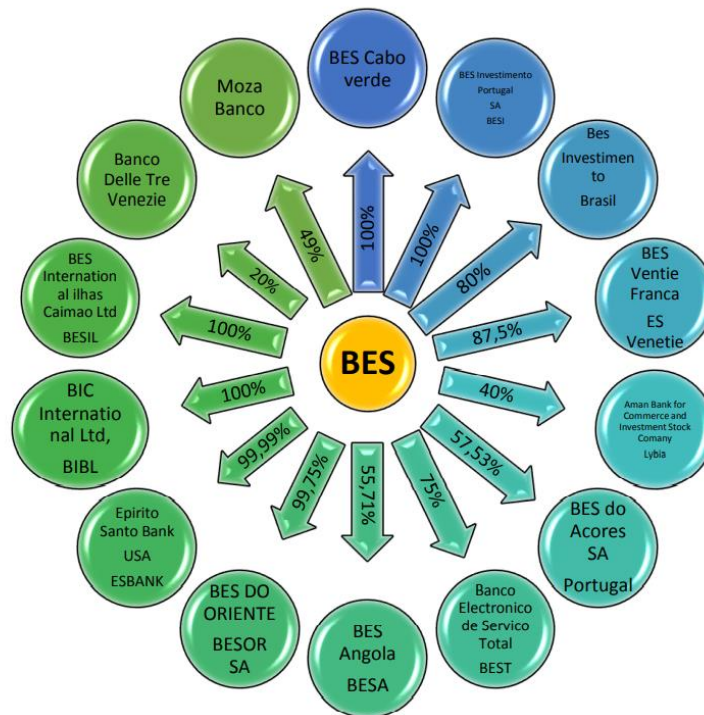


Figure 2: Subsidiaries of BES (Euromoney, 2014)

Chapter II: Fraud Process

Before understanding the fraud process, it is important to understand the corporate structure of the companies regarding the fraud. This convoluted structure came into effect in 2009 for helping the owners for the benefit of owners. 25% of the bank stake is owned by the Espirito Santo Financial Group (ESFG) which is a Luxembourg based company. On the other hand, Espirito Santo International has a 49% stake at the ESFG (Lima, 2014). This complex corporate structure, with the help of a financial intermediary, helped the Espirito Santo family to create a fraudulent plan which ultimately resulted in the demise of the Espirito Santo family dynasty.

Banco Espirito Santo was one of the largest group of companies in Portugal. The company business expands to financial companies, real estates, hotels and agriculture. However, the growth of the business was not the result of management excellence alone. The parent company is a heavily leveraged company since 1993. The leverage works for the business as long as the business has cash inflow to pay for the debt. However, if the cash inflow is low all things go downward spiral. Indeed, this is what happened to the Espirito Santo dynasty and resulted in the demise of the iconic Banco Espirito Santo.

Banco Espirito Santo is the biggest source of revenue for the Espirito Santo Group. However, after the 2008 financial meltdown, the whole world was facing recession in the coming years. Portugal fell into a deep recession in 2011 and the Bank of Portugal imposed restriction on the payment of the dividend to the directors. The restriction on the dividends meant that the biggest source of revenue of the Espirito Santo family is already gone. On the paper, the asset of the company was also dwindling as the value of the Banco Espirito Santo (BES) was fell from \$3.2 billion to \$1.97 billion in 2013 (Wise, 2014). The family lost as much as \$405 million loss as a result of this.

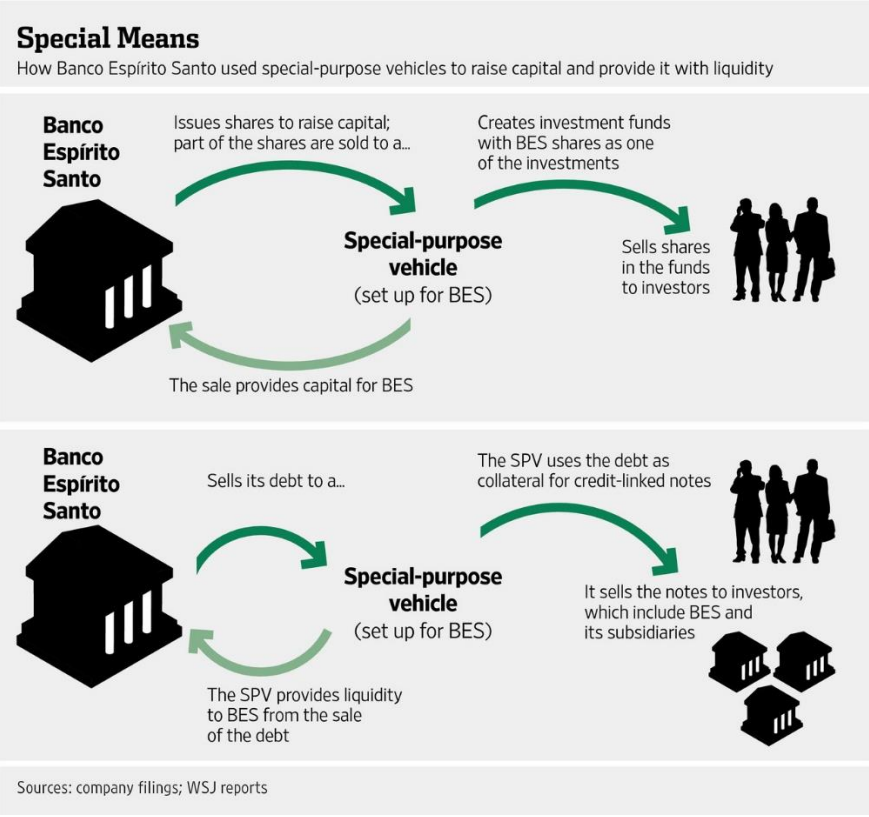


Figure 3: Fraud of the Espirito Santo Using Special Purpose Vehicle (Enrich, Kowsmann and Patrick, 2014)

This is where things started getting complicated. Espirito Santo used a financial intermediary called Eurofin which packaged the growing debt of Espirito Santo International (ESI) and sold it to the retail customers of the Banco Espirito Santo (BES).

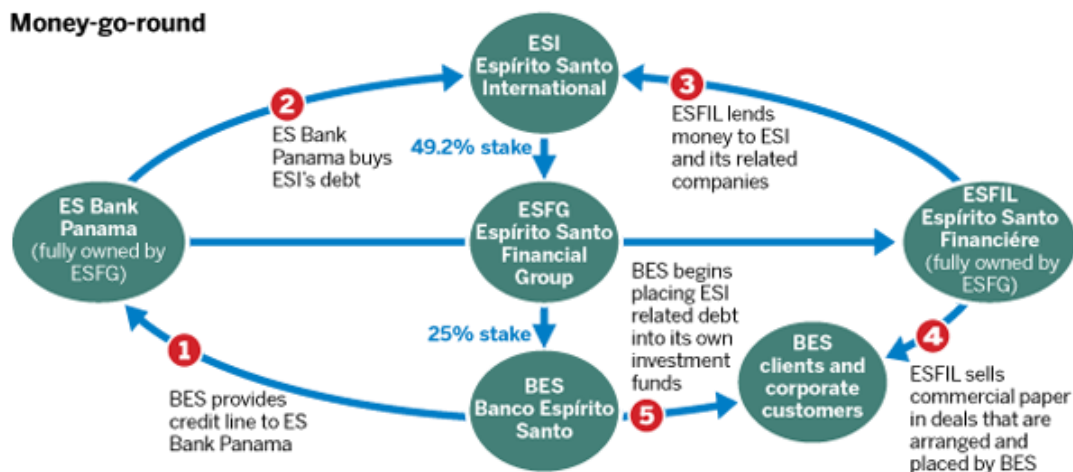


Figure 4: The Fraud Process of the Banco Espirito Santos (BES) (Khalip, Goncalves and Noonan, 2014)

The Eurofins helped the ESI to establish an offshore bank. The BES provided a credit line to the ES bank of Panama. The ES bank of Panama used the money and bought the ESI's debt. The money ultimately goes to the different subsidiaries of the ESI, notably ESFIL. The ESFIL which has packaged the debt of the ESI with the help of Eurofins sells the debt to the BES and the BES ultimately sells the debt to its retail customers.

In 2014, the BES owned debt fund Espirito Santo Liquidez was valued at a staggering \$1.7 billion and consist of only the short term papers that were sold to the retail customers of the BES.

The regulator of Portugal found during an audit found out that the Espirito Santo Family companies are the top borrower of the country and the loans are getting riskier of the default. The Bank of Portugal ordered the KPMG LLC, the external auditor of the BES, to carry out the audit regarding the situation. The fraudulent scheme unfolded more when KPMG started the investigation.

KPMG found that the Banco Espirito Santo (BES) hide the loans taken by the ESI and other Espirito Santo family to hide from the investors. The bank kept the loans off the balance sheet. On the other hand, KPMG found more 'materially relevant' irregular accounting practices. The ESI grossly underreported or did not report at all its liabilities and risks. ESI also inflated the price of its assets. After the audit report, the regulators ordered that if any loans were to be made to any of the company of Espirito Santo, the loans will need to be secured by the assets in case the parents company failed to pay the loans. The bank also had to provide guarantee to the retail customers who had bought the bonds and commercial papers that were sold by the ESI to the retail customers

of the BES. By 2013, the loans of ESI to BES amounted to 6.4 billion Euros. The worst thing is that the loans had to be paid within one year.

The ESFG decided it would provide a guarantee to the retail customers of the BES who had bought the commercial papers and the bonds of the family businesses.

However, the business was slow and the Espirito Santo family was failing to make a turnover so big that would help them to repay their loans. Instead, they started making more loans from the BES by using the ES bank of Panama.

On July 18, the parent company ESI filed for Bankruptcy in Luxembourg. This indicated that the ESI will not pay the debt it sold to the retail clients of the BES. On the other hand, the BES reported a €3.6 billion loss in the first half of July due to the ongoing investigation and the debt sold to its retail clients. Now, the bank has to pay back the loans that were sold to the retail clients of the bank by the ESI. Ultimately, the Portugal government set up an established 6.58 billion and spend the fund to save the bank (Goncalves, 2014).

Chapter III: Role of Management and the Auditor

Role of Management

The Board of directors and the management show a poor to save the interest of the shareholders and the retail clients. The Espirito Santo family had immense control over the board of members. Espirito Santo family had a great number of members at the board of directors who looked after the interests of the Espirito Santo family. As Banco Espirito Santo was a subsidiary of the Espirito Santo Group, they had a great influence on the managers. The CEO of BES, Riccardo Espirito Santo Sagaldo, had been holding the position from 1991 to 2014 when the bank ultimately collapsed. Due to his reign as a CEO for a long time, the managers could not raise their voice over him. Mr Sagaldo was also highly regarded in Portugal for reviving the BES and the then highly successful Espirito Santo other business activities.

There was rising conflict at the top of the management. Jose Maria Ricciardi, one of the family members of the Espirito Santo group was raising her voice about the growing debt of the overall Espirito Santo Group. She was the first in line to replace Mr Sagaldo, however, this created problem for the family. Even though people knew Ricciardi is the one to replace Mr Sagaldo, he is too powerful to ignore in the context of overall Portugal. The top managers were divided, many were concerned about the practices of Sagaldo. Ricciardi opposed many decisions of Sagaldo, particularly borrowing heavy loans even though the loan rates were too high. Even though these concerns were genuine and should have taken into considerations, Mr Sagaldo was still the CEO and his decision was finalised eventually. This power conflict went on and created more inefficiency in the management.

The board of directors are explicitly or implicitly related to the Espirito Santo group. In 2013. There was a total of 10 executive board of directors at BES and 15 non-executive directors at BES. However, of the 15 non-executive directors, many of the non-executive directors had an executive position at many of the Espirito Santo businesses. This association with the Espirito Santo Group meant that the board of directors are likely to make a decision that will go in favour of the Espirito Santo family. This act violates the 'Principal Agent' relationship. The board of directors are not working for the investors, instead, they were favouring decision that will go in favour of the Espirito Santo family.

However, the blame for the downfall of the BES goes to Mr Sagaldo for blurring the line between the family businesses and the Bank. Mr Sagaldo has been so influential in Portugal that no one used to question his decision even those these decisions seemed not favourable for the bank. The leadership of Mr Sagaldo, according to many, is attributed to the demise of the BES. He had been under investigation in Brazil for an alleged fraud of the ESI. Due to the immense rising debt, he had to send a 'Letter of Comfort' to the Venezuelan state oil company, a major investor of the ESI (Khalip and Goncalves, 2015).

From the audit perspective, the management's role is controversial. The number of the board of directors has made it questionable whether they would work for the interests of the investors. The autocratic leadership of Mr Sagaldo has made it easy to make the internal control weakened. The management did hide the rising debt of the company from the investors, the management did not have the goodwill for the investors of the retail customers. The management, on the other hand, made it easy for the Espirito Santo family to bring out more loans for their business out of the bank.

After the collapse, Mr Sagaldo has been charged with fraud and money laundering. Under his leadership, the bank went from being the second wealthiest bank in Portugal to a bankrupt bank.

Role of the Auditor

The report looks into both the aspect of the internal audit and external audit.

The internal audit committee member at the ESI was made of non-executive directors who are supposed to be independent. However, they were under the influence of the ESI. Many of these accomplished audit committee members also worked for the ESI. The internal control has been really poor for the BES. An investigation by the KPMG LLC revealed that the BES has hidden debt that was given to the ESI from the balance sheet. This is a severe violation of the law. The audit committee has been so compromised that ESI overestimated the asset of the company and the audit committee did not raise any red flag. If there were proper internal control and a strong, independent audit committee, they would have raised their concern. The financial statements of the BES did not show a true and fair view of the bank. The audit company has been doing substandard work. There have been questions about the internal audit committee after the bank collapsed. The audit committee hides the facts 'material' from the investors on their financial statements. The audit committee was compromised and they hid the debt of the ESI and showed it

as an off-balance sheet item. The documentation also brings the question about the internal audit committee. Even though the assets were inflated, the audit committee did not inspect or even if they knew they simply let things go because the ESI was related to the CEO and the parent company. Many of the auditors were the non-executive board of directors and they had roles in other businesses of the Espirito Santo family, as a result, they did not want to fall out of favour of the CEO Mr Sagaldo.

After the bankruptcy of the Banco Espirito Santo family, the external auditor KPMG was heavily criticised. Initially, KPMG, after getting an order from the Portugal central bank, worked on the BES and showed the detailed wrongdoings that have been going on at the Bank, however, regulators, investors and the public have criticised the role of KPMG. KPMG has failed to provide warnings to the customers, investors about the wrongdoings and the fraudulent schemes that had been going on at the bank. After the debacle of the BES, authorities were blaming each other for the audit work. However, the KPMG has been criticised heavily for the audit work because they failed to warn the stakeholders about the fraud and the wrongdoings that had been going on at the BES.

Bank of Portugal, in a statement, blamed KPMG LLC for the debacle of the BES. The central bank, Bank of Portugal, blamed KPMG several times for the failure of the BES. However, KPMG denies all the allegations against it. Ex CFO of the BES, sued the Bank of Portugal and KPMG.

KPMG was in a position that could have found out how the money was going out from the BES to the Espirito Santo family. The KPMG could have unearthed the fraud process which could have warned the investors before things got so worse. KPMG also failed to identify the process of selling the Espirito Santo debt to the retail clients of the bank.

This debacle also brings forward the conflict of interest. The auditors were paid a big sum of money by the company they are auditing. However, if they write anything bad about the company they are instantly replaced by a new auditor. The Bank of Portugal highlighted that this position of the auditor and the bank created a conflict of interest. KPMG has been auditing BES since 2002 which created a cosy relationship between the company and the audit firm (Patrick and Kowsmann, 2014). Under the nonbinding guidance of the Portugal market watchdog, KPMG was supposed to be out of contract by 2011. However, they overrode the directives and renewed the contract for another 4 years. This kind of practice has been prevalent in Portugal and all over Europe.

It can be concluded that the auditor, KPMG, has been failed to see the fraud process that has been going on for many years. It has failed to protect the customers of the bank and the investors.

Chapter IV: Current Status

After Events of the Scandal

After weeks of increasingly bad news about the financial state of the lender, particularly its exposure to a cascade of companies headed by its founding Espirito Santo family came the rescue of Banco Espirito Santo (BES). The European Central Bank's (ECB) governing council in a video conference informed Banco de Portugal, the Portuguese central bank that it was cutting off BES's access to ECB funds on August 1, 2014. Two days later on August 3, 2014, Banco de Portugal announced a taxpayer-funded bailout (€4.4 billion) and a breakup of BES as a private bank and BES be restructured by splitting it into two. The bailout was funded by the Portuguese Resolution Fund, a structure created in 2012 with contributions from Portuguese banks and the financial sector and its operations audited by the Portuguese regulator Banco de Portugal. BES was to be split into a "good bank" to keep its healthy operations, and a "bad bank" to keep its toxic assets.

Good Bank

Novo Banco, the healthy bank, was introduced on 4 August 2014 by Portugal's central bank to rescue the assets and liabilities of BES. It incorporates every staff, branch, deposits, credit customers and holders of senior bonds of BES. It launched its first communication campaign in its very first month, to mark the beginning of the change in the image of the bank. The formerly symbol of the butterfly has incorporated the animal's wings in the shape of mathematical power, as a way to symbolize the commitment to "have once more the leading role it once had." The change in the brand was made progressively, starting with the facades in the bank's branches.

Novo Banco is a reference in the Portuguese financial system, recognized by its high standards of service quality and commercial dynamics with which its clients, individuals, companies and institutions are served. It assures a wide coverage of clients financial needs, acting in a transversal way in all areas of financial services, such as Corporate Banking, Asset Management and Insurance.

In Portugal, Novo Banco has a vast network of branches, business centres and an excellent service - NBdirect, and NBnet- one of the most innovative home banking service systems. At present, the bank is owned three quarters by U.S. private equity firm Lone Star and one quarter by the state-backed Portuguese Resolution Fund.

Bad Bank

The bad bank to house BES's exposures to the troubled Espirito Santo business empire and its Angolan subsidiary was Banco Economico, formerly Banco Espirito Santo Angola (BESA), founded in 2001 and renamed in 2015.

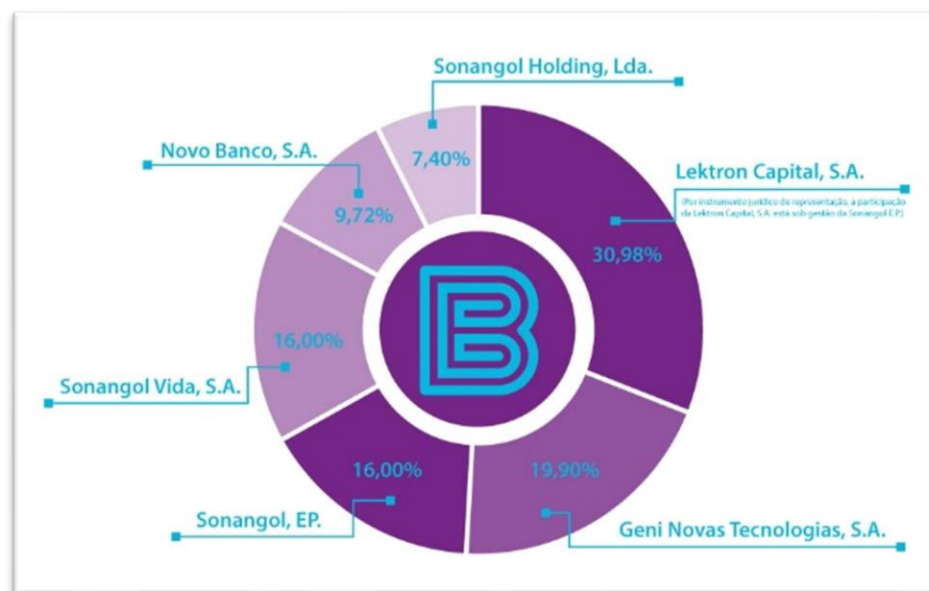


Figure 4: Shareholders' Structure

At present, the largest shareholders of Banco Economico are Sonangol, with about 39.4% shares; Novo Banco, with 9.72%; Geni Novas Technologies, with 19.9% of the capital and Lektron Capital, a Chinese capital company with 30.98%.

The Banco Economico group operates throughout the financial sector, also in the insurance, pension funds and capital markets sector through its subsidiaries. It is also fulfilling its social responsibility towards education, health, culture and environmental areas.

Banco Economico considered Best Internet Bank Angola 2016, Best Bank Governance Angola 2016 & 2019 by the Capital Finance International awards program, Best Mobile Banking Application Angola for two consecutive years 2017 & 2018.

Investors' Problems with Government

Portuguese central bank, Banco de Portugal imposed a restructure maintaining bad assets in BES, Banco Economico and transferring stable funds to the newly created Novo Banco. Novo Banco leads the European Central Bank and the EU banking Union to call upon the Portuguese Central Bank to reduce its liabilities. In response, Banco de Portugal cherry-picked €2.2 billion worth of bonds from Novo Banco and retransferred them back to the toxic BES, Banco Economico. These bonds were held by foreign and institutional investors and as a result of the move from the Portuguese central bank, they faced heavy losses.

International investors who found themselves at a loss have since attempted to find recourse through the Portuguese legal system but in vain. Recover Portugal, a campaign group, was established to raise awareness of the case. The case has continued to damage the reputation of Portugal as a safe destination for foreign investors even seven years later when the EU is seeking to raise funds on international markets in order to finance the bloc's recovery from the coronavirus pandemic.

So the recovery group has called for investors to be compensated for their losses and has also called for guarantees of redress and equitable treatment before considering partial funding of the EU recovery fund. The investors want to recover the more than €2 billion that was taken from them. They also want the interests of investors to be protected and the Novo Banco problem is solved by the Portuguese government very soon.

Conclusion

The report shows what the lack of proper audit oversight can do. Even though BES was a wealthy banker, the parent company did not have goodwill. The parent company created a complex company structure and offshore banks, a financial purpose vehicle that made it easier to bring out more money as a debt from the BES to run their already high leveraged businesses. At the same time, it is important to mention the role of the management, particularly the CEO, Mr Sagaldo who has been sued for fraud and money laundering. The CEO is responsible and for the financial scandal that had been going for years at the bank. The bank, in simple words, sold the debt of the parent company to the retail investors of the bank. The parent company, ESI, inflated the price of the asset against which they had been taking loans. The bank showed the loan of the ESI, parent company, as an off-balance sheet item, the external auditor KPMG did not raise a red flag. The external auditor failed to find the fraud process even though they had been auditing the bank for 12 years. The audit firm, KPMG, played a significant role and a big failure in this debacle.

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