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Europe can’t afford to ignore Novo Banco

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Opinion Plus

Portugal’s central bank must correct its mistaken bail-in, if it wants to rebuild trust with the international investment community.

Euro notes and padlock | *Photo credit: Adobe Stock*

Portugal’s return to the capital markets last September was widely heralded in Europe as a sign of the country’s recovery coming of age. It has now won back its investment-grade credit rating from S&P and Fitch, with sovereign bond yields falling to their lowest level in almost three years as a result.

But investors in Portugal’s revival should be on their guard, for the country’s institutions remain weak and prone to governance failures. A house built on poor foundations is likely to show its cracks again, even if they have been papered over.

Portugal has long been regarded as one of the weakest eurozone economies – and its journey since the 2011 bailout has been arduous. Indeed, the European Commission's latest economic forecasts for 2018 show that Portugal is bottom of the league, with predicted GDP growth at half the level of Ireland and below that of Cyprus and Greece.

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And Portugal has the dubious honour of doing something that even Greece never did, by imposing discriminatory losses on specific senior bondholders and breaking 'pari passu', the well-established international principle that creditors in equally ranked securities must be treated equally.

On 29 December 2015, just three days before the EU's Single Resolution Board came into being, Portugal's central bank, Banco de Portugal, took the unlawful decision to move five of 52 outstanding series of senior bonds from Novo Banco, the 'good bank' created in 2014 as a result of the resolution of Banco Espírito Santo, back to the 'bad bank'.

The result was that investors representing pensions and savers, as well as retail investors, found their fundamentally good investments had suffered huge losses overnight, in an attempt by Portugal's central bank to 'cheaply' plug a hole in Novo Banco's balance sheet.

Banco de Portugal's stated justification for breaching the sacrosanct rule of pari passu was that the five series of bonds selected were issued to international institutional investors, rather than to retail investors.

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While it is a breach of resolution law to discriminate against investors on the basis that they are institutional rather than retail, it was also a flawed justification, as Banco de Portugal undertook no due diligence to determine who actually held the retransferred notes. Some were in fact held by retail investors.

However, the most important, and unstated, criteria behind Banco de Portugal's selection was much more opportunistic: the retransferred notes were all governed by Portuguese law, with all other series bar one subject to English law, thereby conveniently avoiding the prospect of litigation in an international forum.

It is now two years since this remarkable failure of capital markets governance, and yet since that time, Banco de Portugal has failed to meaningfully engage with the bondholders upon whom it imposed such significant losses in breach of fundamental legal principles.

Yet the problem is not going away for Portugal – or for Europe.

Legal challenges by the Novo Note Group and others are still ongoing, and new legal action is set to be launched over the unlawful decisions taken by Portugal's central bank.

The consequences of the Novo Banco retransfer are not just legal, however. The decision has led to an inherent distrust of Portugal among the international investment community – whose help it badly needs if the country's recovery is to be sustained, especially in its banking sector.

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Actions taken by the authorities have undermined the legal certainty and level playing field that the eurozone has sought to create via the EU's Bank Recovery and Resolution Directive (BRRD), making it even harder and more expensive for peripheral banks to raise capital.

The decisions on Novo Banco have also set a worrying precedent: that regulators can do what they want, as long as they say it is in the "public interest". This has ramifications for the broader banking system and European law as a whole. Action to address this is urgent. The EU needs to step in and enforce oversight.

Portugal's banking system remains frail and, despite recent good news on the economic front, is in dire need of help if it is to survive. Europe can ill afford to ignore the uncertain investment climate created as a result of this failure of governance. If investors are to take risks to help shore up Portugal's banks, then their price for doing so will be high, if indeed they decide to take the risk at all.

If Portugal is to rely on the international support it needs for its recovery to succeed in the long-term and to withstand future shocks, Banco de Portugal must correct its mistaken past actions. Together with decision-makers in Europe, the country must look to rebuild trust with the international investment community.

Ignoring the issues raised by Novo Banco, or sweeping them under the carpet, is not an option.

About the author

The Novo Note Group
(Coordinators: Attestor Capital, BlackRock, CQS, PIMCO)

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