Behind the Collapse of Portugal's Espírito Santo Empire

Regulators Believe Switzerland's Eurofin Played Key Role in Financing Failed Conglomerate

By
Patricia Kowsmann in Lisbon and
David Enrich and
Margot Patrick in London

Aug. 12, 2014 5:37 p.m. ET

Over nearly 150 years, Portugal’s Espírito Santo clan built a corporate dynasty whose interests ranged from European banks to Miami condos to a diamond mine in Angola. Its current patriarch was nicknamed "Dono Disto Tudo," or "Owner of All This."

Now the empire is in ruins. The family’s prized asset and Portugal's second-biggest bank, Banco Espírito Santo SA, BES LB -40.30%, collapsed this month, and Espírito Santo's main holding companies have filed for bankruptcy amid allegations of accounting problems and fraud.

The scandal has rocked Portugal's political and business elites and sent shock waves through Europe's fragile financial markets. Portugal's main stock-market benchmark has tumbled 22% since Espírito Santo's crisis intensified early last month. The fact that regulators didn't spot the
company's problems has rekindled fears among investors that trouble might be lurking in other European banks.

At the heart of the affair lies a small Swiss financial company now called Eurofin Holding SA, which was set up 15 years ago largely to handle financial transactions for the Espírito Santo family and its companies.

For years Eurofin was partly owned by an Espírito Santo company. Eurofin played an important role in buttressing Espírito Santo's finances, according to internal Eurofin emails, trading records and other documents reviewed by The Wall Street Journal, as well as former executives and other people familiar with the relationship.

The records indicate that Eurofin moved money between Espírito Santo entities, often in ways that were difficult for outsiders to detect. Some of the moves took place in the heat of the global financial crisis, when southern European banks were struggling to stay afloat.

At times, a Eurofin-managed vehicle was the only buyer of certain Banco Espírito Santo bonds, trading records show. Eurofin helped package large sums of debt from various Espírito Santo companies, which were then sold to the bank's customers. One arrangement attracted attention from a top French bank's compliance department, prompting that bank to stop processing transactions between Eurofin and Espírito Santo, according to a person familiar with the matter.

Portugal's central bank governor, Carlos Costa, now says the shuffling of funds among Espírito Santo companies amounted to fraud. Espírito Santo "developed a fraudulent funding scheme between the companies belonging to the group," Mr. Costa said recently. He added that "these frauds are very difficult to detect before they collapse, in particular when activities are carried out in various jurisdictions."

Family patriarch Ricardo Espírito Santo Salgado, shown in a 2010 photo, resigned as CEO of publicly traded Banco Espírito Santo in July. Associated Press
Portuguese regulators suspect that Eurofin played a central role in the Espírito Santo affair, according to a person familiar with the investigation.

Eurofin, a privately held company based in Lausanne, Switzerland, said in a written statement that it "is fully autonomous and independent" of Banco Espírito Santo and the wider Espírito Santo Group. Eurofin confirmed that it had extensive business dealings with Espírito Santo entities, but said the company "has always acted in full compliance with applicable laws and regulatory requirements." The company said it never distributed any financial products to retail customers.

Alexandre Cadosch, chief executive of Eurofin, said in a brief interview Tuesday: "I firmly believe we are the wrong target."

A spokesman for Espírito Santo International SA, the family's main holding company, which filed for bankruptcy last month, declined to comment.

Family patriarch Ricardo Espírito Santo Salgado resigned as chief executive of publicly traded Banco Espírito Santo in July. He recently was detained for questioning by Portuguese prosecutors in a money-laundering investigation. He has said he "believes that truth and justice will prevail." A spokesman said Mr. Salgado would speak publicly only when the Bank of Portugal completes its investigation.

The collapse of Portugal's Banco Espírito Santo, whose Lisbon offices are seen above, has sent shock waves through Europe's fragile financial markets. Associated Press

The Espírito Santo dynasty started with a foreign-exchange business in Lisbon, launched in 1869 by José María do Espírito Santo e Silva. The business eventually became Banco Espírito Santo and expanded beyond banking into a global empire that included real estate, hotels, health care
and energy and agricultural interests. Mr. Salgado, a soft-spoken man with deep blue eyes who is the great-grandson of José Maria, became the bank’s CEO in 1991.

In 1999, the family's growing fortune prompted the creation of a separate entity, Eurofin Services, mainly to manage the clan's financing and transactions, according to former Eurofin executives. It was founded by Mr. Cadosch, then a vice president at an Espírito Santo trust company.

Under Mr. Cadosch, Eurofin gradually expanded into offering wealth-management services to other rich families.

By 2008, Eurofin employed about 40. The Espírito Santo family, through a company called Espírito Santo Resources, owned 23% of Eurofin. Its second-largest shareholder, with a 22% stake, was a powerboat-racing promoter named Nicolo di San Germano.


But serving Espírito Santo was always Eurofin's main mission, the internal emails and documents show.

At a May 2008 presentation to Banco Espírito Santo executives, Eurofin officials floated the idea of the bank buying a majority stake in an arm of Eurofin. They noted that the firm's name could be "changed to an Espírito Santo branding," according to a copy of a slideshow. The slides also noted plans, independent of any acquisition, for Eurofin "to develop a range of products" for the bank's clients.

Eurofin managed several investment funds that were sold to clients of Espírito Santo's Swiss private bank, according to Eurofin documents and a former executive. And a stock fund managed by Eurofin counted stakes in Banco Espírito Santo and Espírito Santo Financial Group SA as its two biggest investments, according to marketing documents.

Eurofin was managing more than 1.4 billion Swiss francs ($1.6 billion) of assets for Espírito Santo entities, representing most of Eurofin's total assets under management in 2010, according to an internal Eurofin email.

Not everyone at Espírito Santo was comfortable about the close relationship with Eurofin, the documents show. Before an October 2009 meeting with Espírito Santo, a senior Eurofin executive, Michel Creton, wrote to colleagues to warn them that a top bank executive isn't "friendly" toward Eurofin because of its perceived role serving as a special-purpose financing vehicle. Mr. Creton didn't respond to requests for comment.

That same year, the Espírito Santo family sold its stake in Eurofin, according to Eurofin. The powerboat-racing promoter Mr. di San Germano became Eurofin's majority shareholder.

But the connections between Eurofin and Espírito Santo remained deep, the documents show.

In late 2009, Banco Espírito Santo created a Lisbon trading desk named Tulipa. Its main mission was to sell its customers debt issued by various parts of the Espírito Santo Group, according to a Eurofin memo discussing the project. The memo estimated annual volumes could reach €30 billion, or about $40 billion.
Bank executives turned to Eurofin for help establishing a "paper trail" to "demonstrate the involvement of a third party in the transactions with its clients," according to the Eurofin memo, written after Eurofin executives discussed the setup with bank officials.

Asked about Tulipa, Eurofin said that in 2010 it "set up an intermediary to provide intermediation services as arranger to institutional clients, but these services were never provided to retail clients by Eurofin."

In early 2010, Mr. Creton, the Eurofin executive, flew to Lisbon to meet with Espírito Santo executives. "They were all happy to see that we present ourselves as an independent party with whom they can envisage to work," Mr. Creton emailed his colleagues after the meeting.

Eurofin also helped manage two British Virgin Island-registered investment funds, called EG Premium and Zyrcan. The two funds regularly bought and sold assets and lent money to one another, as well as with Espírito Santo entities, according to internal fund documents. Internal Zyrcan spreadsheets referred to certain counterparties simply as "our friend," which the former executive said was a reference to Espírito Santo.

The former Eurofin executive said the two funds' largest investors were Espírito Santo-owned companies.

In the summer of 2009, Banco Espírito Santo issued so-called zero-coupon bonds with a face value of about €1.8 billion. Zyrcan was the only buyer, and it quickly sold the bonds at prices double or triple what it had paid, according to trading records. A Zyrcan affiliate said in a letter at the time to an intermediary bank that it hoped to profit by selling the bonds in several batches "to clients of Banco Espírito Santo, Lisbon." On many days from 2009 through 2011, the Zyrcan fund bought tens of millions of dollars of debt issued by Banco Espírito Santo's internal finance arm, providing the bank with a steady stream of liquidity during financial crises, according to trading records.

In the first week of January 2011, for example, Banco Espírito Santo's funding costs were soaring to their highest level in years as anxious investors and banks rushed to curtail their exposure to southern European lenders. That week, Zyrcan bought about €174 million of the bank's long-term bonds, trading records show.

Eurofin said that its Eurofin Capital unit "acts as mere investment advisor" to EG Premium and Zyrcan. Internal fund documents show that senior Eurofin executives, including Mr. Cadosch and the firm's deputy director, Valérie Cholvy, were closely involved with managing the funds and that Eurofin was paid quarterly "management fees." Ms. Cholvy didn't respond to requests for comment.

A large portion of the transactions among Espírito Santo companies, EG Premium and Zyrcan were routed through Caribbean branches of French bank Société Générale SA, GLE.FR -0.28%, according to trading records.

In early 2012, employees in Société Générale's compliance department wanted to learn more about the transactions their bank was processing between Eurofin and Espírito Santo entities, according to a person familiar with the matter. Compliance employees repeatedly requested additional information. When they didn't hear back, the French bank stopped serving as an intermediary, this person said.
Things started unraveling late last year.

In November, Portugal's markets regulator imposed a rule limiting the amount that funds could invest in entities affiliated with the fund managers.

The Journal reported in December about Espírito Santo International accounting practices that some outside experts deemed questionable, and noted that Banco Espírito Santo was selling debt issued by other Espírito Santo entities to its retail clients. At the time, Espírito Santo defended its accounting practices and said its sales practices were proper.

That month, the Bank of Portugal told Banco Espírito Santo to reduce its exposure to other Espírito Santo companies, and it requested that KPMG LLP audit Espírito Santo International's books.

This spring, KPMG informed the Bank of Portugal it had uncovered a variety of accounting "irregularities," according the Bank of Portugal's Mr. Costa. In March, the auditor of Espírito Santo International's books, Francisco Machado da Cruz, stepped down from Eurofin's board of directors, according to Eurofin. He didn't respond to requests for comment.

On July 18, Espírito Santo International filed for bankruptcy protection from creditors in Luxembourg.

Banco Espírito Santo's auditors, meanwhile, were finding new areas of exposure to its bankrupt parent. On July 30, the bank reported a €3.6 billion first-half loss, a larger-than-expected blow caused by newly uncovered Espírito Santo debt that had been sold to the bank's retail clients, which the bank said it might have to buy back. The bank said the debt was packaged by financial intermediaries and then sold to clients at an inflated price.

Days later, Mr. Costa identified Eurofin as an intermediary that packaged that debt. Mr. Costa said the securities that Eurofin helped package caused about $1.7 billion in losses for the bank as it set aside money to repay customers.

On Aug. 1, the European Central Bank's governing council, in a lunchtime videoconference, informed the Bank of Portugal that it was cutting off Banco Espírito Santo's access to ECB funds. Two days later, Mr. Costa announced a taxpayer-funded bailout and breakup of the bank.

Eurofin said in its statement that as of June, Espírito Santo "represented a significant part" of its business, although it noted the exposure was "far lower" than a few years ago, when more than two-thirds of its assets were tied to the family.

Mr. di San Germano, the powerboat enthusiast who is majority owner of Eurofin, says he is still trying to figure out what happened. "It was a really big, big surprise to hear" of Eurofin's extensive dealings with Espírito Santo, he said in an interview. "I did not know personally about these things."

—Noémie Bisserbe in Paris contributed to this article.

Write to Patricia Kowsmann at patricia.kowsmann@wsj.com, David Enrich at david.enrich@wsj.com and Margot Patrick at margot.patrick@wsj.com