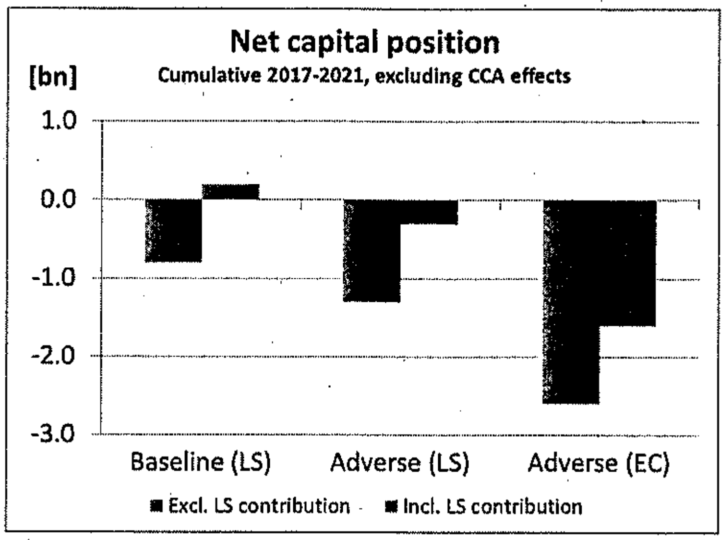

7.4.2. *Viability concerns – legacy issues*

(225) Novo Banco has a large portfolio of legacy assets, a number of which are of inferior credit quality or could readily deteriorate to inferior credit quality. In order to assess potential problems related to those assets, the Commission requested a complete loan tape of the bank as of 30 June 2016 and 31 December 2016. In addition, it requested the complete loan documentation of a small sample of 20 of those loans, stratified by client type and performance.

(226) The Commission notes that Novo Banco appears to be suffering from significant deficiencies in its Management Reporting capabilities. The bank was not able to produce loan tapes with complete or correct information. In particular:

(a) Default probabilities were provided for less than [...]% of all line exposures and zero in another [...]%; in some product areas, such as retail mortgages, only [...]% of lines had non-zero values; if provided at all, the meaning of credit ratings is unclear as is their last review date, making it impossible to use them to supplement the information on default probabilities;

(b) Loss given default estimates are provided slightly more systematically than probabilities of default. However, the numbers seem very much unreliable and cannot be verified because of the absence of collateral information;

(c) There is no information provided about whether or not a given exposure is collateralised or not; moreover, the bank was also unable to provide a collateral tape allowing the matching of collaterals to specific loans, let alone addressing second order questions such as cross collateralization of exposures or prior liens potentially further reducing collateral coverage.

(227) The Commission points out that these findings are in themselves problematic as they point to severe issues with both IT systems and more importantly, risk management reporting capabilities.

(228) The Commission also notes that the pricing information in the loan tape is uncorrelated to the probability of default or cost of risk[76]. This absence of correlation points to serious flaws in the business model or the business management of the bank.

(229) In this respect, the Commission notes that those findings do not only pertain to the period prior to the BES resolution in 2014 but continue to impact the performance of Novo Banco under management by the Resolution Fund under the responsibility of the Bank of Portugal. Even new lending in 2016 after Bank of Portugal had already been in charge for more than one year shows significant deficiencies in all those categories.

(230) The credit file review performed by the Commission fully confirms the findings in the loan tape, namely that past lending practices of BES have contributed to its demise. But it also indicates that even after the establishment of the bridge bank and under direct control of the Bank of Portugal, Novo Banco seems to have done little to remedy previous problematic lending practices or substandard credit risk management.

(231) With respect to the credit file review, the Commission noted the following deficiencies:

(a) In many credit files: absence of cash flow analyses or an indication of repayment capacity of the client (absence of income declaration or fiscal statements for retail clients, granting of Corporate and SME mortgages purely on the basis of the underlying collateral);

(b) Loan agreements with insufficient protection (e.g. under the form of covenants) against changing creditworthiness or changing credit circumstances;

(c) Loan documentation often inaccurate, incomplete or insufficiently updated, in particular credit file reviews lacked depth and sometimes misrepresented the factual situation;

(d) Presence of an example of "name lending" (loan granted as a favour);

(e) Inconsistent real estate collateral valuations, with practices often differing across branches or regions;

(f) Erratic pricing, not adhering to consistent Risk Adjusted Return objectives, both in the granting of new credits as well as in restructuring cases; and

(g) Deficient or inconsistent Credit Risk assessment ([…]% default probability to factoring, […]% probability of default to a company with negative equity, no rating at all for "lack of financial information", etc.).

(232) Overall, the Commission's findings raise the issue about the quality of the legacy credit portfolio of Novo Banco. In particular, those findings would suggest that relying on the bank's loan tape for the assessment of lending quality of the legacy

[76] Cost of risk would be probability of default times loss given default and provides a measure for the riskiness of a given exposure. Such riskiness should in general terms be reflected in the interest rate to be paid by the customer for the loan