

19 February 2015

Oak Finance and Banco Espírito Santo

NZ Super Fund Media Backgrounder - Frequently Asked Questions

What has happened?

On 3 August 2014, the Bank of Portugal used its powers in relation to insolvent credit institutions to transfer certain of the assets and liabilities of Banco Espírito Santo (“**BES**”) to a bridge bank (“**Novo Banco**”), while keeping other assets and liabilities in BES. The assets and liabilities retained by BES were mostly those connected with existing relationships between BES and certain other companies in the Espírito Santo Group, which was the major shareholder with 25% ownership. Novo Banco specifically confirmed that, as expected, the assets and senior liabilities, including customer deposits, which were transferred to Novo Banco included the senior loan which had been made to BES in July 2014 by Oak Finance.

On 22 December 2014, the Bank of Portugal purported to reverse this earlier declaration in respect of Oak Finance. This purported reversal, which was expressed to have effect from 3 August 2014, was based on a misunderstanding of both the nature of the Oak Finance loan and the application of the 2% rule which was introduced on 1 August. This was an unprecedented scenario and was not something we were able to anticipate.

Following the 22 December 2014 decision, Goldman Sachs provided the Bank of Portugal with further details of both its shareholdings in BES and the structure of Oak Finance, in order to explain that the factual assumptions underpinning the 22 December decision were inaccurate.

On 18 February 2015 the Bank of Portugal re-affirmed its 22 December decision. This is both surprising and disappointing.

What was the purpose of the Oak Finance loan?

The loan was used for general corporate purposes including the finance of trade transactions being entered into by BES. The benefit of the loan proceeds was transferred to Novo Banco on 3 August, and remains with Novo Banco.

What is the 2% rule?

In broad terms, an amendment was made to the Portuguese bank insolvency regime on 1 August 2014 which prohibited the transfer of liabilities of "old bank" vis-à-vis shareholders who had at any point in the previous two years owned greater than 2% of the shares of the insolvent "old bank", effectively preventing claims from such category of shareholders transferring into "new bank".¹

This rule was intended to be consistent with the principal purpose of the bank resolution, namely to enable the continuity of most of the business of BES through Novo Banco (which is designed to be sold), while making shareholders, other subordinated creditors and those responsible for the distress of BES bear first losses through respective exposure to BES, which continues to exist depleted of most of its assets and is to be liquidated.¹ Accordingly, the 2% rule was intended to (and has otherwise been used to) prevent claims from, e.g., former management and controlling owners of BES making claims into Novo Banco.

Goldman Sachs disclosed a 2% interest in BES in July 2014. On what basis is the Oak Finance loan not caught by this 2% rule?

First, it is Oak Finance, not Goldman Sachs, which is the lender under this loan. Accordingly, Goldman's equity shareholding in BES is not relevant to the decision as to whether the Oak Finance loan was properly transferred to Novo Banco. Oak Finance's only major asset was a loan to BES and it owned no shares in BES.

¹ Although there is real doubt as to whether the purported retrospective effect of this amendment is valid as a matter of Portuguese law.

Even ignoring that point, however, Goldman has never been a shareholder of BES with a holding in excess of 2%. For a period of 8 days between 15 July 2014 and 23 July 2014, prior to the introduction of the 2% rule and after the Oak Finance transaction had already closed, Goldman's total holding for the purposes of provisions of Portuguese law implementing the EU Transparency Directive exceeded 2%. However, the test for a shareholding under the EU Transparency Directive is materially different from, and broader than, the applicable test for the purposes of the 2% rule.

Only 1.6% of the shareholding was a physical holding of BES shares, which is the only relevant ownership for the purposes of the 2% rule: the balance of 0.67% was Goldman's interest in cash settled swaps², which did not carry any voting interest in nor right to acquire BES shares.

In any event, as referred to above, by the date of implementation of the amendments to Portuguese law, Goldman's interest in BES shares (even on the basis of the substantially broader test under the EU Transparency Directive) had dropped below 2%.

What information led the Bank of Portugal to come to this conclusion?

We understand that earlier in December, Bank of Portugal made certain requests for information to Deutsche Bank, as agent for Oak Finance. However, these queries did not address the key issue of Goldman Sachs' interest in BES, and were not communicated to Goldman.

In the absence of the necessary information, the Bank of Portugal then proceeded to make its reversal decision on 22 December. In our view, this finding was based on a misunderstanding of both Goldman's relationship with Oak Finance and the nature and level of Goldman's interest in BES shares.

On 18 February 2015, the Bank of Portugal reaffirmed its 22 December 2014 decision, saying:

- Evidence provided by Goldman Sachs [subsequent to 22 December] showing that they had less than 2% voting shares was considered by Bank of Portugal to be insufficient for it to reverse its decision. The Bank of Portugal says cash settled swaps have an influence on BES voting rights.
- The Bank of Portugal's view is that evidence that third party investors provided the funds to Oak Finance to make the loan to BES may only be confirmed by a court.

Was the Oak Finance structure intended to circumvent the 2% rule?

No. The financing was conceived of and implemented prior to both the introduction of the 2% rule and the apprehension of BES' imminent insolvency. Refer to the timeline provided for further details.

Why did the New Zealand Superannuation Fund invest in the Oak Finance bonds in the first place?

This investment is part of a broader active investment strategy to invest in a range of credit opportunities globally. This strategy has been in place for a number of years and has been successful over time and when considered as a whole.

This particular investment opportunity was to purchase the bonds at a level where the Fund was getting a yield that that was higher than the cost of the credit protection insurance that it also bought.

Were you concerned about the bank's solvency?

BES was at the time of the loan Portugal's largest commercial listed bank and had successfully completed a EUR1 billion equity rights issue in June 2014. Immediately after completing this equity rights issue brokers estimated that BES had a tier 1 capital ratio of 10.4% and on 30 June 2014 the Bank of Portugal stated that BES had a solid solvency position.

What is the loan worth now?

² It is only physical settled swaps pursuant to which the counterparty will acquire an interest in the shares themselves which counts for the purpose of the 2% rule

We have taken an extremely conservative position and are not ascribing any value to the loan as at today. 2/3 of the write-down was reflected in our December performance figures. Ultimately the value of the loan depends on the outcome of the court case as it depends on whether the loan rests with BES or Novo Banco and the issue of where it should sit is what is being disputed. We believe we have a strong case.

What is the impact on the Fund's performance?

While US\$150 million is a large investment in dollar terms, it represents only 0.7% of the total New Zealand Superannuation Fund.

Overall the Fund, which is highly diversified and of which this is only a small part, continues to perform well, as does the strategy of which this investment was undertaken. To illustrate, even after factoring in a conservative write-down of this loan to zero, the Fund has returned 16.71% over the last 12 months (as at 31 January 2015, after costs, before tax).

The impact on financial year to date performance will be to lower Fund returns by 0.69%. This will also lower the Fund's since inception annualised return by 0.07% (to 9.98% p.a.) as at 31 January 2015.

Did you have credit protection insurance?

Yes, we purchased credit protection insurance on Banco Espírito Santo at the time the Oak Finance made the loan to Banco Espírito Santo. Following the intervention at the Bank of Portugal and the transfer of the senior obligations (including the Oak Finance loan) to Novo Banco, the International Swaps and Derivatives Association on August 8, 2014 determined that a succession event had occurred.

As a result of the succession event occurring, the Fund's credit protection therefore moved to Novo Banco in the same way that the Oak Finance bonds did. If the Bank of Portugal's purported decision to move the Oak Finance loan from Novo Banco to Banco Espírito Santo is upheld, it would be likely to make our credit insurance ineffective. The insurance follows the majority of senior debt, which remains in Novo Banco.

Do you do many of these sorts of trades?

While this is one of many trades that have been undertaken over the years, in total this strategy makes up a small proportion of the overall Fund – around 2.5% of Fund NAV. Overall the strategy has been successful.