
MANAGING STRUCTURE AND SHAREHOLDER COMPOSITION: PILLARS OF THE ENTERPRISE SUCCESS OF THE BANCO ESPIRITO SANTO (1920-1955). A CASE STUDY

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Introduction

With a history stretching back 140 years, the Banco Espírito Santo is the oldest private Portuguese banking establishment in activity today. In terms of European banking, this almost century and a half of existence pales in comparison to the advanced ages of several other private banking institutions which have been in business for more than three centuries in countries such as Germany, England and Italy. However, within a national financial context and as the bank completes 14 decades of life, this study in the field of corporate history seeks to make known a number of aspects relating to the governance of the bank.

The shareholder structure, the faithfulness to ethical principles, the proactive capabilities of the bank's leaders and its technical teams, the family unity, the intimacy with political power or the good grace of economic environments explain the successful trajectory of the founder's descendents.

This paper covers the period from 1920, date the company was formed as a Public Limited Company to 1955, the final year of the Chairmanship of Ricardo Espírito Santo Silva.

I

The origins of the bank go back to the work started in 1869 by José Maria do Espírito Santo e Silva (1850-1915), owner of an Exchange Bureau in the Bairro Alto, a traditional Lisbon neighbourhood. It was there that the young entrepreneur negotiated the purchase and sale of letters of credit and exchanged currencies while also holding the lucrative rights for the sale of tickets in Portugal for the then very fashionable Spanish lottery.

Working as a broker between investors and users of capital, in just a few decades José Maria do Espírito Santo e Silva managed to transform an obscure Exchange Bureau into the most important bank in Lisbon and one of the country's main banks.

Adverse to extravagance and leading a discrete and unostentatious life (required conditions to gain public trust), Espírito Santo e Silva was a self-made man with natural skills for business and, according to comments from his peers, was even prepared to cope with sacrifice (“with regard to my house I am quite capable of doing all the work”, he wrote in March 1877). He also knew how to maximize the opportunities presented by the economic climate in the last decade of the XIX century.

In almost half a century of continuous business activity, he always avoided speculative risks, which could leave him at the mercy of undesirable creditors.

If we combine these qualities with his other masterful business skills, such as prospective vision, diversified investment (in colonial companies), honesty and thoroughness (with an emphasis on moral values), a goal to maintain family assets fully intact and a rare ability to deal with people and establish friendships, we can see how he managed to create his own identity, one which would be evident throughout the family and the bank, starting a tradition which his sons, José (1895-1968), Ricardo (1900-1955) and Manuel (1908-1973) would uphold.

Towards the end of 1915, due to the volume of business and the scope of the client portfolio, his last company – *J. M. Espírito Santo Silva & C^a*, – became one of the most important establishments in Lisbon in the field of banking, and generally known in the city as “Espírito Santo’s Bank”.

Although the founder passed away, his legacy remained. It was José Ribeiro do Espírito Santo e Silva, the eldest son, who from 1916 to the spring of 1920 and acting as “manager for life” and assisted by his brother Ricardo – led the successor company, the Banking House *Espírito Santo Silva & C^a*. The use of this firm fell exclusively and solely to him.

Of the 400,000.00 Escudos [5.6 million Euros¹] of capital, 1/8 was divided among the heirs and other non-family partners with residual holdings. This division of shares, differing in

¹ Cf. Law 772/2009 – Table for the updating of currency in current terms.

their rights and interests, in line with a concern for the solidity of the institution, continued to reflect family wishes to maintain control of the Bank through a majority capital holding.

II

With the First World War over, banks had to face the dilemma of change or crisis. As it was one of the most important banks, *Espírito Santo Silva & C.^a* was the first to alter its legal status and at the beginning of the 2nd quarter of 1920 became a Public Limited Company with the name of *Banco Espírito Santo*.

Still in the possession of the founder's descendents, this new financial institution, during a time of hardship which required ongoing efforts to modernize in order to survive, sought to follow the commercial and organizational practices of the Midland Bank, an institution which for the young Espírito Santo bankers (José and Ricardo) was a benchmark in the world of banking.

The young Bank was to face difficult times. In the early 1920s – one of the most turbulent periods in Portuguese economic history - the instability of political, social and economic life was to aggravate the country's difficulties. The upheaval caused by the 1914-1918 war together with a combination of serious structural issues brought problems which lasted well beyond the end of the conflict and which were to be strongly felt in all walks of life. The inefficiency of government, the collapse of public order, social chaos and economic decline were serious challenges for which the country could not find a satisfactory answer.

It is however, against such a background of uncertainty that the Espírito Santo family decided to go ahead with the strengthening of the financial institution that they had inherited. The share capital of the new establishment, now 50 years "old", was 3,600,000.00 Escudos – divided into 40,000 shares (nominative, to the bearer and reciprocally convertible) with a value of 90.00 Escudos – fully subscribed through the net assets of *Espírito Santo Silva & C.^a* 39,303 shares, and the company building (property of the founder's children) 690 shares.

In the early stages, the company was managed by a board chaired by José Espírito Santo and two other directors, one of whom had ties to the Espírito Santo family, and one General-Secretary (Ricardo Espírito Santo, who held the right to vote and was empowered to substitute

for the Chairman in his absence or incapacity). Inspections were to be carried out by a 3 member council, who were also required to be company shareholders.

Voting rights at General Assemblies were restricted to shareholders owning 500 or more nominative shares or groups of shareholders, (never more than 20). As a result of this restriction, only the representatives of *Espírito Santo Silva & C^a* (controlled by the Espírito Santo family) were allowed to vote. Every 50 shares brought the entitlement to one vote, although no shareholder, regardless of the number of shares owned, could cast more than 10 votes.

In February 1921, and due to the small core of subscribed capital, just the 17 shareholders present at the first general assembly represented 67% of the capital.

Three months after the Bank was founded and with the express intention of opening it up to participation by large investors in the field of banking, the capital was doubled to 7,200,000.00 Escudos, with a Reserve of 3,600,000.00 escudos (50% of the capital) being immediately set up.

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In 1920, the organizational model established by the Bank's owners institutionalized a number of the basic principles of company governance which assured that they had the minimum conditions required to overcome, although not without difficulties, the crisis years of the 1920s: the economic repercussions of the Great War, political and social unrest, inefficient government, legislative wavering, hyperinflation and currency depreciation. To illustrate these difficulties, the average cost of living index in 1919 was 317, while in 1924 it rose to 2652. Moreover, in the same period, the devaluation of the Escudo in relation to Sterling hit record levels, and the exchange rate rose from 7.9 in 1918 to 134 in 1924.

With loan-sharking proliferating, the Espírito Santo bankers had to learn to swim without sinking. However, this was not the only problem. In a highly unbalanced environment, they sought to ensure survival and, if possible, to grow but without deviating from established principles. At no time do they ever seem to have neglected the key considerations of a financial institution: volume of own funds, recruitment of qualified staff, break down of shareholders, dividend policy, cash and foreign currency positions and relationships with other Banks and

Public Administration. What is more, during these difficult years, they became true pioneers in Portugal by expanding into other areas of the country. Espírito Santo branches appeared in numerous cities with the declared intention of getting closer to clients.

Focused on the short-term management of aims, they opt for a conservative position, centralized on the Chairman of the Board and the General Secretary, choosing safety over greater growth. Nor did they leave return on equity to chance, fully aware that the market was paying special attention to the solidity of banks, their financial position and the size of the capital base at the institutions where they deposited their savings.

Another aspect which displayed the conservative character of management during this period related to the policy of dividend payments. In the first financial year, they approved a dividend payment of 15% to the founding shareholders and 9% to subscribers of the first increase in capital. In other banks, the level of profits set aside to pay dividend was close to 30%, despite profits not being high enough to justify such a figure. At these banks, as the capital was owned by thousands of small shareholders, management ended up giving in to pressure and paid high dividends at the cost of the capital base.

We can thus better understand how, in such a far-reaching recession which reached its peak in 1923 that Banco Espírito Santo managed to consolidate its position over competitors. In the Report and Accounts for that financial year it was said: "Better alive but not growing than entertaining growth which involves risks of imbalance, possibly fatal".

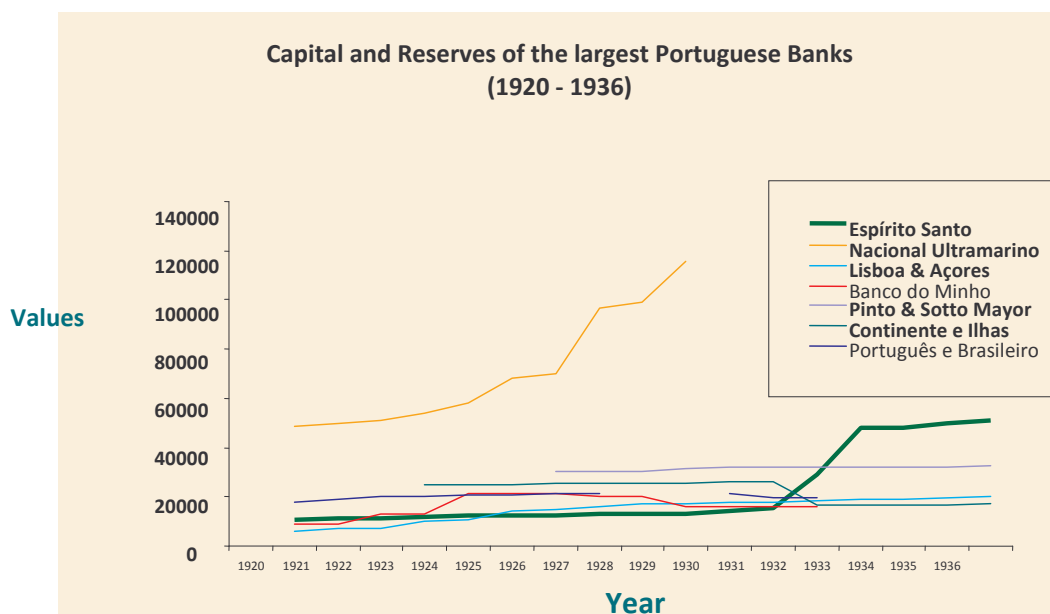
The strategic decisions of the board partly explain the almost insignificant growth seen in the first five years of trading. However, and appropriate for the times, this solid protectionist stance ensured their survival and left greater opportunities for growth intact, as soon as conditions allowed.

In the aftermath of the crisis which Portugal went through from 1920 to 1925, many financial institutions were to succumb, some to bankruptcy, others merging in the false hope of being able to continue. After this clearing of the market, Portuguese banks were better balanced and better prepared for the future. As a result of the disappearance of several banks, BES rose a number of places in the ranking of national financial institutions. In 1926, it was already part of the big five holding 50% of the deposits of all of the commercial banks. The

following year, in 1927, and as a consequence of this growth, the bank placed its shares on the stock market for the first time; few days later, BES shares were already valued at 400% above their nominal value.

Until the end of the decade, the trend towards a gradual rise in operating profits continued, consolidating the position of Banco Espírito Santo as one of the largest credit institutions in the country.

Graph 1



Up to the end of the 1920s, the business prosperity of the Espirito Santo family continued to be marked by an ever increasing value of the bank with management of continuity which was suitable for the circumstances. However, these circumstances were not exclusively based on economic restraints as we can see if we analyze the ontological differences of the two brothers.

The split was to take place in 1932 with the promotion of the General Secretary Ricardo Espirito Santo to the Chairmanship, after his older brother resigned his position. The new General Secretary was the younger brother, Manuel Espirito Santo, who was then just 24 years old.

Emblematic of this moment of transition – and full aware that change involves discontinuity – Graph 1 reflects the first of many of the important decisions made by the new leader: a reinforcement of Own Funds, a category in which the Banco Espírito Santo has a relatively modest position when compared to its competitors.

The year of 1932 marks the end of the first stage in the evolution of this financial institution.

Schumpeter, in one of his works of reference, *History of Economic Analysis*, refers to the importance of the personal element in institutional change. This is mentioned now because of the heterogeneity of personalities among the different Espírito Santo heirs. If the behaviour of each of the bankers from this family had its own repercussions and more or less relevant economic effects on the institution's results, the management of Ricardo Espírito Santo (which lasted until 1954) brought a number of determining factors which were crucial to the rapid elevation and consolidation of the company, both nationally as well as internationally. These factors were decisive for the progress made by Banco Espírito Santo over the next two decades.

Ricardo Espírito Santo, in the environment of economic and financial stability seen in the 1930s and as a result of other favourable outside conditions and his development of an ambitious (and successful) expansionist policy, was able to see the logic and future needs of the banking business. Pre-empting the changes taking place in the market, he created a competitive leadership through a new style of retail banking, promoting innovation in technological processes which made decision making more agile. This allowed a faster reply to client requests, particularly in the field of commercial and industrial financing. As a consequence of this internal revolution, in that year of 1932 profits rose 48% over the previous year.

The benefits obtained in 1932 allowed dividends to be paid and the amortization of all credits which had been lost or were simply doubtful. It was even possible to transfer from £40.000 to £ 60.000 to reserves on an annual basis.

This saving was achieved not due to luck or chance but to the fact that BES carefully selected its clients and did not participate in operations which were not exclusively commercial in nature. Moreover, the bank closely followed client businesses and conceded credit only when

strict criteria were met so as to limit risks. The following example clearly reflects the bank's policy: while the bankruptcies of a number of large firms in Lisbon and Porto only brought maximum losses of £1,350 to BES, the total amount of credit lost by banks was £90,000, of which £15,600 was lost by the Bank of London & South America, Ltd. Clear proof that good practices led to greater value.

Furthermore, the consequences of the 1931 crisis led to the closure through bankruptcy or merger of a number of banks, leaving Banco Espírito Santo greater room for growth. In 1930, despite the deep economic crisis which followed the stability of the Escudo, a crisis which was aggravated by the then world overproduction, BES losses were practically insignificant when compared to the number of deals and to the results which, despite the crisis, were positive every year.

At the same time as the change in leadership, 1932 also saw the progressive return of business, inaugurating what some authors consider to be the start of a new period of Portuguese monetary history.

According to Ricardo Espírito Santo, *without ever having deviated from our traditional observance of sound banking principles and prudent approach to the concession of credit, while also avoiding operations which could reduce the perfect liquidity of our assets ... [...] we feel that this is the most efficient way of defending both the interests of shareholders as well as those of our clients, who find in this Bank the best guarantee of security and continuity of our collaboration.* (Report and Accounts 1933)

In accordance with their goals, formalized in public documents (Minutes of General Assemblies and Reports and Accounts), the medium and long-term aims were laid down: strengthening of the network of branches to take Espírito Santo to all parts of the country, management centralized on the Chairman (whose presence at the head office was constant), strengthening of own funds and scrupulous compliance with legislation "even if prejudicial to the bank", among others. Faithful to their inheritance, the Espírito Santo bankers were of the opinion that these principles represented the necessary competitive advantages to ensure client trust, "the most valuable capital" of the Bank for which they sought continued growth.

Also during the 1930s, the internal organization of the company showed great dynamism, both as a result of the strategic designs of the brothers (and particularly those of the Chairman, Ricardo Espírito Santo), as well as through the pressure of outside factors. The organizational structure was to undergo successive remodelling so as to meet the strategic objectives announced by the management.

At the base of the pyramid of these organizational changes was the proposal to alter the statutes. The justification given by the Board of Directors was that they wanted to be “surrounded by all types of collaboration which could be useful to them”. The underlying objective was to create a new company body headed by another brother, José Espírito Santo, thus reinforcing the family’s control over the bank. For the first time in their history, and a not insignificant fact, all of the brothers (José, Ricardo and Manuel) were together and in charge of the main company bodies, a situation which was to be maintained over the next two decades.

The family’s commitment to the ambitious project to strengthen their position in the national market was gaining consistency. Accompanying government policy to facilitate the expansion of credit, the ultimate aim was to increase market share, giving the bank a position of leadership in the sector.

These signs of the company’s vitality were naturally reflected in the annual results which had a rate of growth greater than that of competitors. The solidity of the bank was confirmed with the family accumulating more resources mainly by subscribing to increases in capital through companies that they controlled.

Through this brief summary it can be seen, especially from 1932 onwards, that there was a structured plan with ambitious medium and long term aims which together with the freedom of choice allowed by the family’s majority control clearly augured for success.

And if in the medium term these organizational capabilities allowed the bank to effectively sit at the top of the national ranking in 1936, the long-term goals – thanks to the timely changes which the Espírito Santo family implemented and the exceptional conditions caused by the renewed outbreak of conflict in Europe from which Portuguese companies could benefit as the country had adopted a policy of neutrality – were to catapult BES to a position of clear leadership in Portuguese banking, drawing even further ahead of direct competitors.

Various circumstances and options explain this successful trajectory. Taking into consideration the uncertainties of the domestic and foreign economic climates of over half a century and the strict compliance with the regulatory framework of the financial market, an analysis of the management strategies used by the Espírito Santo directors at different times reveals a prudent use of capital. It also shows an almost obsessive concern with maintaining comfortable levels of asset liquidity while financing the needs of a demanding and very dynamic economy.

This constant game, sometimes tense, could only be sustained over such a long period of time because the majority of company capital was, as has already been mentioned, held by a small core of family members. There was also an unquestioning obedience to the basic rules as defined by the “family spirit”: know how to choose, and respect and support the leader, under any circumstances

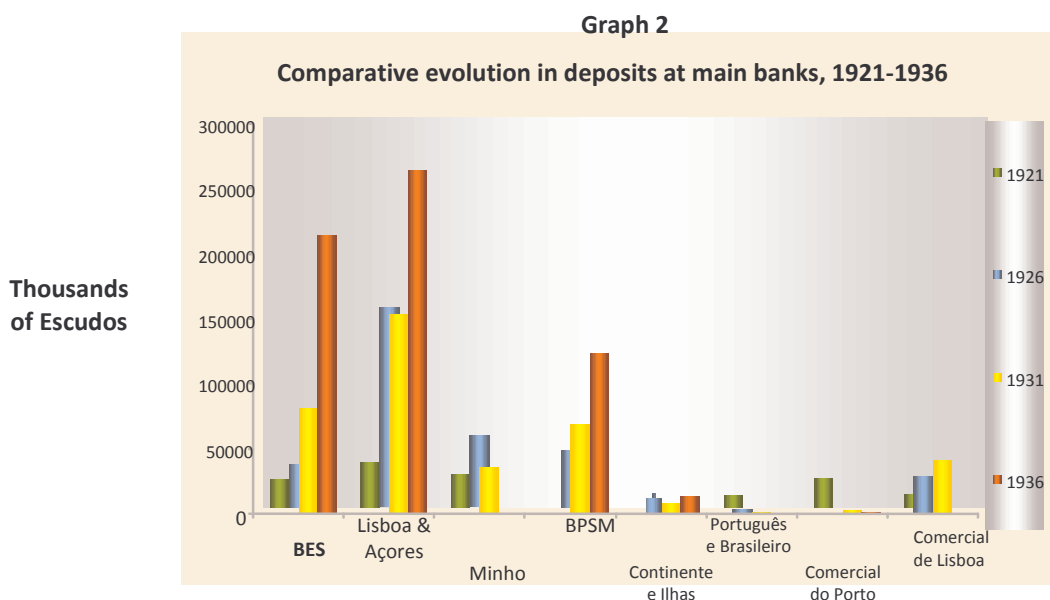
Once again, the basis for this was family cohesion which ensured continuity in the expansion of the business project that they had inherited, as well as faithfulness to principles and an ethical posture, practices which had also been handed on from the founder.

What also proved to be decisive was the self-imposed rule which was observed by the three brothers to work exclusively for the bank and gain experience in all areas. This direct contact learning gave them solid training which was used as the basis to specialize in areas of strategic importance.

For this reason, the rationalization of services, the expansion of the network, credit analysis, cash flow control, international financial relationships and all other relevant aspects of banking activities were areas which were familiar to them. As a result, staff naturally followed a competent leadership and, for the same reason, confidence was transmitted to clients.

At the same time, the continued practice of cautious management was of the greatest importance, a management that was always conservative and based on a policy of secure credit which did not contemplate operations involving loan schedules or guarantees which would represent risks which were considered excessive.

To exemplify BES growth, Graph 2 shows the comparative evolution of Deposits, one of the main categories of banking activity, for the period of 1921 to 1936.



The determining role which the behaviour of the Espírito Santo brothers (with emphasis on Ricardo Espírito Santo up to February 1955, the year of his death) had on the economic results of the institution (and because this also explains the success of the organization), requires a rapid analysis of the ontological features of these brothers.

Factors such as the family inheritance, ethical values, the exclusive dedication of the 3 brothers to the bank, the dynamics in the change of paralyzing routines, the awareness of leadership, the search for technological innovation and new products and services which were suitable for retail banking, the family spirit, their interaction with middle management and the phased decentralization of power, among other reasons, resulted in the moulding of behaviour and standards of conduct. This, together with primacy of management of family interests, a family with majority holdings, in the final analysis explains the good performance of the bank as

seen in return on equity and holding return (two key measures), on market share and also on the longevity of the project.

It should also be mentioned that the expansion of the company required the setting up and perfecting of means of control, internal auditing and supervision of delegated competences, sufficient reasons to establish the position of Inspector-General at the end of 1937, a position which was also handed to a member of the Espírito Santo family. It also led to a widening of the circle of relationships with other banks, especially European banks, an approach which was to consolidate the Bank's international network.

The second period of this phase – 1939/1945 – includes the decisive years of World War II, the outbreak of which was to bring about substantial changes in Portuguese economic and business life, altering the conditions in which banking took place.

The legitimacy conferred by Portuguese neutrality, allowing commercial relationships to be maintained with any of the countries involved in the war, was to prove to be beneficial for the Portuguese economy and for its banks in particular. The banks lived in an unpredictable climate which frequently determined new and unexpected working conditions, which they had to adapt to practically on an ongoing basis. As BES had a much more extensive international position among the Portuguese banks, greater even than all of the other private banks together, it was the main player in operations to finance trade from and to Germany and Great Britain, through the Bank of Portugal. Almost all operations were to go through Espírito Santo not only because of its size but also due to the scope of its portfolio of clients.

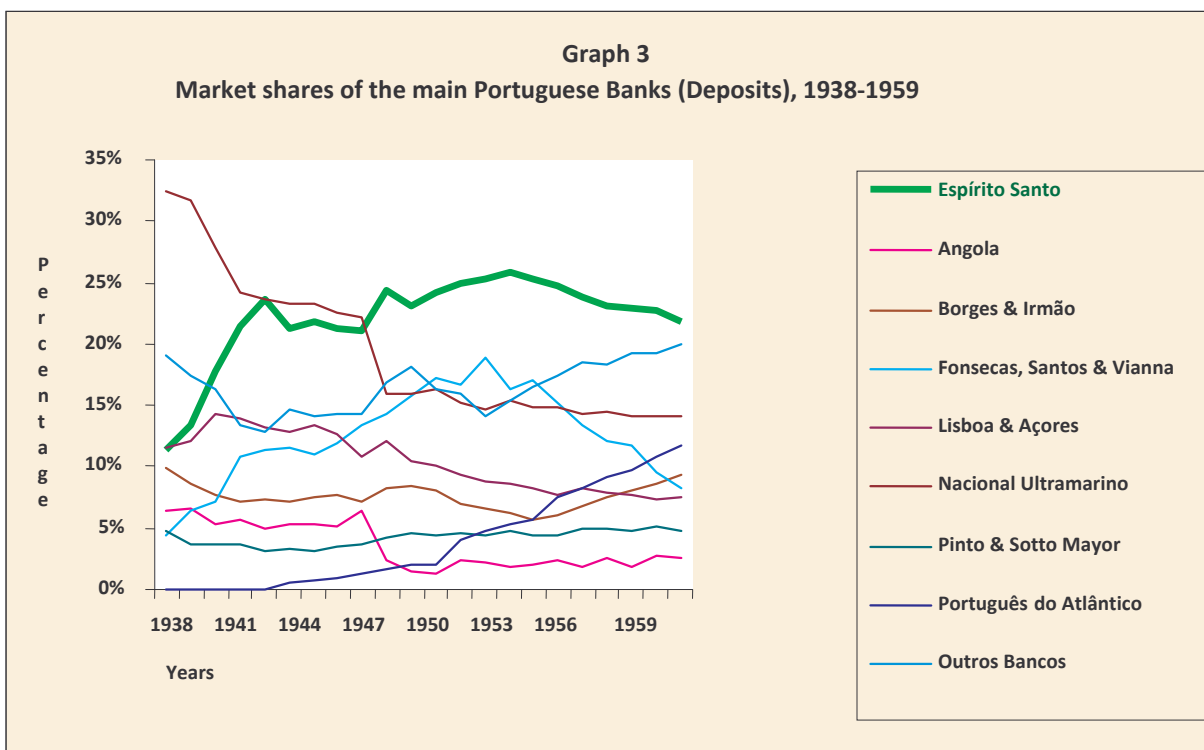
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The seven year period under analysis probably corresponds to one of the most interesting periods in XX century Portuguese economic history. During this short space of time, the country saw sound development, mainly driven by the substantial increase in funds coming from abroad. Conditions which proved to be unique for the accumulation of cash and savings, all channelled to the banking system.

The expansion in BESCL activities during these years of war was also due to the fact that the bank had the largest network of branches in the country, which helped distance the company from other banks. The comfortable position with regard to assets and own funds, the national and international projection and the experience of the management team and staff allowed the bank to take maximum benefit from the situation, consolidating the dominant position which it had won in the Portuguese banking and financial system.

With the end of combat, most European countries which had been directly or indirectly involved in the war saw the start of reconstruction. However, this was not before going through times of uncertainty and difficulty arising from the adaptation to the new situation of peace.

At the start of the 1950s, the capability of the banks was once again put to the test as a result of the changes taking place in the financial system and the new requirements of the domestic economy. Comfortable in its position as the clear leader in Portuguese private banking, Banco Espírito Santo calmly and convincingly took its place as the main private financier for economic development, for example, by financing the national hydroelectric network.



For approximately thirty years, a remarkable period of progress was to be seen in Europe, known as the Golden Age. This was due to a policy of cheap money which benefited expansion, and fomented the internationalization of economic relationships.

In 1952, Ricardo Espírito Santo observed that everything was going up except the price of money, something which was partly due to the economic progress of the country and the improvement in the standard of living. However, this credit policy brought problems to institutions which followed the law, as was the case with Banco Espírito Santo, which had to contend with competitors who were anxious to win new clients and business.

Nevertheless, due to the consistency of their efforts, prominent position of solidity, resources and sound expansionism, BES was in pole position to assist the domestic economy. However, for Ricardo Espírito Santo and his team, the defence of liquidity would constitute a limitation to the unconditional expansion of bank credit. Moreover, the growing competition from banks with smaller market share but focused on aggressive expansion policies was to create tremendous pressure and resulted in clear distortions in banking activity which were more perceptible in the second half of the 1950s. Squeezed between tight margins, short times and legal and formal difficulties, the more traditional banks had little motivation to expand the concession of credit.

One of the possible solutions to sustain the deregulation into which the sector was to fall was to lie not in disloyal competition between banks but in a plan to complement actions in the interests of the national economy.

It is also clear that in these early days of the democratization of the banking system, Ricardo Espírito Santo was preparing for the emergence of new competitors by planning new projects for technological and organizational modernization and the diversification of products and services.

However, his death in February 1955 delayed all of those goals by more than a decade. The result was that in 1964 Banco Espírito Santo was to lose its position of leadership, falling to 2nd and then the following year to 3rd place in the ranking of Portuguese banks.

With his disappearance, the era of greatest progress at Banco Espírito Santo was to close.

CONCLUDING REMARKS

Using a common expression from the field of corporate history, we are almost tempted to say that the work of the Espírito Santo bankers during the period being studied, with regard to how they exercised their power in the company, could be summarized in the words: inspire the confidence to create solvency.

The Espírito Santo family, owners and dominant shareholders in the bank, had uninterrupted command of the organization, sharing with each other the information, the analysis and risk of decision making, always acting in the way they thought best so as to maximize return on investment. And, as investors, they were always involved in the management process.

Supported by clear and objective rules of operation and codes of conduct which were compulsory for all staff, between 1920 and 1955 – the period covered by this study – they instilled confidence and credibility in their clients, building a name which was a national reference in banking.

In the course of the company's activities, the strategic policy for which they would define without obstructions, they sought to be constantly up-to-date with the dynamics of the markets and economic environments, and apply the mechanisms at their disposal to comply with the company's rules of governance, which they had defined, and in accordance with legal requirements and restrictions.

If conflicts of interests existed, known in economics as principal-agent problems, they cannot be found in the sources of information available. However, through knowledge of the company's history (documentation and witnesses) we have the idea that management (who also owned the capital) always sought, even under the most adverse circumstances, to create value for the shareholders and distribute wealth with total transparency, and in the bank's best interests.

The standards and the strict code of good practices applied by the Espírito Santo banking dynasty, firmly supported by their solid business ethics, were determining factors, which in the early stages, ensured the survival of the company during the more troubled times and later on,

ensured development which would put the company at the forefront of the national banking market.

The quality of this comprehensive internal system of standards and the fortunate success of strategic objectives, delineated, controlled and directed by the owners of the company, differentiated the bank from its more direct competitors and also served the interests of all those involved, both shareholders and stakeholders. It also established the necessary basis for the creation of wealth for shareholders regardless of the conditions, very often adverse, in foreign markets.

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