White Paper

on the regulation and supervision of the financial system

BANCO DE PORTUGAL
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Foreword

The financial system is key to the efficient functioning of the economy and to a country's economic development. It ensures the efficient allocation of the economy's financing capacity, channelling it to investments that optimise profits net of both economic and social risk and thus safeguard savers' security and the return on their savings. However, the actual achievement of these objectives requires a suitable regulatory and supervisory framework. Left on its own, the financial system tends to be taken captive of by misaligned incentives of its different stakeholders, causing public interest to be sidelined as far as the robustness of institutions and the stability of the system are concerned.

The international financial crisis that started in 2007-08 and the subsequent euro area sovereign debt crisis had a considerable impact on the global and European financial system and showed a need to revise the financial system's regulatory and supervisory models. The scrutiny models and methodologies were revised and deepened, regulation at the level of each individual financial institution was expanded, and new regulatory and supervisory components were introduced, notably the macroprudential and systemic areas.

Since then international initiatives have multiplied in pursuit of new regulatory and institutional solutions, and international financial architecture has taken on new features. Against this background, the European Union has played a key role by introducing wide-ranging reforms in the financial sector, especially through the process of creating the Banking Union. This process implied on the one hand, setting up a model for the shared exercise of regulatory and supervisory power endowed with Europe-wide institutions and a common framework of rules, procedures and practices, and on the other, redesigning the scope of powers and the role of national regulatory, supervisory and resolution authorities, with the inherent organisational and procedural changes, so as to ensure a smooth integration into the new reality.

As a result, the financial sector framework in the European Union is undeniably stronger today than before the outbreak of the crisis. However, as it is not yet complete, this new framework is insufficient to break the link between the banking sector and sovereigns and shows clear limitations, namely in terms of coordination, responsibility and risk sharing, of powers and instruments, as well as of implementation of competition rules. The current framework thus poses important challenges that require urgent assessment and action at European level, which also stem from the adoption of the framework, in a macrofinancial context that involves a number of challenges for financial stability itself.

In spite of the unprecedented changes recorded in the past few years at global level, the reflection on financial sector regulation and supervision must continue, taking stock from recent experience to close gaps, eliminate inefficiencies, redundancies and conflicts, benefit from synergies, and improve the quality of institutions and the efficiency and coordination of authorities' action.

Banco de Portugal is deeply committed to this reflection, and has triggered a wide-ranging process of analysis and assessment of the functioning of relevant areas of financial regulation and supervision. This White Paper on financial sector regulation and supervision is an example of that commitment.

In the wake of the process leading to the application of the resolution measure to Banco Espírito Santo, S.A., I have determined the setting-up of an internal working group to analyse models and practices of governance, control and audit of financial institutions in Portugal, chaired by Banco de Portugal's Adviser, Rui Cartaxo. When the working group's recommendations were released on 12 June 2015 I presented Mr Cartaxo with a new challenge: to coordinate the preparation of a White Paper on the financial system, which should include proposals for the improvement of both the institutional and regulatory frameworks and the supervisory model, so as to reinforce their efficiency. The work carried out since then, involving a number of the Bank's staff, has resulted in the White Paper which is published today.

I would first like to express my deepest thanks to Rui Cartaxo and the staff members who collaborated with him for the important work undertaken over the past few months, which also benefited from previous work, namely the assessment by an independent commission of the decisions and actions of Banco de Portugal in the supervision of Banco Espírito Santo, S.A., a study on supervisory models adopted in Portugal and in the European Union prepared for Banco de Portugal by Professor Luís Silva Morais from the University of Lisboa School of Law, as well as reports prepared by working groups set up at the initiative of the National Council of Financial Supervisors, whose recommendations have already been released.

The authors of this White Paper were given total independence to carry out their work, with no interference or guidance from the Bank's decision-making bodies. Hence, the conclusions and recommendations herein reflect the opinion of the authors and may not coincide with the position of Banco de Portugal's Board of Directors.

I consider this White Paper to be a very important part of the material supporting Banco de Portugal's ongoing reflection on the Portuguese financial system, namely on the supervisory model. It will also surely be an important element for a wide-ranging debate on this matter and in particular for a reflection on the Portuguese financial supervision system recently launched by the Minister of Finance, to which Banco de Portugal has given its contribution, and which will be made public in due course.

I am confident that the ongoing reflection in Portugal and the quality of the analyses and reports produced will pave the way for the introduction of informed reforms with consistent technical bases in terms of regulation and supervision of the Portuguese financial sector.

The Governor

Carlos da Silva Costa

Introductory note

The writing of a *White Paper on the regulation and supervision of the financial system* (hereinafter 'White Paper') came about through an initiative by the Governor, following the completion of a series of internal analyses prepared before the summer of 2015 with the purpose of submitting recommendations improving Banco de Portugal's ability to respond to the new challenges posed by financial supervision, especially in the banking sector.

The idea behind the White Paper is to summarise several reflections within Banco de Portugal. The reflections benefit from the institution's accumulated experience in its double role as a participant in the construction of the euro area Banking Union and the banking institutions' national supervisory authority, with a role that was redefined in the context of the new European institutional architecture. The White Paper is also an opportunity to present to a wider public the main objectives and challenges of the supervision of the financial sector today.

Several documents were used as inputs for the elaboration of this White Paper:

- A working paper prepared by an independent commission for the assessment of the decisions and actions taken by the Banco de Portugal in the supervision of former Banco Espírito Santo, S. A., whose recommendations were released on 4 July 2015;

- A working paper by an internal working group on the corporate governance models and practices existing in the main Portuguese banking institutions, whose recommendations were released on 12 June 2015;

- An assessment report on the efficacy and efficiency of the legal enforcement role of financial supervisory entities, prepared by a working group set up on the initiative of the National Council of Financial Supervisors (NCFS), whose recommendations were published on 17 July 2015;

- A study of the financial sector supervisory models adopted in Portugal and in the European Union, commissioned by Banco de Portugal to Professor Luís Silva Morais, PhD in Law and Professor in the University of Lisboa School of Law, and published simultaneously with this White Paper;

- A report on conduct of business risks associated with the mis-selling of saving and investment products, prepared by a working group set up at the initiative of the National Council of Financial Supervisors (NCFS), whose recommendations were released in February 2016.

This White Paper does not claim or intend to cover the entire scope of intervention of financial sector supervision. For example, the issues of prevention of money laundering and terrorist financing activities are not addressed, although they have become increasingly important topics in the post-crisis period.

Nor is it an objective of the White Paper to make a critical in-depth reflection on the evolution of international financial supervision since the early years of the millennium. Some of the features of this path raise fundamental doubts and may be legitimately questioned, in a context of discussing the factors causing or at least exacerbating the damage caused by the financial collapse that began in the summer of 2007. Two aspects raise specific doubts. The first is the financial supervision paradigm shift brought about by the so-called 'Basel II regulatory package', of June 2004, which transferred to the banking industry the responsibility for building its own risk quantification metrics for the purpose of calculating capital requirements, relegating the supervisory entities to the role of scrutinisers of the banks' internal models. This paradigm shift (somehow mitigated by the post- crisis regulatory package adopted in 2010 as 'Basel III') exacerbated the potential for conflict of interest among banks' shareholders, who tend to be more risk prone and focused on the short term, and public interest, to whom financial stability is of paramount importance. The second aspect is closely related to the first: a tendency towards a growing complexity and opacity of financial supervision methodologies (partly associated with the growing complexity of the operating structures and processes of supervised financial groups). Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms is a consummate example of the extreme complexity this financial regulation adopted in response to the failures revealed by the global financial crisis.

In view of this, one asks oneself whether the tendency towards complexity and detail has gone too far, in the vain attempt not to let anything escape the net of supervision. Maybe it is time to recover a certain spirit of 'back to basics', by repositioning regulation and supervision towards promoting the return of banking institutions to their key mission of collecting savings and channelling them to lending to the economy, and refocusing supervisory entities on monitoring the soundness of the business models adopted by banks, the trustworthiness of banks´ managers, and the alignment of managers' and other staff members' incentives with the requirements of a sound and prudent management of institutions. This type of strategic reflection goes beyond the objectives of the White Paper. More modestly, it aims at summarising a limited set of topics that have recently been the aim of internal documents prepared by Banco de Portugal and that draw on some of the main lessons from the financial crisis and from the subsequent construction of the Banking Union.

The team that prepared and edited this White Paper was coordinated by Rui Cartaxo, Adviser to the Board of Directors of Banco de Portugal, and included a project management office,[1] different parts of the document and wrote Part I (Challenges for financial supervision in Portugal). Parts II to V were written by internal teams grouped in four thematic workstreams.[2] Finally, Part VI was drafted by Professor Luís Silva Morais.

The opinions expressed in this White Paper are those of the authors and not necessarily those of Banco de Portugal or the Eurosystem. Any errors and omissions are the sole responsibility of the authors.

Notes

1. The project management committee was composed of Rui Cartaxo (coordination), João Raposo, Elsa Ferreira, Ana Rita Campos, and Ana Acácio.

2. The thematic working groups were coordinated by Graça Damião (Part (ii), António Pedro Nunes (Part (iii), Fernando Coalho (Part IV), and João Raposo (Part V).

PART I

Challenges for financial supervision in Portugal

This text is not a summary of the White Paper, but rather a reflection of the project management committee on the priority challenges for financial supervision in Portugal.

1. The new role of Banco de Portugal within the framework of the Banking Union

The international crisis started in the summer of 2007 and the subsequent sovereign debt and banking crisis in the euro area led to a reassessment of the financial supervision models and practices at international level. Concern over safeguarding financial stability led to the widening of scope of action to include macroprudential supervision and banking resolution, complementing the traditional prudential and banking conduct supervision components. Multilateral institutions such as the Basel Committee on Banking Supervision – BCBS (hereinafter 'Basel Committee'), the Financial Stability Board (also based in Basel), the European Systemic Risk Board (ESRB) and European Supervisory Authorities for banking, insurance, and financial markets (EBA – European Banking Authority, EIOPA – European Insurance and Occupational Pensions Authority, and ESMA – European Securities and Markets Authority) have played a leading role in the EU's new legal framework approved by the European Parliament and the Council of the European Union (in the wake of the 2009 de Larosière Report).

Among the practical initiatives, the creation of a Banking Union at euro area level stands out, involving three main vectors:

- The centralisation of prudential supervision of banks in a Single Supervisory Mechanism (SSM), operating under the aegis of the European Central Bank (ECB);
- The creation of a single banking resolution mechanism, under the aegis of a European resolution authority (the Single Resolution Mechanism) supported by a dedicated European fund – the Single Resolution Fund;
- The projected setting-up of a common deposit guarantee fund, which will make – in practice and not only in theory – all the guaranteed deposits within the euro area interchangeable components of the money stock.

As of 4 November 2014 the ECB is the entity responsible for the Single Supervisory Mechanism, which covers all euro area credit institutions, while the Single Resolution Board, based in Brussels, is as of 1 January 2016, the European resolution authority.

Contrary to expectations, national prudential supervision and resolution authorities – in the Portuguese case, Banco de Portugal – have retained a relevant role in the new model, materialised especially in two ways: (i) high-level participation in the governance of Banking Union institutions, and (ii) intervention in areas that remained under national responsibility.

Hence, the construction of the Banking Union has implied a redefinition of the scope of powers and of the role of national authorities, whose regulatory, supervisory and resolution activities are now developed, within the scope of Banking Union, according to five main vectors:

- Implementation at the national level of the regulatory and supervisory guidelines issued by the ESRB, EBA and ECB/SSM;
- Participation in the Banking Union's decision-making processes, through institutional representation in its governance bodies, namely the ESRB General Board; the EBA Board of Supervisors and Resolution Committee; the ECB Governing Council; the SSM Supervisory Board; and the Single Resolution Board;
- Participation in the supervision of significant credit institutions of the euro area, through the involvement of national staff members in the joint supervisory teams under the coordination of ECB/SSM staff;
- Direct supervision of less significant national credit institutions overseen by the SSM;
- Participation in internal resolution teams for institutions under the direct responsibility of the Single Resolution Board, and autonomous intervention – albeit within a common framework – as regards other institutions;

- Exercise of macroprudential powers at national level (without prejudice to the possibility of the ECB applying stricter measures).

The new European institutional and regulatory framework brought about a series of amendments to national legislation. In the Portuguese case, the legal act that harbours most European determinations and/or recommendations in these matters is the Legal Framework of Credit Institutions and Financial Companies (RGICSF in Portuguese). This piece of legislation is a code governing the pursuit of banking business in Portugal and its supervision. It is complemented by the direct implementation in the legal system of the Union's legal acts adopted as regulations (in the light of the idea to create a single European set of rules – Single Rulebook – for the purpose of regulating the financial sector so as to overcome excessive disparities of national regulations that have persisted with the previous harmonisation process). Finally, Banco de Portugal's Organic Law was also adapted to the new framework (e.g. by explicitly assigning to the central bank the capacity as national macroprudential authority).

In sum, the construction of the Banking Union did not imply an elimination of Banco de Portugal's regulatory and supervisory responsibilities, but rather a significant redefinition of its role.

In this new context, a series of topics gave rise to several analyses by Banco de Portugal, aimed at contributing to improve the efficiency of financial supervision, both at national and European levels. These topics gained an increased importance as the global financial crisis unfolded and several Portuguese banks went through serious crisis, notably the supervision of banks' corporate governance; the prevention of conflicts of interest, the supervision of the marketing and sale of financial products; the supervision of cross-border activities. The crisis also highlighted the need to address the legal enforcement regime, as well as the role of central banks in the resolution of banking institutions and the institutional organisation of financial supervision in Portugal. These are the themes addressed in the following paragraphs of this Introduction, where we include several recommendations for improvement. Some of the recommendations extend beyond the national scope of action. Their inclusion in the text aims at contributing to influence the evolution of the European framework. Some of the issues addressed in the recommendations are further developed in subsequent chapters of the White Paper). Among those falling within the national scope of action, some are the legislator's responsibility, others Banco de Portugal's responsibility.

2. The supervision of corporate governance

Today it is generally agreed that failures in corporate governance were one of the factors that contributed most to undermining the international financial system in the run-up to the 2007-09 global crash. The unfolding of the world crisis highlighted the inadequacy of most banks' governance models, from global institutions to merely local or regional-sized ones. Those failures provided fertile ground for the multiplication of reckless and unethical business models and management practices.

The crisis also emphasised an often forgotten truth: no matter how important the existence of good governance rules in institutions, the most important factors for good governance are, first, the dimension of banks' leaders in terms of integrity, expertise and experience, and second, zero tolerance towards unethical behaviours. In fact, one of the main lessons from the global financial crisis is that not only are robust corporate governance models necessary, but there is also a need to promote a demanding culture as regards the trustworthiness and competence of institutions' managers.

The Portuguese case illustrates the importance of the conduct of leaders. A common denominator in the collapse of several credit institutions was the inadequate conduct of some of their leaders and the abuse of power by a number of relevant stakeholders – namely managers and relevant shareholders – who were able to influence the conduct of business for their own benefit, to the detriment of more vulnerable stakeholders, such as depositors and small investors (particularly within the scope of mixed business conglomerates, understood as groups of financial and non-financial entities directly or indirectly controlled by one or more holdings).

Several factors explain the critical importance of the trustworthiness of banks' shareholders and managers. First, banking institutions have in their custody the savings of depositors and investors, which cannot be at the mercy of abusive use. Second, the complexity and potential opacity of the banking business makes it critical that those in charge are trustworthy. Third, the impact of a bank´s collapse is potentially systemic.

These are the factors that explain why the supervision of corporate governance of financial institutions needs to be more demanding than that applicable to non-financial corporations. That is why central banks go beyond the recommendations envisaged in codes of good practice, as in the case of Portugal, where today, governance requirements for banks are tighter than those included in the codes of the Portuguese Securities Market Commission and of the Portuguese Institute of Corporate Governance (which are about to be merged).

In the European Union, Directive 2013/36/EU of 26 June 2013 (CRD IV) includes a section devoted to governance (Subsection 3), which addresses the principles of good governance, the requirements to be complied with by members of management bodies (including limits to the combination of directorships), and the compensation policies applicable to senior management and other persons with senior positions in credit institutions. In Portugal these guidelines were transposed into the RGICSF in October 2014.

Besides enforcing a set of more demanding legal requirements, Banco de Portugal has been devoting growing attention to the supervision of credit institutions' governance, not only in terms of organisation and the adoption of proper formal procedures approved by institutions, but, most importantly, in terms of verifying how they are applied by banks in their day-to-day business.

In turn, the legal framework governing the assessment of the trustworthiness of members of banks' governing bodies would benefit to a large extent from the clarification of two aspects. On the one hand, the (already existing) segregation of the trustworthiness assessment from sanctioning procedures should be further clarified. On the other, it should be clarified that the judgment on suitability may be based on mere suspicion and Banco de Portugal should be clearly empowered to refuse the certification of trustworthiness if at the end of the assessment process and considering all information collected, reasonable doubt persists as to the trustworthiness of the candidate(s).

Here are some recommendations aimed at improving the supervision of corporate governance of banking institutions:

Recommendation 1: Banco de Portugal should entertain a high level dialogue with both reference shareholders and members of management and supervisory bodies of the main banking institutions, so as to monitor their business strategies and models, as well as corporate governance practices. This dialogue should aim at taking preventive action before certain decisions are taken.

Recommendation 2: The legal framework should be amended so as to (i) reinforce the autonomy of trustworthiness assessment processes with regard to any sanctioning procedures and (ii) clarify that the Banco de Portugal can legitimately refuse registration on the grounds of non-compliance with the

trustworthiness requirement if at the end of the assessment process and considering all elements collected, reasonable doubt persists on the trustworthiness of a candidate.

Recommendation 3: Banco de Portugal's supervision of banking institutions' governance should increasingly focus on the actual functioning of governance structures, as well as their formal existence.

Recommendation 4: Banco de Portugal should monitor the Key Performance Indicators (KPI) used in the calculation of the variable compensation component of banks' managers, and encourage changes whenever those KPIs are severely misaligned with the requirements of sound and prudent management.

3. Prevention of conflicts of interest

Two main types conflict of interest are common in banks: conflicts involving related parties (usually relevant shareholders or members of statutory bodies), and conflicts involving customers (both between customers and credit institutions, and between different customers).

In continental Europe's business environment, where (financial and non-financial) shareholding capital is typically more concentrated than in Anglo-Saxon countries, it is common for a reduced number of shareholders – sometimes even a single shareholder, acting on his/her own behalf or as a group – to hold controlling interests in enterprises. In Portugal, for example, all major banks have reference shareholders with voting rights that amount to double figures in percentage terms, granting them strong leverage over the governance bodies and the conduct of business.

In this context, the greatest risk faced by the most vulnerable stakeholders – minority shareholders, creditors, small investors, depositors – is that major shareholders, both directly and through management teams of their choice, use their influence over corporate governance bodies to their own benefit, to the detriment of other stakeholders. One of the most frequent bad practices of banks in Portugal is granting credit to relevant shareholders or other related parties in amounts exceeding the limits compatible with prudent risk management and in better terms than those prevailing in the market. Another common malpractice is the inducement of customers to finance the banks' related parties. To prevent these risks, adequate internal procedures to prevent conflicts of interest involving related parties are absolutely critical.

The documents produced by the Working Group on Corporate Governance and by the Commission for the assessment of the decisions and actions taken by Banco de Portugal in the supervision of Banco Espírito Santo, S. A. contain several recommendations related to the prevention and management of conflicts of interest with related parties, which are recovered in Part III of this White Paper. The most relevant are the following:

Recommendation 5: Banco de Portugal should ensure the existence and effective implementation of proper internal regulations governing prevention of conflicts of interest with related parties. Among other provisions, these regulations should (in liaison with new legislation whenever needed) prohibit the sale to non-qualified investors of financial products issued by related parties (unless otherwise approved by Banco de Portugal), either by the institutions themselves or via Special Purpose Vehicles (SPVs) or investment funds controlled by them.

Recommendation 6: The legal limit for the (direct or indirect) financing of qualified

shareholders (currently set at 10% of an institution's own funds) should be substantially reduced. The stake threshold to be considered for this purpose should be significantly reduced, from the current 10% to, for example, 2%.

Recommendation 7: The legal prohibition against granting credit to directors should cover all board members and not just executive directors or members of the audit committee.

Finally, the potential for conflicts of interest in banking institutions that are part of economic groups warrants the access by supervisors to all relevant information concerning the controlling entities, which should be clearly identified and monitored as regards their economic and financial standing. Lack of access to this information prevents the supervisor from duly monitoring financial flows between institutions and their main shareholders, as well as the possible financing of entities from the non-financial branch of the economic group in question through the abusive placement with the banking institution's customers of financial products issued by said related parties (often presented to customers as being similar in risk to simple bank deposits).

Recommendation 8: Banco de Portugal should monitor the financial standing and activity of the entities that control banking institutions. At the very least, the Bank should have direct access to the relevant financial information on these entities, as well as to the respective external auditors. If such access is denied, institutions should be required to change their organisational model as needed to allow for access to the information on their controller(s).

4. The dual perspective of financial product marketing supervision

The production and sale of financial products to customers should be supervised from two complementary perspectives: (i) the perspective of customer protection (conduct supervision), and (ii) the perspective of safeguarding the soundness of financial institutions (prudential supervision).

4.1. The perspective of customer protection (conduct supervision)

The main goal of conduct supervision is to ensure transparency, non-discrimination, and completeness of the information provided to depositors/savers/investors/borrowers, and the narrowing of the information gap between financial institutions and their customers. Conduct supervisors seek to ensure that customers are aware of the characteristics and risks of the different types of investments they make (or of the loans they take), and on the other, to prevent and sanction mis-selling practices by financial institutions.

In Portugal there are three bodies entrusted with conduct supervision of financial products: Banco de Portugal regulates and oversees the sale of banking products and services (deposits and credit) and also supervises means of payment; the Portuguese Insurance and Pension Funds Supervisory Authority, has similar powers in terms of insurance products; and the Portuguese Securities Market Commission (CMVM), regulates and oversees the sale of public securities, as well as the functioning of securities markets. The main alternative to this institutional model is the so called 'Twin Peaks' model, adopted in other European countries such as the United Kingdom and the Netherlands. In each of these countries, two entities are entrusted with the conduct supervision and the prudential supervision, respectively, covering the financial sector as a whole. Specifically, the authority entrusted with conduct supervision (Financial Conduct Authority in the United Kingdom, and Authority for the Financial Markets in the Netherlands) covers the whole range of saving and investment products sold to the public, plus loans granted.

Given that most non-qualified investors are also depositors (in Portugal there are over 900,000 holders of investment fund units), the model adopted in Portugal implies that three different public bodies have banking conduct supervisory responsibilities over the same commercial relationship, involving a bank account manager and a customer. As a result, none of the three bodies has a comprehensive overview of that commercial relationship, which may be a problem for the effectiveness of financial supervision.

4.2. The perspective of safeguarding the soundness of financial institutions (prudential supervision)

The prudential perspective is mainly concerned with the preservation of the soundness of financial institutions. The main link between this perspective and the banking conduct perspective is the reputational risk of financial institutions: if misconduct is recurrent and not an isolated event, it affects the institution's reputation and ultimately depositors' confidence. Thus, the difference between the perspectives is mostly a scale issue: individual misconduct cases are typically the realm of banking conduct supervision, whereas large-scale misconduct is a concern for prudential supervision.

Several situations that have occurred in Portugal over the last few years illustrate how the placement with retail customers of financial products issued by related parties can affect the solvency and liquidity of financial institutions: public awareness of the broadly based occurrence of these practices was one of the factors that triggered the collapse of some institutions. The Portuguese experience also drew attention to a recurrent phenomenon in banks belonging to economic groups: managers being induced by some shareholders to use the bank balance sheet – or alternatively its depositors' savings – to address financial difficulties of other business areas of the group.

4.3. The potential for conflict between the prudential and conduct perspectives

One of the most debated issues concerning alternative institutional models for financial supervision is the potential for conflicts of interest between conduct supervision and prudential supervision. From the prudential perspective, the soundness of institutions is the supervisor's key concern. Any situation that may compromise it must be kept confidential until it is solved, so as not to affect the confidence of depositors in the institution and the financial system itself. In the conduct perspective, the supervisor's chief concern is to prevent practices that may be detrimental to depositors or non-qualified investors, i.e. the weakest links in the relationship between individuals and institutions. The fast and transparent release of information is an essential part of the ethos of conduct supervision. Hence, while there are no more serious problems it is not difficult to bring the two perspectives together to prevent crises. However, when a crisis develops, the two perspectives may collide. The question then is: which institutional architecture is better suited to manage the potential for conflict between the two perspectives of financial supervision? There is no clear cut answer to this question and this issue is further pursued in the last section of Part I.

Regardless of each country's choice of institutional architecture, an important point to retain is that the sale of financial products must be effectively supervised both from the conduct and the prudential perspectives.

Hence, the entities responsible for the prudential supervision of financial institutions should always monitor financial product marketing in those aspects that are relevant for the soundness of institutions, as is the case with reputational issues. Moreover, prudential supervisors should intervene to stop any conduct affecting institutions' financial stability, regardless of whether they are or not legally responsible for banking conduct supervision.

Recommendation 9: Banco de Portugal should reinforce the prudential supervision of all financial products sold by credit institutions to their customers. This supervision should focus on the prevention of conflicts of interest and corporate governance, thus being autonomous and complementing banking conduct supervision.

In fact, to mitigate risks associated with financial flows between banking institutions and related parties, especially in the context of mixed business conglomerates, the prudential arm of Banco de Portugal must systematically oversee the marketing of financial products, without prejudice to the separated competences of its banking conduct supervision arm.

In sum, the two main target areas of prudential supervision of the sale of financial products through credit institutions are: (i) controlling the risks associated with financial flows involving related parties, (ii) preventing the risks of reputational damage liable to affect customer confidence.

5. The supervision of cross-border activities

The activity of banks of a certain size generally involves more than one jurisdiction, posing important challenges to supervisors, in more than one aspect: (i) to ensure that there is effective supervision of the different jurisdictions of a given bank, (ii) to provide the parent undertaking's supervisor with a proper picture of the whole group enabling it to monitor the (direct or indirect) financial flows between the parent undertaking and its branches and subsidiaries, or other financial entities related with the bank.

Response to these challenges is hindered when jurisdictions outside Portuguese territory are uncooperative. No wonder that, as a consequence, some groups deliberately create international subsidiaries in those jurisdictions and build opaque group structures.

In Portugal several banking institutions created vehicles located in opaque jurisdictions and used them to carry out transactions below the radar of supervisors, namely involving triangulated flows between credit institutions (or their customers) and entities belonging to shareholders, the supervisor not having duly identified these flows.

The Portuguese experience has also shown how vital it is to limit the size of the exposure of banks to subsidiaries located in uncooperative jurisdictions, and to pay attention to indirect forms of exposure, involving third parties located in other jurisdictions.

The CRD IV Directive addresses the assessment of equivalence of third countries' consolidated supervision in relation to the standards applied in the European Union, while Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 addresses in detail the implications of recognising such an equivalence. This is an important issue, since the recognition of equivalence makes it possible, on the one hand, to consider as intragroup those transactions that take place between a bank and a subsidiary located in a third country for which equivalence has been recognised, and on the other, that the customers of said subsidiary are treated as individual customers of a credit institution located in the European Union. As of 1 January 2015 the power to recognise equivalence is exercised by the European Commission and no longer by national authorities.

The Portuguese experience has shown that it is essential to establish as a *sine qua non* for assigning equivalence to supervision by a third country that the country allows the European supervisor (or the national supervisor, as applicable) to conduct on-site inspections to subsidiaries located in that country and that it shares the relevant information. Failing that, equivalence should not be recognised.

The different supervisory authorities have rightly tried to respond to the recent financial crisis by increasing cooperation and information sharing. However, it is necessary to go further not only by reinforcing the sharing of information among supervisors (on the activity of branches or subsidiaries and on shareholders of the different banking groups and respective ultimate beneficiaries), but also by preventing, through assertive supervisory methodologies that benefit from all powers at the supervisor's disposal, the creation of opaque structures, with weak internal governance that pose additional risks to supervised entities and make prudential supervision more difficult and less effective.

The White Paper's chapter on prudential supervision includes a series of recommendations to improve the effectiveness of financial supervision in cases involving cross-border activity, of which the following are especially relevant:

Recommendation 10: Banco de Portugal should limit the pursuit of banking business and/or increase the respective prudential requirements (namely by not granting large-exposure intragroup exemptions) to subsidiaries or branches located in jurisdictions whose supervision is not considered equivalent to that of the EU or where access to information is considerably restricted. Ultimately, the disposal or closure of the branch may be required.

Recommendation 11: Banco de Portugal should demand the reinforcement of the supervised entities' internal control and governance mechanisms, so as to ensure adequate monitoring of risks emerging from cross-border activity.

6. Legal enforcement

An efficient enforcement of the rules to which supervised entities are bound is an important condition for the effectiveness of supervision.

The international financial crisis and the simultaneous unveiling of a series of very serious illicit activities by some Portuguese credit institutions made it very clear that there was a need to promote deep changes to the regulatory framework applicable to legal enforcement, namely in terms of large and complex administrative offence proceedings. On the other hand, the crisis also showed that Banco de Portugal needed to reinforce its sanctioning powers and capabilities.

In fact, significant steps have been taken at both levels since then.

As far as legislation is concerned, a specialised court to decide on regulatory issues was set up in 2012, the Competition, Regulation and Supervision Court, based in Santarém. In addition, in October 2014 several changes to the Portuguese banking legislation (namely the RGICSF) were approved, resulting in the reinforcement of the sanctioning powers of Banco de Portugal and of the severity of the applicable sanctions (in line with European Union decisions).

In terms of the reinforcement of Banco de Portugal's internal governance structure, the creation of a Legal Enforcement Department (DAS) in 2011 deserves a special notice. With this new department, the legal enforcement function became autonomous from the supervisory function and its effectiveness was upgraded through the hiring of additional staff with expertise on sanctioning matters. The DAS was entrusted with ensuring that all administrative offence proceedings initiated, dealt with and decided by Banco de Portugal are enforced, as provided for by the law.

Finally, the three Portuguese sectoral financial supervisors – Banco de Portugal, the Insurance and Pension Funds Supervisory Authority and the Securities Market Commission – prepared a joint report, drafted by a working group set up within the scope of the National Council of

Financial Supervisors and concluded in 2014, with an extensive set of recommendations aimed at improving sanctioning procedures. Part V of the White Paper develops the analysis and recommendations on legal enforcement.

However, all the above-mentioned initiatives over the past few years remain insufficient, especially in the cases of larger and more complex processes, where certain constraints impede an adequate speedy procedure. The main difficulties remaining are procedural and partly associated with the fact that in the current regulatory framework governing administrative offence proceedings of Banco de Portugal's responsibility there is a complex succession of back and forth from different legal environments (from the RGICSF to the general legal framework applicable to administrative offences, from this to the Code of Criminal Procedure and finally from the latter to the Code of Civil Procedure), which often leads to uncertainty concerning the regime applicable to each specific problem. This raises judicial issues that may limit the efficiency of legal enforcement proceedings, increase litigation, and lead to the use of approaches that were devised for different situations.

Hence, to strengthen and expedite legal enforcement, especially of larger and more complex processes, it is important to improve the legal framework governing Banco de Portugal's legal enforcement powers, as described in the following recommendations:

Recommendation 12: National legislation should promote greater autonomisation of the (administrative) procedural system applicable to the financial sector, considering its marked specialisation, from the general legal framework applicable to administrative offences and the Code of Criminal Procedure, through the creation of a general legal framework for financial violations.

Recommendation 13: The principle of opportunity should be introduced in law for minor violations, allowing for a greater concentration of resources in larger and more complex processes. With full observance of the underlying principles of administrative law, additional transaction and leniency mechanisms should also be envisaged, making it possible to speed up justice in terms of administrative offences.

In turn, the very significant increase in the number of administrative offence proceedings initiated and decided annually by Banco de Portugal has caused an overflow in the agenda of the Board of Directors. Considering that most of those proceedings involve minor violations and sanctions, changes may be warranted to the power delegation rules within the Bank's Board, allowing it to focus on the most important offences.

Recommendation 14: The Board of Banco de Portugal should delegate powers to a specialised commission (or simply to the Director with the remit of DAS) to (i) initiate administrative offence proceedings, (ii) decide on expedited administrative offence proceedings (concerning minor violations, where the applicable fine is also itself legally limited, and where a final decision has to be accepted by the entity itself or the person to whom it is applied).

The implementation of the latter part of this proposal implies a legislative amendment, given that, pursuant to paragraph 2 of Article 213 of the RGICSF, the Board of Directors of Banco de Portugal has the final say on administrative offence proceedings.

7. Coordination between the European bank resolution framework and Member States' financial stability objectives

In the early years of the financial crisis, interventions by the European Union Member States' national authorities to cope with banking crisis situations were fragmented and taken on a case by case basis. In an environment of emergency, there were cases of unilateral intervention by a few countries that triggered violent reactions in other countries, such as the Irish government's granting on 29 September 2008 of a two-year unlimited guarantee covering all Irish bank stakeholders.

Meanwhile, a euro area-wide legal framework for the recovery and resolution of distressed banks was put in place. The most significant milestone occurred in 2014, with the adoption of the European Banking Recovery and Resolution Directive (the so-called BRRD) and the corresponding SRM Regulation (Regulation No 806/2014 of 15 July 2014), applicable to the euro area within the scope of the Banking Union. The BRRD enshrined the principle of bail-in in bank resolution, involving the stakeholders of institutions subject to resolution, with the exception of depositors with amounts lower than €100,000.

The BRRD was transposed in 2015 into Portuguese law through Law No 23-A/2015 of 26 March 2015, which amended the RGICSF (although the first legal act that provided for the bank resolution processes had entered into force in 2012, through Decree-Law No 31-A/2012 of 10 February 2012, i.e. the Portuguese legal system anticipated the European Union rules at this level, largely incorporating elements of the European framework in an advanced stage of preparation).

In parallel, the construction of the Banking Union led to the emergence of a new and complex institutional architecture, in which multiple European entities intervene. The tasks assigned to these entities (legislative, regulatory, supervisory, resolution, competition policy) have a material impact on the financial sector and on financial stability. This notwithstanding, national authorities have remained responsible for preserving financial stability and an ongoing suitable flow of financing to the real economy of each Member State. In other words, responsibility for financial stability has remained chiefly at national level, although some of the policy instruments were transferred to the supranational jurisdiction or are not even available anymore.

For this institutional model to be sustainable, in addition to achieving the third pillar of the Banking Union through a single deposit guarantee mechanism, it is essential to ensure adequate coordination among all authorities and that they take into due consideration the objective of preserving financial stability in each member country. It is also necessary to put in place supranational mechanisms of financing of last resort that ensure the efficiency and credibility of the whole system, and uniform levels of confidence in the whole Banking Union.

In turn, the bureaucratisation of emergency management mechanisms resulting from the articulation between the new rules on recovery and resolution of credit institutions, on the one hand, and rules regarding State aid, on the other, have made it more difficult to support viable banks when warranted (e.g. banks located in financial systems subject to systemic shocks). A framework that is too rigid for the recapitalisation of viable banks increases the probability of recourse to resolution measures, compounding the risks to the financial stability of the country in question, instead of reducing them, while affecting confidence in the integrity and sustainability of the euro area.

In line with the above-mentioned concern, Banco de Portugal should propose to the competent governance structures of the Banking Union the changes needed to overcome the deficiencies that were highlighted by the Portuguese experience.,. In this vein, we make the following recommendation concerning the positions to be assumed by Banco de Portugal in the various governance structures of the Monetary Union and the Banking Union.

Recommendation 15: The excessive rigidity of the current European framework in terms of crisis management should be corrected, particularly as regards the possibility to support viable banks; on the other hand the coordination between different authorities acting on the financial system should be improved, with due regard to the objective of preserving financial stability in each country.

8. The institutional and governance model of financial supervision in Portugal

Notwithstanding the progress made so far, the transformation of the institutional model of financial sector supervision in the euro area is not yet complete, neither at European nor at national level. Nevertheless, more than one year has elapsed since the entry into operation of the first pillar of the Banking Union – the Single Supervisory Mechanism – and with the entry into force of the second pillar's legal framework – the Single Resolution Mechanism – there is already minimum experience with the new framework of national central banks that allows for initial stocktaking and reflection on a number of improvements to the supervisory model of the Portuguese financial sector within the new European framework.

A radical change to the institutional model currently existing in Portugal does not seem to be in order. In fact, a drastic institutional transformation would imply using precious time and energy that may be better spent in other priorities. On the other hand, the fact that the European supervisory architecture is not yet fully stabilised also advises against radical changes.

In this framework, we recommend keeping a three sector institutional model, albeit with some adjustments to improve the efficiency of financial supervision, while keeping options open to adapt the model in light of future developments at European level.

We choose to put forward some recommendations aimed at improving the efficiency and efficacy of financial supervision, while keeping the institutional model based on three supervisory entities.

8.1. Concentration of the banking conduct supervision of financial products and services in a single supervisory authority

Point 4 states that the current allocation of responsibilities among the three sectoral supervisory entities implies that none of them has an integrated view of the relationship between financial institutions and their customers. The following recommendation aims to correct this situation.

Recommendation 16: The legal framework should be amended so as to concentrate in a single authority the responsibility for the regulation and conduct supervision, covering the marketing of the whole range of financial products, without prejudice to retaining a financial supervision model relying on three entities.

The above mentioned concentration would allow for an integrated oversight of the banks' relationship with customers, covering the sale of all type of saving and investment products, be it deposits or other financial products, as well as the granting of loans. The question of which entity should perform that oversight is open to debate. Whatever the solution adopted, a greater institutional segregation of responsibilities between prudential and conduct supervision will render the financial sector supervisory model more transparent and reinforce the accountability of each of the supervisory authorities as regards the attainment of their respective priority objectives.

8.2. Separation of the Resolution Fund from the central bank

Two banking resolution processes occurred in Portugal to this date: of BES - Banco Espírito Santo, S. A. in August 2014, and of BANIF – Banco Internacional do Funchal, S. A. in December 2015. The former resolution involved the setting-up of a bridge bank (Novo Banco, S. A.), currently under a sale process, whereas the latter implied the sale of assets and liabilities to another banking institution after the carving out of problematic assets to an asset management body.

The experience with these two cases showed the disadvantages of coexistence in the same entity of regulatory /supervising responsibilities and the execution of resolution measures, namely the sale of assets and/or of bridge banks. For example, during the first attempt to sell Novo Banco, S. A., Banco de Portugal had to rank different proposals submitted by entities in whose supervision it participates (although under the guidance of the ECB). The fact that the regulator makes decisions on the ranking and/or exclusion of proposals of regulated entities may put into question the perception of its impartiality and give rise to a noticeable discomfort in the market.

The main conclusion to be drawn must be that the responsibility for applying measures associated with resolution processes, as regards executive action, such as sales of assets or of bridge institutions, must be discharged outside the responsibility of Banco de Portugal possibly by an autonomous entity within the Ministry of Finance.

Recommendation 17: The legal framework should be amended so that the Resolution Fund becomes independent from the central bank, to operate under the responsibility of the Ministry of Finance with statutory guarantees of autonomy.

Recommendation 18: The legal framework should be amended to allow for a redrafting of the statutes of the Resolution Fund, so that its executive powers include: (i) the conduct of sale processes of bridge institutions or assets and liabilities of institutions subject to resolution, and (ii) the management control of bridge institutions.

8.3. Reinforced cooperation among the three financial supervisory authorities

Recommendation 19: The legal framework should be amended so as to reinforce the National Council of Financial Supervisors' ability to act, granting it autonomy in terms of financial and human resources.

The reinforcement of the National Council of Financial Supervisors should essentially rely on two vectors:

- The setting-up of a permanent technical structure (secretariat) endowed with sufficient resources to centralise, in a stable manner, the tasks of coordinating the supervisory functions based in the three existing authorities. Our recommendation is for a structure headed by a General Secretary, to be appointed by consensus by the members of the National Council of Financial Supervisors, with a small number of highly qualified staff, while assigning the (technical and logistical) secretariat tasks of the NCFS equally to each supervisor;
- The NCSF should have its own intervention areas, namely in fields such as: supervision of financial conglomerates; monitoring of complex financial products (so as to combine the prudential and banking conduct perspectives); setting-out of measures to combat money laundering; establishment of minimum requirements for information sharing; conduct of joint inspections.

The NCFS should continue to perform advisory tasks for Banco de Portugal as the Portuguese macroprudential authority, contributing to identifying risks to the financial system stability and analysing specific macroprudential policy proposals.

The Council should be supported by financial contributions from each of the authorities, in accordance with an allocation criterion to be defined and sufficient to make it independent from the State budget.

8.4. Redesign of Banco de Portugal's governance model

The lessons drawn from the 2007-08 global financial crisis and more recently from the construction of the Banking Union have brought about significant changes to the role and powers of national central banks and national prudential supervisory authorities.

These changes have led a number of Member States to reorganise the institutional organisation of financial supervision and adapt their central banks' governance models and organisational charts. In Portugal, although the tripartite sectoral model has undergone virtually no changes, in the past few years there has been a series of legal changes that altered the scope of Banco de Portugal's powers as well as its organisational chart (both as a result of the transfer of powers to European institutions within the Banking Union, and of the assigning of new powers to central banks with the reformulation of financial supervision in the post-crisis world).

Meanwhile, the experience gained since the start of the Banking Union's construction process already makes it possible to envisage a number of adjustments to Banco de Portugal's governance model, in the sense of increasing the institution's responsiveness to the new challenges of the Banking Union, as proposed in the recommendations that follow.

8.4.1. Reinforcement of the autonomy of microprudential supervision within Banco de Portugal

A higher degree of autonomy, of the microprudential supervisory activity within the central bank would have two advantages. First, it would increase the transparency of supervision. Second, it would bring the central bank's organisational chart and modus operandi closer to the ECB's, facilitating the liaison between the national authority and the European authority within the framework of the Banking Union.

Recommendation 20: The legal framework should be amended so as to segregate microprudential supervisory activity within the central bank, be it through the creation of an autonomous entity under Banco de Portugal (along the lines of the Prudential Regulatory Authority, which is a part of the Bank of England), be it through adjustments to the governance model of Banco de Portugal, namely through the creation of specific and differentiated commissions within the Board of Directors.

8.4.2. Reinforcement of the national resolution authority's autonomy within Banco de Portugal

As already mentioned, the executive tasks associated with resolution processes should be placed outside the scope of the central bank, and be the responsibility of a reformulated Resolution Fund under the Ministry of Finance.

Furthermore, before the execution of resolution decisions, several tasks have to be performed: the design of Resolution Plans for each institution; the decision on the need to apply a resolution, the analysis of compliance with the pre-conditions for a resolution, and of the selection of the resolution instrument(s) to be applied to each case (among the instruments envisaged in the BRRD).

With the entry into force of the Single Resolution Mechanism (SRM), said responsibilities were shifted in most cases to the Single Resolution Board.

However, national authorities have retained relevant responsibilities over future resolution processes involving credit institutions remaining under their direct supervision that do not have activities in other euro area Member States. Secondly, national authorities assign some of their personnel to the resolution teams coordinated by the Single Resolution Board. Finally, national authorities continue to have responsibilities in the implementation of resolution measures under processes prior to 1 January 2016 (such as those of BES and BANIF).

In the new institutional architecture stemming from the construction of the Banking Union, most Member States chose to assign the responsibilities of a national resolution authority (NRA) to autonomous units within their respective central bank. In a minority of cases the NRA's tasks were entrusted to entities other than central banks and supervisory authorities.

In our opinion, as long as the executive tasks subsequent to a resolution decision are transferred to the Resolution Fund, it is justifiable that Banco de Portugal retains the remaining powers that the SRM Regulation assigns to national resolution authorities. However, these tasks must be clearly segregated in the central bank's organisational chart, and concentrated in an autonomous entity with autonomous governance bodies.

Recommendation 21: The legal framework should be amended so that there is greater segregation, within the organisational chart of Banco de Portugal, of the national resolution authority function, through the setting-up of an entity endowed with own statutes, regulations and governance structure.

8.4.3. Reinforcement of the Board of Directors of Banco de Portugal

As seen above, and contrary to what might be expected, the construction of the Banking Union increased the complexity of the functions of national central banks' management bodies, as well as the number of institutional fronts they have to be involved in. As a result, the challenges posed by the new European framework warrant the reinforcement of the governing bodies of national central banks.

In our opinion, one of the initiatives that may reinforce the Banco de Portugal's governance ability to cope with the challenges posed by the Banking Union is to open its board to non-executive directors. This would enlarge the central bank's perspectives, add value to the decision making process and create room for an increased delegation of powers, notably through the creation of an executive commission to carry out day-to-day management, and through the incorporation of the audit committee into the Board of Directors. The work of these committees, as well as of specialised committees to be created (some of them with the participation of people outside Banco de Portugal, e.g. for systemic risk and macroprudential supervision themes), would allow the Board of Directors to focus on themes that are strategically more relevant to the accomplishment of the mission entrusted to Banco de Portugal within the framework of the Banking Union. That is the aim of the following recommendation.

Recommendation 22: The legal framework should be amended to allow for a reorganisation of the Board of Directors of Banco de Portugal, by strengthening the institution's governance and reinforcing its ability to act within the framework of the Banking Union; this reorganisation should include the widening of the Board to non-executive directors, the delegation of day-to-day management to an executive committee, and the integration of the audit committee into the Board of Directors.

In conclusion

A radical change of the tripartite institutional model existing in Portugal does not seem necessary, as it would imply a waste of precious time and energy that may be better invested in other priorities. On the other hand, the fact that the European supervisory architecture is still not fully stabilised would suggest keeping all options open. The main alternative to the current model would be a 'Twin Peaks' model, where prudential supervision of the whole financial sector would be concentrated in a single authority, with banking conduct supervision in another. Although that option would have its merits, namely a potential saving of resources, it does not seem to be the best moment to take that step. In addition to the transition costs that this option would imply, the current virtual inexistence of financial conglomerates in Portugal makes this measure's advantages less obvious.

These motives have led the signatories to adopt a more modest approach, by making a set of recommendations that, despite making some adjustments to the existing division of responsibilities among different entities, do not require the abandonment of the three sector supervisory architecture. In our opinion, the simple implementation of this White Paper's recommendations would result in a considerable improvement in the efficiency and efficacy of financial sector supervision in our country.

PART II[1]

Institutional and regulatory framework

1. Institutional architecture

1.1. European framework

With the setting-up of the Single Market in 1993[2] there has been a long financial integration process in the European Union (EU), only reversed during the international financial crisis period[3]. The introduction of the euro in 1999, years after the launching of its bases and as a result of a growing convergence and the coordination of national monetary policies, is another important step in the process of the Economic and Monetary Union (EMU), also contributing to the financial integration process.[4]

1.1.1. The transformation of the European supervisory model in the post-crisis years

In the wake of the global financial crisis that started in the summer of 2007 there was a significant change in the institutional framework and in the powers assigned to the European financial supervisory committees (set up under the so-called 'Lamfalussy Process'[5] and composed of national supervisory authorities), following an in-depth reflection on various failures in regulation and supervision, incorporated in the 'de Larosière Report', prepared at the initiative of the European Commission and published in 2009.[6]

In this context, in 2011 the above committees became European Supervisory Authorities (ESAs), and the Joint Committee of the European Supervisory Authorities was set up. These authorities became EU agencies having legal personality, a full-time Chairperson[7] and a reinforced set of roles and powers, among which:

- Collection of information on financial institutions;
- Contribution to the development of harmonised and coherent rules (Single Rulebook);
- Contribution to the coherent implementation of EU legislation, namely by creating a common supervisory culture, mediating and settling disputes among competent authorities and ensuring the coherence of the functioning of colleges of supervisors;
- Conduct of peer reviews and identification of best practices;
- Monitoring, assessment and measurement of systemic risk and collaboration with the European Systemic Risk Board (ESRB);
- Development and coordination of recovery and resolution plans;
- Possibility of adopting measures in emergency situations and possible coordination of actions undertaken by relevant competent supervisors.

This transformation coincided with the setting-up of the ESRB, responsible for the macroprudential supervision of the EU's financial system, with the purpose of contributing to prevent and mitigate systemic risks to EU financial stability and thus guarantee the sustainable contribution of the financial sector to economic growth. Contrary to the ESAs, which have a sectoral division of powers, the ESRB has a broadly based responsibility across the various financial system sectors. The ESRB has been equipped with non-mandatory tools, and may issue alerts and recommendations targeted at EU institutions generally, or specifically at one or more authorities. The ESRB's counterparty in EU Member States was tasked with the setting-up of national macroprudential authorities, with an explicit mandate to conduct a national macroprudential policy targeted at preventing or mitigating risks to financial stability.

These institutional and functional changes aimed at addressing some of the weaknesses detected in financial system supervision, namely as regards: (i) failures in supervision in situations involving cross-border activity that required cooperation among different national supervisors; (ii) lack of resources and powers assigned to the previous 'level 3' committees that were part of the so-called 'Lamfalussy Process'; (iii) lack of tools for supervisors to coordinate their actions and make joint decisions; and also (iv) failures in supervision and in measures leading to the promotion of the stability of the financial system as a whole.

National supervisory authorities, ESAs, their Joint Committee, and the ESRB constitute the European System of Financial Supervision (ESFS).

1.1.2. The construction of Banking Union

The financial integration process in the EU following the creation of the Single Market and subsequently of the euro area was not accompanied by the full integration and harmonisation of banking system supervision nor by "safety net" mechanisms, such as the deposit-guarantee scheme and institutions' recapitalisation and resolution mechanisms, which have remained essentially national in their nature.

This extended the mutual dependency between the banking system and the respective home State, contributing to amplify the euro area sovereign debt crisis as of 2010, involving the so-called peripheral economies. In this period, the banking systems' crisis – hit by the bursting of real estate bubbles and the cut in external funding caused by the distrust of financial markets in terms of those countries' external solvency – unfolded simultaneously with the public finance crisis, which in some cases was triggered by public intervention to avoid the collapse of banks. In these economies, prior to external intervention, domestic banking systems accumulated the public debt that the State could not place with international investors, in a self-preservation strategy that naturally was only efficient on a transitional basis and did not prevent these countries from resorting to external financial assistance.

The fragmentation of the euro area funding markets, compounded at the height of the sovereign debt crisis in 2012 was met by a new political impulse to deepen the European, and in particular, the EMU integration process. In this context, there was a need to create an integrated financial framework that was eventually called Banking Union, which would contribute to guarantee financial stability in the euro area and minimise the costs of bank bankruptcy for tax payers and European citizens in general. In this regard, a pan-European supervisor was created at euro area level, operating in liaison with a resolution system and a common deposit-guarantee scheme. Of these three pillars, the first is fully implemented at the moment, the Single Supervisory Mechanism (SSM), the second is partially implemented, i.e. the Single Resolution Mechanism (SRM), and the third – a common deposit-guarantee scheme – is yet to be attained.

The first pillar of the Banking Union, the SSM, became operational on 4 November 2014 with the purpose of ensuring the prudential supervision of credit institutions in a coherent, efficient and supranational manner. The SSM is composed of the European Central Bank (ECB) and the national competent authorities of the 19 euro area Member States, including Banco de Portugal (it is open to the participation of other Member States). Within the framework of the SSM, the ECB is ultimately responsible for the prudential supervision of all credit institutions, being directly responsible for significant credit institutions (in December 2015 this population was comprised of around 129 banking groups, 1,200 credit institutions, accounting for a turnover of around €25 trillion and 82% of the total assets of euro area credit institutions). The direct supervision of less significant credit institutions is the responsibility of national supervisory authorities, following common guidelines. However, under certain conditions, it may be undertaken by the ECB.

The ECB also has macroprudential powers within the scope of the SSM, but the responsibility is primarily of national macroprudential authorities, and the ECB may apply stricter measures than those adopted by national authorities, as long as they are instruments harmonised in the European legislation.

The second pillar of the Banking Union, the SRM, establishes the setting-up of an integrated institutional framework for the orderly resolution of credit institutions of Member States within the perimeter of the Banking Union. The SRM relies on a single resolution authority, the Single Resolution Board (SRB), and on a common mechanism to fund resolution measures, the Single Resolution Fund (SRF), funded by contributions from the participating institutions themselves. The SRF is expected to be designed to reach at least 1% of the covered deposits amount of all credit institutions authorised in all Banking Union Member States (corresponding to around €55 billion, to be reached in 2024). The SRM is composed of the SRB, the European Commission, the EU Council, and national resolution authorities.

The third pillar of the Banking Union, i.e. the common deposit-guarantee scheme, aims at setting up a single European mechanism for the protection of deposits (minimising the probability of deposit run phenomena and of a sudden deterioration in banking system liquidity), in view of the pooling of banking risks at EU level, consistent with supervisory responsibilities. It has been more difficult to find a political agreement for this pillar, since ultimately it may involve sharing costs among banking systems that would *a priori* have a very different financial standing. Hence, although common rules have been established for the various national systems, a decision has not been made to put into practice a common deposit-guarantee scheme at EU level.

At this moment a series of initiatives targeted at deepening EMU is being discussed in European fora, as summarised below.

First, the European deposit-guarantee scheme project has to address the vulnerabilities of national systems to major idiosyncratic shocks. For now, reference should be made to the European Commission's proposals to reinsure the various national systems based on the European deposit-guarantee scheme in force for the first three years, with a view to the transition to a co-insurance system with progressively higher coverage of the common component over the four following years. From 2024 onwards this coverage will be complete.

Second, common financing arrangements are yet to be established to ensure the SRF's guarantor of last resort (backstop) function, namely through the European Stability Mechanism. This backstop could be neutral from a fiscal viewpoint, through ex-post financing with the whole banking system.

It is also important to monitor risks emerging in the financial system, including those related to the so-called shadow banking, which consists of the part of the financial system that is not regulated in the same way as the banking system, but provides financial intermediation services involving similar risks to those inherent in the 'traditional' banking business. For this monitoring, authorities with macroprudential functions and tasks involving systemic risk assessment at EU level, namely the ESRB and the ECB, should be able to detect risks and maximise their mutual synergies.

Finally, the prudential treatment of sovereign exposures should be analysed, in an attempt, on the one hand, to ensure greater disconnection between the banking and the public sectors, and on the other, to guard against any adverse effects of regulatory change in this matter, namely the financing of the economy.

EMU with its three fully operational pillars will pave the way for a better pass-through of monetary policy impulses, with no fragmentation among financial markets from a geographical viewpoint within the euro area, minimising the possibilities of causal links being established between banking system risk and the respective sovereign risk and reinforcing depositors' confidence in the banking system, in a single currency context. Naturally, the effort to conclude the Banking Union does not hinder the parallel need to deepen fiscal harmonisation and convergence.

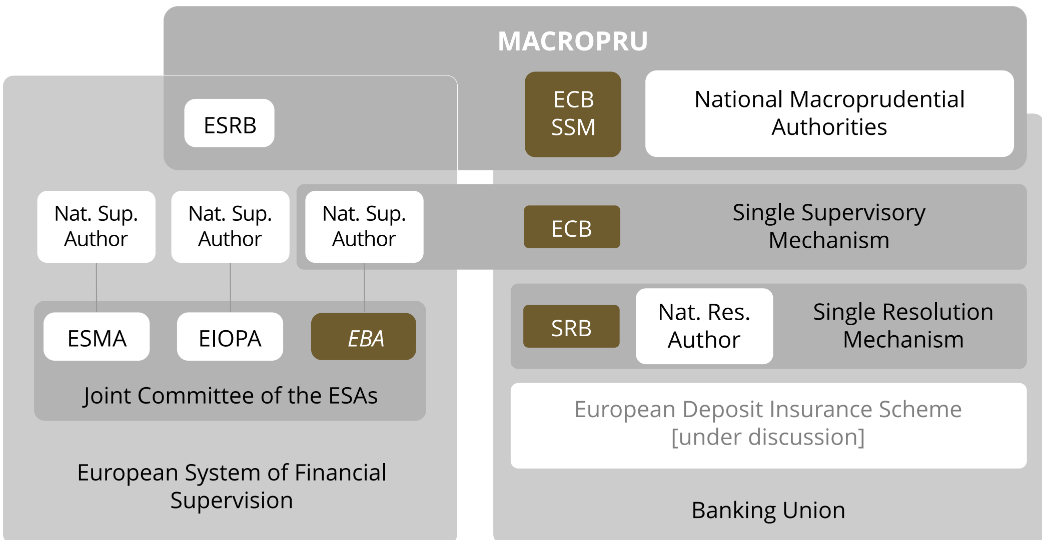
In addition, the institutional framework established in the ESFS also needs revision. Not only because the regulations of European supervisory authorities and the ESRB so require, but also because the developments stemming from the creation of the Banking Union should be taken into consideration, and there is a need to minimise institutional and powers overlapping. As an illustration, the ECB's regulatory powers within the SSM vis-à-vis the European Banking Authority's (EBA) tasks need to be further clarified. The Commission held a public consultation in 2013 on the revision of the ESFS, and in August 2014 it published two reports. One was on the functioning of ESAs and the ESFS[8] and the other on the ESRB's mission and organisation,[9] with proposals for improvement in the short to medium term, despite not containing proposals for legislative changes. The European Parliament also issued its opinion on the steps to be taken in the revision of the ESFS[10]. For now, no legislative proposals have been made, and this revision will probably be carried out in parallel with the revision of the Capital Requirements Directive/ Capital Requirements Regulation regulatory package (the so-called CRDIV/CRR), particularly as regards its macroprudential component.

In relation to the ESRB's role as macroprudential institution, the new institutional context where the ECB has macroprudential responsibilities over euro area banks within the framework of the SSM also advises a rethink of the ESRB's focus. Hence, there should be a distinction between the ECB's macroprudential scope of action and the ESRB's responsibilities in this matter. The ESRB should focus on establishing a framework for the conduct of macroprudential policy in the whole EU, identifying and mitigating systemic risks occurring across the whole financial sector and in countries not belonging to the Banking Union. In turn, the ECB should focus on the national macroprudential policy of each Member State participating in the Banking Union, in complement to national macroprudential authorities.

Considering the creation of these authorities at national level, a trend that started in 2012/13, it is also important to rethink the governance and composition of the ESRB's decision-making body to include these authorities, which do not always coincide with central banks or national supervisory authorities.

In schematic terms, the liaison between the ESFS's and Banking Union's institutional architecture can be summarised through the following diagram:

European System of Financial Supervision and Banking Union:



Given the multitude of national and supranational authorities acting at financial system level, namely in the legislative, regulatory, supervisory, resolution, and competition policy fields, it is essential to ensure effective coordination between said authorities and that European authorities duly consider the objective of preserving financial stability in each country in the exercise of their mandates.

1.1.3. The role of the European Banking Authority (EBA)

The context of the European institutional architecture with regard to the banking sector would not be completed without a mention to EBA, whose purpose is to contribute to the stability and efficiency of the financial system in the short, medium and long term, to the benefit of the EU economy and its citizens and enterprises. The main decision-making body of the EBA, the Board of Supervisors, is composed, among others, of the heads of each of the EU's national banking supervisory authorities.

The EBA's powers focus on prudential rules, issues related with corporate governance, audit and financial reporting, regarding the activities of credit institutions, financial conglomerates, investment firms, payment institutions, and electronic money institutions.

Among the EBA's tasks, the following should be highlighted: first, those related with the harmonisation of the EU's financial regulations, namely the interpretation and regulation of the Single Rulebook, referred to below and intended to ensure a suitable level playing field for the EU's banking sector; second, and from a banking conduct perspective, the promotion of depositor and investor protection; finally, there are also tasks related to the convergence of supervisory practices and methodologies, the uniform and coherent functioning of colleges of supervisors, the monitoring, assessment and measurement of systemic risk, the development and coordination of recovery and resolution plans, and the reinforcement of the European deposit-guarantee scheme.

To pursue its objectives, the EBA has powers that include the adoption of individual decisions addressed to national authorities or financial institutions in specific circumstances (emergency situations, mediation, non-compliance with legislation) and the issuing of warnings intended to prohibit or restrain certain financial activities, when it considers that they pose risks to financial stability. They also include the prerogative of requiring of national authorities the information needed to carry out its tasks and participate in colleges of supervisors, including inspections, information collection and sharing (creating a centralised system), and coordination of stress tests. It is considered the 'competent authority' within colleges.

The EBA should focus its tasks on the design of the regulatory framework and the promotion of convergence of supervision and cooperation, aiming at a balanced functioning of the internal market, with special emphasis on the liaison among supervisors of non-SSM Member States and between these and SSM members. An important aspect for the smooth functioning of the institutional model at European level is good liaison between the EBA and the ECB, to avoid the duplication of perspectives and conclusions on the same matters, namely as regards the SSM and the implementation and regulation of legal acts currently integrating the Single Rulebook, including any changes to it.

1.2. The institutional model in Portugal

In Portugal there is an established sectoral financial supervision model – which includes the prudential and banking conduct components – composed of three authorities: Banco de Portugal, the Portuguese Insurance and Pension Funds Supervisory Authority (ASF), and the Portuguese Securities Market Commission (CMVM).

Banco de Portugal is responsible for the (micro) prudential and banking conduct supervision and regulation of credit institutions and financial companies.[11,12] As of 4 November 2014, its responsibilities regarding the prudential supervision of credit institutions are exercised in the context of the SSM.

The ASF is entrusted with the (micro)prudential and conduct supervision and regulation of insurance and reinsurance activities, insurance and pension fund mediation, as well as related and complementary activities[13].

Finally, CMVM's mission involves the regulation and supervision of markets in financial instruments, as well as of the entities intervening therein.[14]

As of 2013 Banco de Portugal is also the national macroprudential authority,[15] responsible for defining and executing macroprudential policy, namely for identifying, monitoring and assessing systemic risks, as well as proposing and adopting measures to prevent, mitigate or reduce such risks, to safeguard the stability of the Portuguese financial system.

The three financial supervisory authorities gather periodically at the NCFS set up in 2000.[16] The NCFS performs coordination tasks among the financial system's supervisory authorities and since 2013 has been advising Banco de Portugal as the Portuguese macroprudential authority. In its advisory functions to Banco de Portugal, the NCFS meets at macroprudential level, where a representative from the Ministry of Finance also participates as an observer.

Occasionally, the three supervisory authorities of the financial system also meet at the National Financial Stability Committee (CNEF), set up in 2007, through a Memorandum of Understanding signed between the Ministry of Finance and the three authorities. The CNEF was created with the specific purpose of ensuring cooperation among these entities in case of financial crisis, in line with the Memorandum of Understanding established at EU level for cooperation among national financial supervisory authorities, central banks and ministries of finance on cross-border financial stability.[17] The CNEF aims to foster cooperation mechanisms for financial stability purposes, and mechanisms liable to be triggered in case of crisis with a systemic impact on the Portuguese financial market.

2. The legislative and regulatory framework

2.1. The European framework

2.1.1. The setting-up of a single market for financial services

Prior to the signing of the Single European Act in 1986, the first specific initiative on the non-discrimination within the banking sector was Council Directive 73/183/EC,[18] which should be implemented in coordination with the principle of equal treatment for national and foreign citizens or enterprises as regards the provision of banking services. Ensuring such equal treatment would require, in the context of completing of the internal market, that national laws and regulations were aligned with the purposes of the setting-up of said market. Hence, the need for coordination of regulations across the different Member States was expressly recognised in 1977, with the First Banking Coordination Directive.[19] In addition to this Directive, and following the 1985 White Paper of the Commission on the completion of the internal market, in 1989 the Second Banking Coordination Directive[20] set forth the principle of mutual recognition[21] within the scope of the freedom to provide banking services. This principle is and works as a "vote of confidence by each Member State with regard to the institutions and rules of the other Member States".[22]

The principle of mutual recognition had two main consequences for the regime applicable to citizens and enterprises providing banking services in an EEC member country and intending to do so in other Member States: the first consequence concerned the conditions for taking up and pursuing business, since the legislation of other Member States started being recognised, following minimum harmonisation, thereby ensuring a certain level playing field with regard to the "essential prudential control rules"[23] including the conditions for authorisation. The second consequence, complementing the first, concerns control by the home Member State, the so-called 'home country control', and consists of recognising supervision by authorities of other Member States in the application of harmonised legislation.

The combination of these three vectors, i.e. principle of mutual recognition, minimum harmonisation and home country control, would make it possible to create a single authorisation or single banking licence for the pursuit of banking business throughout the whole Community. The authorisation ceased to be of an exclusively national scope to be of a Community scope, which is why the possibility of the taking up and pursuit of a series of banking activities[24] in another Member State involving the provision of services or establishment of a branch, as long as the credit institution was authorised and supervised by the authorities of its home country became known as the Community passport.

The implementation of the Community passport implied that Member States would regulate activities that could be carried on by credit institutions with their principal place of business in another Member State. In this vein, issues relating to the taking up and pursuit of their business – a special role being played by requirements for authorisation, suitability of board members, internal governance, qualifying holdings, conflicts of interest, prudential rules – went on to be regulated in harmonised terms, allowing for implementation of the Community passport and the principle of home country control, more generally in compliance with the principle of subsidiarity. In accordance with this principle, the EU exercises a series of tasks or powers only if there is evidence that the EU's objectives (in this case, the internal market's) cannot be sufficiently pursued through the individual intervention of Member States, but rather through intervention at EU level.[25]

Notwithstanding the harmonisation attained among Member States, and considering a more ambitious commitment was not achieved, the harmonisation had some minimalist aspects and did not cover, for instance, the concept of the credit institution, despite the relevance of the concept for the banking system in general terms.

In Portugal the enshrining of these principles and the transposition of the Second Banking Coordination Directive was pursued through the RGICSF.[26] The completion vectors of an internal banking market did not undergo substantial changes in the ensuing Directives (such as the initial Banking Directive of 2000, the recast Banking Directive, also known as Capital Requirements Directive of 2006 (CRD),[27] and the 2013 Directive relating to the taking up and pursuit of the business of credit institutions and investment firms (CRD IV).[28] Rather, they offered inspiration for the harmonisation of other matters, particularly prudential, which over time have benefited from the achievements of European integration.

At national level the RGICSF is thus the key legal act applicable to credit institutions and financial companies, having to a large extent incorporated Community rules on the taking up and pursuit of the business of these institutions.

2.1.2. The evolution of prudential regulation – from Basel I, II and III to the CRR and the CRD IV

Developments in prudential regulation in the past three decades have largely been a reflection of the banking sector's growing complexity and globalisation on the back of a climate of broadly based confidence and optimism, albeit eventually undermined by the subprime crisis and the ensuing events, from the summer of 2007 onwards.

These developments had the Basel Committee as pivotal institutional entity, which has established itself as a major world reference in the past few decades. In addition to various particularly relevant thematic documents for banking regulation and supervision, notably at the level of risk control and management, this Committee has published the three major regulatory packages that became known as Basel I, II and III and which provided the basis for the prudential legislation issued in the EU and established the Core Principles for

Effective Banking Supervision that continue to be an international reference, as used in Financial Sector Assessment Programmes (FSAPs) conducted by the International Monetary Fund in a number of jurisdictions worldwide since 1999.[29]

The first Capital Accord of the Basel Committee, published in 1988, focused mainly on credit risk, seeking to safeguard minimum solvency levels. Among other rules, institutions had to permanently hold a minimum capital ratio of capital to risk-weighted assets of 8%. However, the growing universality of banking business led to the introduction of amendments to the first Capital Accord, particularly in 1996, with the calculation of minimum capital requirements also for market risks, namely for risks in trading book positions, liquidity risk, credit counterparty risk, and foreign exchange risk.

The revision of the first Capital Accord culminated in 2004, with the publication by the Basel Committee of the first draft of a second major regulatory package eventually called Basel II. This framework changed the concept of prudential regulation, by structuring it into three major pillars that continue to be followed today.

The first, Pillar 1, was targeted at reinforcing the prudential framework hitherto in force, significantly changing the rules for calculating capital requirements, seeking to render them more risk-sensitive. The new framework, in addition to also demanding capital requirements for operational risk, allowed more sophisticated institutions, under certain conditions and upon authorisation from the supervisor, to be able to use their own risk management and assessment methodologies in the computation of capital requirements. Pillar 2, in turn, established the concept of 'supervisory process', which gathers a series of principles chiefly aimed at reinforcing the link between the internal capital held by an institution and the risks emerging from its business. These principles seek on the one hand to lead institutions to adopt systems and procedures to calculate and maintain the internal capital suitable to the nature and magnitude of risks incurred, and on the other, assign supervisors responsibility for assessing the quality of said systems and procedures, and for imposing corrective action should the internal capital computed not be appropriate for the risk profile. Pillar 2 also includes risks not taken into account or not fully captured by Pillar 1

(e.g. credit concentration risk, interest rate risk in the banking book and strategic risk).

Finally, Pillar 3 introduced requirements regarding institutions' disclosure of information to the public on solvency and other elements characterising the risk profile, with a view to ensuring effective market discipline.

Notwithstanding the innovative nature of Basel II, a few years later the financial crisis disclosed various weaknesses still not addressed by the regulatory package, in areas such as capital, liquidity, excessive leverage, pro-cyclicality, systemic risk, internal governance, and compensation policy.

The new regulatory reform originally published by the Basel Committee in December 2010 (and already subsequently revised) sought to address some of these weaknesses, and became known as Basel III.

The major purpose of this reform was to improve the banking sector's capacity to absorb shocks caused by adverse economic and financial scenarios, regardless of their origin, thus reducing the risk of pass-through to the real economy.

The Basel Committee concluded that it was essential for banking business to have an underlying high-quality capital base, since the crisis proved that this capital base – essentially comprised of equity capital, reserves and other retained earnings – had actually absorbed banks' losses.

Hence, an important part of the measures introduced by Basel III aimed to reinforce the quality and quantity of capital. On the one hand, the eligibility criteria of certain instruments for the highest quality capital components became more demanding in matters such as permanence, loss absorption capacity and flexibility in compensation payment. On the other hand, minimum ratios were set for the highest quality capital components, and a minimum of 4.5% was set for the common equity tier 1 ratio and 6% for the tier 1 ratio. The total capital ratio, i.e. tier 1 plus tier 2 capital, maintained the already existing 8% minimum.

One of the most destabilising elements of the crisis was the pro-cyclical effect of certain factors on the compounding of financial shocks, with consequences for the banking system, financial markets and the economy as a whole. In response, the Basel Committee decided to introduce measures aimed at mitigating this effect, including the creation of two types of capital buffers to be used by institutions in adverse situations, without compromising their normal functioning, or the normal funding of the economy. Hence, the setting up of a capital conservation buffer was envisaged, corresponding to 2.5% of the total risk exposure amount, as well as a countercyclical capital buffer of up to 2.5% of the total risk exposure amount. The Basel Committee set out that both capital buffers could be gradually implemented up to 1 January 2019, as of when its full application will start.

The setting up of the capital conservation buffer had an additional motivation, i.e. the fact that at the outset of the crisis some banks held back considerable distributions of dividends, share buybacks and other types of compensation of shareholders, despite their financial standing and the overall deterioration of the banking sector. This type of action was mostly accounted for by market stigma, according to which a reduction in distributions could be understood as a sign of weakness of institutions. To mitigate this market failure, the Basel Committee decided to introduce a capital conservation buffer that, as the name suggests, promoted the retaining of earnings and other types of regulatory capital, helping to increase the banking sector's resilience in downturns and favouring that capital's reconstruction in upturns.

The countercyclical capital buffer added to the capital conservation buffer and was created to be chiefly macroprudential in nature. Over the course of the crisis, losses incurred in the banking sector were compounded for having followed a period of excessive credit growth. In addition, given their magnitude, these losses had a destabilising effect on the banking sector and the economy in general. Hence, this buffer is targeted at contributing to moderate credit growth, simultaneously leading institutions to accumulate a capital surplus in an upturn that can be used to absorb losses, or maintain an adequate flow of credit to the economy in case of a downturn. The value of the countercyclical capital buffer is adjustable over time and varies across jurisdictions. For a specific jurisdiction, its value should be zero in normal times and raised in case of excessive credit growth. Each institution should have to comply with a specific countercyclical capital buffer that depends on the geographical distribution of its exposures.

When facing an adverse scenario, institutions may temporarily fail to comply with the aggregate value of the capital conservation buffer and the countercyclical capital buffer. However, institutions not complying with that aggregate value are required to retain a share of distributable profits, which will be higher depending on the degree of non-compliance. They also have to submit a plan to the supervisor to reinforce the levels of capital adequacy allowing for a return to normal within a period of time considered appropriate.

Another measure introduced by the Basel Committee also with macroprudential purposes was the setting up of a capital buffer for global systemically important financial institutions (G-SIFIs), which may range between 1% and 3.5% of the total risk exposure amount. Over the course of the crisis, the failure of large-sized institutions caused shock waves that spread throughout the whole financial system and the economy as a whole. The risk of systemic disruption led the different government authorities to act promptly, resorting to an injection of public funds to restore financial stability. The disruption caused by these events led the Basel Committee to create measures to reduce the probability of these failures occurring. In 2015, 30 G-SIFIs were identified, none of them having its head office in Portugal.

Another feature shown by the crisis was the banking sector's excess leverage in some countries (e.g. Ireland) and an ensuing need for deleveraging with a negative effect on the economy's funding. In response, the Basel Committee decided to establish a leverage ratio that could limit this type of situation going forward. The intention was to have a simple and transparent ratio that did not depend on exposure risk, calibrated to act as a credible complementary measure to risk-sensitive capital ratios. The ratio is being monitored, and its final calibration is forecast for 2017, with a view to a possible integration into Pillar 1 in 2018.

Another important part of Basel III focused on liquidity. After summer 2007, at the inception of the financial sector crisis, many banks, even those with adequate capital levels, were struggling to manage their liquidity. The fast reversal of market conditions showed how liquidity could disappear rapidly for lengthy periods of time. The banking system was under strong pressure then, which required central bank intervention to support the functioning of institutions and the economy's funding.

In response, in 2008 the Basel Committee published the principles for sound liquidity risk management. To complement these principles two new ratios were introduced for achieving two distinct but complementary goals. The first goal was to promote short-term resilience for the liquidity risk profile of banks, ensuring that they would have sufficient highly liquid assets to survive over a month in a strongly adverse scenario. The Liquidity Coverage Ratio (LCR) was developed for this goal. The second goal was to promote resilience over a longer-term horizon, creating further incentives for banks to continuously fund their business by resorting to more stable sources. The Net Stable Funding Ratio (NSFR) was developed for this. The liquidity coverage ratio was implemented in 2015, still benefiting from a series of transitional provisions, while the Net Stable Funding Ratio is being monitored, its final calibration being forecast for 2017 and implementation in 2018.

Basel III rules have been adopted in the EU through the Regulation on prudential requirements for credit institutions and investment firms, the so-called 'Capital Requirements Regulation' (CRR),[30] and the CRD IV – both published in 2013 and replacing the two Directives published in 2006[31] – whose scope of application are European credit institutions and investment firms in general. Hence, in compliance with the principle of proportionality, the rules that were originally designed by the Basel Committee for large internationally active banks were extended to smaller-sized institutions. The use of a legal instrument whose main feature is the direct immediate and mainly uniform application of the rules established therein shows a change in approach from 2006, since the rules on prudential requirements were envisaged in the CRD. Although the CRR provides for cases where it is possible to accommodate certain national specificities into the European framework (by exercising options and discretions), these cases do not preclude the standardising nature that it intends to impose, as opposed to Directives, usually of a harmonising nature, to a greater or lesser extent.[32] The European legislator's choice will surely take into consideration level playing field concerns inseparable from the Banking Union and the Single Rulebook, which integrates the SSM and SRM Regulations and the legislative bloc composed of the CRD IV, the CRR, the Directive establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD),[33] and the Directive on deposit-guarantee schemes[34] (DGS), as well as the corresponding secondary legislation (Level 2 legislation).

For this reason, the new rules for calculating capital and capital requirements, as well as those on leverage and liquidity were introduced through the CRR, and implemented in all Member States as of 1 January 2014.

The transitional arrangements envisaged in Basel III were also adopted, albeit with a few adjustments aimed at safeguarding specific European traits.

In the adoption through the CRD IV of capital buffers introduced by the Basel Committee, the European legislator went further than the Committee and introduced two new types of capital buffer, also with macroprudential purposes, a buffer for other systemically important institutions, ranging from 0 to 2% of total risk-weighted positions and a systemic risk buffer with no defined ceiling.

The capital buffer for other systemically important institutions complemented the buffer for global systemically important financial institutions introduced by the Basel Committee, and was intended to be applied to systemically important domestic institutions.

The systemic risk buffer was created to prevent and reduce in the long term, non-cyclical systemic risk that might cause disturbances in the financial system liable to have serious negative consequences for the system and for the real economy of a given Member State. In contrast to the other capital buffers, this one can be applied to all institutions or to one or more sub-groups of institutions, provided these institutions have activities with similar risk profiles,

Another specificity introduced by the European legislator was the option granted to Member States of appointing a national authority other than the microprudential supervisory authority to apply and calibrate the new capital buffers. This possibility made an important contribution to reinforcing the powers of the macroprudential authorities starting to emerge in the EU.

The financial crisis that started in the summer of 2007 also showed weaknesses at the level of corporate governance and compensation policies of certain institutions, which led the European legislator to adopt measures in those fields.

Therefore, the European legislator required that Member States introduced principles and rules to ensure effective supervision by government management and supervisory bodies, promote a sound risk culture at all levels of credit institutions and investment firms, and allow competent authorities to supervise the suitability of internal corporate governance systems.

It was also concluded that compensation policies encouraging excessive risk taking behaviours may compromise institutions' sound and efficient risk management. In this sense and taking into consideration the principles published by the Financial Stability Board in September 2009 on sound compensation practices, the European legislator decided to require institutions to establish and maintain compensation policies and practices consistent with efficient risk management for the categories of staff whose professional activity has a considerable impact on the risk profile.

Another new feature brought about by European legislation was the introduction of a series of rules regarding the application and publication of sanctions and other administrative measures, so as to guarantee actual compliance with the obligations imposed in said legislation and ensure that any violations would be similarly addressed across the whole EU.

2.1.3. The construction of a European framework for the resolution of credit institutions

The lack of suitable instruments to safeguard financial stability in situations of insolvency or severe financial imbalance of credit institutions whose disorderly winding up could compromise confidence in and resilience of the financial system led the European legislator to reform the framework for intervention or recovery in 2014. This was an attempt to avoid or mitigate recourse to public funds in the bail-out of these entities, as was often the case during the financial crisis.

The BRRD provides for the harmonisation of conditions, objectives and general principles that are common to recovery and resolution measures, as well as the procedures, powers and instruments at the authorities' disposal. In addition, the BRRD sets forth that Member States appoint public administrative authorities or authorities entrusted with public administrative powers[35] to perform the functions of national resolution authority, set up financing arrangements to support the application of resolution measures (such as the Resolution Fund), and envisage the establishment of resolution colleges, to liaise between the resolution authorities of different countries.

According to the approach followed by the BRRD, one or various resolution measures envisaged therein should be applied, namely the sale of business or shares of the institution under resolution, the setting up of a bridge institution, the separation of the performing assets from the impaired or under-performing assets of the failing institution, and the bail-in of the shareholders and creditors of the failing institution.

The Directive sets forth that the authorities' intervention should be compatible with the Charter of Fundamental Rights of the European Union,[36] namely by protecting the rights of the shareholders and creditors of institutions in the context of protecting a public good such as financial stability. In this vein, shareholders and creditors should not incur greater losses than they would have incurred if the institution under resolution had been wound up – no creditor worse off principle – i.e. no creditor is worse off than under normal insolvency proceedings – and had no financial stability risks. This principle requires resolution authorities to ensure a fair valuation of the assets and liabilities of the institution before resolution measures have been applied, for the purpose of comparison with a winding-up scenario. This makes it possible to compensate shareholders and creditors, in case there is an unfavourable difference. On the other hand, the principle of equal treatment of creditors should also be ensured, without prejudice to the possibility of divergence in duly justified and proportionate situations, and once certain classes of creditors of the institution are protected, such as holders of covered deposits. Their exclusion is always ensured, to protect confidence in the financial system.

The application of one or more recovery or resolution measures to an institution involves a degree of interference that should be justified by the resolution authority on a case-by-case basis, given the intrusiveness of this intervention for the rights of the institution's shareholders and creditors. The legal framework envisaged in the Directive means a true change in paradigm, from a philosophy of implicit bail-out to full bail-in. The Directive sets forth that the resolution authority acts at a stage of severe financial imbalances in the institution that may compromise the safety of funds entrusted to it, such as depositor savings and especially the stability of the whole financial system. Resolution works in this context as a measure of last resort for the institution – whose solvency should be ensured by the institution's shareholders and creditors – aimed at minimising the impact that this disruption may have on the financial sector, while safeguarding the interest of taxpayers and the public purse.

Finally, this harmonised framework provided for in the BBRD should be interpreted in the light of the SRM provisions, especially of the liaison between the Single Resolution Board and national resolution authorities.

2.1.4. Progress towards a deposit-guarantee scheme

The first Directive on the establishment of a deposit-guarantee scheme in all Member States (Directive 94/19/EC)[37] was published in 1994, in a context of pursuit of the business of credit institutions throughout the Community. Alongside this development, the European legislator recognises the importance of reinforcing banking system stability and ensuring the protection of savers.

After the progress recorded with the enshrining of the principle of single authorisation and home country control, the Directive recognised that the pursuit of a credit institution's business in another Member State could not be sufficiently achieved if there was no harmonised minimum level of deposit protection. This protection was considered as essential as the prudential rules for the completion of the single banking market.

The harmonisation intended by the Directive was confined to what the legislator considered at that date to be "the main elements of deposit-guarantee schemes",[38] i.e. the setting of a repayment period of three months, with the possibility of extension, in exceptional circumstances, to nine months,[39] and a minimum guarantee level of ECU 20,000, with the objective of protecting the deposit holder. To address those cases where Member States provided higher coverage, the legislator allowed branches of credit institutions operating abroad to join their host countries' deposit-guarantee schemes, so that within the same country there would be no disparities in compensation and unequal conditions of competition.

In 2009, Directive No 2009/14/EC[40] amended this Directive so as to restore confidence in and ensure the proper functioning of the financial sector, in response to the urgency of an appropriate proposal to promote convergence of deposit-guarantee schemes. This Directive was targeted at increasing the scheme's coverage level and reducing payout delays.

In 2014 the DGS was finally published, already from the Single Rulebook perspective. The intention of this European legislative act was to broaden and clarify the scope of coverage, have faster repayment periods, improved information and robust funding requirements.[41]

Contrary to the 1994 Directive, which did not find it necessary to harmonise the guarantee schemes' financing arrangements, this need is acknowledged approximately 20 years later, leading to the introduction of risk-based ex-ante contributions, namely considering the institutions' different business models.

On the other hand, the DGS replaced the concept of minimum protection with a uniform protection of EUR 100,000. However, transitional rules were set out for Member States with higher covered amounts. This decision sought to eliminate market distortions, which caused transfers of funds from depositors to credit institutions with head offices in countries with higher protection levels.

Finally, the Directive also established a shorter repayment period than initially set out, i.e. seven working days.

2.2. The Portuguese framework

2.2.1. Banco de Portugal as supervisor

Pursuant to its Organic Law, Banco de Portugal is responsible for supervising "credit institutions, financial companies and other entities subject to it by law".[42]

Banco de Portugal is also responsible for supervising payment institutions and electronic money institutions.[43]

The subjective scope of Banco de Portugal's supervision has been widened over time, to accommodate the needs and new realities emerging from financial market dynamics, although the new European supervisory architecture, the SSM, has altered the national supervisor's specific responsibilities. The prudential supervision of investment firms is an example of this widening of the scope of responsibility of Banco de Portugal.

A closer observation of entities under the supervision of Banco de Portugal shows a multitude of realities and entities with different purposes, business and risk profiles.

As an illustration, Banco de Portugal not only supervises banks, regardless of their size, but also exchange offices, mutual guarantee societies or brokers, which are rather distinct and should be subject to intervention proportionate to their size, internal organisation and nature, scope, and business complexity. Under its supervisory and regulatory powers, Banco de Portugal should address these different realities so as not to subject them to prudential and banking conduct requirements – as applicable – that are considered disproportionate, namely for being liable to cause excessive regulatory costs that may compromise their competitive position in comparison with similar entities acting in other countries.

2.2.2. The liaison between the legal framework in Portugal and the European legal framework

The accelerated transformation of the Portuguese financial sector and in particular of the banking sector, largely results from developments in the European integration process, best illustrated by the various Directives published since 1973. It was the responsibility of the national legislator to interpret the new European legal and institutional reality, with the RGICSF as the expression of these new times.

The purpose of the original RGICSF approved in 1992 was "to govern the taking up and pursuit of the business of credit institutions and financial companies".[44] Its approval had two key objectives: to transpose to the Portuguese legal order several Community rules[45] and codify national rules while seeking to simplify the source system and improve the material solutions established. According to the legislator, the 1992 RGICSF aimed to "reform the general regulations of the Portuguese financial system, with the exception of the insurance and pension funds sector",[46] which resulted in the repealing of 22 Decree-Laws upon entry into force of this legal act. This attempt at simplifying sources was accompanied by the setting out of principles and the systematisation of rules on the back of legal and scientific criteria, i.e. typical tasks of a "true codification"[47] (and not only compilation), the RGICSF being, according to some doctrines, a "short institutional banking law code".[48]

Although the purpose of the RGICSF suggests regulating a rather restricted set of matters, limited to the taking up and pursuit of the business of credit institutions and financial companies,[49] in fact a closer analysis of these two vectors allows us to conclude that they are quite comprehensive. Since its approval in 1992, the RGICSF has undergone approximately 40 legislative interventions, being an example of remarkable regulatory resistance. Within the limits of its flexibility, and keeping the fundamental thematic identity that presided over its approval (the taking up and pursuit of business), over the course of more than two decades, the RGICSF has been able, with varying degrees of difficulty, to accommodate quite different and profound transformations that the reality of the banking sector and the financial sector eventually imposed on the legislative text in general.

Taking as reference the changes of the past decade and a half, it should be noted that the RGICSF has accommodated the revision of the typology of credit institutions and financial companies,[50] of the regime of authorisation and of prudential and supervisory rules. It has incorporated the conclusions of the three pillars set up by the Basel Committee (reflected at EU level in the two above-mentioned 2006 Directives)[51] regarding minimum capital Directives, the reinforcement of the supervision of capital adequacy (SREP) and the reinforcement of market discipline and transparency by institutions. It has accompanied the emergence of matters guiding the relationship between customers and institutions, and accommodated another discipline, which was known as of 2008 as 'banking conduct supervision'. The RGICSF has also accommodated the various changes to the sanctioning regime since 2009, for greater efficiency and strengthening of Banco de Portugal's power to intervene, and has endured the reform of institutions' recovery measures, establishing as of 2012 three distinct intervention stages, including resolution. It integrated the reform of European prudential regulation in 2013, which translated into the reinforcement of institutions' resilience at the level of risk management and corporate governance, the implementation of the third pillar of Basel (public disclosure of information) and also at the prudential supervision and especially macroprudential supervision level, setting out in 2014 macroprudential instruments to prevent and mitigate systemic risks. Finally, in 2015 it accommodated the changes stemming from the transposition of the DGS and those also resulting from the BRRD, completing the legal framework designed in 2012.

As may be observed, the RGICSF has been to a certain extent, the privileged legal act for accommodating Community requirements (via the transposition of Directives) and taking in the national banking sector's own demands, although it has not always been possible to accommodate all realities, especially the more technical ones. For example, the transposition of the CRD and Directive 2006/49/EC[52] showed that it was not possible to introduce in the RGICSF a series of matters related in particular to prudential requirements. The legislator chose to transpose most of the matters envisaged in the above Directives by creating two new legal acts (Decree-Law No 103/2007 and No 104/2007 of 3 April 2007) that in turn contained legal rules that enabled Banco de Portugal to issue regulations (Notices or Instructions) on that matter. The high complexity and technicality of the matters advised against the incorporation into the national legal order via substantive amendments to the RGICSF, which could seriously undermine its understandability.

Without prejudice to this particular case, in fact, in terms of the underlying topic and with the exception of the resolution regime, none of the matters that are nowadays part of the RGICSF were absent from its original 1992 version. The major difference is perhaps the dense nature of the current legal act as opposed to the original version. For this reason, one may claim that the current RGICSF is a maximalist regime in comparison with the minimalist 1992 version.[53]

The discipline of institutions continues to rely mostly on the scheme established for the taking up and pursuit of their business, although with an increased level of detail. The suitability requirements of the members of the institutions' bodies are nowadays more demanding, and so are the rules regarding the prudential limits to be observed (e.g. in total capital ratio composition). The supervisor's banking conduct, prudential, macroprudential, and preventive intervention powers are also strengthened. Perhaps only in the case of resolution can one claim that there is an absolutely innovative matter compared with the 1992 regime, given that in relation to capital buffers, the legislation applicable to institutions has always noticeably imposed capital requirements to accommodate exposure to various risks, with no capital requirements having been directly applied to systemic risk to date.

The evolution of European banking law has contributed to the current state of the RGICSF. In fact, up to the global crisis in the summer of 2007, the path of EU banking integration relied on a logic of minimum harmonisation, which in the post-crisis period gave way to a maximum harmonisation approach, as seen in the case of the CRD IV.

This external context results in an RGICSF that, despite maintaining its original thematic identity, is currently highly dense and complex, even being difficult to interpret and apply. Although the RGICSF currently regulates to a large extent the same type of matters it regulated in its original version, albeit much more densely, the fact that it transposed most of the European Directives on credit institutions and investment firms, and accommodated various interventions of national inspiration contributed to a material but chiefly systematic precariousness of this legal text, which would suggest it requires reform so as to better serve institutions, the banking supervisor itself and the public in general.

Firstly, a systematic reform of the RGICSF is warranted, allowing for greater clarity and simplicity in the application of its rules.

In turn, implementation of the SSM and the SRM implies adjustments to the RGICSF, given that the new European institutional reality includes a single supervisor and a single resolution authority, in liaison with national authorities, for euro area credit institutions.

Furthermore, upon completion of the transposition of the CRD IV, the BRRD and the DGS (soon the MiFID II) and the implementation of the CRR, a certain stability can be expected in the European regulatory framework governing the banking sector, and now the opportunity to reflect on the intelligibility and quality of the current national legal framework is fully warranted.

Finally, this structural change of the legal act will be an opportunity to improve the liaison between Banco de Portugal's tasks and related powers, thus seeking to set out a work framework contributing to a greater efficiency of the supervision function. Still at the material level, the revision should provide a consolidated institutional framework namely through the integration into the RGICSF of a series of matters in individual legislation that address the purpose and activities allowed and/or forbidden in the legal frameworks of other entities subject to the supervision of Banco de Portugal (such as savings banks, mutual agricultural credit banks and the Central Mutual Agricultural Credit Bank, as well as payment institutions and electronic money institutions). Finally, this opportunity should be taken to eliminate contradictions and gaps among legal provisions, and also to improve the current existing material solutions, nevertheless taking into consideration the restraints resulting from EU law.

2.2.3. The framework system for macroprudential powers

Expressly enshrining Banco de Portugal's capacity as national macroprudential authority in its Organic Law,[54] followed the guidelines issued by the European Systemic Risk Board (CERS) and Recommendation CERS/2011/3, requiring the clear and transparent identification of the authority or entity responsible for setting out and implementing macroprudential policy. The legislator chose Banco de Portugal given that it was already responsible for "safeguarding the stability of the Portuguese financial system" and because of its expertise and existing responsibilities at microprudential level.[55]

The mandate consists of identifying, monitoring and assessing systemic risks, adopting measures to prevent, mitigate or reduce those risks, including the issuing of provisions, warnings and recommendations thus targeted at public and private authorities and entities to achieve the macroprudential policy set out.

The macroprudential mandate is exercised in collaboration with supervisory authorities and also in liaison with a Government representative from the Finance Ministry, all of whom participate in the NCFS, which acts as advisor to the macroprudential authority.

However, although the Organic Law establishes Banco de Portugal's general powers, and the macroprudential instruments harmonised at European level have been incorporated into the RGICSF, no legal framework has been developed for implementation of this policy.

Hence, it is important to set up a legal framework envisaging the performance of the national macroprudential authority, in liaison with the other relevant supervisors and entities, endowing it with the appropriate powers to pursue its mandate.

This legal framework should establish from the outset the purpose of macroprudential policy, and identify some of its guiding principles, to which it should contribute.

In turn, without prejudice to the powers of the national macroprudential authority, it should be recognised that the implementation of macroprudential policy lacks strict coordination between said authority and the group of national financial supervisors, which play an extremely relevant role in promoting financial stability and mitigating systemic risks.[56]

Broadly speaking, the national macroprudential authority should act through warnings, recommendations and provisions, whilst national financial supervisors may also issue recommendations and provisions (or other binding acts) to the entities under their supervision. The performance of the national macroprudential authority is conditioned at all times by proportionality requirements, depending in particular on the need and appropriateness of the respective intervention.[57]

In a legally defined emergency or exceptional situation, the national macroprudential authority may issue a recommendation or provision directly to the entities under the supervision of other supervisors. This is a measure of 'last resort' that may only occur once the relevant assumptions are met and in accordance with the proportionality criteria assessed in the specific case. In this situation, the national macroprudential authority must take into due consideration why the national financial supervisor has decided not to implement a certain recommendation and adequately justify the need for its direct intervention.

It should also be mentioned that in terms of the relationship with the ECB, SSM-related recommendations are also considered to be addressed to the former authority, in its capacity as supervisory authority, although the national macroprudential authority imposes the recommendations and provisions directly to institutions supervised under the SSM.

The legal framework should also provide for the right of initiative of national financial supervisors, which may submit to the national macroprudential authority proposals for macroprudential measures under their respective powers.

It is also important to include rules for the disclosure of the macroprudential policy strategy, as well as the warnings, recommendations and provisions issued (which also applies to national financial supervisors, with the necessary adaptations), ensuring suitable disclosure and transparency of the national macroprudential authority's performance, while allowing for the creation of an additional channel for the supervision of the conduct of macroprudential policy.

Finally, the project should list the series of duties of supervised entities (including the duty to provide information to the national macroprudential authority and national financial supervisors, as well as compliance with the recommendations and provisions addressed to them) and incorporate the provision of a sanctioning regime governing non-compliance with these obligations.

2.2.4. Awarding the status of national resolution authority to Banco de Portugal

The setting-up of the legal framework for resolution in 2012 in the RGICSF was accompanied by the awarding to Banco de Portugal of the responsibility for preparing and applying resolution plans and resolution measures. This awarding was expressly enshrined in Banco de Portugal's Organic Law the following year, the bank being thus considered the Portuguese resolution authority responsible for safeguarding national financial stability.

Awarding this function to the central bank results from its privileged knowledge of the banking sector, in particular the task conferred on it as regards the prudential supervision of credit institutions and financial companies. On the other hand, the guarantees of independence required of the banking regulator, enshrined in the Treaty on the Functioning of the European Union (TFEU),[58] are an assurance that decisions regarding the resolution function (that, despite being assigned to Banco de Portugal, should be organised internally independently from any other tasks, particularly the supervision function) are based on strictly technical and not opportunity criteria, thereby ensuring the neutrality, credibility and expertise that characterise an independent regulator.[59]

However, the experience gathered over the course of the past three years should lead to weighing the possible advantage of a few adjustments to the above-mentioned institutional model. Hence, while the responsibility for preparing resolution plans, choosing the types of resolution most suited to each case, and the timing of the application of resolution measures to institutions should remain within central banks, since they are in a better position to decide on these matters. Notwithstanding, given that the implementation of resolution measures, namely those involving the sale of bridge banks or packages of assets and liabilities of institutions in a resolution process, should be separated from the central bank's sphere, because otherwise there might be conflicts of interest harmful to the central banks' impartiality towards regulated entities. In this vein, adjustments may be warranted to the current institutional set-up as far as these responsibilities are concerned.

2.3. Some challenges of the recent regulatory developments

"Modern finance is complex, perhaps too complex. Regulation of modern finance is complex, almost certainly too complex... You do not fight complexity with complexity. Because complexity generates uncertainty" Haldane, 2012.[60]

The creation of the single banking market corresponds to a harmonisation of the rules applicable at EU level, insofar as the co-existence of non-harmonised national laws would lead to regulatory arbitrage areas and contribute to this single market's fragmentation.

In this context, the so-called the 'de Larosière Report' recommended the adoption of European rules governing the financial sector, safeguarding a number of specific national traits, through Directives of maximum harmonisation or Regulations. The latter should be privileged, given that, being directly applicable in Member States, they ensure the standardisation of regulatory solutions, without depending on transposition into national legislation.

The implementation of a Single Rulebook poses important challenges that might reveal regulatory trends that should not be dismissed. The issue of new legislation or the improvement of existing legal frameworks should nevertheless be subject to more in-depth and thoughtful discussion on the objectives intended with the ongoing modification of the regulatory framework, not least because regulation does not necessarily mean better regulation. When moving away from a crisis context and there is a need for regulatory action, the first response is usually quite conservative, giving rise to subsequent corrections that in time will tend to converge to a new point of balance, like a pendulum. Hence, at a first stage there is a risk of over-regulation of matters and sectors that during the preceding crisis were excessively complex, dynamic or opaque.

Regulation, similarly to the business it governs, has been widening its scope to cover a greater number of risks and operations, largely reflecting the growing complexity of the institutions' business. It has thus become equally complex, both in terms of content and volume. As an example, from 2008 to 2013 more than 16 regulations were approved on the EU financial sector,[61] surely due to the pressure of certain political fora such as G20, as well as public opinion's growing call for greater regulatory intervention in financial markets.

This movement started a few years before, when through the Basel II regulatory package a series of more sophisticated mechanisms to identify and quantify risk were introduced in prudential regulation, making it possible to use, under certain conditions, the institutions' in-house methodologies to calculate capital requirements. Conceptually, the use of more risk-sensitive methodologies brought the advantage of allowing for a stricter assessment of expected and unexpected losses associated with a given exposure, as well as the detection of changes in underlying variables that allow for an early perception of changes in the size and probability of occurrence of these losses. However, applying these more sophisticated methodologies introduced pro-cyclical effects, bringing some opacity to the risk measurement process, hindering its understanding.

As a general rule, an institution intending to use internal models for prudential purposes should prove to the supervisory authority approving it that the models are an integral part of its risk management and assessment system. This internal governance rule is key to ensuring that the institution's management bodies have suitable knowledge of the design of the model used, understand their results and take them into consideration in the decision-making process. However, if under any circumstances this model fails in the assessment of a given risk, the implications of this will simultaneously affect management and supervision. In the specific case of credit risk, this possible failure can be mitigated by the supervisor through implementation of an independent risk assessment system developed from its own historical databases. This assessment system would allow the supervisor to compare results with institutions and identify potentially anomalous situations that deserve in-depth examination and, where applicable, correction.

The performance of an internal model depends, inter alia, on the existence of historical databases that are sufficiently robust to estimate the statistical parameters that feed the respective algorithms, with an appropriate degree of statistical confidence. In the case of extreme events of operational risk or credit exposures with a low default ratio (e.g. sovereigns, institutions and large-sized enterprises), ensuring that there is a robust database can be a difficult challenge to overcome. Thus, internal models tend not to be very reliable in determining requirements for operational risk or requirements for credit risk in low default portfolios, and may generate significantly different results among institutions due to different parameterisations. This uncertainty and variability in results warrant the regulators' rethinking about the use of internal models under these circumstances. For that purpose, one should consider the adoption of more objective alternative methodologies, easy to implement and monitor, which are simultaneously prudent and ensure greater harmonisation of results.

The Basel Committee is noticeably sensitive to this issue and considering measures to reduce the excessive variability of risk-weighted assets. In addition, it is important to establish additional metrics that are simple to manipulate and can be used together with the so-called capital ratios. An example of this type of metric is the leverage ratio introduced by Basel III forecast to be implemented in 2018. This ratio allows supervisors to consider an institution's total exposures in a single indicator, including those currently not affecting prudential ratios, as is the case with the public debt of European Union countries denominated in local currency.[62] Although the leverage ratio has already lost some of its original simplicity, it is still legitimate to defend the advantages of implementing simple and easily understandable rules that may be used as a complement or alternative to more complex ones, which are more difficult to implement by institutions and to monitor by supervisory authorities. The implementation of these rules would also make it possible to increase the institutions' levels of transparency, leading investors, supervisors and the general public to more easily compare institutions in terms of their risk profile.

Confidence is a major asset in the financial sector, and therefore the measures incorporated in national and European legislation to fight institutions with opaque governance and capital structures should be reinforced. Institutions lacking transparency traditionally have more funding difficulties, which are idiosyncrasies that emerge in stress situations, given that investors are less capable of conveniently assessing risk in situations of greater uncertainty. In this context, a simpler regulatory framework would allow the market to better discipline institutions, as intended by Basel's Pillar 3, since the information disclosed would be more easily understandable. Regulators should pay special attention to the challenge of communicating complex issues in a simple manner.

This growing complexity of legal texts, namely as regards Regulations and Directives, has complicated the objective of harmonisation pursued by the European Commission and other EU bodies, within the framework of operation of the Single Market. In the past few years efforts have been stepped up towards a greater standardisation of prudential regulation in the EU, which culminated in the Single Rulebook. In this vein, the EBA and European Union supervisory authorities have been working in coordination with the European Commission to identify options and discretions currently left to the Member States and supervisory authorities which can be eliminated or restricted. Although one recognises that it is important to keep a few options and discretions in regulations, due to specific national traits, a differentiated application of the basic rules of prudential regulation can have a material impact on the comparability and overall resilience of the financial system. Harmonisation, however, does not depend only on the elimination of the options and discretions currently still in regulations. In order for this harmonisation to be effective, regulations must be interpreted equally and implemented consistently across all European Union jurisdictions. The EBA has been playing an important role in this field, via the issuing of technical rules, guidelines and recommendations on various prudential matters and the maintenance of an interactive system of responses to questions addressed to it on implementation of the CRD IV and the CRR. These initiatives show, on the one hand, the important effort made by European institutions to achieve harmonisation, but on the other, also reflect a greater complexity of regulation itself.

The challenge lies therefore in being able to adequately regulate an activity that has gradually become more complex, with no pass-through of this growing complexity to the respective regulatory framework, in compliance with basic principles such as the principle of proportionality and the principle of private autonomy. Otherwise, a holistic monitoring and understanding of the risks incurred by institutions and a uniform application of rules may be compromised.

Rendering the Single Rulebook – which seeks a greater harmonisation of the applicable prudential rules – compatible with these rules being addressed to institutions of a different size and complexity poses a rather particular challenge as to the application of the principle of proportionality. This principle is enshrined in the TFEU[63] and requires that the adequacy, need and objectives warranting regulatory intervention are taken into consideration. The challenge in the application of the principle is observed especially in the situation in question, where it is necessary to distinguish the relevance of matters subject to appraisal by the legislator and the regulator.

At European level this challenge may still not be totally concluded, since the regulations issued as a response to the 2007 financial crisis may have placed an excessive burden on institutions with various obligations. Complexity and proportionality are not mutually antagonistic, but their compatibility requires expert, informed and balanced intervention taking into account the different interests at stake.

Notwithstanding the fact that the prudential regulation in force seeks to apply the principle of proportionality in various matters, the cost of implementing it in small-sized institutions is still relatively high, namely in terms of reporting and compliance. In this context, the standardisation of the information to be reported to supervisory authorities should be considered in terms of usefulness and appropriateness. There is still room for further rationalisation in this matter. However, compliance is a more challenging topic, insofar as concerns with its cost cannot be used to lead institutions to adopt a box-ticking exercise with no holistic or critical analysis. The application of the principle of proportionality cannot be understood in the same way across all domains. For example, an adequate evaluation of suitability criteria is a key requirement for the taking up and pursuit of the business of institutions, regardless of their size or complexity.

Regardless of the business model or the risk profile, there are recognised advantages in the application of rules aiming at certain common objectives, namely ensuring that institutions have appropriate internal governance systems allowing for sound and prudent management, maintain balanced asset and liability structures allowing them to meet their obligations on a timely basis, and have sufficient regulatory capital to accommodate possible losses from business risks.

The principle of proportionality should not be seen separately from the principle of subsidiarity and transparency. These three axes – proportionality, subsidiarity and transparency – are part of the European Commission's "Better Regulation Agenda" programme. The rules should be transparent, clear and understandable, and not cause unjustifiable damage to enterprises, citizens and Member States. The drafting of regulations should thus observe methodologies suited for the identification of the objectives to be reached and the respective cost-benefit analysis, prior to being issued, and a process of monitoring and assessment of results by said regulations, after being implemented.

However, more harmonised regulation cannot mean regulation leading to totally homogeneous behaviour and response patterns that limit and lead institutions to adopt similar business models or rein in their differentiation and innovation capacity, enhancing homogeneous behaviour patterns. Regulators and supervisors should reflect on how to avoid such risks and assess the ensuing dangers to the stability of the financial system as a whole. The materialisation of those risks would be like having institutions that individually could even be more resilient but would then be vulnerable to the same type of adverse effects. This would cause the whole system to become likewise vulnerable.

Notes

1. Part II of the White Paper was written by a thematic working group formed of José Manuel Rosas, Nuno Ribeiro, Ana Rita Mateus, Joana Saldanha Santos, and João Luís Gonçalves, coordinated by Graça Damião.

2. See http://ec.europa.eu/internal_market/publications/docs/20years/achievements-web_en.pdf.

3. See the financial integration composites (FINTECs) calculated by the European Central Bank for dates subsequent to 1995 (Chart 1, Financial Integration in Europe, April 2015).

4. What lies beneath the euro's effect on financial integration? Currency risk, legal harmonization or trade?, ECB Working Paper No 1216, June 2010.

5. The 'Lamfalussy Process' (first proposed in 2001 for the securities market and subsequently widened to the remaining sectors) is divided into four levels: (i) adoption of legislation by the European Parliament and the Council of the European Union, typically following a European Commission initiative (level 1); (ii) detailed measures of implementation developed with the support of Committees linked to the Commission (level 2); (iii) setting-up of three European supervisory committees composed of national supervisory authorities, which advised the European Commission on the drafting of regulation and responsibilities in the convergence of national supervisory practices and supervision cooperation (level 3); (iv) control by the Commission of the process of transposing EU legislation into all national legal orders (level 4), without prejudice to the role of the EU Court of Justice as the competent body to assess cases of non-compliance.

6. The De Larosière Report, February 2009, at http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

7. Appointed by the respective Board of Supervisors following a public tender, being subject to a non-objection procedure by the European Parliament.

8. The Report from the Commission to the European Parliament and the Council on the operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS) can be consulted at http://ec.europa.eu/finance/general-policy/docs/committees/140808-esfs-review_en.pdf.

9. The Report from the Commission to the European Parliament and the Council on the mission and organisation of the European Systemic Risk Board (ESRB) can be consulted at http://ec.europa.eu/economy_finance/articles/governance/pdf/2014-08-08_esrb_review_en.pdf.

10. The European Parliament report is available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A7-2014-0133+0+DOC+PDF+V0//EN.

11. Article 16-A of Banco de Portugal's Organic Law, approved by Law No 5/98 of 31 January 1998.

12. Financial intermediation activities (i.e. the provision of services and investment activities in financial instruments, as well as the respective ancillary services) carried out by credit institutions and financial companies are subject to the banking conduct supervision of the Portuguese Securities Market Commission.

13. Article 7 of Decree-Law 1/2015 of 6 January 2015, approving the AFS statutes.

14. Article 4 of Decree-Law No 5/2015 of 8 January 2015, approving the CMVM statutes.

15. Article 17 of Banco de Portugal's Organic Law.

16. Decree-Law No 228/2000 of 23 September 2000.

17. Memorandum of Understanding on co-operation between the Banking Supervisors, Central Banks and Finance Ministries of the European Union in Financial Crisis situations, of May 2005 and revised in June 2008.

18. See Council Directive 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions and the reference to the need for coordination of the laws, regulations and administrative measures. This Directive forbade the authority of the Member State where one intended to pursue one's activity to impose the nationality requirement on the Chairman of the Board of Directors of a credit institution, or a higher capital level for foreign banks compared with that required for national banks.

19. See Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions.

20. See Council Directive 89/646/ECE of 15 December 1989.

21. Concept first created by the European Court of Justice (nowadays the EU Court of Justice) and developed in the Cassis de Dijon of 20 February 1979 on the lack of harmonisation between the application of national legislation and compliance with Community rules.

22. Ferreira, Bruno, "Passaporte comunitário bancário: sucursal e livre prestação de serviços", in Revista da Ordem dos Advogados Vol. 69 Iss. I/II (2009), available at http://www.oa.pt/Conteudos/Artigos/detalhe_Artigo.aspx?idsc=84043&ida=84108 (in Portuguese only).

23. See Calheiros, José, O sector bancário e a CEE, 1993, pp. 92 and 111 and following.

24. Activities set forth in Annex I to the Second Banking Coordination Directive.

25. Quadros, Fausto, Direito da União Europeia, Almedina, Lisbon, 2004, pp. 102 and 103.

26. Approved by Decree-Law No 298/92 of 31 December 1992.

27. Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 and Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions.

28. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

29. In emerging economies these programmes are held jointly with the World Bank.

30. Regulation No 575/2013 of the European Parliament and of the Council of 26 June 2013.

31. Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

32. Minimum harmonisation, as is the case with the CRD, or maximum harmonisation, as is the case with the CRDIV.

33. Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, the BRRD is applicable not only to credit institutions and investment firms, but also to a wider group of entities than provided for in paragraph 1 of Article 1. For a better illustration, the group of entities to which the BRRD applies will be referred to as 'institution'.

34. Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit-guarantee schemes.

35. See whereas (15) of the BRRD, according to which Member States should "appoint public administrative authorities or authorities entrusted with public administrative powers to perform the functions and tasks in relation to resolution ...".

36. See whereas (13) of the BRRD.

37. Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes.

38. See the preamble to Directive 94/19/EC of 30 May 1994.

39. See Article 8 of Directive 94/19/EC of 30 May 1994.

40. Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009.

41. See whereas (8) of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014.

42. See paragraph 1 of Article 17 of Banco de Portugal's Organic Law.

43. See Article 6 of the Legal Framework governing Payment and Electronic Money Services, approved by Decree-Law No 317/2009 of 30 October 2009.

44. See paragraph 1 of Article 1 of the original RGICSF.

45. Paragraph 8 of the preamble to the Decree-Law that approved the RGICSF mentions the objective of transposing the following Community Directives: Council Directive 77/780/EEC of 12 December 1989, in the part that, under the derogations agreed, still had not been incorporated into the Portuguese legislation; Council Directive 89/646/EEC of 15 December 1989 (Second Banking Coordination Directive); and Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis.

46. Ibid.

47. Cordeiro, Menezes, Manuel de Direito Bancário, 4th edition, 2010, Lisbon, pp. 857.

48. Ibid.

49. Compliance with these requirements aims at ensuring the institution's sound and prudent management, as well as other constitutional values, such as efficient market functioning, the safety of savings and the principle of confidence, enshrined in the rule of law (see subparagraph (f) of Article 81, Article 101 and Article 2 of the Constitution of the Portuguese Republic respectively), namely confidence in the prudent management of funds allocated to institutions.

50. The RGICSF presents a stricter typology of credit institutions than that in force in its original version (pursuant to the current Article 3 of the RGICSF, banks, caixas económicas (savings banks), the Caixa Central de Crédito Agrícola Mútuo (Central Mutual Agricultural Credit Bank), caixas de crédito agrícola mútuo (mutual agricultural credit banks), credit financial institutions, and mortgage credit institutions are considered to be credit institutions, in addition to other undertakings which are classified as such according to the law, reducing the context costs brought about by the acquis of prudential rules envisaged in the CRR and the CRDIV and directly applicable to institutions). The latest revision of the RGICSF on this matter occurred in 2014 and had two underlying reasons. The first, for (lack of) market purposes: the repealing of credit institutions that are no longer used in practice by economic agents was promoted. The second, to reduce costs created by regulations: other credit institutions no longer allowed to receive repayable funds from the public (as deposits) were requalified as financial companies.

51. Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

52. Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

53. As an illustration, let us compare the number of original Articles with those currently integrating the RGICSF: 232 vs. around 400.

54. See Article 16-A of Banco de Portugal's Organic Law.

55. See whereas (7) of the preamble of Recommendation CERS/2011/3.

56. As set forth in their statutes.

57. Hence, as regards entities directly supervised by the banking supervisor, the macroprudential authority may issue recommendations and provisions directly to those entities. With regard to other national financial supervisors, the national macroprudential authority may only issue recommendations to those supervisors, for these to implement them in the institutions they supervise.

58. See Article 7 of Protocol No 4 of the TFEU on the Statute of the European System of Central Banks and of the European Central Bank.

59. Carl Schmitt is the author of the neutral power theory referred to by Lucas Cardoso in Autoridades Administrativas Independentes e Constituição, Coimbra, Coimbra Editora, 2002, pp. 85 and 198. Neutrality, credibility and expertise are often quoted in the doctrine of independence of regulators, which explains why the regulation of some sectors ceased to be conducted by the Government (the State in the broad sense, with the purpose of addressing or mitigating market failures) to be carried out by independent entities, which ensure to a larger extent that regulatory decisions are based on neutrality, expertise and credibility.

60. Haldane, A. and Madouros, V. (2012), "The Dog and the Frisbee", speech delivered at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium, August, Jackson Hole (WY), p. 19.

61. Simonova, Anna, "EU Banking Law: Developments and Challenges", in International Company and Commercial Law Review, vol. 26, 2015.

62. For credit institutions with traditional business structures the leverage ratio is given by the division of capital by assets, which should result in a ratio equal to or exceeding 3%.

63. See paragraph 4 of Article 5 "Under the principle of proportionality, the content and form of Union action should not exceed what is necessary to achieve the objectives of the Treaties."

PART III[1]

Prudential supervision

1. Objectives and principles of microprudential supervision

1.1. Objectives

The Portuguese State has a constitutional duty to promote financial stability.[2] Against this background, Banco de Portugal acts as microprudential supervisory authority of credit institutions and financial companies, monitoring on an ongoing basis compliance with prudential rules, i.e. rules that aim to promote the financial soundness of institutions in the long term.[3]

Its tasks as microprudential supervisory authority are performed in the context of Portugal's participation in the European Union (EU), amid growing harmonisation and in cooperation with counterparties of other Member States and the European Central Bank (ECB), most notably in the framework of the Single Supervisory Mechanism (SSM).[4] As such, in the performance of its supervisory functions, Banco de Portugal must bear in mind financial stability in Portugal, but also in all EU Member States, according to available data.

In its capacity as microprudential supervisory authority, Banco de Portugal monitors the performance of financial institutions from a prudential perspective, and acts to ensure their compliance with prudential rules to which they are bound. However, Banco de Portugal does not take upon itself the management of supervised institutions. Banco de Portugal's supervision does not mitigate nor decrease the responsibility on the part of the management and internal supervision of financial institutions to ensure their sound and prudent management, and the substantial, and not merely formal, compliance with prudential rules.

1.2. Principles

In its capacity as microprudential authority, Banco de Portugal must act in an informed, diligent and unbiased manner, engaging critically and independently from any interests other than the protection of financial stability.[5] It also carries out its tasks in strict compliance with the law (principle of legality), interpreting its tasks and powers pursuant to the provisions of the Constitution of the Portuguese Republic and EU law.[6]

It is incumbent on the Bank to act in a proactive and timely fashion, identifying and actively fostering the mitigation of potential risks. In the performance of its tasks, Banco de Portugal must take into account case-specific circumstances, based on objective data available and the need to bear in mind the size and complexity of the institution's activities. Therefore, Banco de Portugal is obliged to treat all institutions fairly, in accordance with the principles of equality and proportionality.

Banco de Portugal must use its powers in a rigorous, informed, comprehensive, meticulous and exhaustive manner, in accordance with the international best practice. It is called upon to foster a reliable performance, by acting in a consistent, coherent and transparent fashion, which can be easily understood by the various internal and external stakeholders. For that purpose, the Bank must provide financial institutions with the necessary information in a timely manner so that they may understand the Bank's expectations regarding compliance with specific prudential rules and adequately justify their decisions.

Notwithstanding the above, Banco de Portugal must maintain the necessary secrecy over confidential information entrusted to it, which is essential for safeguarding financial stability. The disclosure of out-of-context, inappropriate or late information may inhibit the Bank's ability to act as supervisory authority and, in an extreme scenario, jeopardise financial stability.

Lastly, Banco de Portugal is responsible for its actions and accountable to citizens and other internal and external stakeholders. As such, the Bank must act in a transparent way, making available, in accordance with the secrecy obligation by which it is bound, the necessary information so that the various internal and external stakeholders can assess its performance at any given moment.

In the light of the aforementioned principles, Banco de Portugal, in its capacity as microprudential supervisory authority, takes into account context and conducts a risk assessment, directing its actions with a view to safeguarding financial stability. In this analysis, Banco de Portugal identifies clearly and concisely the objective it pursues in its work and the instruments available for the purpose. In this framework and on the basis of all information available, the Bank decides on a course of action.

In the performance of its tasks, Banco de Portugal considers the prevailing stage of the business cycle. In cyclical upturns, the Bank encourages institutions, in their risk-taking, to bear in mind that this stage may be short-lived and that risks may materialise during a downturn, or in a crisis situation. At a less favourable stage, or in a crisis situation, the Bank draws the attention of institutions to the need to be equipped with the necessary human and financial resources to overcome these situations.

2. Microprudential supervision in the scope of the Single Supervisory Mechanism

2.1. Background: the Single Supervisory Mechanism

Under Article 127 (6) of the Treaty on the Functioning of the European Union, the [EU] Council may confer specific tasks on the ECB concerning prudential supervision. This is precisely what happened, in the wake of the financial crisis, in the form of Council Regulation (EU) No 1024/2013 of 15 October 2013 (SSM Regulation), which established the SSM, with the ECB being responsible for its effective and consistent functioning.[7]

The microprudential tasks conferred on the ECB are set out in Article 4 of the SSM Regulation, covering a very wide (but not exhaustive) range of prudential supervision matters and processes. In turn, the framework for cooperation between the ECB and national competent authorities (NCAs) is set out in Regulation (EU) No 468/2014 of the ECB of 16 April 2014 (SSM Framework Regulation).

The starting premise is that the ECB is responsible for the prudential supervision of all credit institutions established in the participating Member States.[8] However, as the SSM currently stands, NCAs are responsible for directly supervising less significant institutions (LSIs), except in a number of specific matters, which are conferred on the ECB.[9] In turn, the significance of institutions is determined by the institution's size, its importance for the economy of the participating Member State and its significance with regard to cross-border activities. To assess these criteria, the SSM Regulation includes specific minimum values above which a credit institution is deemed 'significant', while bearing in mind that, in principle, the three largest credit institutions in each participating Member State are always classified as significant.[10] With regard to LSIs, the ECB issues regulations, guidelines or general instructions addressed to NCAs, in the light of which these authorities carry out the tasks established in Article 4.[11] The ECB may also decide, after consulting with the NCAs, to directly supervise LSIs in order to ensure the consistent application of supervisory standards.[12] Overall, the ECB is responsible for overseeing the functioning of the system, and may request NCAs to report on how they act in the scope of the SSM. In order to carry out its tasks effectively, the ECB may also request information from credit institutions, and conduct its own investigations and on-site inspections (if necessary through judicial authorisation).[13]

At operational level, this new supervisory system is likely to require, particularly in future challenging or crisis situations, a clear allocation of responsibilities and leadership as regards processes, and the establishment of close links between the various players. In this context, the efficient functioning of the SSM also depends on the commitment of the national authorities, so that their experience close to credit institutions (that until recently had been supervised by them) can be applied to the joint supervision under the aegis of the ECB.

2.2. Tasks and responsibilities of Banco de Portugal in its capacity as national supervisory authority

2.2.1. The role of Banco de Portugal in the supervision of significant institutions

With regard to significant institutions, under the tasks conferred on it by the SSM Regulation, the ECB is exclusively competent to supervise these entities. In this context, the NCAs play a major role in assisting the ECB. For instance, they are responsible for assisting the ECB in the preparation and implementation of any supervisory acts regarding a credit institution, including assistance in verification activities and the implementation of its decisions.

Article 4 of the SSM Regulation confers on the ECB a set of tasks concerning issues relating to prudential supervision (in addition to macroprudential tasks, set out in Article 5). As such, NCAs are responsible for carrying out supervisory tasks not conferred on the ECB.[14] For the purpose of carrying out the tasks conferred on it by the SSM Regulation, the ECB shall apply all relevant EU law, and where this EU law is composed of Directives, the national legislation transposing those Directives.[15] Therefore, as regards supervised entities, the ECB shall exercise in particular the powers envisaged in national legislation that transposes the Capital Requirements Directive – Directive 2013/36/EU of the European Parliament and of the Council of 26 June (CRD IV), and the Capital Requirements Regulation – Regulation No 575/2013 of the European Parliament and of the Council of 26 June (CRR), which is directly applicable. Any prudential supervision power that is not regulated by EU law shall not, in principle, be exercised by the ECB, even where that issue falls within the purview of the ECB under Article 4 of the SSM Regulation. The ECB may, in any case and by way of instructions, require that NCAs make use of their powers, under and in accordance with the conditions set out in national law, where the SSM Regulation does not confer such powers on the ECB.[16]

Following the establishment of the SSM, Banco de Portugal lost decision-making power regarding a number of issues, but nevertheless it is still closely involved in decision-making. This is the case for authorisations to take up business, but also the assessment of notifications of the acquisition of qualifying holdings in credit institutions.[17] First, these types of request are sent to NCAs by the persons concerned. Afterwards, NCAs analyse these requests and, as applicable, send a formal draft decision or proposal to the ECB. These processes require an official statement of Banco de Portugal's position, which is typically followed by the ECB's decision on each of these cases.

Banco de Portugal's participation in the microprudential supervision of entities classified as significant takes place mostly through the integration of staff members in joint supervisory teams (JSTs). Indeed, in the context of the SSM, there is one prudential supervisory team for each significant entity or banking group, which is composed of staff members from the ECB and from the NCAs where that entity or group operates. Each JST works under the guidance of a Coordinator, who is a designated ECB staff member, and one or more NCA sub-coordinators.[18]

The JST structure, coordinated by the ECB, aims at creating a level playing field for all significant supervised institutions under the SSM, making it possible to exchange best practice in supervision between authorities. National competent authorities, and Banco de Portugal in particular, should participate in JSTs in a spirit of cooperation, transparency and full independence, thus bringing added value to supervision due to: (i) familiarity with the specific characteristics and regulations of national banking sectors, (ii) in-depth knowledge of national institutions and their historical background, (iii) physical proximity and mastery of the working language, and (iv) the allocation of headcount in sufficient number and with adequate skills for the national systemic importance of supervised institutions.

In order for this mechanism to work properly, a substantial number of operational challenges must be met. First, as it stands, the SSM requires the allocation of human resources, both at NCA and ECB level. The hub-and-spoke model results in a duplication of structures and formal requirements that cannot be ignored and that has led to an increase in the total headcount needed under the SSM, as a whole, compared with that seen before the implementation of this mechanism.[19] Furthermore, given that the technical skills needed for supervision are rather specific and have no match in the labour market, most resources recruited by the ECB, quite naturally, had to be tapped from the NCAs, which resulted in human resource management issues.

In turn, the SSM provided a new supervisory philosophy, drawing a strict distinction between ongoing supervisory functions (carried out by JSTs) and on-site inspection functions (carried out by cross-cutting areas). Although JSTs propose the necessary inspections on each significant entity, the latter are subject to an annual planning process and the availability of resources in cross-cutting areas, which leads to an actual loss of discretionary power when conducting on-site investigations.

Furthermore, an obvious obstacle stands (and is likely to always stand) in the way of the supervisory model, which is the physical distance and native language differences separating JST members from the ECB and those from NCAs, on the one hand, and between JST members from the ECB and supervised entities, on the other hand. The first factor hampers communication within JSTs, which is made worse given the various supervisory cultures. The second factor limits the ability of ECB staff members in JSTs to interact with institutions, thus making this contact solely dependent on NCAs.

Also, some ambiguity surrounds reporting lines, particularly for JST members from NCAs, given that they fall hierarchically under NCAs but are functionally dependent on JST coordinators. This double reporting line may give rise to tensions and conflicts. Although hierarchical reporting lines within NCAs facilitate communication and information-sharing with the respective senior management, it is still necessary to increase cooperation between the ECB's senior management and that in the various NCAs. In this area, the JST sub-coordinator is responsible for not only ensuring communication and the timely exchange of information on issues of major relevance in the field of prudential supervision with the NCA senior management – thus contributing to cooperation between the ECB's senior management and that of Banco de Portugal and efficient and effective prudential supervision – but also for transmitting and making sure that Banco de Portugal's opinion on specific matters and decisions is taken on board, where it differs from that of the ECB. Lastly, JST members from Banco de Portugal and the respective senior management debate any issues, additionally and where necessary, to support or assist Banco de

Portugal's participation in the Supervisory Board's decision-making process.

2.2.2. Supervision of less significant institutions

Turning to less significant credit institutions, the ECB is responsible for overseeing the system's operation, while Banco de Portugal is accountable for the direct supervision of institutions. In this context, Banco de Portugal has to ensure compliance with requirements in terms of capital, liquidity and limits on large exposures, to safeguard the enforcement of internal governance requirements, to conduct the annual supervisory process, to oversee credit institutions' parent undertakings on a consolidated basis, and to supervise cross border branches or services provided in a non-participating Member State. Conversely, Banco de Portugal is no longer liable for granting or withdrawing authorisations, the assessment of notifications of the acquisition or disposal of qualifying holdings in credit institutions, except in the context of bank resolution, and it does not participate in the supplementary supervision of financial conglomerates in relation to LSIs included in them.[20]

Nevertheless, the ECB has the power to issue regulations, guidelines or general instructions to NCAs, according to which these authorities exercise their supervisory powers.[21] The ECB's instructions may refer to specific supervisory powers regarding groups or categories of credit institutions, with the purpose of ensuring the consistency of supervisory outcomes within the SSM.[22] In very serious situations, when necessary to ensure the application of high supervisory standards, the ECB may at any time and after consulting with the relevant NCA decide to exercise directly all the powers for an LSI.[23]

The ECB's control of NCA actions regarding the supervision of LSIs varies in intensity according to their category. The ECB shall inform NCAs annually of the categories of LSIs and the nature of the information required. In turn, national authorities submit to the ECB an annual report on LSIs, less significant groups or categories of less significant supervised entities in accordance with the ECB's requirements.[24] The ECB may, in fact, impose specific and distinct obligations in terms of notifications that must be provided by NCAs. The supervisory procedures drawn up by the ECB establish that the system's supervision intensifies depending on the priority level of LSIs. As such, NCAs shall report information ex ante on the supervision of high-priority LSIs. The opposite is true for low and medium-priority LSIs, for which only ex post reporting is required.

However, Banco de Portugal may, on its own initiative, notify the ECB, regardless of the priority of LSIs, of supervisory procedures it considers relevant or supervisory decision procedures that require the ECB's opinion or that may negatively affect the SSM's reputation. The ECB may also, at any given time, request information from Banco de Portugal on its tasks associated with LSIs. Lastly, reporting requirements apply if there is a risk of deterioration of an LSI's financial situation and Banco de Portugal shall notify the ECB on a regular basis of any administrative penalties imposed on supervised LSIs.

It is also crucial to ensure that LSIs are treated homogeneously and have a fair and equitable competitive position. For that purpose, bearing in mind that NCAs have greater flexibility when setting and implementing their supervisory approach, Banco de Portugal's work under the SSM must focus on the preservation of the level playing field. In particular, the goal is to safeguard it when comparing between LSIs and significant institutions, between high-priority and low or medium-priority LSIs, and between LSIs in different Member States.

The preservation of the level playing field between LSIs in different Member States hinges on a cross-cutting perspective within the SSM, which is not accessible to each NCA on its own. By contrast, situations that compromise the level playing field between LSIs and significant entities and between high-priority LSIs and low or medium priority LSIs mostly occur within each Member State and, therefore, they must be identified and, as far as is within their power, addressed by NCAs.

In most cases, these situations are related to possible disproportionality between the supervisory approach applied to each entity and the risks resulting from its activity to financial stability and society at large. This disproportion may imply costs to LSIs that, as a rule, are proportionally more substantial than in significant entities, thus creating distortions in their competitive position. The central pillar for the preservation of the level playing field is therefore considered to be the application of the principle of proportionality when setting out the approach to be followed when overseeing each LSI. For that purpose, it is important to assess their characteristics and their influence on the aforementioned risks.

This assessment necessarily takes into account the type of entity, given that it may reflect, on its own, substantial differences as regards risks that must be mitigated: the supervisory approach applied to a bank that takes deposits from the public necessarily differs from that applied to a credit institution that does not take deposits. Consideration should also be given to the entity's size and systemic importance, given that the magnitude and comprehensiveness of risks, even if not exclusively determined by both characteristics, tend to be proportional to them. The nature, level and complexity of activities and the business model being pursued as well as the inherent risks to the activity sectors where the entity operates and the types of counterparty with which it typically interacts, should also be given proper consideration in this process.

The application of the principle of proportionality makes it possible to use a diversified approach in various domains, first of all as regards supervisory intensity, which should increase in proportion to the risks associated with the supervised entity.[25] Secondly, the rigour of the operational structure and internal governance should be adjusted, including control functions and statutory bodies. In a smaller entity, compliance with a number of these requirements may be a proportionally greater burden than for larger entities. In this respect, structures should be adjusted to the activity's lower complexity or inherent risk.

Turning to regulations, differentiation between types of entities, complexity and underlying risk is generally deemed insufficient when setting the applicable ratios and limits and in the coverage and frequency of required reports. In fact, over recent years, as a response by national and transnational regulatory entities to causes of instability in the financial system, there has been a substantial increase in the quantity, scope and complexity of regulations applicable to supervised entities, particularly as regards prudential or legal ratios and limits and prudential reporting requirements, without a proper application of the proportionality principle.

Notwithstanding the above, the application of the proportionality principle cannot, under any circumstances, exempt supervised entities from having at their disposal policies, procedures and internal structures that, due to their size, systemic importance or complexity, are deemed necessary to ensure sound and prudent management and effective control of incurred risks.

2.2.3. Banco de Portugal's active involvement in the SSM

With the establishment of the SSM, Banco de Portugal is no longer directly responsible for the supervision of significant institutions, and its action regarding LSIs is subject to the ECB's scrutiny and guidance. In this context, Banco de Portugal's quality of participation and ability to influence the ECB and the new fora within the SSM is increasingly important as a way to project its ideas and defend supervisory values it deems essential.

First, as regards its model and objectives, Banco de Portugal's active involvement in the SSM shall chiefly aim to protect national financial stability. In fact, ensuring the EU's financial stability, which is one of the main concerns of the SSM, does not mean, at least automatically, that the financial stability of each participating Member State is also safeguarded. As such, without detriment to the establishment and deepening of the banking union, the truth is that EU banking markets are still relatively fragmented and have well-defined borders. Therefore, there may be cases where a decision in the scope of the SSM, which is not cause for significant concern as regards the EU's financial stability, may, however, result in very substantial losses to a Member State's financial stability. In cases like these, the ECB and NCAs must ensure that Member States' viewpoints and concerns about financial stability are always duly taken into account in the SSM's decision-making process. Banco de Portugal's intervention in the SSM may, in fact, be designed as a tool to promote the Portuguese financial system's stability, without prejudice to the concern for the EU's own financial stability, to which the Bank naturally intends to contribute.

In terms of institutional intervention mechanisms, Banco de Portugal's active involvement with the ECB should, in the first instance, be carried out by its representative on the Supervisory Board.[26] In this regard, it is incumbent on Banco de Portugal's structures in charge of prudential supervision to monitor, support and warn the national representative on the Board, particularly where projects or decisions discussed there raise risks to financial stability or other challenges about which the national authority should be heard.

On a more operational level, Banco de Portugal's structures should actively intervene in the supervision of significant institutions operating in Portugal, and coordinate the conditions and intensity of its intervention with its supervisory team. In fact, given that the SSM comprises a cooperation system bringing together the ECB and NCAs, it would be strange if the members of national authorities with the greatest responsibility and direct intervention powers were excluded from tasks crucial to the single mechanism and thus from contributing to an efficient and close supervision. JSTs should define the times and ways in which the Bank's structures may (and should) intervene, e.g. via direct contact with supervised institutions, without prejudice to the monitoring of the entire process by the relevant JST.[27] The JST sub-coordinator, who continues to be a staff member of Banco de Portugal, plays an important intermediation role and, insofar as is possible and appropriate, promotes and organises the active involvement of other national authority structures, most notably at senior management level. This is crucial for ensuring that JSTs are properly integrated in Banco de Portugal, without prejudice to their responsibility towards the ECB, while boosting the active cooperation and close monitoring of institutions relevant to national financial stability.

In addition to the participation in JSTs, which are directly responsible for the ongoing supervision of significant institutions within the SSM, there are a series of cross-cutting tasks conducted by Banco de Portugal that are vital to its active intervention within the SSM. Chief among these are on-site inspections, model validations, the assessment of the suitability of members of the governing bodies, internal governance supervision, legal advice and participation in networks and other multilateral technical fora. Although these functions performed by Banco de Portugal are not integrated in the ECB's structure in the same way as JSTs, i.e. permanently and continuously subject in functional terms to the authority of a Coordinator within the ECB,[28] the fact of the matter is that they play a crucial role in the contribution made by Banco de Portugal to prudential supervision within the SSM.

The level playing field issue is also particularly important in certain cross-cutting areas, such as inspections. Given that the Bank's active involvement includes ensuring that the procedures and methods applied by its staff when conducting inspections meet the highest supervisory standards, it is crucial that this is accompanied by strong intervention under the SSM across all technical fora where the specific procedures and rules are established on the implementation of legal requirements applicable to credit institutions and which influence the conducting of on-site inspections. This would ensure that any action taken by other competent supervisory authorities of participating Member States is coordinated, thus generating high and consistent levels of supervision at European level.

Given the nature of the SSM and the growing importance of decisions adopted at European level in the prudential supervision field, Banco de Portugal shall also seek to fully exploit and actively participate in networks, working groups or other task forces, which are set up within the ECB to analyse and address specific themes that raise challenges requiring coordination and harmonisation between the various stakeholders. In the light, first of all, of Portugal's size compared with other Member States participating in the SSM, it becomes even more necessary for Banco de Portugal to mark its intervention in such fora through its regular presence and the quality of its contributions. This will certainly be a major tool for projecting effectively the Bank's own views in matters of prudential supervision on the SSM, which, in turn, would give it influence over decisions in terms of regulations, recommendations and supervisory methodologies. On the other hand, this involvement makes it possible to continuously update and recycle the matters in question and, in general, bolsters the Bank's ability to always adapt to the shifting demands of the single supervisory system.

Lastly, it is important to place a value on the quality of legal aid in SSM issues and to establish a closer link between these functions at national and European level, via the creation and development of a network of legal experts from NCAs and the ECB, thus providing a store of knowledge on the SSM and a platform for the coordination and resolution of more complex topics. Similarly to other cross-cutting matters, the active role played by Banco de Portugal hinges on its ability to make a substantial contribution to these new transnational fora, which should be encouraged and seen as an opportunity for the Bank itself.

2.3. Regulatory powers within the SSM

The question of whether or not regulatory powers have been conferred on the ECB has proved important and, at times, controversial. The term 'regulatory power' means the ability to establish and develop technical standards, in general and in the abstract, to regulate the banking sector's activities. Indeed, the SSM Regulation does not confer a generic regulatory power on the ECB.

For the purpose of carrying out the tasks conferred on it by the SSM Regulation, the ECB shall apply all relevant EU law, and, where this EU law is composed of Directives, the national legislation transposing those Directives.[29] To this end, the ECB may adopt guidelines, recommendations and decisions. On the basis of these instruments, the ECB must, in practice and in the exercise of prudential supervision, apply the legal requirements to which credit institutions are subject. The ECB may also adopt regulations only to the extent necessary to organise or specify the arrangements for the carrying out of the tasks conferred on it by the SSM Regulation.[30] The ECB's regulations in the field of prudential supervision are, indeed, focused inwards, on organising the SSM procedures.

A special case challenging the boundary between prudential supervision and regulations relates to the so called 'options and national discretions'.[31] Where the relevant EU law is composed of regulations and where those regulations explicitly grant options to Member States, clearly the ECB shall also apply the national legislation exercising those options.[32] On the other hand, with respect to the exercise of options provided for in regulations and mandated to competent authorities, the ECB may decide on such matters, particularly in the supervision of credit institutions classified as significant.[33] This means that the ECB may, in principle, directly exercise options laid down, for instance, in the CRR where the supervisory authority is solely competent to exercise such options. In this regulation, the ECB is implicitly granted a certain amount of regulatory power, although restricted to options. However, this does not mean that the ECB may, under any circumstance, exercise options that, pursuant to the CRR, are the sole responsibility of a Member State or competent authority, or that the ECB is automatically empowered to exercise options incumbent on Member States or competent authorities laid down in the CRD IV.

Defining the boundaries between prudential supervisory activities and the exercise of regulatory powers is clearly challenging. However, it should be borne in mind that, within the EU, only the European Commission may adopt non-legislative acts of general application and issue implementing acts where it is necessary to establish uniform conditions for implementing legally binding EU acts, while the ECB is, naturally, obliged to implement the acts and conditions set out therein.[34] The ECB is also subject to EBA recommendations and guidelines.[35] In this context, any decision made by the ECB that goes beyond the mere exercise of prudential supervision may clash with the tasks and scope of other EU institutions or bodies.[36] Furthermore, given the current environment, the greater the ECB's power to implement regulatory acts, the more probable it is for a regulatory dualism to be established at European level. Consequently, the EU legislature opted, at least for now, to restrict the ECB's powers to prudential supervision matters and decisions, while maintaining the regulatory obligations in the EU's remit (and not the SSM's).

Implementation of prudential supervisory rules in the context of an imbalanced completion of the banking union

As emphasised above, the banking union consists of three pillars, although each is at a (very) different stage of development. As such, while prudential supervisory functions are strongly integrated, the transition to a genuine single resolution mechanism has remained gradual and there is as yet no single deposit guarantee mechanism at European level. The practical effect of the imbalance between the pillars that form the banking union is the fact that it is clearly better equipped for banking sector supervision than for the direct taking over of losses resulting from bankruptcy procedures.

The Imbalance in this institutional and material architecture may generate a number of paradoxes and poses new challenges to the application of rules by the ECB as prudential supervisor. Indeed, several legally-established EU rules applicable to the banking sector work well in aligning the exercise of powers by competent (national) supervisory authorities and each State's responsibility for its own financial system and the individual assumption of losses, should specific credit institutions within this Member State experience difficulties. In withdrawing supervisory powers from Member States without setting up an equally developed safety net for the system, the centralised application of prudential rules by the ECB must consider the specific framework where such rules are now being implemented, taking into account any financial costs that may fall on Member States.

A telling example in this context is the competent authorities' ability to derogate to the application of liquidity requirements on an individual basis.[37] As such, competent authorities may waive, in full or in part, the liquidity requirements applicable to an institution and to all or some of its subsidiaries in the EU, and then supervise them as a 'single liquidity sub-group', provided that a number of conditions are met.[38] The approval of this derogation depends on a joint decision by the competent authorities, making it possible, within certain parameters, for subsidiaries to no longer meet regulatory liquidity requirements provided that the parent institution on a consolidated basis complies with such obligations.[39] Furthermore, in the case of a group solely comprised of significant institutions, the ECB may directly grant exemption from application of liquidity requirements on an individual basis and, even in the case of subsidiaries classified as less significant, the ECB may decide that NCAs must apply such derogations to these institutions, provided that the legal requirements are met.[40]

Subsidiaries of significant institutions authorised in Member States other than that where the parent institution is established on a consolidated basis face, therefore, a major challenge. Against a background of financial crisis, the supervisor (i.e. the ECB) may decide to release subsidiaries from the obligation of meeting minimum liquidity requirements, thus safeguarding the position of the parent institution on a consolidated basis, given its greater importance. Such a decision, in the absence of fully integrated resolution and deposit guarantee schemes, poses additional risks to Member States hosting only subsidiaries. When exercising such powers, the supervisor (i.e. the ECB) must have due regard to the potential impact of such supervisory decisions in terms of resolution and deposit guarantees, given the aforementioned imbalance, or gradual development process, of the banking union.

3. The exercise of prudential supervision

Approximately a year and a half after the start of the SSM on 4 November 2014, a number of priority topics remain the focus of attention of the ECB and the NCAs. These topics are mostly related to the approaches and culture of supervisors and supervised entities, which often imply a shift from traditional methodologies to better address challenges raised in this post-financial crisis period.

3.1. The advantage of an intrusive approach

The global financial crisis highlighted the need for a more intrusive approach by supervisory entities, to encourage the timely monitoring of supervised entities' activity, strategy and any existing fragilities, while mitigating, as far as possible, any information asymmetry between the supervisor and the supervised entity.

First of all, the supervisor must be acquainted with the main shareholders of supervised entities and their strategy. For that purpose, it must regularly meet those with qualifying holdings in supervised entities, according to agendas previously established by Banco de Portugal.

In turn, the supervisory entities and the Board of the main supervised institutions should also meet regularly, on topics related to major business risks, the bank's relationship with its main shareholders and, overall, strategy and corporate governance issues.

Furthermore, regular contact should be established between the supervisor and key function holders in supervised entities, as well as staff responsible for internal supervision (non-executive directors and members of the supervisory board), statutory auditors and external auditors.

The supervisor's intrusiveness should also entail the close monitoring of internal decision-making processes and associated management information, requiring unrestricted access to information systems and databases of supervised entities, which give the supervisor a comprehensive and independent insight into their position.

One of the benefits that may result from this closer connection is the fact that the supervisor can act in a more pro-active and timely manner. For that purpose, Banco de Portugal adopts a forward-looking approach when assessing the position of supervised entities and their strategic planning. Actions based solely on the ex post review of historical data, albeit crucial when assessing the risks incurred by supervised entities, must be supplemented by a forward-looking perspective. Otherwise, the ability to act in a preventive fashion may be constrained. As such, the tools available to the supervisor should provide a medium to long-term insight according to various scenarios, namely under baseline and business continuity (on the basis of funding and capital plans as well as internal capital adequacy assessment process exercises), contingency or adversity (stress tests and recovery plans) and non-continuity scenarios (resolution plans).

Furthermore, the array of issues underlying the exercise of prudential supervision is remarkably wide and complex and, therefore, a duly structured and considered plan is essential, making it possible to set out strategic priorities and, ultimately, maximise supervision's effectiveness. For that purpose, a risk-oriented approach is key, by adapting the intensity of supervision to each supervised entity's idiosyncratic risk. Risk-based supervision should also be dynamic, cross-cutting and comprehensive, given that the activity of supervised entities evolves and results in new risk typologies and changes to the existing typologies.

Also when conducting its corrective actions, the supervisor must determine which of the instruments available to it can more effectively produce the desired effects. Indeed, when the supervisor acts to enforce the laws and regulations applicable to supervised entities, it should prioritise the use of formal instruments (issuance of regulations, specific rules, recommendations or the obligation to implement corrective measures) and, where it seeks to influence behaviour, the supervisor may also make use of other instruments, such as the adoption of an educational or persuasive approach, which would also produce effects more promptly.

3.2. Corporate governance supervision

Banco de Portugal supervises people, structures, systems and procedures used in the institution's management and control, given their major impact on the institution's attitude towards risk, as has been well illustrated by the financial crisis.

3.2.1. Internal governance structures

In the Portuguese legal system, three internal governance models are available (Latin or classic, Anglo-Saxon and Germanic models), which are characterised according to how powers and tasks are allocated to the general assembly and to the management and supervisory bodies.[41]

Regardless of the internal governance model adopted, it is incumbent on institutions to ensure that their bodies, and corresponding support structures, are fit for purpose, thus fostering a sound and prudent management of the institution and compliance with the other prudential requirements, which include a proper risk management strategy and the maintenance of adequate capital and liquidity ratios.

The general assembly elects the members of the corporate bodies and, unless otherwise provided for in the statutes, decides on paramount issues for the firm. As such, it is essential that shareholders, particularly qualifying shareholders, effectively exercise their rights of access to information, so that they may make decisions on a well-informed basis and closely monitor the institution's management.

The management body must perform, in an effective, interventive and cooperative manner, the tasks conferred on it by law and the articles of association, namely its day-to-day operation. For that purpose, it should have a thorough knowledge of the institution's activities and strategy.

Surveillance of the management body's actions falls, first of all, on the body itself and each of its members. The latter should regularly undertake a critical review of their procedures, so as to address any shortcomings and make the pursuit of the institution's strategy and business activities more efficient. Accordingly, it is particularly important that the management body also comprises independent, non-executive directors, who stand ready to cooperate, critically and impartially, in this assessment.

The general and supervisory board, according to the Germanic model, and the members of the audit committee, according to the Anglo-Saxon model, perform this role. In the Latin/classic model, institutions are advised to delegate their day-to-day management to an executive committee, which includes formally independent non executive directors, ready to make objective contributions to the institution's strategic decisions and to strengthen the general internal supervision of the institution's day-to-day management – naturally, subject to the overriding need for the supervisory board to undertake its tasks in full.

Where executive and non-executive directors coexist in a management body, the roles of Chief Executive Officer (CEO) and Chair of the Board of Directors should be performed by different persons, and the latter should not take on the institution's day-to-day management. This is due to the fact that those performing such managerial roles must ensure the smooth functioning of the body as a whole, the correct interaction between executive and non-executive functions and the proper coordination of non-executive directors.

Non-executive directors should proactively and diligently exercise due care, by monitoring and staying informed about the institution's day-to-day management. Where they encounter a situation prejudicial to the interest of the institution and its stakeholders, they should call on the management body as a whole to intervene and, where necessary, to report it to the supervisory board and/or the general assembly.

It is also good internal governance practice[42] to set up specialised committees, within the management body, comprising members of the management and supervisory bodies. It is particularly important to include formally independent members (other persons may be invited to attend because their specific expertise or advice is relevant for a particular issue). These specialised committees may include an audit committee, a risk committee, a nomination/assessment or human resources committee and/or a governance, ethics or compliance committee, or other committees, depending on the institution's size and complexity.

To clearly define and systematise its functions, the management body should govern its own operation on the basis of written statutes. This document must include, as good governance practice, rules on the tasks and powers conferred on the Chair, the CEO, and the executive and non-executive directors, as well as rules on the distribution of functions among its members. It should also establish the estimated time that non-executive directors must allocate to their roles and the availability of formally independent directors to be members of at least one committee. This document should be properly advertised in-house and externally.[43]

As regards the distribution of functions by board members, the aforementioned statutes should also set out that executive directors responsible for internal control (internal audit, compliance and risk management) shall not accumulate these with operational functions, as they are assessed by these control functions.

Pursuant to Notice of Banco de Portugal No 5/2008, the management body is responsible for the implementation and maintenance of an appropriate and efficient internal control system, which, in line with the principles of an adequate control environment, a solid risk management system, an efficient information and communication system and an effective monitoring process of the internal control system, ensures that compliance, performance and information objectives inherent in the institution's activities are met, in the light of its characteristics.

In terms of risk, it is incumbent on the management body to determine the institution's risk profile, appetite and tolerance, by promoting a healthy, responsible and prudent attitude towards risk and equipping the support structures for control functions and the internal supervision function with the means to efficiently conduct their functions. It should also actively monitor the institution's activities, in full knowledge of the risks incurred while making sure that they are within the established limits, and ensure that the information system governance fosters the production, storage and access to good-quality information.[44]

The supervisory board is responsible for the internal supervision of the institution (together with non-executive directors, where applicable). Supervisory board members should be fully aware of their tasks and legal powers, exercise their powers diligently, critically and autonomously from the management body, and monitor in an effective fashion the institution's day-to-day management, across all dimensions, in the interest of the institution. They should be proactive, by staying properly informed on the institution's activities and effectively monitoring the institution's day-to-day management, so that they can intervene where harmful situations arise.

To guarantee that the supervisory board is properly informed, control functions are of special relevance. These should be functionally independent from the areas they supervise and have the human and technical resources necessary to undertake their tasks in full. Also, those responsible should be able to report directly to the supervisory board, if they see fit.

The supervisory board should comprise a majority of members formally classified as independent[45] and it must be chaired by one of such members.[46] This majority of formally independent members is a *sine qua non* for the board to pass valid judgement and, in its absence, any decision made by the supervisory board shall be void. It falls to the institution to ensure that a majority is accomplished.

The management and supervisory bodies are co-responsible for the institution's sound and prudent management, ensuring separation of functions and the prevention of conflicts of interest, namely through a clear delimitation of responsibilities and reporting lines within the institution. The institution should identify and properly manage conflicts of interest involving members of its management and supervisory bodies, particularly by putting into place rules on the prevention, reporting and resolution of conflicts of interest (discussed in more detail below).

As these are public-interest entities, credit institutions should employ a statutory auditor. Although performing supervisory functions, statutory auditors are not part of the supervisory board. They must meet their reporting obligations to Banco de Portugal and, if their service terminates before the period prescribed, they must send a written statement to Banco de Portugal, clearly setting out the reasons for the termination. When submitting their opinion on the institution's internal control, statutory auditors should put forward positive evidence.[47]

Banco de Portugal must actively supervise institutions' internal governance structures, by assessing their adequacy and quality, taking into account the institutions' risk profile, appetite and tolerance and the necessary monitoring, at all times, of the adequate capital and liquidity ratios and levels suitable to the size and nature of their activities. For that purpose, the Bank should assist with the establishment of the institutions' bodies, demand periodical reports from institutions, and compile ad hoc all information needed for the exercise of its prudential supervision function. It should also take on board any information received via whistleblowing.

3.2.2. Adequacy of qualifying shareholders, members of governing bodies and key function holders

a) Qualifying shareholders

An institution's qualifying shareholder (in accordance with the definition in the CRR, transposed into Article 2-A of the Legal Framework of Credit Institutions and Financial Companies (RGICSF)) directly or indirectly holds 10% or more of the capital or of the voting rights of the institution[48] (quantitative criterion) or directly or indirectly holds a share which makes it possible[49] to exercise a significant influence[50] over the institution's management (qualitative criterion[51]).[52]

The shareholding structure of credit institutions must be transparent, comprising qualifying shareholders of good repute, with the necessary qualifications and financial resources to promote the institution's sound and prudent management. Banco de Portugal should not permit opaque and obscure shareholding structures, which make it impossible to establish the ultimate beneficial owners of qualifying holdings, e.g. due to the cross-linked proliferation of special purpose vehicles in the equity holding chain.

Therefore, Banco de Portugal should always oppose the purchase of a qualifying holding by entities where the beneficial owners are unknown. If a given holding is described as 'qualifying holding', Banco de Portugal should demand to know the identity of its beneficial owner(s). If proper information is not provided, Banco de Portugal should prevent shareholders from exercising voting rights associated with this holding.

Banco de Portugal shall arrange meetings with the institutions' qualifying shareholders, particularly those that exercise control over such institutions, by actively monitoring their intervention in management issues, and request qualifying shareholders to provide it with any information it deems relevant to its supervisory actions.

b) Management and supervisory board members

Management and supervisory board members of institutions should promote their sound and prudent management, by safeguarding, in a diligent, well-informed and critically oriented fashion the institution's financial stability, interests and pursuit of business activities, with regard to the long-term interests of shareholders, depositors, investors and other customers, as well as those of its staff.

For that purpose, at the time of their appointment and throughout their term of office, board members should bring the necessary reputation,[53] independence,[54] qualifications[55] and availability[56] to carry out their tasks successfully. They should also identify and adequately prevent or manage potential conflicts of interest.

It is incumbent on institutions, above all, to assess the suitability of management and supervisory board members to conduct their tasks. For that purpose, they should have in place a policy approved by the general assembly for selecting and assessing members of the bodies.

Without prejudice to the criteria and requirements laid down by law and in future regulations of Banco de Portugal on this matter, the development of the selection and assessment policy for members of governing bodies should not be a mere formality, but rather be tailored to each institution, taking into account the material concern of accommodating its specificities. This is the only legitimate means towards its main goal: to ensure, in a rigorous, effective and critically oriented fashion, that those managing the institution are the most fit and proper for the pursuit of the institution's purpose and activities.[57]

In this exercise, the institution is obliged to carry out a double assessment: the individual assessment of each applicant for membership of a management and supervisory board and the assessment of governing bodies as a whole (collective assessment of the body), although the latter only focuses on the qualifications and availability requirements. The assessment findings should be published in a report that goes beyond what is formally mandated by law. Indeed, the report should examine, in particular, individual and collective compliance with adequacy requirements laid down by law, following for that purpose the selection and assessment policy approved by the institution's general assembly.

Taking into account their size and complexity, institutions should have appropriate training plans in place for members of its management and supervisory boards. The greater the gaps in experience and/or academic qualifications of some of the members selected for such bodies, the more thorough and comprehensive must be these plans. On the other hand, institutions should also, as good governance practice, establish succession plans that favour the regular turnover of management and supervisory board members, as well as an orderly transition when they are replaced.

In another level of scrutiny, Banco de Portugal also assesses the adequacy of the institution's management and supervisory board members, on the basis of the aforementioned requirements and criteria, for the purposes of authorisation for the taking up of functions. In this context, the legal framework governing the assessment of the suitability of the institutions' management and supervisory board members would benefit from a two-tier clarification. On the one hand, the separation between the suitability assessment processes and any penalty procedures should be clarified. On the other hand, it should be clarified that the opinion on the suitability of members is based on evidence. Consequently, for Banco de Portugal to lawfully refuse to authorise a member as a result of the non-compliance with the suitability requirement, it suffices that, at the end of the assessment process and taking into account all evidence gathered, an objectively justified doubt persists on their suitability.

Lastly, in the assessment of management and supervisory board members by institutions and Banco de Portugal, additional rigour should be exercised in the case of supervisory board members and non-executive directors. There should also be effective promotion of training for members on the role of internal supervision, which they are to adopt within the institution.

Given the tasks and responsibilities of institutions' governing bodies, in the pursuance of its supervisory tasks, Banco de Portugal should maintain a close relationship with the members of such bodies, by arranging regular meetings with them, most notably non-executive directors and supervisory board members.

c) Key function holders

Institutions should identify the individuals whose position gives them significant influence over the management of the institution, but who are not members of the management or supervisory bodies. This means that institutions should identify the individuals that are involved in high-level decision-making within the institution.

For that purpose, these individuals always include those responsible for compliance, internal audit and risk control and management within the institution, as well as other functions which might be deemed key by the institution or Banco de Portugal.

The assessment of key function holders by institutions has already been established. This does not preclude Banco de Portugal from also conducting its assessment, where it sees fit, for instance, if it deems that the assessment of the circumstances prevailing at the time of their appointment (or other circumstances) by the institution was manifestly insufficient, or on the basis of supervening circumstances. In these cases, Banco de Portugal may apply measures to correct non-compliance with the requirements, and also decide on the temporary cessation of functions, similarly to what is applicable to management and supervisory board members.[58]

Without prejudice to Banco de Portugal's power regarding internal control function holders (compliance, risk management and internal audit), their importance and effective impact on credit institutions' activities may call for a mandatory assessment of such function holders by the supervisor, pursuant to the conditions applicable to the assessment of governing body members, at least as regards significant institutions, according to their size, internal organisation, nature, scope and complexity of their activities.

For these reasons, information on control function activities must be directly reported to the management body as a whole (executive and non-executive directors) and not just to the executive committee or those responsible for the corresponding functions, while control functions should maintain a continuous information flow with the supervisory board. This means that hierarchical reporting must not hamper the functional independence of control functions, nor their obligation to report to the management and supervisory boards, such that their members may undertake their tasks in full.

In the supervision of key function holders, it is essential for the supervisor to maintain a close liaison and interact on a regular basis with the institutions' key function holders, in general, and the person responsible for internal audit, in particular. Indeed, due to the fact that internal audit plays the role of internal supervisor and acts as the third line of defence, the supervisor must take it more fully in consideration.

Banco de Portugal should encourage institutions to grant internal control function holders the necessary status and power to effectively carry out their tasks. This concern may warrant a number of measures to support the empowerment of internal supervision, such as granting supervisory board members and non-executive directors power to make certain decisions.

3.2.3. Supervision of institutions' culture and behaviour

The financial crisis seen over the past few years, which resulted in the collapse of a number of relevant credit institutions, showed that, in most cases, in addition to inadequate internal governance structures and leadership quality and profile issues, certain institutional cultures were conducive to management decisions inconsistent with sound and prudent management principles. Awareness of this fact brought institutional culture and behaviour supervision to the foreground, as an effective tool for risk prevention and mitigation at institutional level.

There is not one single 'correct' culture, given that diversity is vital in market economies, where institutions with different backgrounds, experiences and manager/staff profiles operate and compete. However, it is incumbent on institutions to ensure that their culture fosters values compatible with a sound and prudent management, and in accordance with ethical principles as regards the relationship between institutions and their stakeholders and society in general. Supervising entities may contribute to this, without endangering the diversity and cultural identity of each institution.

Under the SSM, on the basis of the current internal governance supervisory methodologies, namely in the context of the Supervisory Review and Evaluation Process (SREP), the ECB is also working towards the supervision of significant institutions' culture and behaviour. This work, which has been followed by Banco de Portugal and promotes a more intense and systematised monitoring of several internal governance aspects within institutions, should contribute to the development of this type of supervision also in Portugal. Indeed, the supervisor will only be in a position to issue recommendations or specific orders on internal governance matters if it is well aware of the culture of the institution subject to them and extent to which certain behaviour patterns may play a more or less beneficial role in its operation.

3.3. Remuneration policies and alignment of incentives with objectives

Remuneration policies and practices of institutions have been cited as a catalyst for the financial crisis. Remuneration policies and practices that create incentives for institutions to invest in order to maximise benefits in the short run, although bearing medium and long-term risks, foster a short-term oriented management, which is willing to take high risk that only would materialise in the future. The implementation of these kinds of remuneration policies and practices in the period prior to the financial crisis exacerbated the crisis at European and global level, causing serious damage to financial stability.

The remuneration of institutions' management and supervisory board members, although not mandatory, is recommended and, typically, these functions are paid.

This, as a general rule, is the case of executive directors, who are awarded variable remuneration. The opposite is true for some non-executive directors and supervisory board members, who, as they are not entitled to variable remuneration – which is only natural, given their functions – are remunerated via attendance fees of symbolic value, according to the number of meetings they attend, or, in some cases, are not paid at all.

Given that remuneration is based on performance, which should be effective, competent and intrusive, the aforementioned individuals should receive incentives to exercise their functions in a well-informed and engaged fashion. This will only be accomplished if remuneration levels, albeit fixed, are compatible with the tasks and responsibilities in question, which should be revised in the case of many Portuguese credit institutions.

In this regard, it is therefore recommended, as good governance practice, that remuneration paid to the Chair, the non-executive directors and supervisory board members should not be set below a given percentage of the fixed remuneration paid to executive directors.

Furthermore, several laws, regulations and recommendations have recently focused on remuneration policies and practices, to ensure their alignment with the institution's risk profile and its long-term interests and strategy. Among these rules, particularly notable are those that link the allocation and payment of the variable remuneration component to the institution's financial situation, those that lay down a deferred payment of the variable remuneration component, those that lay down the payment of part of the variable remuneration component through financial instruments and those that apply malus[59] and clawback[60] clauses to the variable remuneration component.

On the other hand, remuneration policies applied to management and supervisory board members must be approved by the general assembly, while policies applicable to other staff members are typically approved by the management body. Remuneration policies should be disclosed in-house and externally, more specifically via the institution's website, to allow a better understanding of how they influence the institution's attitude towards risk taking and its long-term strategy.

Institutions should be capable of gauging the impact of their remuneration policy and practices on their financial situation, making use of the necessary human and technical resources. They should also ensure that their remuneration policy and practices do not have a negative impact on the design and sale of products (e.g. by incentivising excessive risk taking in the design and aggressive selling of products).

Their policy should be flexible enough to adapt should the institution's financial position change, and its design and implementation should take into account the business cycle. In any case, remuneration policies should be subject to a centralised annual review by the supervisory board as to its effectiveness and adequacy.

There is, however, one aspect that, albeit underlying the remuneration policy, is not expressly provided for in any law or regulation applicable to this matter and it would benefit institutions and the supervisor, which is responsible for assessing compliance with these rules: the statement of the remuneration policy to be approved by the general assembly must be specific, detailed and comprehensive, and enumerate the conditions and criteria for the allocation of remuneration in its fixed and variable components. In particular, the statement should refer expressly to the Key Performance Indicators (KPIs), which form the basis of the calculation of the variable component, and specify the actual minimum and maximum variable remuneration allocated to each executive director.

Consequently, Banco de Portugal should be informed on an annual basis of the KPIs that form the basis of the calculation of the variable remuneration allocated to executive directors, as well as to those responsible for compliance, internal audit and risk management functions in major credit institutions. Where it finds significant misalignments with requirements for sound and prudent management or the defined risk management policy, the Bank should issue recommendations as appropriate.

Significant institutions should set up a remuneration committee. This committee should be composed of supervisory board members or non-executive directors. It is responsible for judging remuneration policy and practices and preparing decisions on remuneration, in particular regarding the remuneration policy, to be taken by the competent body. Although the law states that the committee should be composed of non-executive members of the management body or supervisory board members, it does not exclude other formally independent members, pursuant to internal governance best practice.[61]

3.4. Prevention and management of conflicts of interest

Management and supervisory board members must promote financial stability and safeguard the long-term interests of the institution, taking into account the long-term interests of stakeholders, more specifically shareholders, depositors, investors and other creditors and customers in general. Also those on the Board of Directors, or in senior, middle or equivalent management positions, should bear in mind the interests of stakeholders in the pursuit of their tasks.

Within the corporate culture prevailing in several countries of mainland Europe, corporate capital, both in financial and non-financial sectors, is typically more concentrated than in Anglo-Saxon countries. It is common for a small number of shareholders – at times, a single shareholder, whether acting individually or collectively – to hold controlling interests in firms. This is even more frequent in specific European regions, such as Scandinavia or Mediterranean basin countries. In Portugal, for instance, the main shareholders of the largest banks have voting rights amounting to double-digit percentages, which, at the very least, puts them in a very influential position.

Against this background, the greatest risk incurred by the most vulnerable stakeholders – creditors, small investors, depositors – is that the main shareholders, whether directly or through management teams, influence the governance of institutions to their own advantage and to the expense of other stakeholders. To mitigate this risk, corporate governance and the supervisor must pay special attention to the prevention of conflicts of interest[62] that may result from the abusive exercise of influence by the most powerful stakeholders of credit institutions: their main shareholders and directors – particularly executive directors.[63, 64]

Although formal independence is not a pre-condition for the individual exercise of functions by management and supervisory board members, it falls to institutions to manage any conflict of interest identified prior to and during the mandate. For that purpose, institutions should have in place written rules of prevention, reporting and resolution of conflicts of interest. These rules should be applied, from the outset, when the institution assesses the independence of management and supervisory board members and key function holders.

In this respect, it must be ensured that the role of executive director in an institution is not accumulated with functions in qualifying shareholders' corporate bodies. The same applies to the accumulation of positions by those responsible for compliance, risk management and internal audit within an institution with top-level positions in a qualifying shareholder.

Written rules on the prevention, reporting and resolution of conflicts of interest must pursue, inter alia, the following goals:

- continuous assessment of current and potential conflicts of interest, including any situation (e.g. relationship, service, activity or transaction) that may be regarded as a conflict of interest by a third party;
- inclusion of management and supervisory board members and key function holders within the institution;
- obligation of those envisaged to report to the institution any situation covered by the rules and to avoid any situation conducive to unreported conflicts of interest, including guidance thereon;
- identification of information that those envisaged report to the institution to determine whether the situations covered by the rules are taking place;

- setting up of a procedure prior to the taking up of (accumulated) functions outside the institution that may give rise to serious risks of a conflict of interest;[65]
- setting up of a procedure on the acceptance of gifts;
- establishment of methods to prevent and mitigate risks associated with conflicts of interest, such that when in use a third party could not question the objective and unbiased analysis used in the decision making process of the body where those envisaged have taken up functions.

When formulating its rules on the prevention, reporting and resolution of conflicts of interest, the institution should bear in mind related parties (i.e. which have a common economic interest with the institution), including entities that are part of the same group (i.e. with which there is an economic interdependence relationship, namely due to crossed holdings with several other entities).[66]

Examples of related parties include: (qualifying) shareholders in the institution, members of the institution's governing bodies and those of intra-group entities, the institution's staff, large depositors, major creditors, major debtors and entities partially owned by the institution.

In this regard, to ensure adequate prevention and resolution of conflicts of interest, institutions should also have in place written regulations on transactions with related parties, covering all types of transaction (and not just lending), to make such transactions transparent and prevent the positive discrimination of related parties as compared with conditions applicable to other stakeholders under similar circumstances.

On the other hand, without prejudice to existing legal and regulatory provisions on this matter, transactions with related parties should be monitored by the supervisory board (*a priori*, when involving substantial amounts, and *a posteriori*, in all other cases), while large-value transactions should be approved by a qualified majority of two-thirds of the management body.

Lastly, mixed conglomerates are a particularly intense source of conflicts of interest. In a crisis situation, the institution might be tempted to sacrifice the interests of its depositors and other customers to the interests of non-financial qualifying shareholders that urgently need financing, taking advantage of the institution's reputation. Therefore, institutions should set up and report to the supervisor clear rules on the separation between the economic group's financial and non-financial arms, which make it possible to prevent potential conflicts of interest.

Institutions should also report the economic group's organisational structure to the supervisor, which should be aware, at all times, of the institution's qualifying shareholders and beneficial owners. The supervisor should be aware, at all times, of the effective shareholding structure of the institutions and which stakeholders to reach in case of need.

As such, regarding conflicts arising from transactions with related parties, the banking sector would also benefit from the implementation of the following measures:

- formal allocation to a non-executive directors committee within the management body of the responsibility for monitoring compliance with rules on the prevention of conflicts of interest between credit institutions and related parties, or among different related parties;
- prohibition for credit institutions or associated investment funds to sell financial products to non-qualified investors issued by entities that directly or indirectly have qualifying holdings or control them, excluding insurance products or other products that Banco de Portugal does not deem to adversely affect the interests of their beneficial owners;
- prohibition from lending to retail customers for the purchase of debt or capital instruments issued by the credit institution or any other party related to the institution;
- significant downward revision of percentage caps on lending or on any other source of direct or indirect financing provided by a

credit institution to qualifying shareholders or to entities that directly or indirectly control or are controlled by these shareholders and all related parties, excluding those within the supervisory perimeter on a consolidated basis;[67]

- the Bank's request, at any given time, of clarification about the shareholding structure and beneficial owner(s) of any shares or voting rights within an institution, in order to secure the necessary information to issue specific orders or to apply corrective measures/specific orders to correct risk situations. Voting rights are suspended and exposures are reduced pursuant to Article 109 of the Legal Framework of Credit Institutions and Financial Companies if that clarification is not satisfactory or if doubt persists thereafter;
- in the case of groups with opaque shareholding structures that are difficult for the supervisor to understand, Banco de Portugal may determine its restructuring, to facilitate the effective supervision of the groups concerned;
- the policy on transactions with related parties should preclude lending to members of the governing bodies, including those that are currently exempted from that ban. However, an exception should be made for loans granted under the institution's human resources policy.

3.5. Institutions' attitude towards risk

In most cases, financial entities are part of the private sector and their purpose is to bring value added and, ultimately, to generate profit for their shareholders. However, these entities are subject to prudential supervision given that their individual activity is closely associated with the stability of the financial system and the economy as a whole.

Therefore, when carrying out their activities, these entities should pursue business goals that do not jeopardise the balance between profitability and risk, i.e. never letting the search for profitability to prevail over the need to limit risks, while returns for the management body members (remuneration) and shareholders (profit, increased share value and dividends) should be subordinated to a long-term vision and take into account the need for an organic generation of capital that ensures their sustainability.

This means that it is important for supervised entities to focus strongly on actual risks resulting from their current activities and the potential risks arising from the implementation of their business strategy in the future. First, it is incumbent on the management body to pursue sound and prudent management, ensure and demand risk measurement, monitoring, limitation, diversification and control. For that purpose, the management body should promote the establishment and dissemination of a risk culture that permeates all functions within the entity across its hierarchical levels and ensures that risk concerns are present in all decisions.

In this respect, it falls primarily to the supervisor to determine whether an effective and consistent risk culture exists within the entity, as opposed to just conducting internal exercises to comply with regulatory obligations or to be aligned with market practices. On the other hand, the supervisor should assess how risks are taken into account during the decision-making process at its various stages, and assess the quality of management information in terms of content, scope and frequency and whether it is sufficient for informed and timely decision-making.

It is also incumbent on the management body to set the right conditions for the existence of formally and effectively independent control functions (internal audit, risk management and compliance), that have the authority, empowerment and unrestricted access to all information needed for the pursuit of their tasks and have in place sufficiently qualified human and technical resources in sufficient quantities. These control functions play a key role in the identification and monitoring of risks to which supervised entities are exposed and, in practice, they work as a tool for the management body to gain a clear and independent insight into the main sources of such risks.

Furthermore, the management body should establish, document and regularly update its position concerning risk appetite, and set the quantitative or qualitative limits and the various key risk indicators (KRIs). This position takes into account exogenous factors, such as the macroeconomic, regulatory and competitive environment in which the entity operates, but also endogenous factors, such as its business model, financial position and, most of all, its risk profile assessment.

Unlike risk appetite, which reflects the management body's stance on the magnitude of risks that the entity is willing to take in the pursuit of its strategic goals, the risk profile assessment consists of a reflection on the materiality of risks taken at a given moment in time. As such, the regular assessment of the risk profile is a crucial tool for monitoring compliance with risk appetite requirements and, where necessary, its revision.

There should also be a cohesive and reciprocal relationship between the risk profile assessment and a number of other mostly forward-oriented management instruments, such as strategic planning, funding and capital plans (FCPs), internal capital adequacy assessment process (ICAAP) exercises, internal liquidity adequacy assessment process (ILAAP) exercises, stress tests and the recovery plan.

Without prejudice to the importance of this assessment, the supervisor is responsible for conducting its own assessment of the supervised entity's risk profile, by comparing both and exploring its findings further and, should substantial divergences subsist, confronting the management body. The Supervisory Review and Evaluation Process (SREP) falls within this scope. SREP is a continuous and forward-oriented process, which evaluates whether the capital and liquidity position is sufficient and the adequacy of mechanisms, strategies and internal control processes in place to ensure, at all times, an adequate management and coverage of risks to which supervised entities are, or may be, exposed.

Although SREP runs continuously, it results in a formal decision (SREP decision) by the supervisor, mostly on an annual basis, on the prudential requirements applicable to each supervised entity, including the minimum capital and liquidity levels to be maintained at all times as well as any measures that have to be implemented by the supervised entity to address insufficiencies detected by the supervisor.

In this respect, regulations at European and national level establish, as a rule, similar minimum capital and liquidity levels for all supervised entities. However, the SREP process allows the supervisor to establish different capital and liquidity levels for each entity taking into account the supervisor's critical evaluation of the entity's risk profile. As such, the supervisor may require that an entity has capital and liquidity levels higher than the legal minimum levels according to the evaluation of its risks and controls, business model, strategy and internal governance structure.

The minimum regulatory capital levels (which are similar for all supervised entities) do not take into account, as a rule, total risks incurred, more specifically those associated with the interest rate risk in the banking book and concentration risks. Therefore, the evaluation conducted by institutions and its review by the supervisor are key.

With regard to risks not fully captured by the minimum regulatory capital levels, sovereign risks must also be borne in mind, thus acknowledging that there are no risk-free assets as recent lessons have proven, with a major impact on financial institutions worldwide. Without prejudice to likely regulatory developments in the future, these risks, more specifically regarding concentration in sovereign entities, should be particularly monitored by institutions and included in the risk appetite definition. In this context, it is also important to help mitigate the contagion between sovereign risk and the financial system.

Turning to the measures established in the SREP decision, they are of varying natures and priority levels and may include, inter alia, the correction of specific fragilities within the internal control system (e.g. implementation or changes in provisions, processes, mechanisms and control strategies), changes to the entity's governance model (e.g. establishment or changes in the governance structure, limits to variable remuneration) or even adjustments to the business model, to safeguard the viability and sustainability of the supervised entity's business model (e.g. restrictions, limitation or disinvestment in a given business area, reduction of the risk inherent in activities, products and systems).

Lastly, the risk profile is not only relevant as regards the evaluation made by entities and the review conducted by the supervisor. The risk profile of supervised entities is also of interest to various agents outside the supervisor/supervised relationship. The most immediate examples are rating agencies and institutional investors, but also include non-institutional investors and depositors, which have become increasingly sensitive to differences in terms of soundness across financial entities. As such, in addition to ensuring that their risk profile is adequate and safeguards the sustainability of their operations, supervised entities should also bear in mind and monitor how it is perceived externally.

3.6. Supervision of cross-border activities

The geographical expansion of a banking institution's activities beyond the country of its residence or head office is inevitable in an increasingly globalised world. This expansion presents advantages but also non-negligible risks. Advantages include a greater geographical diversification and, consequently, more diversified sources of income, thus reducing domestic concentration or home bias risks typically faced by Portuguese banking institutions. Either by lending to or supporting exporting companies or by setting up branches or subsidiaries outside Portugal that personally interact with firms and citizens in other countries, or also by conducting direct activities outside Portugal, this geographical expansion is beneficial to institutions due to its risk diversification component.

Furthermore, cross-border activities are usually associated with a set of risks to both supervised entities and the supervisor.

From the perspective of supervised entities, cross-border activities may lead to increased legal risks, which may be associated with the need to meet different legal requirements and to act according to local cultures where the entity is now operating, increased risks associated with money laundering and terrorist financing and, finally, increased risks of fraud due to the greater difficulty in overseeing their structures in different countries in an efficient manner.

On the other hand, supervised entities become exposed to country risks, both in its political risk component (e.g. due to constraints on capital transfers) and as regards the risk of contagion across countries and banking systems, as a result of closer financial connections and interdependence worldwide.

There are further risks in cases where entities are established abroad via branches or subsidiaries. When those branches or subsidiaries are not self-sufficient in terms of liquidity, i.e. when liquidity needs are met through funds from the supervised entity, it becomes exposed to substantial financial risks. Furthermore, even when branches or subsidiaries abroad are self-sufficient in terms of liquidity and capital, supervised entities are exposed to financial risks linked to the investment made there, as well as a permanent associated reputational risk. The latter implies that the supervised entity is forced to meet the needs of its branch or subsidiary, or run the risk of seeing its brand and reputation being tarnished with customers and investors alike.

Given that they affect the risk profile of the supervised entity, all these risks associated with cross-border activities should also be monitored by the supervisor.

At the same time, international expansion may also lead (whether deliberately or inadvertently) to the establishment of complex or opaque group structures that give rise to practical difficulties in the exercise of supervision.

The setting up of branches or subsidiaries in jurisdictions whose local regulations prevent or hamper access to relevant information on their activity or other shareholders and ultimate beneficial owners – offshore centres and non-cooperative jurisdictions are typical examples – is significantly detrimental to the supervisor's effective action and the exercise of activities by the external auditor, the supervisory board, non-executive directors and control functions (audit, compliance and risk management) within the parent institution.

It is also possible that those that have directly or indirectly taken equity stakes in the supervised entity may be established in jurisdictions that hinder access to information on its shareholders and ultimate beneficial owners.

This phenomenon is typically associated with the use of special purpose entities for legal, tax and regulatory arbitrage by supervised entities and their customers These cases may involve credit operations or deposit accounts with supervised entities.

Although branches or subsidiaries, as a rule, are subject to supervision in their home country, it is possible that the regulatory and supervisory regime to which they are subject is not deemed as being equivalent to that in the EU, which leads to constraints to the supervised entity's activities both on an individual and consolidated basis (higher capital requirements, lower limits to large exposures, etc.).

In view of these risks, which appeared in the recent financial crisis, the various supervisory authorities reacted by increasing cooperation and information sharing, most notably via the establishment of supervisory colleges. However, more needs to be done, not only by reinforcing information sharing among supervisors (on the activities of branches or subsidiaries, as well as on the shareholders of the various banking groups and respective ultimate beneficial owners) but also by imposing corrective measures, specific orders or regulations that prevent the creation of opaque group structures, with internal governance fragilities and giving rise to both additional risks to supervised entities and increased difficulties in the effective exercise of prudential supervision, on the basis of the following set of measures and principles:

- Principle whereby banking activities are not carried out, as far as the group's consolidated activities are concerned, in jurisdictions deemed non-cooperating, chiefly as regards the prevention of money laundering and terrorist financing;
- Principle whereby banking activities are not carried out, in full or in part, as far as the group's consolidated activities are concerned or, alternatively and temporarily, imposition of non-consolidation for prudential purposes of subsidiaries, where there are legal obstacles to the respective jurisdictions in terms of access to or transfer of information that is relevant or necessary for supervisory purposes, or where such obstacles are faced by the external auditor, the supervisory board, non-executive directors or control functions (audit, compliance and risk management) within the parent institution;
- Principle whereby banking activities are not carried out, as far as the group's consolidated activities are concerned, with entities whose ultimate beneficial owner is unknown;
- Restrictions on the conduct of banking activities and/or increase in the respective prudential requirements, as far as the group's consolidated activities are concerned, in jurisdictions where regulations and supervision are not deemed equivalent to those of the EU. Restrictions on the conduct of activities or the increase in prudential requirements may lead, for instance, to the refusal to grant large-exposure intragroup exemptions to subsidiaries in these jurisdictions or, ultimately, the obligation to dispose of a subsidiary or close down a branch;
- Restrictions on the conduct of banking activities and/or increase in the respective prudential requirements, as far as the group's consolidated activities are concerned, with entities whose ultimate beneficial owner is known but where existing guarantees or collateral do not adequately limit credit risks in these operations;
- Restrictions on the conduct of banking activities and/or increase in the respective prudential requirements, as far as the group's consolidated activities are concerned, with

branches or subsidiaries in jurisdictions with capital transfer constraints;

- Restrictions on the use of special purpose entities or increase in the respective prudential requirements, to discourage the use of these structures for the purposes of prudential regulations arbitrage;
- Increase in prudential requirements, as far as the group's consolidated activities are concerned, as regards branches or subsidiaries that are not self-sufficient in terms of liquidity;
- Refusal to grant large-exposure intragroup exemptions to subsidiaries in third countries, where it is deemed that country risks may materialise or if unrestricted access is not given on information relevant for the effective exercise of supervision on a consolidated basis;
- Strengthening of the internal control and governance mechanisms so that the supervised entity may adequately monitor risks arising from cross-border activities.

Notas

1. Part III of this White Paper was written by a thematic working group formed by Fernando Infante, Elsa Ferreira, Isabel Cardoso, Miguel Melancia, Ana Rita Campos, Luís Barroso and João Pedro Mendes, coordinated by António Pedro Nunes.

2. This follows from Article 81 (a), (f) and (j) in conjunction with Article 101 of the Constitution of the Portuguese Republic.

3. Microprudential supervision should not be confused with macroprudential supervision. While the first focuses on institutions on an individual level, the latter focuses on the financial system as a whole.

4. The SSM is the ultimate example of harmonisation and cooperation in terms of microprudential supervision in the European Union. Banco de Portugal participates in the SSM together with the European Central Bank, Banco de España, Banca d'Italia, Autorité de Contrôle Prudentiel et de Résolution (Prudential Control Authority – France), Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority – Germany), Bank of Greece, Central Bank of Ireland, Oesterreichische Nationalbank, Bank of Malta, Banka Slovenije, Národná banka Slovenska, Latvijas Banka, Lietuvos bankas, Eesti Pank, Banque centrale du Luxembourg, Nationale Bank van België/Banque Nationale de Belgique, Central Bank of Cyprus and Suomen Pankki.

5. As part of the European System of Central Banks, Banco de Portugal is functionally independent from the Portuguese State. As regards the SSM, Banco de Portugal participates on the basis of its autonomy from the ECB, its unbiased analysis and a critical approach.

6. Banco de Portugal carries out its supervisory activities against an everchanging backdrop, inherent in financial market developments. To adapt its actions to market dynamics and intervene in a timely and adequate fashion in the various situations that crop up, Banco de Portugal applies principles and rules to institutions subject to its supervision, taking into account European and international best practice.

7. Article 6 (1) of the SSM Regulation.

8. Article 4 (1) of the SSM Regulation.

9. Article 6 (6) of the SSM Regulation. The ECB shall maintain decision-making powers over all institutions as regards the granting and withdrawal of authorisations of credit institutions, and the assessment of notifications of the acquisition and disposal of qualifying holdings in credit institutions.

10. Article 6 (4) of the SSM Regulation.

11. Excluding powers regarding authorisations and the assessment of notifications of the acquisition of qualifying holdings.

12. Article 6 (5) (b) of the SSM Regulation.

13. Articles 10 to 13 of the SSM Regulation.

14. Article 1, fifth paragraph, of the SSM Regulation.

15. Article 4 (3) of the SSM Regulation.

16. These instructions may be issued "to the extent necessary to carry out the tasks" conferred on the ECB by the SSM Regulation. See Article 9 (1), third paragraph.

17. Article 4 (1) (a) and (c) of the SSM Regulation. See also Articles 14 and 15 of that Regulation.

18. Joint supervisory teams are responsible for conducting the supervision process, participate in the supervisory examination programme to be submitted to the ECB's Supervisory Board, implement the approved supervisory examination programme and any decision made by the ECB regarding the significant institution or group, ensure coordination with on-site inspection teams (where they exist), and cooperate with NCAs where necessary.

19. This a hub-and-spoke model as it is organised around a central structure (hub), which establishes links between all other dispersed points in the system, through connection lines (spokes) between each of these points and the central structure.

20. Article 6 (6) of the SSM Regulation.

21. Article 6 (5) (a) of the SMM Regulation.

22. Article 6 (5) (a), second paragraph, of the SSM Regulation. These specific powers include, for instance, to require credit institutions to hold own funds in excess of the capital requirements, to restrict or limit the business of institutions, to require the reinforcement of internal governance proceedings, to impose specific liquidity requirements, or to require that institutions use net profits to strengthen own funds.

23. Article 6 (5) (b) of the SSM Regulation.

24. Articles 99 and 100 of the SSM Framework Regulation.

25. In this context, supervisory intensity refers to the breadth of focus (both of the direct supervisor – NCAs – and the indirect supervisor – the SSM), as regards both the scope and depth of monitoring as well as how frequently it interacts with the supervised entity.

26. The Supervisory Board is an internal body of the ECB, which plans and carries out the ECB's tasks relating to prudential supervision. It is composed of the Chair and Vice-Chair, four representatives of the ECB, and one representative of each NCA. The Supervisory Board proposes draft decisions for adoption by the ECB's Governing Council, which are deemed adopted by the ECB if the Governing Council raises no objection.

27. The cooperation discussed here derives, in fact, from the SSM's legal framework, which establishes that one of the tasks of joint supervisory teams is "liaising with NCAs where relevant" (Article 3 (2) (e) of the SSM Framework Regulation).

28. On-site inspections have, nonetheless, some contact points with the JST organisation model.

29. Article 4 (3) of the SSM Regulation.

30. Article 4 (3) of the SSM Regulation.

31. Options and national discretions are established by EU law, both in the form of Directives and Regulations, and give Member States or competent authorities the choice to apply the regime laid down therein or not. Options and national discretions may be granted to Member States alone, competent authorities alone, or both. An example of this is the competent authorities' ability to waive an institution from compliance with liquidity requirements on an individual basis, under certain conditions (Article 8 of the CRR).

32. Article 4 (3) of the SSM Regulation.

33. Recital 34 of the SSM Regulation.

34. Articles 290 and 291 of the Treaty on the Functioning of the European Union.

35. Article 4 (3), second paragraph, of the SSM Regulation. The 'EBA Regulation' is Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November.

36. The EBA encompasses not only Member States that participate in the SSM, but all EU Member States.

37. Article 8 of the CRR.

38. Article 21 of the CRR. Therefore, the parent institution on a consolidated basis or the subsidiary institution on a sub-consolidated basis monitors and has oversight at all times over the liquidity positions of all institutions within the group or sub-group that are subject to the waiver and ensures a sufficient level of liquidity for all institutions. Institutions involved shall enter into contracts that, to the satisfaction of the competent authorities, provide for the free movement of funds between them.

39. Article 8 (1) (a) of the CRR.

40. Article 6 (5) (a) of the SSM Regulation.

41. European rules, guidelines and recommendations on internal governance, for the most part, do not follow the Latin/classic model, nor do they take into account the role played by the general assembly in the organisational structure of Portuguese institutions. For this reason, when transposing, regulating or implementing such rules, guidelines and recommendations, or when supervising compliance therewith, Banco de Portugal and institutions must adapt them to the specificities of Portuguese law.

42. Established in EBA Guidelines on internal governance (GL44), paragraph 6 of Point 14, and in Recommendation II.1.7. of 'CMVM Corporate Governance Code 2013 (Recommendations)' of the Portuguese Securities Market Commission (2013).

43. More specifically, by posting that regulation on the institution's website.

44. Within a group, the management body of the parent institution is responsible for ensuring that there is an adequate internal control environment in place for the group as a whole, without thereby affecting the interest and autonomy of subsidiaries.

45. Article 31-A (3) of the Legal Framework of Credit institutions and Financial Companies, approved by Decree-Law No 298/92.

46. Article 3 (2) (c) of Law No 148/2015 of 9 September.

47. As such, when giving their opinion, statutory auditors must expressly and clearly check: (i) the validity of support information, (ii) the levels of cash flow and inventories of any kind of goods and securities belonging to the institution or received by it as collateral, deposit or otherwise, (iii) the accuracy of the institution's accounts, and (iv) whether accounting policies and valuation rules adopted by the institution lead to a correct evaluation of its assets and results.

48. The calculation of the share of the participant's voting rights is determined by the rules on the distribution of votes laid down in Articles 13 and 13-A of the Legal Framework of Credit Institutions and Financial Companies.

49. This refers only to the potential exercise of significant influence, not its actual exercise.

50. Significant influence is the power to participate in the institution's operational and internal policy decisions, without necessarily controlling them.

51. To assess whether a shareholding may result in significant influence over the institution's management, Banco de Portugal will take into account the specificities of that particular case, looking, inter alia, at the following evidence: (i) the relative importance of shareholdings, given the dispersion of shares, (ii) to what extent the shareholder is represented on the management or supervisory board or if there are in place any special rules on the election of directors, (iii) to what extent they intervene in the setting up of the institution's management policy, (iv) whether any relevant operations have been conducted between the institution and the shareholder, (v) the fact that management and supervisory board members are shared by the shareholder and the institution, (vi) the provision of essential technical information by the shareholder to the institution, (vii) the existence of limitations to the exercise of voting rights, (viii) the statutory classification of shareholdings, (ix) the frequent issue of proxies over voting rights amongst shareholders, (x) the nature of the shareholder's intervention at the general assembly, (xi) the historical origin and stability of holdings as to their ownership, (xii) the existence of formal or informal conciliation of economic interests amongst shareholders, and (xiii) the existence of personal/family relationships.

52. Being classified as a qualifying shareholder has a number of specific consequences for shareholders, most notably: (i) obligation to inform Banco de Portugal of any serious irregularity in the management, accounting procedures, or internal control of the institution that may result in financial imbalances; (ii) obligation to supply Banco de Portugal with all the information which they consider relevant for the supervision of institutions in which they own holdings; (iii) to be heard by Banco de Portugal on all relevant aspects of decisions related to resolution measures; (iv) existence of limits to lending to qualifying shareholders; (v) management and supervisory board members of an institution are not allowed to participate in the assessment and decision of lending to legal persons in which they own qualifying holdings; (vi) holding companies that own qualifying holdings in an institution are subject to the supervision of Banco de Portugal; (vii) qualifying shareholders commit a very serious infringement when taking action that seriously prevents or hampers the sound and prudent management of the institution.

53. Suitable is taken as describing those that conduct themselves in a way that inspires confidence among market participants, namely due to considered and judicious decision making, and timeliness in fulfilling obligations. Suitability is assessed on the basis of evidence. Someone will be assessed as suitable as long as no evidence precludes that assessment.

54. Independent is taken as describing those that act neutrally, defend the institution's interests and take into account the interests of all stakeholders in the legally prescribed way, without being unduly influenced by external or internal interests when making their analysis or decision. The institution should put in place conditions for analysis and decisions to be made with independence and, therefore, it should efficiently manage real or potential conflicts of interest. In this respect, the existence of a majority of members classified as formally independent, pursuant to Article 31-A (3) of the Legal Framework of Credit Institutions and Financial Companies, is not a requirement for the individual exercise of this function, but rather a requirement for the adequate functioning of the supervisory board as a whole.

55. Qualified is taken as describing those that can effectively conduct their tasks as they have adequate academic qualifications or specialised training or even adequate levels of professional experience in relevant areas, in light of the institution's characteristics, complexity and size, as well as the risks associated with its activity.

56. Available is taken as describing those that have enough time to effectively perform their functions, in full compliance with their inherent obligations and responsibilities. The importance of the availability of members of the bodies is directly proportional to their tasks and responsibilities.

57. Furthermore, the better adapted its policy and the more it takes into account the reality of the institution, the better assessment reports it will tend to produce. This will affect the assessment of members of the bodies by Banco de Portugal, given that these reports are among the documents analysed by the supervisor in this context.

58. Similarly to management and supervisory body members, credit institutions' shareholders should approve a selection and assessment policy on the adequacy of their key function holders, which may be set out in the same document as that regarding the management and supervisory board members or in an independent document. The assessment of key function holders should be made on the basis of the aforementioned requirements and criteria of suitability, qualifications and experience, independence and availability regarding the assessment of members of the bodies, in addition to those set out in regulations on internal control functions (Notice of Banco de Portugal No 5/2008).

59. Mechanism that permits the institution to reduce the value of the variable remuneration before it has vested.

60. Mechanism that permits the institution, after the variable remuneration has vested and been paid out, to recover the variable component in full or in part. The institution has the responsibility to exercise best possible efforts to recover this amount, on a case by case basis.

61. Unrelated to any specific interest group of the institution and not associated with any situation liable to undermine their neutrality, as far as third parties are concerned.

62. Conflicts of interests arise when, as far as third parties are concerned, a relationship may lead decision-makers, to the detriment of financial stability and any other interests that they are bound to protect, to introduce a foreign interest into their analyses and decisions, or to excessively take into account one such interest in particular.

63. The global financial crisis that started in the summer of 2007 showed, for instance, that many financial institutions made investment decisions, with respect to their portfolio management, which were in direct conflict with the interests resulting from investment decisions made by customers due to the advice provided by them.

64. At international level, a renowned case was the sale by Goldman Sachs of collateralised bonds to customers, while the bank made use of its balance sheet to bet on the fall in the price of such products. Also in Portugal, Banco Português de Negócios, Banco Privado Português and Banco Espírito Santo proved how retail customer resources – and, at times, even those of institutional customers – may be misused by credit institutions to benefit the private interests of managers or shareholders.

65. Serious risks are those which have a high probability of materialising, taking into consideration the specific circumstances of each individual case, particularly given the relationship between the entity in question and the entity where the person in question intends to work and the markets where both entities carry out their activities.

66. Including (qualifying) shareholders and members of the bodies in entities within the same economic group.

67. That would imply amendments to Article 109 of the Legal Framework of Credit Institutions and Financial Companies.

PART IV[1]

Banking conduct supervision

1. Banking conduct supervision

1.1. Characterisation

National law has entrusted Banco de Portugal with the task of exercising banking conduct supervision on credit institutions, financial companies, payment institutions and electronic money institutions in markets where so-called retail banking products and services are sold, i.e. deposits, credit products (with the exception of products used to finance transactions in financial instruments with the intervention of the lender), payment services and electronic money services.[2] Banco de Portugal has been entrusted with this task in recognition of the fact that the efficiency and stability of those markets are influenced by the conduct adopted by these institutions towards their customers and the information they possess when deciding to buy these products and services.

First and foremost, Banco de Portugal's banking conduct supervision includes regulating the relationship of credit institutions, financial companies, payment institutions and electronic money institutions with their customers when advertising and selling retail banking products and services. In accordance with the mandate conferred on it by law, Banco de Portugal has focused its regulatory intervention on promoting the transparency and accuracy of information provided to customers in the various stages of advertising and selling these products and services.

Banco de Portugal's banking conduct supervision also includes monitoring compliance with the legal and regulatory principles and rules guiding the conduct of credit institutions, financial companies, payment institutions and electronic money institutions in markets where retail banking products and services are traded (usually referred to as 'retail banking markets').

In this aspect of banking conduct supervision, Banco de Portugal has focused on checking whether the conduct of institutions complies with applicable conduct and information duties by carrying out ongoing monitoring activities (e.g. monitoring information provided in institutions' price lists, analysing advertising on banking products and services, checking the compliance of information in leaflets on indexed and dual deposits, checking the compliance with the maximum rate regime in consumer loans, checking whether mandatory information is included in credit agreement templates used by institutions, monitoring procedures and measures implemented by credit institutions in order to manage pre-arrears or arrears situations), inspections (off-site or on-site inspections of branches and central services of institutions, whether identified inspections or 'mystery shopping' exercises) and assessing complaints made by bank customers.

Where it detects irregularities in the conduct of credit institutions, financial companies, payment institutions and electronic money institutions, Banco de Portugal may issue recommendations and specific orders, under the terms and conditions established by law, requiring institutions to adopt the required measures to correct irregularities detected. Furthermore, Banco de Portugal also has the power to penalise the conduct of supervised institutions, in accordance with the law, where such conduct constitutes an administrative offence.

Banco de Portugal has interpreted its mandate for banking conduct supervision in a comprehensive manner. In accordance with international best practice and principles, which it has also helped establish, Banco de Portugal considers that exercising this task is not limited to regulating and monitoring the conduct of credit institutions, financial companies, payment institutions and electronic money institutions. Banco de Portugal considers it a priority to act on the demand side of retail banking markets, promoting the financial information and the education of bank customers by creating and developing the Bank Customer Website and promoting financial education initiatives, specifically as part of the National Plan for Financial Education, which it has fostered and led after the 1st survey on the financial literacy of the Portuguese population in 2010.

Banco de Portugal exercises banking conduct supervision in a transparent manner, providing the public with detailed information on its activities and putting forward its main regulatory initiatives for public discussion. Without prejudice to the Bank's strict compliance with its legal duty of professional secrecy, Banco de Portugal is also bound by a principle of accountability.

In order to achieve this objective, Banco de Portugal has also established regular dialogue with consumer associations, financial sector associations, business confederations and public entities with activities focusing on issues related to consumer protection, specifically within the activities of the Forum for Banking Conduct Supervision, an advisory body supporting banking conduct supervision, which began its activity in 2011.

In Banco de Portugal's internal organisation, the exercise of banking conduct supervision is entrusted to a specific department – the Banking Conduct Supervision Department. Nevertheless, it should be stressed that the effectiveness of banking conduct supervision is enhanced by the synergies arising from its integration in Banco de Portugal, either at the regulatory level (particularly as regards payment and electronic money services, considering Banco de Portugal's intervention in the oversight of payment systems), in the exercise of monitoring activities (particularly taking into account access to information in Banco de Portugal's databases, for example the Central Credit Register) or in financial education (in particular, the ability to spread financial education initiatives across the country thanks to Banco de Portugal's regional network of delegations and agencies).

1.2. The exercise of banking conduct supervision by Banco de Portugal

1.2.1. Objectives and strategy for banking conduct supervision

The regulation and monitoring of the conduct of institutions in retail banking markets and the organisation and functioning of the markets themselves are generally deemed essential for financial stability, considering the key role of supervising the conduct of institutions operating in these markets for the confidence placed by bank customers in such institutions.

When exercising its banking conduct supervision, Banco de Portugal has strived to increase the confidence of bank customers in credit institutions, financial companies, payment institutions and electronic money institutions, carrying out initiatives that, on the one hand, reduce the informational asymmetry between bank customers and supervised institutions and, on the other, prevent the adoption by these institutions of conducts and business practices that may undermine the confidence of bank customers.

Currently, the informational asymmetry between customers and institutions is usually considered one of the main reasons for public intervention in retail banking markets. The fact that institutions have access to more and better information than customers on the characteristics of products they sell may affect the quality of decisions made by the latter (customers may not have the tools to accurately assess the characteristics and risks of products on offer, and at times such risks are only fully known during the lifetime of the banking product), and may negatively influence the conduct of institutions themselves (which have incentives to take better advantage of the information they have than their customers).

Reducing informational asymmetry has a positive impact on the functioning of retail banking markets (by mitigating one of the main market failures) and on financial stability. In effect, more informed customers make better decisions, which are therefore more responsible and suited to their needs and borrowing capacity, giving incentives to institutions to sell products and services that are more appropriate and have a lower risk, while promoting competition among institutions (shopping around). Appropriate allocation of financial resources by costumers and institutions contributes to adequate levels of savings and responsible recourse to bank loans, thereby also contributing to sustained and inclusive economic growth.

Banco de Portugal, exercising the regulatory power entrusted to it by the legislator, has issued rules to strengthen the transparency of information provided to bank customers during negotiations when purchasing retail banking products (e.g. by establishing minimum information requirements on the characteristics of the products which institutions are required to provide to their customers, and harmonising the way in which this information should be disclosed), in credit agreements entered into by institutions and customers (by specifying mandatory information to be included in contractual clauses), and during their lifetime (by requiring information on retail banking products to be provided periodically to customers).

In parallel, Banco de Portugal has promoted the disclosure of the rights and obligations of bank customers (by providing information on developments in the applicable legal framework on the Bank Customer Website, preparing themed leaflets and specific booklets and brochures), as well as financial inclusion and the exercise of a responsible financial citizenship by carrying out financial education projects and initiatives.

It is also Banco de Portugal's mission to monitor the conduct and business practices of credit institutions, financial companies, payment institutions and electronic money institutions. In effect, although it is the responsibility of the legislator to reconcile the various interests in play, Banco de Portugal has given particular attention to the conduct and business practices adopted by institutions, monitoring compliance with legal provisions framing their activity in retail banking markets, promoting regulatory initiatives, within its remit, and issuing guidelines and best practice to be adopted by these institutions, where needed.

As a result of the amendments which have been introduced in the legal framework of retail banking markets in the past few years:

- Information on retail banking products and services provided by institutions to customers has been strengthened (with the legal and regulatory establishment of minimum requirements for pre-contractual information, information to be specified in agreements and information to be provided during their lifetime), and the provision of this information was harmonised (mostly as regards pre-contractual information through the definition of standardised information sheets);
- The understanding that institutions have of their customers has been strengthened and their monitoring of contractual relationships with customers was reinforced (e.g. rules created by law to prevent and manage arrears on credit agreements have led institutions to change or, in certain cases, create tools, procedures or even specific structures to monitor bank customers in pre-arrears or arrears on their contractual obligations);
- The interests of bank customers have been safeguarded through legislative initiatives that prohibit or establish limits to certain conducts adopted by institutions (specifically regarding fees);
- Business practices have been harmonised, as a result of legislative initiatives (e.g. the calculation and rounding of interest rates in credit operations), regulatory initiatives (e.g. as regards the use of the term 'deposit' and the conditions to open and withdraw deposits) or the establishment of best practice (e.g. regarding unilateral changes to interest rates or deferred debit cards).

1.2.2. Main challenges to the exercise of banking conduct supervision

Banco de Portugal faces a number of challenges in exercising banking conduct supervision. The following subsections identify the main challenges faced by the Bank in its intervention in retail banking markets.

a) Reconciling the mandate entrusted by law for the assessment of complaints with bank customer expectations

In accordance with the law, Banco de Portugal is entrusted with assessing complaints made by bank customers in the Complaints Book provided at the branches of credit institutions, financial companies, payment institutions and electronic money institutions on the conduct of these institutions in retail banking markets. Banco de Portugal is also legally responsible for assessing complaints directly submitted by bank customers on the conduct of these institutions in retail banking markets.

Typically, complaints refer to disputes concerning small amounts, and, as a rule, bank customers do not consider the possibility of bringing proceedings before a court for resolution, preferring other means to achieve this quickly and with fewer costs. In the absence of mechanisms for the alternative resolution of these disputes, bank customers consider submitting complaints and Banco de Portugal's intervention to be a way that is simple and free of charge of reaching the timely resolution of differences and problems arising from their relationship with these institutions.

However, considering how the law has established the Bank's intervention in the assessment of complaints,[3] it is concluded that, in accordance with the law:

- Banco de Portugal only assesses bank customer complaints regarding the conduct of credit institutions, financial companies, payment institutions and electronic money institutions in the markets where retail banking products and services are sold (deposits, credit products, payment services and electronic money services);

  In effect, as Banco de Portugal is entrusted with monitoring compliance with the rules governing the sale of products and services in retail banking markets, its intervention in assessing complaints is materially limited to situations regarding the conduct of these institutions in these markets. It is therefore not the responsibility of Banco de Portugal to assess complaints focusing on the conduct of these institutions in areas subject to rules outside its remit (for example, the sale of financial instruments or insurance);[4]

  The intervention of Banco de Portugal in assessing complaints is not aimed at resolving disputes between customers and supervised institutions.[5] Banco de Portugal assesses complaints with the sole purpose of monitoring compliance with the rules governing the conduct of institutions subject to the Bank's supervision in retail banking markets;

- Consequently, Banco de Portugal cannot issue opinions on complaints which, despite focusing on the conduct of these institutions in retail banking markets, are not related with compliance with the aforementioned rules (specifically, complaints on the commercial policy of these institutions, complaints of a purely contractual nature, [6] as well as complaints focusing on commercial, labour or tax issues or other more general issues);

- The results of the analysis made by Banco de Portugal of complaints under its remit only have an effect on the legal situation of complainees. This results from the legal tasks entrusted to Banco de Portugal and the objective envisaged by the legislator with the intervention of the Bank in assessing bank customer complaints (monitoring the conduct of institutions in retail banking markets).[7]

  In accordance with the law, the consequences for complainees resulting from the Bank's assessment of complaints derive from Banco de Portugal using the supervisory tools established by law, i.e. the issuing of recommendations and specific orders or the filling of administrative proceedings, 'where the conduct of complainees deems it necessary, namely due to its seriousness or repeated occurrence'.

Although Banco de Portugal may issue specific orders resulting in institutions returning amounts unduly charged to customers, where there is a direct breach of a mandatory provision under the Bank's remit, this specific order has as sole addressee the complainee (which might be subject to an administrative proceeding, were it to fail to comply with the specific order), and does not signify an enforceable judgment for the parties in a complaints procedure.

There is consequently a gap between the expectations of complainants and the role of Banco de Portugal in the assessment of complaints. In addition to the risks which may arise for the supervisor's image, this gap also suggests that the level of protection of bank customer interests is lower than in other European countries.[8]

Without prejudice to studying other solutions (specifically, giving the assessment of complaints to a Bank Customer Ombudsman who would be independent from supervised institutions and have powers to resolve conflicts between the parties and impose a decision on these institutions),[9] it might be possible to reconcile the various interests in play by establishing an obligation for supervised institutions to provide bank customers with access to out-of-court procedures for the resolution of disputes over amounts equal to or lower than the limit for courts of first instance, that may arise from their activity in retail banking markets.

In this respect, this obligation is already set out for institutions providing payment and electronic money services, which, in accordance with the law, must provide their customers with access to out-of-court procedures that are effective and appropriate to settle disputes over amounts equal to or lower than the limit for courts of first instance.[10] When assessing complaints on the provision of these services, if Banco de Portugal finds no evidence that complainees have breached any legal or regulatory rules in force, it informs bank customers that they may use the out-of-court dispute resolution procedures provided by these institutions, and may obtain additional information on recourse to these procedures on the Bank Customer Website.

Establishing an obligation for supervised institutions to provide their customers with access to out-of-court procedures for the resolution of disputes concerning other retail banking products (specifically, savings deposits and credit products) would ensure access by bank customers to procedures that would effectively resolve their disputes with institutions, thereby complementing the monitoring intervention of Banco de Portugal in the assessment of complaints.

b) The effectiveness and adequacy of tools provided by law for the exercise of banking conduct supervision

The legislator has conferred a set of tools on Banco de Portugal to deal with irregularities it may detect in the conduct of credit institutions, financial companies, payment institutions and electronic money institutions. In practice, under the provisions established by law, Banco de Portugal may issue recommendations and specific orders, as well as penalise infringements on rules governing the conduct of institutions, which constitute an administrative offence by law.

Overall, these supervisory tools have been adequate to the exercise of banking conduct supervision.

However, this supervisory task has a number of specificities that could justify further consideration by the legislator.

This is the case of:

- The intervention of Banco de Portugal regarding advertising:

  In effect, although the law entrusted Banco de Portugal with regulating the information and transparency requirements for institutions when advertising products and services, as well as monitoring advertising messages on retail banking products and services,[11] providing the Bank with specific tools for the purpose,[12] it did not confer, at least expressly, any power to penalise non-compliance with the provisions governing advertising. In fact, the law conferred on the Directorate-General for Consumers the power to initiate administrative offence proceedings and apply fines and additional sanctions for infringement of the legal provisions establishing requirements for the advertising of retail banking products and services.

In addition to materially limiting the effectiveness of Banco de Portugal's monitoring, this situation may lead to different understandings on the part of Banco de Portugal and the Directorate-General for Consumers regarding the actual application of the rules governing the advertising of credit institutions and other entities supervised by Banco de Portugal.

- The apparent inadequacy of sanctioning proceedings, as it is desirable that sanctions are applied quickly to administrative offences that concern small amounts and are easy to verify:

  Without prejudice to the attempt by the legislator to simplify sanctioning proceedings, the introduction of amendments to sanctioning proceedings is deemed justified, in order to punish a number of administrative offences more quickly, particularly when detected within the context of inspections of institutions' branches (for example, failing to display mandatory information in branch). [13]

c) Recognising the promotion of financial education as an integral part of the banking conduct supervision function conferred on Banco de Portugal

Financial education plays an important role in the strategy implemented by Banco de Portugal for the exercise of its banking conduct supervision function. In effect, financial education and information help bank customers to have the tools to understand and interpret the information provided to them by institutions, better informing their behaviours and attitudes.

It is therefore not surprising that Banco de Portugal has been particularly committed to developing financial education activities, both as part of the National Plan for Financial Education, and independently, allocating considerable resources to initiatives and projects which will only have an effect in the medium and long-term.

Considering the importance of financial education for citizens to make informed decisions in all areas relating to personal finance (and the results of these decisions for their well-being and macroeconomic and financial stability), as well as the complementary role it plays in regulating and monitoring the conduct of institutions in retail banking markets, it is desirable that the strategic commitment of Banco de Portugal to financial education be strengthened, by including it in the Bank's legal tasks of banking conduct supervision.

d) Inclusion of other entities in the scope of banking conduct supervision

One of the main challenges that Banco de Portugal will face in exercising its banking conduct supervision function in the near future is the expected redefinition of the scope of the Bank's intervention, both at a material and subjective level.

Narrowing for now the analysis of potential changes at the subjective level, as a result of Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property, the Mortgage Credit Directive is expected to extend the scope of banking conduct supervision to credit intermediaries.

Moreover, the inclusion of so-called 'debt collection agencies' in the scope of banking conduct supervision should also be considered, i.e. entities which purchase debt from credit institutions and other entities authorised to grant credit to the public. In effect, once these entities purchase the debt from lending institutions, a number of legal provisions cease to apply, which regulated the relationship of these institutions with borrowers. In addition to considerably weakening the position of these borrowers (specifically, their access to information on credit agreements and the application of limits imposed by law on fees associated with arrears situations), this may have an impact on how arrears situations on these contracts are prevented and managed.

e) Redefinition of the objective scope of banking conduct supervision

Similarly, the objective scope of banking conduct supervision is also expected to be extended.

Without prejudice to the amendments which national law may promote in this respect (in particular, in response to the challenges of financial innovation), Community law is considered to be the main agent transforming the material scope of banking conduct supervision. It should be remembered in this regard that, in recent initiatives, specifically, the Mortgage Credit Directive, and Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, Community law extended the intervention of supervisory authorities to issues such as the knowledge and competence of institutions' staff, the prevention of conflicts of interest in the relationship with customers (in particular, the definition of requirements for the remuneration and assessment of staff), provision of advisory services on mortgage credit and structured deposits, and monitoring of the creation and selling of retail banking products and services by supervised institutions (thereby striving to make these products and services adequate to their target audience). These rules, which are much more intrusive over institutions' business models, complement the legal framework for transparency of information, which is currently considered insufficient to ensure strict safeguards to protect the public interest under the remit of the supervision function (specifically, the confidence of customers in institutions and financial stability).

f) Increasing transparency in credit markets for bank customers who are not consumers, in particular sole proprietors, microenterprises and small enterprises

As mentioned above, national law has entrusted Banco de Portugal with exercising banking conduct supervision of credit institutions, financial companies, payment institutions and electronic money institutions in retail banking markets. Consequently, the banking conduct supervision function of Banco de Portugal is not limited to monitoring supervised institutions' conduct in their relationship with consumers, encompassing the way these institutions operate in retail banking markets with all their customers, irrespective of their legal nature and, in the case of legal persons, their size.

Without prejudice to the scope of the mandate conferred on Banco de Portugal, the regulatory rules in force in credit product markets give consumers a level of protection much higher than that applicable to other bank customers.[14] Considering the importance of bank loans for corporate financing in Portugal and that the informational asymmetry in the relationship between supervised institutions and these bank customers is, in a number of situations (specifically, as regards sole proprietors, microenterprises and small enterprises), similar to that of these institutions with consumers, the legal framework governing credit markets supporting the corporate landscape should be reinforced by increasing the information and transparency requirements of institutions when selling these credit products.

1.3. Possible initiatives for improvement

- Revising the model for managing and processing bank customer complaints, specifically by establishing a requirement for supervised institutions to put in place out-of-court mechanisms for the resolution of disputes concerning amounts equal to or lower than the limit for courts of first instance, which may result from their conduct regarding all retail banking products and services;
- Giving Banco de Portugal sanctioning powers regarding advertising;
- Anticipating sanctioning proceedings allowing the timely application, in particular

in the context of inspections, of fines where administrative offences concerning small amounts are detected (for example, displaying mandatory information at branches; refusal to provide the Complaints Book);

- Including credit intermediaries and debt collection agencies under the scope of banking conduct supervision;
- Expressly recognising financial education as part of the banking conduct supervision function of Banco de Portugal;
- Strengthening the legal framework regulating credit markets, supporting the corporate landscape, by increasing the information and transparency requirements of institutions when selling these credit products, in particular to sole proprietors, microenterprises and small enterprises.

1.4. The new challenges of the digital age

The digitalisation of banking activities has become a reality, owing both to the widespread use of digital channels to carry out conventional banking transactions and the sale of innovative banking products and services. This true digital revolution should influence the intervention of Banco de Portugal. As supervisor of institutions' conduct in retail banking markets, Banco de Portugal is responsible for continuing to ensure full compliance with the rules of conduct and information transparency by supervised entities in a digital ecosystem.[15]

Currently, the convenience for customers of having access to integrated banking products and services, 24 hours a day, 7 days a week, irrespective of where they are (whenever/wherever), through the internet or via mobile devices (specifically, mobile phones, in particular smartphones and tablets), bolsters demand for these products and services. Faced with technological developments (particularly those promoted by FinTechs), a changing behaviour of banking service users – due to the increasing relevance of the younger generation (Millennials) – and the entry in the payments market of new payment service providers (such as payment institutions and electronic money institutions), incumbents have striven to modernise and digitalise the services they provide. These institutions increasingly prefer digital channels to selling banking products and services over-the-counter and through call centres. At the same time, there are now banks which are fully 'digital' (see mobile-only banks) and have innovative business models.

Within a context where digital channels are increasingly being used, the relationship between customers and banking service providers has changed, with new risks both for bank customers and the stability of the financial system. Similarly, there are new challenges for banking conduct supervision both at a regulatory and monitoring level, and the strategy of Banco de Portugal must change accordingly.

Firstly, new risks arising from this new ecosystem must be mitigated:

- Security is the first and foremost risk. The sale of new banking products and services, and the use of digital channels to gain access to conventional banking products and services, may increase their users' exposure to new threats, specifically fraudulent practices (e.g. phishing and pharming), given that the guarantees associated with the identification and authentication of providers and users of these services are diluted;

  Against this background, it is necessary to assess the need for Banco de Portugal, within its regulatory intervention, to establish principles and rules that contribute to greater security, specifically by setting out obligations for the prior identification, in a clear manner, of the institution and the product or service, in order for customers to know and recognise the institution contacting them and the product or service on offer. This will allow customers to more easily understand the guarantees at their disposal, the procedures to be adopted and the entities they should contact in the event of a situation which may threaten their security;
- The transparency of information provided by supervised institutions on (both innovative and conventional) banking products and services sold through digital channels is another major risk associated with the

changing relationship between customers and banking service providers, arising from the increasing use of these channels.

The continuing appearance of innovative banking products and services on the internet or via mobile devices and, in certain cases, the sale of conventional banking products and services through these channels in a new package or as 'mixed products' make it difficult to categorise such products and services. Bank customers, drawn to the fact that these innovative banking products and services are simple, quick or tailor-made (such as e-wallets), find it difficult to recognise and understand their features.

The conduct supervisor needs to assess the 'conventional/typical features' and the 'innovative features' coexisting in each product or service, in order to adequately define the information requirements applicable to each case. More intrusive regulation of the provision of pre-contractual information might offer a solution, by establishing rules requiring institutions to identify the instruments that comprise each product or service, their characteristics and functionalities, and to clarify associated risks and the mechanisms to mitigate them in a clear and transparent manner. Institutions should therefore ensure that users are provided with comprehensive and accurate information, enabling them to compare products and services, and to make informed decisions.

In terms of exercising monitoring powers of banking conduct supervision, it will be necessary to reflect on whether conventional supervisory tools are adequate to the new relationship between bank customers and supervised institutions in the retail banking market.

In particular, it may be necessary to redefine a number of initiatives traditionally carried out by Banco de Portugal when monitoring the conduct of institutions in retail banking markets. In this respect, the role of 'mystery shopping' exercises may lose relevance within the inspections carried out, considering that (i) on-site contact is no longer essential (e.g. mobile-only banks can only be accessed through mobile devices), and (ii) when contacting customers using digital means, institutions request that they identify themselves at an ever earlier stage, either for security reasons or in order to provide them with information which is increasingly tailor-made (particularly in business practices focused on customers, where solutions presented are adjusted to their needs and preferences).

Consequently, there should be a discussion on whether inspections of institutions' central services should be intensified and on recourse to alternative methods, such as surveys addressed to 'real customers', which would nevertheless require inspectors to receive specific training and could be more expensive.

In addition, an assessment should be carried out of the role of Banco de Portugal in monitoring compliance by institutions with rules aimed at safeguarding the security of channels they provide and transactions they carry out, specifically the implementation of security systems and measures, in accordance with their risk mitigation policies (e.g. the introduction of strong customer identification and authentication mechanisms), both in terms of prudential supervision and banking conduct supervision.

As conduct supervisor, Banco de Portugal is faced with situations where the security systems implemented by institutions may experience failures. However, the assessment of specific situations poses serious difficulties within the banking conduct supervision function, particularly considering it requires collecting evidence. In order to be analysed, this evidence requires appropriate technical expertise on the part of the resources allocated to the monitoring function, as well as a valuation which, very often, only judicial authorities may effectively undertake (e.g. a case-by-case analysis of complaints on the fraudulent use of payment instruments and the limited evidence which may be collected and analysed in these proceedings, in order to assess the institution's conduct).

The imposition of previous approval or certification of products and services by Banco de Portugal should also be discussed. On the one hand, the previous approval or certification of products and services provided by supervised institutions would allow Banco de Portugal to assess, at an early stage, the risks involved and the needs for information and training to be provided to bank customers. On the other hand, it should also be acknowledged that this type of intervention by the supervisor may hamper technological progress, to the extent that institutions would be less inclined to invest in products or services using new technology further subject to previous assessment by the supervisor. In addition, it should also be considered that establishing a 'previous certification principle' would imply additional responsibilities for Banco de Portugal, as well as the need for this authority to have in place the human and material resources to pursue this objective.

The previous approval or certification of products can also be discussed in parallel with the standardisation of a number of these products, particularly those aimed at a more vulnerable target audience. Proximity and speed when concluding agreements prompt impulse buying on the part of consumers, with potential effects that must be taken into account.

Another important issue to be considered is the extension of the objective scope of banking conduct supervision to new activities. For example, Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015, repealing Directive 2007/64/EC,[16] extends the list of regulated payment services to include 'payment initiation services' and 'account information services', and, consequently, the activities of entities providing these payment services (so-called Third Party Payment Service Providers or TPP). Accordingly, Banco de Portugal must adjust to the new Directive,[17] when it is transposed into Portuguese law, in order to carry out banking conduct supervision of these services.

Education and training initiatives addressed at bank customers are also essential, especially taking into account that problems arising from the digitalisation of the sale of banking products and services tend to affect bank customers with less technological and digital literacy in particular. Banco de Portugal is expected to have an active role in this respect by promoting campaigns to raise the awareness of users and issuing warnings on the risks of using digital channels.

Modern developments also require that the prudential supervision function and the banking conduct supervision function cooperate closely, as the intervention of Banco de Portugal must be both integrated and cross-cutting. It is necessary to establish rules and procedures to ensure the security of the banking system at a digital level, as well as raise awareness among bank customers of the new risks, ensure they are provided with crucial and adequate information for their protection and promote responsible and safe use of digital channels.

In addition, there is a need to promote cooperation among supervisors and payment systems overseers at domestic level, as well as among supervisors and organisations and other international fora committed to analysing the increasing digitalisation of the banking sector and the risks this entails, particularly in a market that is becoming increasingly less limited to internal frontiers and more and more geared towards cross-border trade.

Within this context, an effective pursuit of the banking conduct supervision objectives of Banco de Portugal in the digital age requires:

- Reassessment of the applicable regulatory framework, ensuring it allows Banco de Portugal to monitor technological progress in the sale of retail banking products and services and give a timely response to the challenges it poses;
- Adjustment of supervisory tools to the new digital age;
- Promotion of initiatives for the financial, technological and digital literacy of bank customers;
- Close cooperation between the functions of banking conduct supervision, prudential supervision and payment systems oversight, and, at international level, with other supervisors, organisations and international *fora*, considering that fighting global risks and giving an effective response to the challenges of digitalisation must be a joint and coordinated effort.

2. Conduct risks across the financial sector

2.1. Characterisation

The relationship of financial institutions supervised by Banco de Portugal with their customers – under the scope of conduct supervision – goes beyond the sale of retail banking products and services, i.e. deposits, mortgage and consumer credit products and payment and electronic money services. In effect, these institutions (particularly credit institutions) frequently operate in areas either belonging to the capital markets sector (such as the sale of financial instruments), subject to the conduct supervision of the Portuguese Securities Market Commission, or to the insurance sector (such as the sale of insurance policies), subject to the conduct supervision of the Portuguese Insurance and Pension Funds Supervisory Authority.

Naturally, operating in any of the three financial sectors has an impact on credit institutions, which may be important at a prudential level. In particular, situations of misconduct may have relevant adverse consequences for financial institutions themselves – which may be subject to the payment of fines or to other additional sanctions – and for their customers. The reputational damage resulting from misconduct, specifically the loss of confidence on the part of customers and the market as a whole, may further weaken the financial situation of these institutions and, in certain circumstances, even jeopardise the stability of the financial system.

The so-called 'conduct risks' have become increasingly relevant in the post-crisis period both at national and international level. Although there is more than one definition of conduct risk, this concept comprises risks associated with the behaviour of institutions (and their staff) when carrying on their activities – whether in retail or wholesale and interbank markets –, and covers a variety of situations, such as: manipulation of market benchmarks; mis-selling of financial products (including self-placement practices); breach of rules on the prevention of money laundering and terrorist financing or trade sanctions; insufficiencies related with IT systems; insider trading or fraud.

As they cover such different practices with such different underlying factors (such as conflicts of interest, inadequate incentive/remuneration structures, internal control inadequacies, among others), these risks require several approaches to prevent and mitigate them.

Proving its current relevance, the issue of conduct risk has been the subject of several studies published by supranational entities, such as the European Systemic Risk Board[18] and the Financial Stability Board,[19] and has also been analysed by the Joint Committee of the European Supervisory Authorities – a cooperation forum between the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority, which promotes initiatives across the three financial subsectors. At national level, a working group was created within the National Council of Financial Supervisors, comprised of representatives from the three supervisory authorities, with the aim of analysing conduct risks related to mis-selling of savings and investment products, as this was considered the most relevant conduct risk at national level.[20]

A common aspect of many misconduct situations is the fact that these involve more than one of the three financial subsectors (banking, insurance and capital markets). Take mis-selling, for instance: this practice is frequently carried out through the sale of financial instruments or insurance by banking sector institutions (credit institutions).

In these cases, without prejudice to the prudential framework applicable to these entities, the conduct of credit institutions is also subject to rules of conduct (or behavioural rules) outside the remit of Banco de Portugal. Considering that, as mentioned, the sale of financial instruments and insurance policies falls under the remit of conduct supervision by the Portuguese Securities Market Commission and the Portuguese Insurance and Pension Funds Supervisory Authority, under the applicable legal and regulatory framework, the prevention of conduct risks in credit institutions should result in the adoption of cross-cutting measures, covering all three financial subsectors.

2.2. Identified weaknesses

Several factors increase the potential for conduct risks arising within financial institutions, such as the existence of conflicts of interest, heightened by inadequate structures and practices in corporate governance, perverse incentives or internal control weaknesses; or the informational asymmetry between institutions and their customers, worsened by the growing complexity of many financial products, which facilitates mis-selling practices (particularly regarding investment products).

The following are some of the weaknesses identified in the relationship between financial institutions and their customers, which may lead to the need for amendments to the legal framework, supervisory practices and the conduct of institutions, in order to prevent situations which may give rise to conduct risks associated with the sale of financial products, or, where these situations persist, mitigate their consequences.

g) Inadequate pre-contractual information:

It is commonly observed that information provided before or during the sale of financial products is very often insufficient for customers to correctly understand the characteristics of the product on offer. In effect, documents with pre-contractual and contractual information on a number of products are at times not transparent, particularly regarding essential information (namely, information on risk-taking). Specific requirements on the content and provision of this information, by standardising it if necessary, may help minimise this problem. In this respect, the provision to customers of standardised pre-contractual information on retail banking products is already established (specifically, for demand deposits, savings deposits, simple and indexed deposits, consumer credit and mortgage credit), to ensure the information provided is clear and comparable.

However, the intervention of the supervisor is extremely important for monitoring compliance with applicable rules. This monitoring may/should include previous assessment of documents, in particular those relating to products which are more complex or have a higher degree of risk (as is the case of indexed deposits) and checking whether these are given to customers before they agree to the product, by carrying out 'mystery shopping' inspections.

h) Inadequate qualification of sales staff

In addition to the inadequacies in pre-contractual information, very often financial institutions' employees do not have enough understanding of the products they are selling or the risks they entail. Consequently, customers are not always provided with comprehensive information on the products on offer, nor with recommendations or advice that are appropriate for their profile.

In this respect, specific rules must not only be imposed, but also enforced through effective inspections.

i) Unclear distinction between lower and higher risk products

Branches of credit institutions sell a wide range of financial products (financial instruments, insurance products, banking products – deposits, loans, payment services). Consequently, not only is the place and person selling the product the same, but, at times, the sale procedures and the information and contractual documents are also similar for different products with very different risks (e. g. savings/investment products with a risk of capital loss vs. deposits). This practice promotes mis-selling, as it does not present the relevant differences between safer products, such as deposits,[21] which are appropriate for any retail customer, and high-risk investment products, which are appropriate for customers with more knowledge and financial capacity.

j) Remuneration and promotions conditional on sales objectives for certain products

Incentives, whether monetary or not, are clearly a factor of considerable importance when determining the conduct of financial institutions' employees. These incentives frequently lead employees to offer products to their customers 'whatever the cost', without assessing whether they are appropriate for those customers. This situation is the result of incentive structures designed to merely reflect sales volumes, without any consideration either for the quality of the service provided or for compliance with rules of conduct.

k) Excessive trust in the account manager or branch employee on the part of customers when taking saving or investment decisions

Frequently, financial product consumers (in particular, bank customers) are too trusting of institutions' employees, in particular 'account managers', often giving them complete freedom to manage their financial investments or accepting their 'advice' without any reservation, when taking saving or investment decisions.

This fact has been attested by the results of the surveys on the financial literacy of the Portuguese population, according to which more than half the respondents stated that the advice they received at the branch was their most relevant source of information when selecting financial products.

This 'excessive trust' in sales staff (combined with the above-mentioned incentives, which are misaligned with the interests of customers, and occasional lack of knowledge of product characteristics and risks) creates a context favourable to the existence of mis-selling.

l) Insufficient financial education on the part of customers – lack of knowledge of product risks

A factor contributing to misconduct on the part of financial institutions is the lack of financial literacy on the part of customers. In effect, better informed customers are better able to understand the information provided and question lack of or insufficient information, as well as any other conduct they deem incorrect on the part of the institution.

Together with the Portuguese Securities Market Commission and the Portuguese Insurance and Pension Funds Supervisory Authority, Banco de Portugal has carried out financial information and education initiatives as part of the implementation of the National Plan for Financial Education, in order to change attitudes and behaviours and improve the population's financial knowledge.

However, financial education generally has medium to long-term results. Awareness campaigns should therefore be considered, using mass media for a more immediate effect, in particular when the target audience is the adult population.

2.3. Possible initiatives for improvement

There are a number of relevant initiatives that can be carried out in order to prevent misconduct on the part of credit institutions. A great number of these initiatives are of a prudential nature and have already been mentioned in a previous chapter. These are mostly aimed at promoting financial soundness in institutions (introducing changes to internal governance structures, incentive structures for staff performing key tasks or regarding conflicts of interest).

Nevertheless, in order to correctly prevent conduct risks by credit institutions, these measures need to be complemented by other financial conduct initiatives, i.e. having an effect on the relationship of financial institutions with their customers, as well as by measures on the demand side, i.e. initiatives promoting the financial literacy of the population.

In this respect, an important issue is whether the legal and regulatory framework currently in force, and applicable to the relationship of financial institutions with their customers, is appropriate. For example, there has recently been an increasing number of initiatives focusing on the sale of financial products to retail customers, namely by European entities (co-legislators – European Commission, European Council and European Parliament – and European Supervisory Authorities). These initiatives have a tendency to complement traditional measures (which are more focused on transparency and the provision of information and on general principles of conduct), with more intrusive measures, for example rules on the creation of products and the incentive structure for staff, as well as measures giving national and European supervisory authorities powers to intervene in financial product markets.

These initiatives, several of which are still ongoing, may contribute to reducing the weaknesses identified. After they have been implemented, it must be assessed whether these initiatives are sufficient to prevent the risks previously identified.

In turn, even where more regulation is not needed, the effective implementation of existing rules requires active supervision and effective sanctions, which imply the need for considerable financial and human resources.

Without prejudice to this legal framework, which is both complex and under transformation, the following are a set of measures aimed at minimising misconduct on the part of financial institutions towards their customers in the following areas: information provided to customers, sales practices, incentive structures for staff offering and selling financial products to customers (sales incentives), and financial education. Some of the proposals have already been made before, either by Banco de Portugal or other entities.

2.3.1. Information provided to customers:

- Increase the standardisation and monitoring of pre-contractual information by:
  - Providing standardised pre-contractual information, particularly when selling investment products, without any exceptions which might circumvent this requirement;
  - Supervisory entities establishing a harmonised definition of contents which must be included in information documents, in clear and accessible language;
  - Strengthening the monitoring of the sale of risky financial products to less informed investors and imposing more stringent conditions on such sales;
  - Supervisory entities imposing previous monitoring of pre-contractual information for riskier products;
  - Strengthening monitoring of the actual provision of pre-contractual information through inspections, specifically 'mystery shopping' exercises.
- Limit the commercial name of investment products and the use of terms and expressions which may lead to misperception or inadequate assessment of their characteristics and risks by:
  - Prohibiting the use of terms and expressions in the commercial name of investment products, where these are inappropriate for their risk profile (i.e. the use of terms such as 'poupança' or 'aforro' (saving) for high-risk products);
  - Mandatory inclusion, in documents with pre-contractual information on financial products which are not bank deposits, in a prominent way (1st page), of the following warning: 'Este produto financeiro não é um depósito e não está abrangido pela cobertura de um fundo de garantia de depósitos' ('This financial product is not a deposit and therefore is not covered by a deposit guarantee fund');
  - Giving supervisors a mandate to implement other relevant rules on the regulation of terms and expressions used when naming these products.

2.3.2. Sales practices

- Make the sale of investment products autonomous from banking products, both in terms of sales channels and sellers, by:
  - Imposing a clear separation between bank account managers and persons selling financial products to retail customers, including products issued by the credit institution itself;
  - Making physical and functional areas for the sale of standard banking products autonomous from those for investment products.
- Strengthen the rules applicable to the sale of riskier products to retail customers, by:
  - Creating restrictions on the sale of high-risk financial products to retail customers at branches of credit institutions;
  - Imposing requirements on the launch of new financial products containing risk, both for the institution's internal procedures and for validation by supervisory entities;
  - Requiring an assessment of the adequacy of financial products' characteristics to the customers' risk profile before they are sold;
  - Requiring that bank customers expressly declare they wish to buy an investment product by producing a written declaration, instead of merely putting a cross on a box or filling out a form.
- Regulate minimum qualifications for staff selling financial products by:
  - Defining mechanisms for the qualification, registration and monitoring of those employees of financial institutions authorised to sell financial products with associated risk;
  - Ensuring there are human resources with an adequate profile and qualifications, throughout the entire hierarchical chain, for the exercise of internal control activities, external auditing and the monitoring of banking institutions by supervisory entities.

2.3.3. Staff incentives

- Defining principles and rules on the incentives policy of institutions for their staff in the sale of financial products, in particular those issued by the institutions themselves (self-placement);
- Imposing obligations on variable remuneration and bonus policies, to increase their transparency, in line with the institution's medium and long-term objectives and the protection of customer interests;
- Regularly monitoring, both through internal and external auditing and by supervisory entities, incentive systems and business practices used by financial institutions;
- Applying stringent and clearly dissuasive sanctions, where unfair business practices on the part of banking institutions are identified, specifically regarding the sale of financial products with an associated risk to less informed investors.

2.3.4. Customer financial information and education

- Actively promoting financial education in order to improve the population's financial understanding in a medium and long-term perspective, as well as carrying out general initiatives for the adult population using mass media; Promoting the adoption, on the part of the customers of financial institutions, of an assertive posture in terms of shared information and institutions' sales or management initiatives;
- Warning and informing consumers of investment products of their risks, specifically by carrying out awareness campaigns using mass media.

Notes

1. Part IV of the White Paper was prepared by a specific working group composed of Tiago Aguiar, Sara Areia and Carla Almeida Ferreira, under the coordination of Fernando Coalho.

2. Financial intermediation activities (i.e. the provision of services and activities for the investment in financial instruments, as well as auxiliary services) carried out by credit institutions and financial companies are subject to the supervision of the Portuguese Securities Market Commission, as regards conduct supervision.

In turn, the conduct of these institutions, as insurance mediators, in the selling of insurance agreements is subject to the supervision of the Portuguese Insurance and Pension Funds Supervisory Authority.

3. In effect, with the exception of payment service providers and electronic money issuers, which, under the provisions of Article 92 of the Legal Framework governing Payment and Electronic Money Services, approved by Decree-Law No 317/2009 of 30 October 2009, as amended, are required to provide users of payment services with access to out-of-court dispute settlement procedures, other entities subject to the supervision of Banco de Portugal have not shown interest in providing these mechanisms or being subject to their intervention.

In this respect, Law No 144/2015 of 8 September 2015, transposing into Portuguese law Directive 2013/11/EU of the European Parliament and of the Council of 21 May 2013 on alternative dispute resolution for consumer disputes does not establish new requirements for the provision of alternative dispute resolution mechanisms on the part of institutions supervised by Banco de Portugal.

4. Without prejudice to other legal provisions (in particular, Article 6 of Decree-Law No 156/2005 of 15 September 2005, as amended, and Article 6 (1) (d) of the Legal Framework governing Payment and Electronic Money Services, approved by Decree-Law No 317/2009 of 30 October 2009, as amended), the intervention of Banco de Portugal in this area is characterised in Article 77-A of the Legal Framework of Credit Institutions and Financial Companies. This legal provision establishes the principles which should guide the intervention of Banco de Portugal (impartiality, swiftness and no charge), and stresses that "when assessing complaints, Banco de Portugal (...) shall take the necessary measures to check compliance with the rules falling under its competence. Banco de Portugal shall also implement the appropriate measures to ensure that institutions take remedial action to put an end to the irregular situations detected, without prejudice to the initiation of administrative proceedings where the conduct of complainees deems it necessary, namely due to its seriousness or repeated occurrence".

5. The assessment of such complaints falls under the remit of the Portuguese Securities Market Commission and the Portuguese Insurance and Pension Funds Supervisory Authority respectively, the authorities entrusted by law with the responsibility of monitoring these issues and assessing complaints focusing on them (e.g. the provisions of Article 4 (2) (a) and Article 6 (6) to (8) of the Statutes of the Portuguese Securities Market Commission, approved by Decree-Law No 5/2015 of 8 January 2015, as well as the provisions of Article 7 (1) (a) and Article 16 (7) (c) to (e) and the Statutes of the Portuguese Insurance and Pension Funds Supervisory Authority, approved by Decree-Law No 1/2015 of 6 January 2015).

6. Contrary to Banco de Portugal, most regulatory entities have the competence to intervene in the resolution of disputes opposing consumers to market operators subject to their regulation.

In effect, Law No 67/2013 of 28 August 2013 entrusts these entities with powers to resolve disputes between operators subject to their monitoring and consumers, by issuing recommendations and orders to these operators for the adoption of the "measures needed to ensure fair compensation of consumers" (Article 47 (3) (e) of the Law). Considering its autonomous constitutional status and its inclusion in the Eurosystem, Banco de Portugal is not covered by this legal act (Article 4 (3)).

7. In effect, although the Bank may use supervisory tools conferred on it by law to intervene where it detects a contractual provision contrary to a legal or regulatory rule under its remit (for example, where it detects that a mortgage credit agreement specifies an early repayment fee which is above the legal limit established by law), Banco de Portugal is not competent to give its opinion on the validity of contractual clauses, nor to assess contractual provisions established by the parties concerning issues which are not specifically regulated by the rules governing the conduct of institutions in retail banking markets.

8. Within this context, it is understandable that, on the one hand, submitting a complaint to Banco de Portugal must not be considered a requirement for bank customers to use other means to defend their rights and interests, and, on the other, that bank customers must not be prohibited from using these means until the Bank has concluded its assessment of the complaint.

9. As is the case, for example, of Italy, Germany or the United Kingdom.

10. A solution adopted, for example, by the United Kingdom, with the Financial Ombudsman Service.

11. In accordance with Article 92 (1) of the Legal Framework governing Payment and Electronic Money Services, approved by Decree-Law No 317/2009 of 30 October 2009, as amended.

The same obligation is laid down in Decree-Law No 141/2013 of 18 October 2013, adopting the measures necessary to apply in Portuguese law Regulation (EU) No 260/2012, for disputes concerning rights and obligations arising from this Regulation.

12. With the exception of advertising on deposits that are considered complex financial products (which, under Article 2 (5) of Decree-Law No 211-A/2008 of 3 November 2008, are subject to the previous approval of Banco de Portugal), most advertising by institutions is subject to ex post monitoring by Banco de Portugal.

This is specifically the case of instruments laid down in Article 77-D of the Legal Framework of Credit Institutions and Financial Companies.

13. In this context, the solutions envisaged for processing minor road traffic offences may serve as a starting point for a reflection on this subject.

14. In this respect, contrary to credit products, legal and regulatory rules framing the sale of deposits, payment services and electronic money services apply to all bank customers, without prejudice to a few exceptions.

15. This issue has been discussed in several fora, resulting in several initiatives, specifically at EU level (for example, the recent publication, by the European Commission, of the *Green Paper on retail financial services*, on 10 December 2015, and the *Guidelines on the security of internet payments*, published by the European Banking Authority (EBA), which entered into force on 1 August 2015), the International Financial Consumer Protection Organisation (FinCoNet) and the International Network on Financial Education of the Organisation for Economic Co-operation and Development (INFE/OECD).

Banco de Portugal has been involved in these initiatives, for example by coordinating a FinCoNet working group to analyse challenges to the supervision of digital payment services, and participating, as a member of the INFE/OECD, in a reflexion on digital financial services, and their implications for financial education and inclusion.

16. Published on 23 December 2015.

17. The deadline for transposing the Directive into Portuguese law ends on 13 January 2018, without prejudice to establishing a transitional period for authorising a number of entities (such as TPP) which began their activity before 13 January 2018.

18. https://www.eSRB.europa.eu/pub/pdf/other/150625_report_misconduct_risk.en.pdf.

19. http://www.financialstabilityboard.org/wp-content/uploads/Misconduct-risk-progress-report.pdf.

20. https://www.bportugal.pt/pt-PT/OBancoeoEurosistema/Cooperacaoinstitucional/ConselhoNacionalSupervisoresFinanceiros/Lists/FolderDeListaComLinks/Attachments/174/CNSF_20160303.pdf.

21. Deposits have a credit risk above €100,000. Up to this amount, bank customers are guaranteed the repayment of deposit(s) in a given institution. This amount is established by institution and depositor. For deposits in credit institutions having their head office in Portugal, this guarantee is given by the Deposit Guarantee Fund (regulated by the Legal Framework of Credit Institutions and Financial Companies, with the exception of deposits with the Caixa Central de Crédito Agrícola Mútuo (Central Mutual Agricultural Credit Bank) and *caixas de crédito agrícola mútuo* (mutual agricultural credit banks) (belonging to the Integrated Mutual Agricultural Credit Scheme), which are guaranteed by the Mutual Agricultural Credit Guarantee Fund.

PART V[1]

Legal enforcement

1. Framework and characterisation of legal enforcement falling under the competence of Banco de Portugal

The international financial crisis that started in the second half of 2007 and the nearly simultaneous disclosure of extremely serious unlawful practices within a number of major national credit institutions (Banco Comercial Português, Banco Português de Negócios and Banco Privado Português) brought to light Banco de Portugal's need to separate and reinforce one of its main functions – the enforcement of penalties.

This came about in 2011 with the establishment of the Legal Enforcement Department (DAS), autonomous from other supervisory departments within the Bank (in a narrow sense)[2] and staffed by experienced and skilled resources in legal enforcement matters. From then onwards, DAS has been solely responsible for the handling of administrative offence proceedings that, by law, are initiated, conducted and decided by Banco de Portugal.

The main factor underlying Banco de Portugal's decision was that, to a greater or lesser extent, the supervisor's effective legal enforcement could make a positive contribution to supervised entities fulfilling their duties and, likewise, help to effectively achieve more general banking supervision objectives and build public confidence in the financial system and the Bank's work.[3]

Overall, this option (separation and reinforcement of legal enforcement actions conducted by Banco de Portugal) has been positive, resulting in a very substantial increase in the number of administrative offence proceedings initiated[4] and decided[5] each year by Banco de Portugal, a clear reduction in the average duration of administrative proceedings,[6] as well as a high percentage (always above 80% over the past four years) of decisions not subject to an appeal by the respective addressees or where the appeal filed by the accused persons is dismissed (in full or in part) by the court.

However, these indicators should not lead to complacency, given that major fragilities remain, more specifically in terms of the legal framework applicable (most notably, in larger and more complex proceedings). Indeed, although the existing legal framework contains procedural tools and solutions making it possible for sanctions to be imposed by Banco de Portugal in small and medium-sized proceedings closer to the time when unlawful acts are detected (e.g. summary proceedings (*processo sumaríssimo*)), there are still a number of important constraints on swiftness in larger and more complex proceedings.

In fact, more complex proceedings, where several accused persons are charged jointly, often comprise tens of thousands of pages of potentially relevant documentation, which means that formal statements of dozens of witnesses must be taken during the administrative stage, and often make it necessary to replicate (i.e. to prove on the basis of sound evidence) extremely complex financial transactions and flows across several countries and involving many (not always cooperative) jurisdictions.

Therefore, the legislator and Banco de Portugal should focus on mitigating the typical difficulties of larger and more complex proceedings (as described subsequently), so as to find solutions that, without prejudice to the legal rights and protection of the accused persons, can help achieve more expeditious proceedings.

However, these solutions do not depart from the current administrative penalties model, to be initially applied by administrative entities with supervisory powers (in this case, Banco de Portugal), under the so-called *direito de mera ordenação social* (administrative offence law).[7] The fact that heavy administrative penalties on financial infringements are initially applied by administrative entities is not exclusive to Portugal. In fact, this is common to all EU countries and, in a number of particular areas and infringements (and not only in the scope of banking law, but also securities law, insurance law and competition law), it results from the transposition of Directives that are binding on Portugal.

To sum up, the solution is not to cease considering more serious financial infringements as administrative offences – and see them only as criminal offences – but rather to reinforce and adjust procedural frameworks in administrative offence law to this special area (illicit finance), so as to provide administrative entities initially responsible for administrative offence proceedings with the necessary procedural solutions and tools to help them pursue the objective of timeliness.

2. Action to guarantee the quality and effectiveness of Banco de Portugal's legal enforcement at all times

2.1. Courses of action exclusively dependent on Banco de Portugal

2.1.1. Quality and effective management of human resources

Most notably among courses of action exclusively dependent on Banco de Portugal aimed at guaranteeing the quality and effectiveness of its legal enforcement at all times are recruiting, training, and promotion of technical and management skills, know-how and experience, which are key to high-quality legal enforcement by the Bank.

This is critical in a particularly specialised area (administrative offence proceedings), where each decision and action (or failure to act) is rigorously verified for compliance with the law by the accused person's legal representatives,[8] and at a later stage, by the court. For effective conduct (in terms of quality and swiftness) of more complex administrative offence proceedings, those responsible for handling the proceedings together with managerial staff must have very good technical skills (theoretical and practical knowledge of legal writings or case-law issues and responses) and be experienced with this type of proceedings.

2.1.2. Ongoing assessment of mechanisms to shorten response time

In order to guarantee that decisions imposing penalties are issued closer to the moment when unlawful acts are committed, strategies and procedures must be implemented in order to help reduce the duration of each of the following three main stages:

- the stage between the practice of unlawful acts and the moment when Banco de Portugal becomes aware of them;
- the stage between the Bank becoming aware of any unlawful acts and the moment when proceedings are initiated;
- the stage between the initiation and the conclusion of administrative offence proceedings.

A number of procedures and strategies aimed at reducing the duration of the three stages were discussed in the 2015 report drafted by a working group established under the National Council of Financial Supervisors (Portuguese acronym: CNSF), with the participation of representatives from Banco de Portugal, the Portuguese Securities Market Commission (Portuguese acronym: CMVM) and the Insurance and Pension Funds Supervisory Authority (Portuguese acronym: ASF). Some of its findings are discussed below.

Accordingly, it is possible to reinforce the procedures, rules and means conducive to a reduction in the time that Banco de Portugal needs to detect unlawful practices by evenly combining the following factors:

- in-depth and up-to-date knowledge of the business strategy, policies and practices of supervised entities, as well as the comprehensive and cross-cutting monitoring of sources of information;
- critical analysis of the quality of information received, by detecting any missing, false or inaccurate information, and assessment on a timely basis of any infringements, concealment of evidence, fraud or other practices that may affect the regular operation of the supervised institution;
- systematic follow-up of compliance with specific orders by a supervised entity;
- systematic consolidation, in procedure manuals, of acquired knowledge and experience.

Furthermore, coordination between the Bank's supervisory and sanctioning activities should be optimised so as to minimise the time between the Bank becoming aware of any unlawful acts and the beginning of the investigative stage, namely by formally establishing rules on information exchange and effective cooperation between departments and organisational units.

Lastly, time spent on the administrative stage of administrative offence proceedings may be shortened, through:

- intensive use of the summary process, when possible;
- use of more efficient investigation tools. Indeed, the initiation of larger and more complex administrative offence proceedings, particularly during their pre-trial stage (which is essentially an investigative stage) often implies dealing with large volumes of information, either on paper or, more often, in electronic form. In such cases, good 'forensic' investigation tools that make it possible to effectively deal with large volumes of information are crucial in two respects. First, because they expedite the analysis of available documentation and, second, they facilitate links between documents, facts and agents that would otherwise be less achievable. Therefore, it is important that Banco de Portugal continues to invest in investigation tools, most notably IT tools, for a more effective and consistent handling of large volumes of information and, to that extent, bring swiftness to the process and high quality to decision-making;
- keeping up-to-date, good databases (law, case-law, legal writings, or any other pertinent information). As specifically regards case-law databases, cooperation between regulatory authorities should be intensified, more specifically by fostering a shared database on relevant case-law or, at least, the implementation of an effective mechanism for the swift communication of judgments among (at least) the three financial system regulatory authorities.

2.2. Courses of action dependent on the legislator

2.2.1. Amendments to the legal framework on administrative offences/establishment of a legal framework (substantive and procedural) of financial sector administrative offences

Aiming to make the system of penalties laid down in the Legal Framework of Credit Institutions and Financial Companies (Portuguese acronym: RGICSF) more effective, in 2014 Banco de Portugal sought the legislator's approval on a number of amendments to Title XI (Sanctions). Some of the amendments proposed were approved in November 2014 and may help expedite administrative offence proceedings and, at the same time, strengthen the Bank's intervention power (without prejudice to the legitimate rights and protection of the accused persons). The main amendments are the following:

- the establishment of a new cause for suspension of the limitation period which, at most, and taking into account all applicable suspension and interruption factors, makes it possible to extend the maximum limitation period for proceedings to 12 and a half years, in the case of serious infringements, and 17 and a half years, in the case of particularly serious infringements;

- still as regards the limitation period, in cases where facts subject to administrative offence proceedings have been concealed, this period shall only start from the moment when the Bank becomes aware of such facts;
- the introduction of stricter limits to the provision of testimonial evidence, by laying down that accused persons, as a rule, may not call more than three witnesses per infringement, nor more than 12 in total;
- the enactment of a wide set of precautionary measures, most notably, the imposition of conditions on the accused person's activities, preventive suspension of specific activities, functions or roles, or preventive closure, in whole or in part, of establishments where unlawful acts have been committed;
- the summary process' refinement and widening of scope, given that it is now possible to impose a fine that may not exceed five times the minimum threshold for the infringement or, in the case of several infringements, a single fine that may not exceed 20 times the highest minimum threshold of administrative offences committed;
- the enactment of a regime which establishes that any appeal of the Bank's decisions, as a rule, only has suspensory effect if the appealer provides surety, within 20 days, to the value of half the fine applied;
- the clarification of the regime for the gathering and transcription of evidence submitted by Banco de Portugal during the administrative stage.

Although these are major amendments, they are still insufficient, particularly in larger and more complex proceedings, where substantial constraints often make it impossible to speed up proceedings. The greatest difficulties are procedural and are partly associated with the fact that, pursuant to the regulations applicable to administrative offence proceedings under the Bank's remit, there is an intricate web of successive referrals (from the Legal Framework of Credit Institutions and Financial Companies to the legal framework on infringements, from this to the Code of Criminal Procedure (*Código de Processo Penal*) and from this to the Code of Civil Procedure (*Código de Processo Civil*)) that often leads to one of two clearly undesirable situations: uncertainty about the regime applicable to a given situation or, even worse, the need to apply an inappropriate normative solution (designed for a different situation).

In the case of the supplementary application of the legal framework on infringements, as the greatest difficulties are due not only to the fact that Decree-Law No 433/82 of 27 October 1982, has been virtually unchanged since its approval[9] – and is consequently significantly outdated regarding a number of solutions – but, first and foremost, the fact that the scope of administrative offences has been successively widened and now covers very different actions and unlawful acts with varying degrees of complexity and damage. This would obviously call for flexible normative solutions that the current legal framework on infringements does not envisage. For this reason, Banco de Portugal frequently has to implement normative solutions that are inappropriate for the administrative offence proceedings it initiates.

In turn, the supplementary application of the Code of Criminal Procedure, which is applicable when the legal framework on infringements does not provide for a given situation, has also been insufficient, due to the varying nature and structure of the criminal and administrative offence proceedings. This often results in the aforementioned uncertainty about the regime applicable or the not infrequent implementation of a normative solution originally intended for criminal proceedings but clearly inappropriate for administrative offence proceedings.

This means that a comprehensive reform of the legal framework on infringements is needed. Preferably, given the specificities of the financial sector (supervisor-supervised relationship, high complexity and harm to society caused by infringements, specific evidence-related issues, high value of fines and seriousness of some of the additional sanctions, etc.), it is necessary to establish a legal framework on administrative offences applicable specifically to financial infringements (for similar reasons, it also extends to administrative offences under the CMVM's and the ASF's remit) which, inter alia, would clarify the powers of administrative authorities and the courts, the right of defence, the regime of annulments/procedural irregularities and their consequences, etc. To sum up, a legal framework on financial infringements adapted to their specific nature and severity must be established, so as to comprehensively address the various aspects of the regime of administrative offence proceedings in this field, thus minimising the need for recourse to the legal framework on infringements or the Code of Criminal Procedure, with negative consequences as outlined above (for the accused persons, administrative authorities and judicial authorities and, ultimately, justice itself).

2.2.2. Review of the types of administrative offences laid down in RGICSF (Articles 210 and 211)

Within the comprehensive review of the RGICSF, the types of administrative offences laid down in Articles 210 and 211 must also be substantially amended, either by redesigning the standard description of a few infringements, or by establishing new infringements (which recent events have proved necessary).

2.2.3. Greater court specialisation (first instance and appeal)

Since it started operating in April 2012, and given the short response time and degree of specialisation that the Court for Competition, Regulation and Supervision (Portuguese acronym: TCRS) has given to the treatment of administrative offence proceedings under its responsibility, it is worth mentioning the importance (as seen in the case of the aforementioned working group created under the CNSF), of:

- ensuring that progress made in terms of response time does not suffer any setbacks;
- analysing ways to guarantee and value specialisation gains achieved, most notably as regards the transfer of judges, so as to consolidate the specialisation process resulting from the establishment of the TCRS;
- assessing the costs/benefits of the fact that the TCRS is located in Santarém, taking into account all relevant aspects, more specifically monetary and non-monetary costs to its users (accused persons, witnesses, experts, lawyers and financial supervisory authorities) and the foreseeable impact on the applications and careers of the judges that apply to the TCRS.

2.2.4. Scope of the principles of opportunity, settlement and leniency

a) Introduction of a principle of opportunity for minor offences

The cautious and well delimited introduction in Banco de Portugal's penalty system of a principle of opportunity to mitigate the prevailing regime – under which each infringement the Bank becomes aware of, regardless of its nature or seriousness, must be penalised – is also crucial. Indeed, it is increasingly important to effectively understand and manage the opportunity costs of Banco de Portugal's action, so that its scarce resources may be primarily allocated to the investigation and the punishment of more serious offences.

As such, Banco de Portugal's penalty framework should provide for the possibility for the Bank to opt out of its sanctioning power – and use other more appropriate instruments instead (e.g. specific orders) – where minor offences and low levels of blame are involved, which do not reflect repeated behaviour, do not damage nor jeopardise its supervision, the rights of depositors, investors, shareholders or other stakeholders, nor significantly harm the financial system or the national economy.

b) 'Settlement' and 'leniency' mechanisms

While the principle of opportunity, associated with other mechanisms already envisaged in the Bank's penalty framework (such as summary proceedings, warnings, or the suspension of proceedings or the total or partial execution of the sanction), already helps dealing with relative efficacy with the establishment of potential responsibility for minor offences, larger and more complex processes call for other types of solutions and procedural tools.

In this context, it is worth further discussing, ideally with other financial regulatory authorities, the advantages and disadvantages of introducing the 'settlement' and 'leniency' mechanisms into the respective penalty framework.

The 'settlement' mechanisms aim at simplifying administrative offence proceedings regarding the response time,[10] while 'leniency' procedures are chiefly the investigation and collection of evidence on infringements (or the offender) where producing such evidence is particularly difficult. One such case is the competition penalty regime, which expressly provides for this mechanism in cartel cases, which are particularly hard to detect and investigate due to the secrecy they involve.

To sum up, the immediate purpose of settlement procedures is to allow for swifter conclusion of sanction procedures, in contrast to leniency procedures, whose major purpose is to produce evidence of infringements that would otherwise be very difficult to obtain (although swifter conclusion of procedures may be an indirect consequence).

A more developed formal settlement procedure was introduced in Portuguese legislation by Law No 19/2012 of 8 May 2012 (Competition Law), largely inspired by the European settlement procedure in the field of competition laid down in Article 10-A of Commission Regulation (EC) No 773/2004 of 7 April 2004 (as amended by Commission Regulation (EC) No 622/2008 of 30 June 2008).[11]

Under the European and national competition penalty framework, the settlement procedure implies that the legal or natural person subject to the proceedings must acknowledge their participation in infringements to the administrative authority[12]. To compensate for this acknowledgment, their fine is proportionally lower than that applied to those who fail to do so should proceedings run their entire course.

Extensive literature on this matter lists various advantages and disadvantages to the administrative authority and those subject to proceedings associated with the inclusion of settlement mechanisms in the authorities' penalty framework. As such, the advantages to the administrative authority include:

- swifter decisions (advantageous for both the realisation of the right and general and specific prevention grounds associated with any sanction);
- the elimination of judicial challenge risks (also beneficial for courts);
- the freeing up of administrative authority resources that may be used in other investigations (or, in the case of courts, bringing other cases to trial).

Possible advantages to the accused persons are:

- the imposition of lenient sanctions;
- gains in terms of saving resources (less time and money spent defending the case);
- lower uncertainty;
- less media attention (either because proceedings are swifter, or because less information will come to light than if the proceedings were to run their normal course).

A major disadvantage to the administrative authority arises where there is more than one accused person, but only one of them considers that no major gains will result from speeding up the proceedings. For the accused persons, the main disadvantage would be that by acknowledging their participation in infringements, they would forego the possibility of being found not guilty.

Lastly, there are also some disadvantages for law enforcement and its perception. In particular:

- the fact that sanctions resulting from agreements are not proportional to the seriousness of infringements (this risk increases when there are no limits to that reduction);[13]

- the potential breach of the principle of equal treatment, given that it allows for two offenders that participated in the same infringement to receive different fines;[14]
- the absence of external control may suggest that a 'deal', in the negative sense of the word, has been reached.[15]

On balance, the advantages of such a mechanism seem to clearly outweigh its disadvantages, as shown by very positive experiences in other central banks (e.g. the Central Bank of Ireland[16] or Banco Central do Brasil).[17]

In turn, what is referred to as 'leniency' is, in fact, the granting of immunity from fines or a reduction in fines in administrative offence proceedings for cooperation in disclosing evidence (in a cartel, under the European and national competition regime).[18] Indeed, this regime provides the administrative authority with a crucial instrument for the investigation and punishment of facts that, in its absence, are extremely difficult to prove. The biggest disadvantage is the fact that it is an ethically questionable instrument, given that, in addition to benefiting the offender that denounces other co-participants, it may even provide immunity to or reduce the fines on the main offender. However, additional discussion is warranted, to ascertain whether, in addition to its original area (evidence on the cartel under competition penalty law), this type of instrument would also make sense in terms of the Bank's tasks, if not as a general rule, at least as regards specific infringements (in situations that can be seen as fraud in matters under the remit of central banks or, in the case of financial market supervisory authorities, in insider dealing and market manipulation matters). Alternately, given that the existing regimes already provide for the accused person's cooperation as a mitigating factor when imposing sanctions, it is worth considering special (or even mandatory) mitigation should the accused persons confess and produce evidence.

Notes

1. Part V of this White Paper was written by a thematic working group formed by Ricardo Oliveira Sousa, Helena Martinho and Patrícia Guia Pereira, coordinated by João Raposo.

2. The separation of legal enforcement from supervision (in a narrow sense) follows international best practice, and was recently adopted by the European Central Bank under the Single Supervisory Mechanism.

3. It is crucial to consolidate the recognition of the role played by legal enforcement in supervision and, therefore, the materialisation of the regulatory goals that must be met by Banco de Portugal. Indeed, an approach to the supervisory process that gives legal enforcement a secondary role or that denotes that non-compliance with the law can be solved only via measures or remedial action for the future, supervisory pressure or moral suasion – thus underrating the response to past infringements – is not the best strategy to consistently ensure supervised authorities' compliance with their duties.

4. Between 2008 and 2015, Banco de Portugal initiated, respectively 22, 23, 44, 49, 76, 183, 128 and 283 administrative offence proceedings.

5. Also as regards the number of administrative offence proceedings decided by Banco de Portugal each year, there was a very substantial increase compared with previous years following the separation of legal enforcement. In this regard, 82, 131, 98 and 88 administrative offence proceedings were decided between 2012 and 2015 respectively, compared with 13, 23, 23 and 36 proceedings decided between 2008 and 2011 respectively.

6. There was a substantial reduction in the average duration of the administrative stage of offence proceedings settled by Banco de Portugal, as illustrated by the fact that at the end of 2015 approximately 71% of proceedings pending with Banco de Portugal had been initiated in that same year. Of the remaining proceedings, around 20% had been initiated in 2014, 9% in 2013 and only one had been initiated before then.

7. On multiple occasions, the Constitutional Court has confirmed this model's compliance with the Constitution, as stated, for instance, in Judgment No 595/2012: " (...)What truthfully matters to realise this constitutional guarantee is that the Defendant is able to contest the administrative decision, without major encumbrances or costs, and initiate true judicial proceedings before a competent court, which are settled by a judge, by means of a contradictory procedure and grants the Defendant all defense guarantees. When such proceedings are initiated, requirements of a fair trial are fully applicable, namely the requirements related to the separation between ownership of the prosecuting initiative and the decision-making competence as well as the neutrality of the decision-making body – requirements that are, in fact, subject to specific constitutional parameters and, therefore, it is not necessary to merge them with the concept of fair trial – but such guarantee is not impaired by jurisdiction rules or the organisational structure of "administrative authorities" involved on the previous administrative penalty decision, which is being contested (...). This obligation of submission to the Law (and the specific performance of the administrative offence proceedings) does not prevent that the same administrative authority is able to perform both as the investigation and the decision-making body, since that must be considered as connatural to the right of defence. Once the rights of hearing and defence are guaranteed, the

administrative phase of the administrative offence proceedings may assume a typical inquisitorial structure, since the principle of the accusatory structure is restricted to criminal proceedings and is not extended to this other type of sanctioning process. As the Court stated in Judgment no. 581/2004 (...), with regard to a similar accusation, the Defendant's position is guaranteed, not only within the limits of the specifics of the administrative proceedings, but also due to the fact that the recipients of the decision may promote their judicial assessment, with all guarantees inherent to the judicial procedure (...). If this is the case when the identity of the author of the investigation or the procedural impulse and the author of the decision are the same, it is necessarily the case when the confusion or the inexistence of a separation of powers or functions within the same proceedings is merely organic, as is the present case. The Court does not ignore that, in some special regimes, without subtracting the processing and primary decision from the Administration, there is a differentiation of functions or competences within the administrative offence proceedings. In fact, in some cases, the competent administrative decision-making entity does not even integrate the competent administrative authority for investigation (see Paulo Pinto de Albuquerque, Comentário do Regime Geral das Contra-Ordenações, page 119). This is a solution that falls within the legislative discretion but does not stem from the constitutional guarantees related to the administrative offense proceedings, but it guarantees that the Defendant is granted the possibility to be heard and defend himself before the administrative sanction decision is issued and the challenging of such decision before a competent and impartial court, with full jurisdiction, by means of an contradictory procedure. (...)".

The European Court of Human Rights' case-law has on multiple occasions indicated (in particular, the ruling delivered in the Menarini case (*Affaire A. Menarini Diagnostics S.R.L. c. Italie*)) that a model where the administrative authority is responsible for deciding on and imposing sanctions is not contrary to its Convention (Article 6), provided that this decision is subsequently subject to effective judicial review. Indeed, that ruling states: "(...)

58. En l'espèce, la sanction litigieuse n'a pas été infligée par un juge à l'issue d'une procédure judiciaire contradictoire, mais par l'AGCM. Si confier à des autorités administratives la tâche de poursuivre et de réprimer les contraventions n'est pas incompatible avec la Convention, il faut souligner cependant que l'intéressé doit pouvoir saisir de toute décision ainsi prise à son encontre un tribunal offrant les garanties de l'article 6 *(Kadubec v. Slovaquie*, 2 septembre 1998, § 57, *Recueil des arrêts et décisions* 1998-VI, et *Čanády c. Slovaquie*, no 53371/99, § 31, 16 novembre 2004) ".

59. Le respect de l'article 6 de la Convention n'exclut donc pas que dans une procédure de nature administrative, une « peine » soit imposée d'abord par une autorité administrative. Il suppose cependant que la décision d'une autorité administrative ne remplissant pas elle-même les conditions de l'article 6 § 1 subisse le contrôle ultérieur d'un organe judiciaire de pleine juridiction (*Schmautzer, Umlauft, Gradinger, Pramstaller, Palaoro et Pfarrmeier c. Autriche*, arrêts du 23 octobre 1995, série A nos 328 A-C et 329 A-C, respectivement §§ 34, 37, 42 et 39, 41 et 38). Parmi les caractéristiques d'un organe judiciaire de pleine juridiction figure le pouvoir de réformer en tous points, en fait comme en droit, la décision entreprise, rendue par l'organe inférieur. Il doit notamment avoir compétence pour se pencher sur toutes les questions de fait et de droit pertinentes pour le litige dont il se trouve saisi (*Chevrol c. France*, no 49636/99, § 77, CEDH 2003-III, et *Silvesters Horeca Service c. Belgique*, n.º 47650/99, § 27, 4 mars 2004).

8. Due to the nature of these infringements, those subject to administrative offence proceedings initiated and decided by Banco de Portugal are natural and legal persons typically advised and represented by the best specialists (namely, lawyers) available.

9. The introduction in Portugal in 1979 of legal enforcement was mainly aimed at the pursuit of three goals, which are still valid: (i) removing from criminal law a series of infringements of no or little ethical and social importance; (ii) punish these infringements with financial penalties (which, from a precautionary perspective, are more effective); (iii) provide for the implementation of these penalties, at a first stage, by administrative entities (instead of courts).

10. The *settlement objectives* are laid down in point 145 of the Portuguese Competition Authority's guidelines: "the settlement's goal is to guarantee the swift conclusion of administrative offence proceedings (...) where it benefits public interest in the pursuit and punishment of the infringement of competition rules and general and specific prevention objectives, inherent in the imposition of fines in administrative offence proceedings, under a standard administrative offence proceeding " (guidelines on the initiation of proceedings implementing Articles 9, 11 and 12 of Law No 19/2012 of 8 May 2012, and Articles 101 and 102 of the Treaty on the Functioning of the European Union) of 22 March 2013, available at: http://www.concorrencia.pt/vPT/Noticias_Eventos/Noticias/Documents/LO_Instrucao_Processos_2013.pdf (in Portuguese only).

11. There is, however, at least one major difference between how this procedure is regulated at European and national level: unlike the European settlement procedure, which is only available in the case of cartels, the Portuguese settlement procedure may be initiated under an administrative offence proceeding targeting other infringements (e.g. agreements, concerted practices and decisions of associations of undertakings, abuse of a dominant position, abuse of economic dependence).

12. Here, the settlement regime laid down under competition law (national and European) differs from that in other countries (e.g. Brazil), where the administrative authority may compromise as to the existence of an infringement of the accused person's responsibility. This means that for a settlement agreement it is not necessary that accused persons recognise that an infringement has been committed or their responsibility in it.

13. However, it can be argued that gains in terms of general and specific prevention resulting from swift decisions following infringements outweigh the disadvantages of a reduction in fines.

14. This is already the case, given that confession or collaboration are already considered mitigating factors under the penalty frameworks in force.

15. Even this risk, however, may be considerably minimised by establishing the obligatory public disclosure of the terms of the agreement and/or approval of the settlement by an independent entity, such as the Public Prosecutor's Office.

16. In the Central Bank of Ireland in 2014, over 90% of the administrative offence proceedings initiated were settled. However, this was chiefly due to the fact that the accused persons in these proceedings were only legal persons. These procedures tend to be less successful where accused persons are natural persons and also in jurisdictions (such as Portugal) where it is not usual for offence proceedings to be concluded (even in criminal cases) through settlement mechanisms.

17. In Brazil, however, the best model and practices regarding this mechanism have been those implemented by the Securities and Exchange Commission of Brazil (CVM), where hundreds of 'compliance commitments' were signed and posted on its website, with a number of them involving the imposition of very heavy fines. In Brazil, signing the compliance commitment does not entail confession as to the matters of fact or acknowledgment of illegal conduct.

18. Under the national competition regime, and as opposed to settlement cases, it is only possible to waive or reduce fines in cartel cases (see Article 75). This does not apply to unlawful acts in terms of competition (e.g. abuse of dominant position).

PART VI

Models of Financial Supervision in Portugal and in the Context of the European Union

Introductory note: This chapter reproduces the *executive summary* of the Independent Study prepared by Professor Luís Silva Morais for Banco de Portugal on the above styled subject.

The translation of this chapter is the responsibility of Professor Luís Silva Morais.

001 This Study provides a critical analysis of the institutional architecture of financial supervision in Portugal within the framework of cross-border financial supervision that is being developed in the European Union (EU). Moreover, it compares the different options envisaged in the most advanced international financial systems, by building on the discussion taking place on a global scale in the main international fora.

002 Given the current context of the national, European and international financial system, this Study's analysis of the institutional models of organisation for the regulation and supervision of the financial system arguably adopts a dynamic and normative approach. The significant changes taking place at the EU and international levels, allow for the development of a better design of financial supervision in Portugal.

003 One of the goals of this comparative analysis is to identify, to the extent possible, *evolutionary trends* in reforms to the institutional architecture of financial supervision, in relation to the global reform of regulation and supervision of the financial system.

004 This analysis is focused on two institutional models of supervision: single supervisor and 'Twin Peaks' model, both of which emerged as an alternative to the traditional tripartite sectoral supervision model. Bearing in mind that these models are configured very differently across the various known examples of their implementation, this Study uses case studies from EU and non-EU jurisdictions to illustrate the potential advantages and the main risks stemming from such models.

005 This Study develops a broad analytical approach to the key principles set out in the framework of the *Basel Committee on Banking Supervision* (BCBS), the *International Organization of Securities Commissions* (IOSCO) and the *International Association of Insurance Supervisors* (IAIS) based on a comparison of several national legal frameworks. Pursuant to this analysis, it is possible to identify four key objectives, that are of structural importance to financial regulation and supervision: (i) financial soundness and sustainability of the institutions; (ii) prevention and mitigation of systemic risk in the financial sector; (iii) safeguarding of loyalty and correction parameters in transactions and of market efficiency; and (iv) protection of customers of financial services and institutions.

006 The first two objectives [(i) and (ii)], which are embedded in the first of the Basel Committee's 'Core Principles for Effective Banking Supervision' (2012), are intertwined and form the *prudential* arm of banking supervision. In fact, the promotion and safeguarding of the soundness and sustainability of financial institutions is undeniably a task of financial supervision, that is intrinsically linked to the safeguarding of the financial system as a whole, so as to horizontally control systemic risk. The objective of ensuring the financial sustainability of each institution should guide the action of financial supervisors (at micro-prudential level), without disregarding the risks affecting the stability of the financial system as a whole (at macro-prudential level).

007 The other two objectives [(iii) and (iv)] are closely intertwined and are commonly known as banking conduct supervision (or, more broadly, market conduct supervision), since they constitute a type of financial sector supervision guided towards the scrutiny of the conduct of financial institutions.

008 Recent experience drawn from the international financial crisis seems to indicate that the model or institutional architecture of financial supervision is not a "silver bullet" for the prevention of serious regulatory or supervisory failures that may trigger financial sector crises.

009 Actually, no model of financial supervision ensures the absolute stability of the financial system, or prevents the eruption of localised crises in some financial institutions. Notwithstanding, the design of the financial supervision architecture is a relevant element for the functioning and effective scrutiny of the financial system. In effect, it contributes to the establishment of a more effective financial supervision framework that both limits potential supervisory failures and hence prevents or mitigates the impact of financial sector crises and contributes to handling financial crises whenever they cannot be prevented.

010 Because of their overall importance, models and institutional architectures of financial supervision should be subject to an ongoing reassessment in light of the prevailing objectives of financial supervision and of the specific financial sector setting at any given State or wider regional integration level (e.g. the EU), as well as in accordance with the specific historical context which characterises the evolution of the supervision models in a given jurisdiction.

011 The aforementioned institutional models of financial supervision should therefore not be copy pasted when designing a reform of financial sector supervision without taking into consideration the national specificities described. Albeit the importance of those abstract models, it is strongly advisable not to undertake abrupt reforms of the institutional organisation, which might be unduly burdensome for the authorities involved and costly in terms of regulatory stability.

012 This Study is therefore underpinned by the assumption that it is important to evaluate each model of financial supervision within the specific context of each jurisdiction regardless of their insertion in supranational frameworks (e.g. EU) or wider international regulatory trends. Because it is important to understand such models as a the pinnacle of a complex institutional evolution, we will focus on the evolution of the Portuguese financial supervision model, while considering in parallel, its historical background and the constraints resulting from the EU regulatory framework (especially from the recent European Banking Union).

013 In addition to the reforms concerning the adoption of the single supervisor or 'Twin Peaks' models and the progressive loss of relevance of the more traditional aspects of the sectoral model, one can identify, on the basis of a systematic and critical analysis of internationally available data, a third trend. This trend is characterised by the progressive development of hybrid models, which are most flexible and tailored to each financial system, so that they can be continuously adjusted to the change dynamics and transnational interconnection of financial systems.

014 In this growing number of jurisdictions with hybrid variations of the institutional architecture of financial supervision, the need for creating coordination mechanisms and platforms for the exchange of information has become paramount in the context of continuous reform and adjustment of the supervisory architecture.

015 In reality, this need for coordination is not limited to the more traditional models of tripartite sectoral supervision and is increasingly turning into an overall structural basis for the actual platform for the organisation of new architectures of financial supervision.

016 Since the creation of the Securities Market Commission ('CMVM') in 1991, Portugal has had a *tripartite financial supervision model of institutional or sectoral type* with a *functional* component, which stemmed from the *profound transformations* that have impacted the national financial sector.

017 These profound transformations took place in the aftermath of the breakup of the Portuguese economic constitution of 1974-75, which led to a

disruption in the banking system followed by the nationalisation and end of the direct state supervision over this sector; and by the new economic and legal framework resulting from the accession of Portugal to the European Economic Community (EEC). The latter ended up influencing the establishment of an institutional insurance supervisory authority, and the development of a national securities market by the end of the 1980s (and later the creation of a competent specialised supervisory authority).

018 Thus, the evolution of the pillars of the Portuguese financial supervision institutional architecture closely followed the profound changes which have impacted the Portuguese financial system since the mid-1970s.

019 The above mentioned pattern is also a consequence of the stabilisation of the supervision model pursuant to the dominant conditions at each moment of the process of European integration. In fact, the current stabilisation is the product of the development in the 1990s of a single market in financial services based on minimum regulatory harmonisation levels and home Member State parameters of supervision on the assumption that the national supervisory authorities would coordinate among themselves. This process of creation of an effective single market in financial services boosted precisely following Portugal's accession to the then EEC.

020 The Portuguese model of financial supervision incorporated the development of new hybrid components, in particular, through the creation of a mechanism for cooperation or functional articulation between the three specialised financial supervisory authorities: the National Council of Financial Supervisors (CNSF), established in 2000. In addition to its institutional/sectoral matrix, the model also involves an ever-increasing number of functional elements which are especially linked to the supervision by CMVM of multiple financial activities and instruments developed in the securities markets regardless of the institutions intervening in such activities.

021 It is important to duly ponder the major transformations of the financial sector that may be occurring from time to time and duly perceive its overall reach prior to conducting reforms of the institutional architecture of financial supervision that might result in unduly burdensome regulatory transition costs.

022 Moreover, given the direct influence of the European integration process over the national supervision architecture, any reform should be carried out in accordance with the EU framework and abide by the stringent constraints that emerged in the wake of the international financial crisis.

023 Under the tripartite sectoral financial supervision model that was in place in Portugal during the early 1990s, the levels of autonomy of the three specialised supervisory authorities were initially relatively imbalanced, to the detriment of the insurance and pension funds authority. This imbalance was corrected via a twofold reform implemented between 1998 and 2001, in the form of amendments to the legislation relating to the access and pursuit of the business of insurance (through Decree-Law No 84-B/98 of 17 April 1998) and of changes to the By-laws of the then Portuguese Insurance Institute (now, the Insurance and Pension Funds Supervisory Authority – ASF), through Decree-Law No 289/2001 of 13 November 2001.

024 This second period of stabilisation (1998-2001) of the Portuguese tripartite (sectoral or institutional) financial supervision model was clearly driven by the purpose to "level the structures of the three supervisory authorities". An aim that was already present when the institutional model was consolidated in 1991 with the creation of CMVM (together with Banco de Portugal and the Portuguese Insurance Institute).

025 This second period was crucial for the stabilisation of Portugal's tripartite financial supervision architecture and coincided with developments that led to the *ex novo* creation of a coordination and articulation platform that linked the three financial supervisors: the aforementioned National Council of Financial Supervisors ('CNSF') in 2000.

026 The goal of "institutionalising and organising cooperation" among the three specialised supervisory authorities resulted from a growing intertwining between the various subsectors of the financial system; it also formed the basis for the key reform trends of the institutional architecture of financial supervision, which started to materialise at the turn of the century and led to significant developments in financial supervision during the past fifteen years. Actually, this trend for reform push was further strengthened in the aftermath of the 2007-09 international financial crisis, although none of the institutional models applicable worldwide rose to the challenges emerging from such crisis.

027 The establishment of the CNSF in 2000 led to an overall change of the Portuguese system into a *sui generis* hybrid tripartite model, that combines:

- a traditional tripartite structure comprising sectoral financial supervisory authorities, divided by subsectors – banking, insurance and pension funds and organised securities markets; and
- an additional body that ensures an appropriate and ongoing cooperation and functional coordination among the three sectoral authorities.

028 In parallel, this more hybrid dimension of the institutional supervision architecture is also somehow mitigated because the additional body created in 2000 lacks an adequate institutional framework. Indeed, the CNSF was not created as a new public legal entity and it still lacks its own structure for technical support.

029 Contrary to what has been often suggested, the CNSF did not correspond to a truly original institutional solution that can be dissociated from the major reformist trends of institutional supervision architectures around in 2000.

030 In fact, although introducing a hybrid element within the national supervision architecture, the creation of the CNSF did not represent an overhaul of the pre-existing tripartite sectoral structure (incorporating some minor functional components). Conversely, the CNSF shares a number of features with wider reforms implemented in other jurisdictions, namely those which replaced the more traditional tripartite sectoral supervisory structure by a single supervisor model or by more ground-breaking 'Twin Peaks' models, which are characterised by a dual-regulatory structure: prudential and market conduct supervision.

031 Those common features involve comparable requirements of efficient coordination among the various institutional poles of the supervisory models at stake and the corresponding need of institutional mechanisms that embody such coordination. Accordingly, the new institutional model that probably carries with it the most ground-breaking reform of previous architectures of supervision (the 'Twin Peaks') also includes a hybrid component whereby coordination is ensured via a specific body, as it is illustrated in a paradigmatic manner e.g. in (e.g., Australia,, which coincidentally was the first country to introduce the Twin Peaks model).

032 Hence, when the Twin Peaks model was first introduced in Australia following the Wallis Commission of Inquiry (Financial System Inquiry) of March 1997, it was foreseen that a Council of Financial Regulators, with striking similarities with the

CNSF, would be established in addition to the prudential supervisory authority (Australian Prudential Regulation Authority – APRA) and the market conduct supervisory and consumer protection authority (Australian Securities and Investment Commission – ASIC).

033 The Council of Financial Regulators comprises members from the Prudential Supervisory Authority, the Market Conduct Supervisory and Consumer Protection Authority, the Australian Central Bank (entrusted with maintaining the general stability of the financial system and lender of last resort) and the Treasury. The Council is a non-statutory interagency body, and lacks own regulatory or supervisory powers. It is chaired by the Central Bank Governor, and it is also staffed (administrative support) by the Central Bank in the performance of its tasks; these involve facilitating and coordinating cooperation among financial system supervisors.

034 This *Council of Financial Regulators* is largely informal in its institutional arrangements, mostly acting through flexible working groups formed by members from the supervisors with seat in the Council. It should be noticed, however, that following the recent reassessment of the Australian financial supervision architecture, which started in the end of September 2013, in the context of the so-called Financial System Inquiry, there have been proposals for a greater institutionalisation of the Council as well as for the reinforcement of its statutory and legal basis for action.

035 Also in South Africa, where a similar 'Twin Peaks' model is undergoing, there have been discussions surrounding the creation of a Council of Financial Regulators with features comparable to the Australian model eventually with stronger institutionalisation features.

036 Furthermore, *councils of financial regulators* have also been responsible for the general *coordination* of specialised supervisory authorities in other major jurisdictions that continue to be based upon the tripartite *sectoral* supervisory models (e.g. China).

037 In fact, even jurisdictions with single supervisor models, have taken significant steps towards the establishment of *coordination bodies*. Hence, also these models became more structurally complex and, to some extent, *hybrid*, especially following the growing development of macroprudential supervisory functions in the wake of the financial crisis. That happened, e.g., in Germany, where the single financial supervisor (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin), and the German central bank, intervening in the macroprudential field, participate in a coordination body.

038 Therefore, a growing *interpenetration of supervisory models* is noticeable at the international level as *hybrid* components are adopted to varying degrees. As a consequence, it is arguable that the *institutional coordination function* is essentially indispensable, regardless of the particular institutional framework adopted in each case.

039 In this context, one of the key variants in the *hybrid* component that has increasingly encroached all supervisory models pertains to the institutional size and legal empowerment and structure binding the bodies entrusted with this *coordination* role within supervisory architectures (even where the tripartite *sectoral* supervisory structure has been abolished).

040 As regards these increasingly interlinked variables, an alternative is now emerging, consisting of the establishment of *specific coordination bodies* (councils of financial regulators or supervisors), with increased institutionalisation and powers, working in parallel with pre-existing supervisors with a more stable structure. This allows meeting the more pressing needs for supervisory intra-system coordination whilst mitigating the transaction and *regulatory transition costs* that are often associated with more radical changes to supervisory architectures.

041 It is important to take into consideration the impact of the EU near 'federalised' regulatory harmonisation arising from the Larosière reform of 2009-10 (not immediately mirrored in the field of financial supervision) when ascertaining potential avenues for reforming the Portuguese model of *supervision* model in Portugal (or in other EU Member States).

042 As regards specifically financial supervision (different from financial regulation), the recent supranational changes stemmed from another, more recent, major development, related with an adverse feedback loop between banking crises and the European sovereign debt crisis. This development led to a *de facto* reversal of the liberalisation trend with gradual unification of national financial services markets and replaced it with a new trend conducive to the fragmentation into national financial systems.

043 it was indeed the reaction to this novel de facto *financial fragmentation* trend that led to the launching of the European Banking Union project at the end of the first half of 2012. One of its major pillars materialised in November 2014, when the Single Supervisory Mechanism (SSM) was created within the framework of the European Central Bank (ECB) – thus leading to truly supranational intervention in the field of supervision - although the insurance and pension funds as well as the securities markets subsectors were carved-out from this newly built European supervisory architecture.

044 Making sense of the various constraints on developments and reforms, which have impacted the Portuguese financial supervision model requires a prior understanding of two conflicting major movements at European level that followed the establishment of the CNSF in Portugal in 2000.

045 During the final stage of the first of such movements, the key concern was how to solve the tensions accumulated during the rapid liberalisation of the financial sector. At that stage, we still faced a rather rudimentary European architecture for regulation and supervision of the financial sector, even after the limited transition which took place in the wake of the de Larosière reform, and that, in turn, still allowed a greater leeway to ponder different solutions for wider reforms of the national model of financial supervision in Portugal (or in other EU Member States).

046 That final stage of the first aforementioned movement coincided with the 2009 public consultation on a possible transition or structural transformation of the Portuguese financial supervision model (hereinafter '2009 Public Consultation'), which took place at a key moment when even the mitigated de Larosière reform was yet to be implemented.

047 On the other hand, the beginning of the second major European movement marked a period of some sort of financial fragmentation in the EU and triggered a response in the form of the banking union project. Accordingly, the implementation of the SSM in the banking subsector narrowed the scope for major reforms of the national financial supervision model, although more hybrid solutions could still be introduced without structural institutional changes. Thus, it became more important to closely monitor the shaping of the European supranational financial *regulatory* and *supervisory architecture*.

048 It is also worth stressing that other later developments ended up shaking the assumptions underpinning the 2009 Public Consultation as regards the financial system supervision architecture, and the overall safeguarding of financial stability (beyond *strictu sensu* supervision), which touch upon the tasks and powers of the government (Ministry of Finance) in matters of monetary, financial and foreign exchange markets oversight (besides the coordination of market agents' activities), pursuant to Article 91 of the Legal Framework of Credit Institutions and Financial Companies (RGICSF).

049 In fact, within the context of such 2009 Public Consultation, the National Financial Stability Committee ('CNEF') was regarded as the main macroprudential forum for the Portuguese financial system. However, this paradigm changed once Banco de Portugal was entrusted the role of national macroprudential authority whilst the CNSF was in turn entrusted with a new role in this filed (although a mere advisory one). The Ministry of Finance was given a seat on the CNSF, in light of the Council's new involvement in macroprudential matters after amendments to its governing regime were introduced in 2013.

050 This institutional development undermines the assumption that the CNEF can in fact be the main macroprudential forum, as had been forecasted in the 2009 Public Consultation. Indeed, in that context, there seems to be some duplication or dysfunction between the roles played by the CNEF and the CNSF in the overall supervisory architecture and control of the Portuguese financial system. It would be advisable to readjust the CNEF *de iure condendo* and centralise that role in a restructured CNSF, in the context of a reform that supports a *greater institutionalisation and a reinforcement of the legal bases for the Council's actions* (see below).

051 An overall comparative analysis of the institutional evolution of the past two decades, shows that the reform movement in institutional financial supervision architectures was triggered (or at least became more visible) following the creation of *single supervisor models*. This involved the combination of different financial system supervision areas and functions in a single authority (even if in flexible models) chiefly in two alternative models: (i) separation of the single financial supervisory authority from the central bank (with its monetary policy responsibilities); (ii) or appointment of the central bank as the single financial supervisory authority.

052 This movement towards establishing single financial supervisory authorities started with the creation of a single financial sector supervisor in Singapore in 1984, rapidly followed by the Scandinavian countries, with ensuing reforms in Norway (in 1986), Denmark (1988) and Sweden (in 1991). However, it was only with the in-depth reform in the United Kingdom in 1997, leading to the establishment of the Financial Services Authority (FSA), that the movement gained wider recognition given the UK status as a major international financial centre.

053 This reform trend marked by the institutional integration of financial supervisory functions evolved over the following decade – particularly in the second half of the 1990s – in accordance with an alternative paradigm of supervision specialised by objectives. This modified approach addressed some of the initial criticism made to the single supervisor model, especially in terms of the disadvantages associated with the high concentration of power in a single authority (as a rule, independent or highly autonomous) and the difficulties it encountered in setting priorities and balancing the primordial objectives of prudential and market conduct supervision.

054 This alternative analytical approach was first conceptualised by Michael Taylor in his ground-breaking study *Twin Peaks: A Regulatory Structure for the New Century*, of 1995. Taylor's study puts forward a model based on two financial supervisory authorities specialised in the achievement of the aforementioned fundamental goals, carrying with it distinct requirements, respectively of *prudential control, (financial soundness)* and *market conduct supervision*.

055 This model forged a second wave of reforms of the institutional architectures of financial supervision, starting in Australia in 1997, in the aftermath of the report published by the Wallis Commission of Inquiry, and closely followed by the Netherlands in 2002.

056 Post-2007 international financial crisis, the 'Twin Peaks' model encroached relatively swiftly, as it became widely viewed as an answer to a series of disadvantages of the single supervisor model whilst preserving the core set of advantages that in theory derive from the integration or relative concentration of financial supervisory functions.

057 This led a number of experts to support the adoption of 'Twin Peaks' models post-financial crisis, although with some institutional variants: e.g. concentration of the prudential pillar in the central bank or the unbundling of the central bank from financial supervisory functions. However, the practical implementing of these models is far from confirming the claim that the 'Twin Peaks' model is capable of overcoming a series of disadvantages attached to the institutional concentration of financial supervisory functions. For these reasons, we find the idea of 'Twin Peaks' as a predominant model to be manifestly premature, on the basis of a comparative analysis of institutional supervision architectures in the more developed financial systems.

058 The comparative critical analysis developed in this Study systematically addresses three basic model alternatives for institutional financial supervision architecture, namely: (i) the *traditional sectoral model* (on a tripartite basis, involving the traditional breakdown of the financial system into the subsectors of banking, insurance and pension funds and securities markets), (ii) the *single supervisor model*, and (iii) the *'Twin Peaks' model*. However, the Study also takes into account the *hybrid components and sub-variants* that give rise to different combinations between these base models and other systematic frameworks, while locating other less relevant or somehow secondary or subsidiary models.

059 In this context, special emphasis should be given to the *functional* financial supervision models (a possible fourth subspecies), which establish different institutional domains of supervision in accordance to the respective business areas, and regardless of the institutional type of financial entity supervised (e.g. credit institution or insurance company). Hence, each supervisory domain includes both *prudential* and the *market conduct* supervision components.

060 In any event, it should be stressed that the aforementioned *functional* models can be, and often are combined with the traditional institutional or *sectoral* models, as the developments occurred in the Portuguese model clearly evidence.

061 The emergence of alternative institutional financial supervision architectures is also inextricably linked to the development of financial conglomerates, which were enabled by the regulatory changes introduced in the last quarter of the 20th century and by financial supervision efficiency and effectiveness requirements within this new financial system context.

062 Underlying the shift towards the designing and establishing of single financial supervisory authorities are concerns over how to prevent or eliminate potential problems associated with the existence of multiple supervisory authorities. These potential problems include: (i) competitive disadvantages or distortions, (ii) overall inconsistency in the various supervisory approaches, and (iii) two opposing tensions – one due to overlapping intervention problems and the other resulting from a higher risk of enforcement gaps in the context of an increasingly widespread universal banking business model as well as other types of cross-pollination among financial activity segments.

063 Independently from the expectations of efficiency surrounding the single supervisor model, especially after the establishment of the

paradigmatic Financial Services Authority (FSA) in 1997, its actual operation shed a light over its potential disadvantages and inherent risks.

064 First of all, the assumption of efficiency associated with this model was not always confirmed. In fact, the establishment of large bodies tends to increase bureaucracy, making their action less flexible when compared with smaller sectoral supervisors.

065 Furthermore, the experience accumulated using this model and a critical analysis of it revealed major risks stemming from the fact that the expected scale economies (whereby a single authority carries out prudential and market conduct supervision and centralises overall superintendence functions, across various financial business areas) is often negatively offset by an institutional incentive to over-accumulate functions, often only marginally related to the core financial supervision functions and objectives (so called 'Christmas tree effect').

066 In addition, the assumption that having a holistic vision over supervised entities provides the supervisor with a clearer focus, at any given moment, on the priority objectives of supervision has also been undermined by the emergence of risks associated with the single supervisor model. In fact, as illustrated by the paradigmatic case of the United Kingdom – which in 2013 reversed the 1997 reform that had created the FSA–, the institutional integration of chiefly prudential and market conduct objectives does not *per se* guarantee a better or more balanced weighting of these objectives and of the prioritisation to achieve them in each market evolution stage.

067 Conversely, the concentration of supervisory functions in a single supervisor may give rise to risks of imbalance between the prudential and market conduct supervisory components, often to the detriment of prudential supervision. This may happen due to the more immediate short-term nature characteristic of the pursuit of consumer protection objectives because of the greater public and political visibility inherent to these objectives, to the disadvantage of prudential goals (*see, e.g.,The Turner Review – A Regulatory Response to the Global Banking Crisis* (March 2009, Financial Services Authority).

068 Another much discussed risk that tends to result from single supervisor models relates to the elimination of a number of virtuous factors which result from *regulatory competition*. In fact, provided that efficient levels of *coordination* between multiple financial supervision interventions are effectively ensured, the combined action of different supervisory authorities may give rise to a virtuous tension between them, that actually enable an easier location of specific problems.

069 In other words, the single supervisor model lacks a true system of checks and balances that can mitigate the issues arising from the failure to detect problems, which are more likely to occur in direct proportion to the growing complexities of financial activities (thus creating a 'single point of failure' in terms of financial supervision).

070 The single supervisor model may also entail the risk of excessive formal simplification and of generating a bias towards *organisational matters* to the detriment of the *actual financial supervision tasks*. In fact, some level of specialisation will still be required, even within the context of a single organization that combines prudential and market conduct supervision and that monitors a wide array of financial institutions.

071 Such specialisation constraints may well lead to the reintroduction within a single authority of functional supervisory intervention 'silos'. In addition, hasty mergers of sectoral supervisory authorities into a single supervisor may actually

result in the mere remaking of the pre-existing separate sectoral lines of action within the new organisation, whilst leaving the fundamental problem of their coordination at a substantive level untouched.

072 These concerns have been confirmed by single supervisors actual practice across the globe, with these authorities' internal structure often being comprised of sectoral departments (e.g. the single supervisory authority in Japan and BaFin in Germany).

073 Issues of communication and *coordination* between different types of supervisory intervention remain key, even in the case of single supervisors. In fact, and somewhat paradoxically, coordination risks end up being more acute in single supervisor settings, if only because they are less noticeable and therefore less tackled. Thus, reforms should downplay the importance of unverifiable benefits resulting from draconian formal simplification measures and instead focus more on the effective exercise of the supervisory tasks.

074 This key issue of *coordination* also became more pressing in the context of the interplay between macroprudential supervision on the one hand and the various types of market conduct and microprudential supervision, in the wake of the 2007-09 financial crisis. In most major international *single financial supervisor* systems, the overall macroprudential supervision, due to its intrinsic characteristics, usually goes beyond the remit of that single supervisor and is also ensured by the central bank and government representatives (particularly in the Finance field).

075 The experience of Germany and the United Kingdom in terms of single financial supervisor model is paradigmatic in this regard and sends mixed messages about the importance of the *coordination* of supervisory activities task.

076 The German experience, especially after the 2012 reform of the supervision system, somehow contrasts with the negative experience of the single supervisor model in the United Kingdom. In particular, it highlights the key importance of *coordination* problems and shows that they are not automatically solved under a single supervisor model. What the case of Germany shows is that it is possible to effectively combine, to some extent, this institutional model with a *hybrid* component, through the establishment of *new coordination bodies* – in this case, the German Financial Stability Committee *(Ausschuss für Finanzstabilität)* – comprised of the single supervisor (BaFin) and representatives of the Deutsche Bundesbank and the Federal Ministry of Finance.

077 By contrast, in the United Kingdom, the Turner Review, the 2009 Report released by the House of Lords *'Banking Supervision and Regulation'*, and the November 2015 Report released by the Bank of England on *'The Failure of HBOS plc'* revealed that the FSA favoured *market conduct* supervision, in operational terms, to the detriment of *prudential* supervision, with major negative consequences in terms of *prudential supervision failings*.

078 This distortion was found to have been encouraged by the single supervisor system (1997-2011). In effect, market conduct supervision is generally more politically sensitive and tends to produce results and returns that are more easily measurable. On the contrary, prudential supervision not subject to the same level of public concern, requires a more discrete supervisory performance and its successes are more difficult to measure. Furthermore, its political impact is normally ignored during periods of normality and highly scrutinised in severe crisis periods. This combination of factors ends up creating, even if almost imperceptibly, an incentive to prioritise resources to market conduct supervision.

079 The twilight of the United Kingdom's single supervisor model, previously a benchmark of international best practice, encapsulates the model's risks and shortcomings that result from *underestimating*: (i) the need for an effective *coordination* of supervision interventions (which are, paradoxically, not eliminated via greater supervisory integration), and (ii) the central role of substantive – and not merely institutional – aspects pertaining to the functional strategy and methodology of supervisory.

080 Hence, the FSA failed to ensure a proper balancing of : (i) *prudential* supervision, (ii) *market conduct* supervision, and, more recently, at a particular level (iii) *macroprudential supervision*; actually this balance depends to a large extent on a set of more hybrid institutional elements coexisting in any architecture of supervision, associated with *reinforced coordination mechanisms*.

081 The importance of these *hybrid* and *coordination* elements is clear when comparing the UK and the German case. In fact, one of the key differences between these two single supervisor model experiments was the hybrid or 'impure' German supervisor model design since 2002. The difference between the two cases largely resulted from Deutsche Bundesbank non-negligible role and continuous exercise of a number of financial supervisory functions (particularly in banking); and from the recognition of the crucial importance of *coordination* functions across supervisory components, also associated with the new concepts of safeguard of financial stability.

082 The *hybrid* or 'impure' elements of the German single supervisor model was reinforced with the 2012 reform, which both consolidated the central role played by the Deutsche Bundesbank in macroprudential supervision and financial stability matters and, established a new body [the aforementioned German Financial Stability Committee (*Ausschuss für Finanzstabilität*] formed by representatives of the Deutsche Bundesbank, BaFin and the Federal Ministry of Finance.

083 The 2012 reform also provided the German Financial Stability Committee – partly modelled on the European Systemic Risk Board – with a wide set of powers and responsibilities, including the safeguard of overall financial stability (namely with powers to intervene in causes for potential future financial crises), and ensuring coordination and cooperation among authorities with financial supervisory powers.

084 Besides supporting new macroprudential supervisory tasks, the Committee chiefly works as a mechanism for reinforced cooperation and information exchange among supervisors – a model somehow similar (*mutatis mutandis*) to the CSNF in Portugal and that never found an adequate institutional support in the UK approach to the single supervisor model.

085 Following the 2012 reform, the German Financial Stability Committee can be seen as embodying the emerging *dominant trend of placing bodies with a specific coordination role and mission at the centre of supervisory models*, regardless of the institutional diversity of these national models which often merely reflect particular national historical developments.

086 The so-called 'Twin Peaks' model, which somewhat corresponds to a second wave of reforms in financial supervision architectures, was designed to preserve the key set of benefits usually associated with the relative integration of financial supervisory functions, while avoiding, at the same time, a number of disadvantages brought about by the single supervisor model (which embodied the first wave of reform of supervisory models).

087 refore, the 'Twin Peaks' model essentially addressed the same concerns that were behind the emergence of the single supervisor model, while creating

a new institutional paradigm of integration of financial supervisory functions that would enable bridging the gaps of the first model in terms of risks and imbalances.

088 The starting point of Michael Taylor's ground-breaking Twin Peaks work is an analysis of the increasing mismatch between regulatory structure and market reality, leading to regulatory failures, dysfunctions and mismatches. Based upon this analysis, Taylor presents *four main arguments that recommend* a concentration in a single authority of all supervisory functions aimed at safeguarding financial soundness and sustainability across all types of financial institutions subject to financial regulation and supervision ('prudential branch' of supervision):

- the growing number of financial institutions with systemic importance;
- risks of an un-level playing field issues among financial institutions due to sector specific regulatory requirements,
- the emergence of financial conglomerates in banking, securities and insurance (essential to take a 'group perspective')'
- need to pool scarce specialised know how and skills for a proper prudential supervision within a context of increasingly sophisticated and complex financial transactions.

089 Bearing in mind the specificities of prudential supervision in terms of implementing methodologies and prudential supervision technical tools vis-a-vis the supervision of commercial conduct , Taylor's conceptual framework also identified aspects warranting a unified (rather than fragmented) pursuit of consumer protection goals in the field of financial services conduct of businesses.

090 One of the main advantages associated with the 'Twin Peaks' model lies in the possibility of overcoming the regulatory gaps caused by the full unification of supervisory functions. By creating two different autonomous entities, according to the primary objectives of supervision (*prudential and market conduct* control), regardless of the subsector where supervised financial institutions operate and the type of products and services they sell the Twin Peaks model seeks to ensure total clarity and focus on each of the supervisory objectives and tasks , without the potential tensions, imbalances and dysfunctions between supervisory strands that are likely to occur under single supervisor models.

091 In a nutshell, the Twin Peaks model is said to present two main advantages in comparison to other models: (i) clarity of the key objectives to be pursued by each supervisory authority, free from flawed prioritisations that usually to reflect misaligned perspectives and interests (in spite of the undeniable persistence of contact points between the prudential and the market conduct strands); and (ii) clearer and sounder accountability of each supervisory authority in terms of performance in the pursuit of the priority goals assigned to it.

092 Accordingly, the 'Twin Peaks' model should contribute to protecting prudential supervision from undue interference motivated by more short-term and politically appealing considerations of market conduct supervision aimed at consumer protection, while at the same time ensuring high quality standards of transparency, market integrity and consumer protection.

093 In other words, the theoretical goal of Twin Peaks is to enhance the quality levels of conduct of business supervision by answering to the novel challenges posed by the need to protect consumers of complex financial products, without jeopardising the intensity and efficacy of prudential supervision, which typically adopts a more long-term perspective.

094 Conversely, an over-specialisation of the know-how and instruments of analysis needed for each type of supervision

also carries significant risks, as it may undermine the legal and economic consistency and interdisciplinary spirit that should generally guide financial supervision.

095 Despite the aforementioned risks, the Twin Peaks model has the advantage of being able to foster different *supervisory cultures*, allowing *prudential* and *market conduct* supervision to develop and mature free from the internal institutional tensions and respective dysfunctions associated that are generally associated with other supervisory models.

096 Lastly, the 'Twin Peaks' model may also have a greater structural capacity of adaptation to financial innovation and changes in nature of systemic risks, when compared to the single supervisor model (but without its inherent disadvantages).

097 There is, however, a risk of over-simplification when describing the Twin Peaks model as a virtuous alternative that combines the advantages of an integrated single supervisor model, without its disadvantages in terms of conflicts and tensions.

098 In fact, the tensions associated with the *integration* of financial supervisory functions are not eliminated, to a large extent, by the 'Twin Peaks' model, but simply moved to a different institutional level. Furthermore, the 2007-09 international financial crisis made clear that the broader 'systemic protection' objective required an enhanced macroprudential supervision, as well as a deeper proper knowledge and scrutiny of the financial sector, involving as such an institutional dynamic that the 'Twin Peaks' model alone could not address.

099 At the same time, the new difficulties and pressures to which institutional supervisory systems are subject to also require an enhanced *coordination* between the various supervisory interventions central to these systems, which the standard 'Twin Peaks' model cannot automatically ensure.

100 One of the major risks posed by the 'Twin Peaks' model lies, paradoxically, in what is normally considered to be one of its major advantages: the clear focus of each supervisory authority on certain core aims of supervision, with different and, at times, contradictory requirements, may result in the *externalisation of these conflicts and tensions*, rather than in its elimination from the system.

101 Whilst such tensions tend to cause dysfunctions, producing shortcomings and gaps within a single supervisory authority or sectoral authority combining prudential and market conduct supervision (because of the undue predominance of one over the other); under a 'Twin Peaks' model, they may result in an *externalisation*, which can be magnified into potential conflicts between the two objective-oriented supervisory authorities.

102 Likewise, the development of and focus on markedly different supervisory strategies and cultures may also generate major risks as regards the optimal levels of relevant information exchange between the two supervisory authorities. To some extent, the objective-oriented supervision and its propensity for institutional tensions, is likely to reduce the incentives for achieving optimal levels of information exchange between the two supervisory authorities.

103 In addition to the risk of potentially developing a conflict or shock between different supervisory strategies, the Twin Peaks model is also not immune from public pressures demanding a greater focus on consumer protection to the detriment of prudential objectives (similarly to what is observed under a single supervisor model).

104 Conversely, recurrent financial imbalances in a number of financial institutions may, in limited occasions, lead to an excessive focus on the prudential supervisory authority to the detriment of the market conduct supervisory authority.

105 In parallel, the over-specialisation in either *prudential or market conduct supervision*, and the erosion of a culture of checks and balances product of a virtuous tension between supervision methodologies may also degenerate into overly-bureaucratic authorities. Despite their diverging goals, prudential and market conduct supervision are not mutually exclusive. Hence, their forced separation may result in a less proactive and slower response to new problems, due to the lack of a joint vision that could otherwise result from the dynamic interaction between the *prudential* and *market conduct* approaches when scrutinising financial institutions.

106 Moreover, 'Twin Peaks' models also entail operational risks due to the highly technical and functional specialisation by objectives that may hamper the necessary coordination among authorities, at both technical and institutional levels.

107 Thus, somewhat paradoxically, 'Twin Peaks' models may not only fail to fix the *coordination* of financial supervisory tasks and functions, but at the same time pose hurdles and exacerbate the need for *coordination* and communication among supervisors (even more so than in traditional sectoral supervisory models).

108 It is therefore safe to argue that the Twin Peaks model does not in itself provide a solution for issues of coordination between supervisory functions. Hence, any reform conducive to the introduction of a 'Twin Peaks' model is not likely to fix such *coordination* issues, which are increasingly worrisome for the operation of the various supervisory systems. For that reason, additional specific institutional solutions are required of an increasingly hybrid nature and generally compatible with a large spectrum of supervisory architectures.

109 Australia, which pioneered the 'Twin Peaks' model also provides a paradigmatic case study in that sense. Indeed, Australia incorporated from the outset a number of hybrid elements, in a way that underlines how specific organisational aspects oriented towards coordination of supervisory functions can transcend any particular supervisory architecture and give rise to hybrid variations of financial supervision models.

110 The hybrid element which ends up defining the Australian model, and somehow explains its longevity, is the paramount importance that is assigned to the organisation of the *coordination of functions* among financial supervisors.

111 This indicates a legal and institutional culture of coordination at the core of Australia's supervisory architecture, as recognised by the key players in this system. Its main corollary was the establishment of a Council of Financial Regulators, which centralises cooperation among the various supervisory authorities. The Council was established on a non-statutory basis, comprising members from the Australian Prudential Regulation Authority, the Australian Securities and Investment Commission, the Central Bank and the Treasury; and it is chaired by the Reserve Bank Governor, with administrative support provided by the central bank.

112 The Australian Council of Financial Regulators has major similarities with the CNSF in Portugal. It functions as an organisational hub for the regular exchange of information between supervisors and, primarily serves as basis to reach operational agreements that set the terms for the coordination of the work between supervisors. This structure thereby enables the formation of permanent functional links between

supervisors through an intense participation of their staff.

113 Building upon the role played by the Australian Council of Financial Regulators, the recent reassessment of the Australian supervisory model conducted through the November 2014 Financial System Inquiry Report, (FSI-2014 Report) gave a strong emphasis to issues of supervisory coordination of the various supervisors, considering them essential for a balanced financial system.

114 Although the final version of the FSI-2014 Report did not formally propose overall changes to the legal status of the Council of Financial Regulators, there is a reference to the discussions held by stakeholders during the public consultation, where it was argued that this entity should be given *statutory recognition* and autonomous substantive powers that would go beyond consultations and coordination of the exercise of each supervisor's powers within the Council.

115 This proposal for institutionalisation and consequently strengthening of the role of the Council of Financial Regulators shows that developments and possible changes to this *coordination body* are perceived as being at the core of the Australian version of the 'Twin Peaks' model.

116 Accordingly, the debate around the reinforcement of the role of supervisory coordination bodies at the core to supervisory architectures has set in motion at international level ,(as illustrate, e.g., with the recent public discussion around the adoption of a 'Twin Peaks' model – also featuring *hybrid* elements – in South Africa).

117 In the second international experience with the 'Twin Peaks' model, the Netherlands, the *coordination* element, chiefly implemented through more detailed and regularly revised *cooperation agreements* between supervisors was arguably less effective (at least, in comparison to the importance Australia placed upon its Council of Financial Regulators).

118 In fact, certain cases provide evidence that the Dutch *coordination* framework failed to prevent diverging public assessments by De Nederlandsche Bank and Autoriteit Financiële Markten (Dutch prudential and market conduct supervisory authorities, respectively).

119 The Dutch version of the 'Twin Peaks' model was also not safe from problems in other areas, particularly in what concerned the prudential pillar and the increased requirements brought about by the greater complexity of the new macroprudential supervision. This type of issues tend to arise when the governance structure of the prudential supervisor must be adapted to allow for more assertive decisions or interventions in cases of macroprudential importance. In light of the above, it seems that the best organisational framework for the Dutch prudential supervisor, in terms of balanced interface between the microprudential, macroprudential and monetary policy areas, is yet to be achieved.

120 Following the first two archetypal cases of international adoption of the 'Twin Peaks' model (Australia and the Netherlands), a second wave of reform of supervisory architectures can be identified, which is characterised by the implementation of several variations of this model (comprising highly variable hybrid components).

121 However, it is still difficult to claim that we are facing a genuine converging international movement towards making this the new dominant model in financial supervision. Furthermore, at the supranational EU-level, forward-looking references in the de Larosière Report indicating possible developments in the European financial supervisory architecture in the direction of a variant of the 'Twin Peaks' model have not materialised, with financial supervision following a different path after the

creation of the Single Supervisory Mechanism within the ECB (SSM).

122 The French case also fits in the in this second, most recent wave, of implementation of the 'Twin Peaks' model, which is marked by increasingly *hybrid* designs that shift away from the original base model. In France, coordination of the system's pillars and safeguard of the financial system stability as a whole was entrusted to the Council for Financial Regulation and Systemic Risk (*Conseil de Régulation Financière et du Risque Systémique* – COREFRIS). This body was eventually replaced in 2013 with the High Council for Financial Stability (*Haut Conseil de Stabilité Financière* – HCSF) with significantly strengthened tasks and powers. These include (for financial system stability purposes) binding legal powers besides the general ability to issue recommendations or guidelines, in what clearly corresponds to a qualitative jump, transforming the *Conseil* in an *intermediate and coordination body* that is not a mere emanation of its member authorities.

123 While keeping the system's two core pillars, this new coordination body in France emerges as a key feature of this second consolidation stage of a composite and '*sui generis*' 'Twin Peaks' model. The *Conseil* embodies such wider trend for *hybrid* and *sui generis* models that has been spreading across various jurisdictions, where a key coordination body is given the following powers:

- coordination of the macroprudential supervision policy;
- the centralisation of permanent cooperation and information exchange among financial supervisory authorities.

124 In addition, the South African implementation of the Twin Peaks model also raises two major issues that contribute to the discussion surrounding this second international wave of adoption of models based on 'Twin Peaks'. The first concerns the introduction of a variation consisting of the establishment of an *autonomous prudential authority within the central bank* but with true operational independence provided by law; the second relates to the *coordination* of the various financial supervisory functions, which likely emerges as the key balancing element regardless of the base models (and hybrid variants) used.

125 This latter topic has been widely discussed as part of the ongoing reform in South Africa and largely benefited from the public debate around the aforementioned FSI-2014 Report in Australia. In this debate certain stakeholders have favoured a more institutionalised (and hard law) model of financial supervisor coordination, in the shape of a Council of Financial Regulators, which, unlike the analogous body in the Australian 'Twin Peaks' model, may have its own statutory basis or exist as an autonomous legal person with statutory recognition.

126 Critical comparative analysis of some of the main and more representative experiences in implementing the 'Twin Peaks' financial supervision model reveals that the model's advantages tend to be presented in an *over-simplified* way.

127 First of all, there is a large degree of *over-simplification* in presenting a theoretical single form for the Twin Peaks model, with advantages inherently associated with its specialisation by objective. In fact, practice has led to a trend towards the implementation of increasingly *hybrid* versions deriving from the 'Twin Peaks' model. These versions *combine elements from various models* and introduce *substantial variations in the institutional design of the prudential pillar*, namely by *increasingly allocating it to central banks*, often via quite innovative designs of institutional structures involving the establishment of autonomous, subsidiary entities within the central banks.

128 This trend towards more complex and diversified designs of *hybrid* models similar to the 'Twin Peaks' is also a

result of the greater complexity which was introduced by the *new macroprudential element* and by the control of systemic risk over the whole financial system.

129 Such trend draws strongly on the specialised skills and know-how of *central banks* while considerably reinforcing the cross-cutting coordination needs among various supervisory functions and authorities, regardless of the institutional base model used. The key importance of these coordination functions to the supervisory system highlights the significance that *specific bodies fully conceived to perform it have in coordinating supervisors*, no matter how directly associated with the exercise of macroprudential supervision such bodies may be. This shifts the core of the reforms of supervisory architectures towards coordination aspects and mitigates the importance and reach of the basic institutional model adopted (*sectoral* or *'Twin Peaks'* or, even, *single supervisor*).

130 A comparative analysis of the actual implementation of the multiple variations of the 'Twin Peaks' model (more specifically, its *hybrid models*) – has actually shown that the model's assumption of superiority as a facilitator of coordination is also an over-simplification of reality.

131 Even if some analyses indicate that this model is less prone to functional overlapping and other associated conflicts than the sectoral model – as well as less prone to internal conflicts of interest in comparison with the single supervisor model – the empirical assessment of its operation suggests otherwise.

132 In fact, these conflicts of interest may be more acutely *externalised*, and tend to be greater when managing crisis situations. The risk of overlapping may rapidly turn into: (i) discontinuities or gaps in supervisory interventions, with each authority focusing on the core areas of their own supervisory strategy and underestimating the links between market conduct and prudential problems, and (ii) situations of direct conflict due to greater communication difficulties among authorities, which may also provoke crisis situations, thus calling for coordination mechanisms.

133 In a nutshell, recent international trends have assigned a greater importance to the *central coordination* of supervisory functions in all supervisory architectures. This encroachment surpasses each system's basic institutional matrices and emerged as a key factor for the balance of any supervisory system. Accordingly, pure theoretical models have increasingly lost ground, whilst hybrid supervisory structures prevail primarily due to the incorporation in supervisory architectures of a cross-cutting macroprudential supervisory function, focusing on the financial sector as a whole, and the on need to find the best organisational formulae to link supervisory functions with other related functions (e.g., *resolution* functions).

134 In addition to these trends, the design of an overall reform of the institutional architecture of financial supervision in Portugal should necessarily take into consideration the new EU constraints post- establishment of the CNSF in 2000 and 2009 Public Consultation. In fact, recent EU developments failed to confirm the Larosière Report initial outlook regarding the deepening of a European supranational system through models close to the 'Twin Peaks' solution. Instead, we have observed a qualitative leap in that supranational construct through the creation of the SSM based upon the pre-existing institutional (*sectoral*) structure in the European supervisory system.

135 Besides these factors, there are also extremely high organisational *transition costs* (transaction and efficiency costs), inherent to any structural changes to the national supervisory model, which also favour a more gradual, contained and balanced reform of the national supervisory model, focusing

on the *critical aspect* of the *coordination* of the various financial supervisory functions.

136 This claim warrants a look into the virtues and scope of a reform of the national financial supervision architecture. Along the abovementioned lines, this potential reform should focus on the *coordination* of financial supervisory functions, which, given the current Portuguese model featuring *hybrid* components (albeit with a *sectoral* basis), widely means analysing the *possibility of reforming the role of CNSF*.

137 Bearing in mind the CNSF's framework and its amendments so far, there are two types of limitations to the operation of the Council that are important to correct.

138 The first type of limitation which unduly restricts the CNSF's purview results from a lack of institutional basis. The Council has no legal personality and institutionally-wise is a relatively informal forum for the coordination of prudential supervisory authorities (albeit also comprising an authority chiefly involved in market conduct supervision), with the ensuing lack of autonomous (legally binding) powers, namely (regulatory powers, executive supervisory powers (powers of inspection), or powers to impose sanctions.

139 Furthermore, given its essentially informal nature devoid of legal personality and institutional basis, the Council is entirely dependent on the technical and human resources of each sectoral supervisory authority. Hence, the CNSF relies on dissimilar resources structures and even heterogeneous financial statutes and autonomy levels (differences that have even become more acute following the much criticised approval in 2013 of the framework law on national regulatory authorities).

140 The CNSF weak institutionalisation and high legal informality have been somewhat offset by a legal praxis practice, and by informal proceedings which have gradually evolved, particularly in the course of the past decade. Hence, although its original statute that has not been decisively amended yet, a *'de facto' institutionalisation* of the CNSF, although limited and incomplete due to the gaps of its legal framework, has actually occurred.

141 Such developments of the past few years in CNSF's operation involved, *inter alia*, the establishment of a Coordination Committee as an informal body (not envisaged in the CNSF's legal framework) that ensures a secondary level of organisation (of variable stability). This level adds-up to the first organisational level (the only one with a statutory basis) corresponding to the sessions for permanent members of the CNSF, which take place at least once every quarter (aside from extraordinary meetings); as well as the regular establishment of working groups on cross-cutting matters linked to financial system supervision.

142 In any event, a substantial part of the matters covered by these working groups is associated with the transposition of European directives or the development of other European regulations; whilst permanent and effective coverage of key problems concerning the *coordination* of the financial system's supervisory activities is not achieved or actually imposed by the applicable statutory rules.

143 To sum up, despite the clear relevance of these informal developments (from a soft law perspective) which led to a *de facto, albeit mitigated, institutionalisation* of the CNSF, the fact is that the availability of skilled technical resources cannot be guaranteed on a permanent basis by the three supervisory authorities. Furthermore, the members of the CNSF's ad hoc working groups report on their actions to the supervisory authorities that employ them, thus further limiting the purview of the CNSF.

144 In parallel, the *bilateral memoranda of understanding* between supervisors concluded within the framework of the CNSF include commitments as to: (i) the exchange of information, (ii) the coordination of specific actions, and (iii) chiefly, the management of crisis situations, which have not proved satisfactory. In fact such commitments are overly-generic and formal being unable to effectively ensure a permanent basis for technical cooperation in specific core financial supervision matters, so as to prevent overlapping actions and, to bridge important gaps in the intervention of supervisors.

145 A second type of limitation which unduly restricts the CNSF's purview is the uncertainty regarding the matters subject to coordination and the minimum levels for information exchange. As a consequence, there is an over-reliance on a case-by-case approach by each supervisory authority.

146 In fact, there is no legal specification, through appropriate legal types, of particular matters that, due to their cross-cutting importance for the financial system as a whole, would make it mandatory for the CNSF to act in a way that is aligned with the European financial supervision architecture.

147 Reference is made here, namely, to the establishment of a *joint committee of European supervisory authorities* (European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA), bearing in mind the specification in the regulations governing each authority of a minimum set of matters where the joint committee ensures the three European authorities *"shall cooperate regularly and closely and ensure cross-sectoral consistency"* (as, e.g., provided for in Article 54 of the Regulation (EU) No 1093/2010, of the European Parliament and of the Council, of 24 November 2010, concerning the establishment of EBA, OJ L 331/12 of 15/12/10).

148 This lack of clarity and detail in the allocation of tasks and powers to the CNSF, which cannot be merely overcome by soft law and informal proceedings (with an ad hoc and reactive agenda driven by EU legislation), does not contribute to the prevention of tensions or to overcome potentially meagre coordination of the supervisors' work.

149 By projecting the general risks posed by the 'Twin Peaks' to the *Portuguese financial system* supervision setting, it is possible to pinpoint predominantly *structural or circumstantial reasons*, which call into question more radical reforms of the national supervision architecture (namely, through the adoption of the 'Twin Peaks' model) Conversely, those reasons favour *more contained and gradual developments in Portuguese model of financial supervision* by *transforming the CNSF* through the correction of the shortcomings, outlined above, associated with its weak institutionalisation.

150 This essential *reform* focused on the *transformation of the CNSF* may also be consistently combined with *other adjustments to the supervisory model* that may expand a number of *hybrid components* incorporated in the past few years. This could be done, in particular, by expanding the already ongoing movement towards the expansion or reinforcement of the powers for market conduct supervision of financial products traded in securities markets, regardless of the type of institution involved (see point 20 above).

151 Such an adjustment would imply the strengthening of the *hybrid* component of the national (sectoral) financial supervision model involving a more *functional* component of supervision by *type of activity*. In this case, this refers to activities carried out in securities markets or even, at a different qualitative level, to an *expansion of the market conduct supervision of multiple financial products* even when not traded in securities markets (focused to some extent in

the institutional pillar of the national system of supervision *where market conduct supervision is already prevalent*), without jeopardising the predominantly *sectoral* supervisory model, thus mitigating the transition costs that would otherwise result from more radical reforms.

152 Hence, this possible variation could lead to a *reinforcement of the market conduct supervision over multiple financial products* by the supervisor which is most suited to perform such functions (due to its original role of protecting financial services consumers in capital markets). This avenue for reform should be *combined with*:

- *an effective coordination of the scrutiny over various financial products mandatorily conducted by the CNSF* (as described in points 176 to 179 below, as one of the normative proposals to transform this CNSF); and
- the strengthening of the scrutiny over the *prudential consequences* resulting from the trading of these financial products for all financial institutions involved. This scrutiny should be carried out by the two sectoral supervisors (of bank and insurance), without prejudice to their participation, at a different level, in a more effective *coordination* of market conduct supervision over various financial products, that would be a mandatory domain of intervention of CNSF, as envisaged above).

153 In any event, this potential alternative adjustment of the Portuguese model of financial supervision, with the aim of *reinforcing or concentrating market conduct supervisory elements in one of the three institutional pillars of this model* should always be made consistently with the major international trends supra identified in terms of comparative analysis of institutional architectures of supervision (and without changing the underlying tripartite matrix of the Portuguese model. Furthermore, and also in line with major international trends, this reform should always maintain its *focus* on the reinforcement of the *coordination* aspect at the core of the system; i.e., through the institutional reinforcement of the CNSF in several areas.

154 Taking the actual conditions in Portugal as a starting point for the analysis of possible or desirable reforms to the national financial supervision model, it is also worth looking into predominantly *circumstantial* reasons that also favour more gradual and mitigated reforms of this model.

155 These *circumstantial* reasons are linked to the difficulties and disproportionate risks, which supervisory models specialised by objectives (*prudential* and *market conduct*) give rise to in the immediate aftermath of a major crisis affecting systemically important institutions. Such a crisis which occurred in Portugal in the wake of other situations of tension in the Portuguese financial system naturally tends to exacerbate the typical tension between *market conduct* and *prudential* supervision (as clearly demonstrated by the recent BES/GES crisis and by previous crises associated with Sociedade Lusa de Negócios (BPN) and Grupo Rentipar/Banif, which triggered a series of problematic public interventions).

156 In the current stage of the Portuguese financial and supervisory systems, this specific circumstantial context would, in all likelihood, contribute to exacerbate tensions between market conduct and prudential supervision, should the 'Twin Peaks' model be adopted, as such, in the near future. Indeed, given the often understated major risk of an *externalisation of conflicts of interest* in the 'Twin Peaks' model (with the transposition of the internal conflict between the *prudential* and *market conduct* spheres in a single supervisor to conflicts or tensions between the specialised supervisors), it is highly likely that these risks would end up materialising.

157 In parallel, the substantial transition and efficiency costs associated with wider and more radical reforms of institutional financial supervision models, corresponding

to *structural* reasons, which condition wider reforms, may also be *circumstantially* problematic in the wake of situations of crisis or tension. These costs recommend the reduction, to the largest possible extent of unpredictable or random factors and discontinuity problems that, inevitably, result from the functional and technical adaptation to wholly new institutional and organisational structures.

158 In addition, these *transition costs* also tend to increase when more radical reforms are applied to more consolidated supervisory architectures, as in the case of Portugal since the late 1990s. This contrasts, for example, with Spain, where insurance supervision in their *sectoral* model was neither stabilised nor converged with the other sectoral supervisors.

159 Considering the two key types of *limitations* to the work of the CNSF (already identified supra) and the set of *structural* and *circumstantial reasons* that in the case of Portugal argue in favour of more contained and gradual reform of the national supervisory model (as an alternative to more drastic transitions towards single supervisor or 'Twin Peaks' models), there is ground to sustain that the reform should focus on the *transformation of the current CNSF* (without prejudice to a number of relatively minor readjustments to the intervention powers and fields of intervention of each of the three supervisory authorities).

160 In view of the analysis above and the key aspects of a balanced coordination of different financial supervisory functions as well as the underlying core supervision goals, this transformation of the CNSF should be based upon three essential elements:

- firstly: adoption of amendments to the institutional statute of the CNSF envisaging the establishment of an own permanent technical staff within the Council with sufficient means to centralise, on a stable basis, effective coordination of supervisory functions that are chiefly conducted by the three existing supervisory authorities;
- secondly: typify the specific areas and topics that would fall under the CNSF mandatory intervention; and
- thirdly: alter the Council's organisational structure and internal decision-making mechanisms and procedures, to ensure greater continuity in its work and a *better balance among its three supervisory authorities*; that would be bound to ensure a greater shared responsibility in the coordination of supervisory functions and ensuing actions.

161 These three strands of a reform of the institutional architecture of financial supervision centred around a major revamp of the CNSF do not in any way imply the introduction of another supervisory authority as such in the national financial supervision architecture, with the ensuing risks that would arise from it in terms of complexity and hardship for purposes of coordination and even of accountability of the relevant actors involved in financial supervision. Instead, such reform would primarily aim at reinforcing an effective standing coordination body, as an emanation of the three authorities.

162 This *intermediate structure* emanating from already existing authorities should thus be reinforced, without transforming it into a full blown separate entity (i.e. dissociated from the three supervisory authorities which are thereby coordinated). This should enable it to act as a hybrid element within the national supervisory model, by taking on a key *coordination* role, thus embodying the most recent trends in terms of financial supervision architectures across various jurisdictions.

163 The reinforcement of the CNSF's role of coordinating financial supervisory functions will necessarily entail the establishment of a standing technical body. Hence, the Council will no longer be fully dependent on ad hoc working groups,

or other casuistic technical support from the three supervisory authorities, and on the mere logistical secretariat support provided by Banco de Portugal.

164 This reform would require a flexible and very selective standing technical body with particularly high technical skills, comprising a small number of members. Despite this may be attained though several institutional formats, it is argued that the transformation of the CNSF into a new legal entity governed by public law appears to be the most consistent method to attain the referred goal as well as to ensure its mandatory permanent areas of intervention of CNSF. Under this solution, CNSF would be transformed into an *administrative independent authority* subject to a special regime pursuant to Article 48 (1) (f) of the framework law on public institutes and not subject to the framework law on national regulatory authorities (similarly to Banco de Portugal, which is one of the supervisory authorities comprising the CNSF).

165 Concomitantly, CNSF's greater institutionalisation should be designed to support a permanent technical staff capable of ensuring (with regard to previously defined matters), the seamless operation of dedicated executive committees and working groups. The latter should partly be comprised of members from the permanent technical staff in the new CNSF, but mainly of members from the three sectoral supervisory authorities.

166 In budgetary terms and consistent with its nature of administrative authority subsidiary to the supervisory authorities, the reinforced CNSF should be supported by mandatory financial contributions by each authority (and, as such, independent from the State budget).

167 A second key aspect in the reinforcement of the CNSF's coordination functions concerns a mandatory legal specification of its operating areas, in both prudential and market conduct supervision. This would strengthen its coordination role going beyond very loose and generic coordination and information exchange commitments arising from the current bilateral cooperation protocols among the three sectoral financial supervisory authorities.

168 To critically assess the possible typifying of mandatory areas of intervention, it is worth looking into the type of matters where the joint committee of the European financial supervisory authorities intervenes, pursuant to Article 54 (2) of the EBA Regulation and other provisions in the EIOPA and ESMA Regulations.

169 This typifying of *mandatory areas of intervention* should be linked to their respective executive coordination by each of the supervisory authorities that are part of the Council. This involves the assignment of coordination tasks to such supervisory authorities either on a *fixed or rotating basis* (without prejudice to the support that is to be provided by the permanent technical staff of the CNSF, in line with the model outlined above).

170 This should result in the creation of a second level in the CNSF's organisational structure with primarily executive functions.

171 Furthermore, this process of institutional strengthening of the CNSF (with typifying of mandatory areas of intervention) should foresee a macroprudential supervision and financial stability vector (besides the microprudential and market conduct supervision vectors).

172 This second basic field of intervention of the CNSF should be the outcome of the strengthening the CNSF's tasks and level of intervention in the field of macroprudential supervision. Furthermore, at a wider level of safeguard of financial stability the remit of CNSF should also comprise areas

beyond financial *supervision (stricto sensu)* although relevant for its consistency seen through the lens of financial stability, especially as regards aspects pertaining to *banking resolution*.

173 These prospective developments should be associated with a possible readjustment of the fields of intervention by the three sectoral authorities in areas which do not correspond *stricto sensu* to financial supervision, with an emphasis on the *institutional and organisational restructuring* of the banking *resolution* function.

174 In accordance with this systematic approach in what concerns (i) microprudential and market conduct supervision and (ii) macroprudential supervision and financial stability, it is important to typify a *range of issues to be legally classified as areas subject to mandatory intervention by the CNSF*, without prejudice to other outstanding areas of intervention, that may be subsequently established by the decision-making board that is to be set up in the restructured Council.

175 In this context, a first area of mandatory intervention should correspond to the general monitoring of the supervision of financial conglomerates and corporate groups, present in more than one financial subsector, even if not strictly falling under the EU law formal category of 'conglomerate'.

176 A second area of mandatory intervention should cover the monitoring of *complex financial products* from a market conduct perspective (within the meaning of Decree-Law No 211-A/2008 of 3 November 2008, which strengthened the CNSF's coordinating role at this level, albeit in a still rather insufficient or incomplete manner) and, more widely, of *retail investment products* (which coincidentally are also subject to specific intervention by the Joint Committee of European Supervisory Authorities, pursuant to Article 54 (2) fourth paragraph of the EBA Regulation, cit., and the corresponding provisions of the EIOPA Regulation and the ESMA Regulation).

177 This should provide an *integrated or horizontal* overview of the market conduct scrutiny of financial products, thus enabling an appropriate control of the main *conduct risks* associated with such products, particularly those involving *miss-selling* or *self-placement* practices, and allowing the establishment and development of more active market conduct supervision methodologies.

178 In light of the evolving international best practice in the field, this would require a number of actions, including:

- the strengthening of relatively standardised procedures for the prior oversight of pre-contractual information, combined with certain specific types of supervisory intervention, such as the utilisation of the so-called 'mystery shopping' exercises;
- the diversification of types of inspection initiatives following in a more intrusive and systematic pattern, although based on sampling factors previously defined by supervisors, with special focus on certain product distribution strategies;
- the strengthening of supervisory actions to check effective means for the internal control and governance of the decision-making process regarding the design of investment products and their marketing, with a view to timely detect important *miss-selling risks*, in line with the principles set out in the Joint Position and Guidelines regarding *"manufacturers' product oversight and governance processes"* of the Joint Committee of the European Financial Supervisory Authorities.

179 This new area of mandatory intervention area by the CNSF should to be monitored predominantly from a market conduct perspective by an executive sub-committee of the restructured CNSF, and

coordinated by one of the three authorities that are part of this Council – according to a *new organisational structure* developed below. However, this type of strengthened, horizontal monitoring of investment products should also allow for greater synergies and interaction between this market conduct perspective and the potential prudential consequences arising from the occurrence of specific market conduct risks in certain products.

180 A seamless framework of synergies and interaction – without monitoring gaps or disruptions depending on the type of product – should be developed. This would allow, in turn, widening the lens of supervisory scrutiny from a consumer protection perspective at product level, towards the safeguarding of public confidence in the financial institution involved in the respective transaction. That should entail a proper prevention and control – from a chiefly prudential perspective – of the considerable reputational risks that may impact that particular institution in certain situations. Such prevention and control should be continuously ensured by the supervisor primarily responsible for the prudential supervision of the institution in question, although benefitting from coordination at the CNSF level and of a horizontal market conduct monitoring of the investment products at stake).

181 A third area of mandatory intervention by the CNSF should include the establishment and regular review of *"senior management regime – accountability"* – meaning requirements common to the senior management level of financial institutions operating in the different subsectors of the financial system, in accordance with a model to be subsequently defined, and very much in line, e.g., with the *Supervisory statements* of the *Prudential Regulatory Authority* (of the Bank of England) on (executive and non-executive) *senior management functions* and their *accountability*.

182 A fourth area of mandatory intervention by the CNSF should include the supervision of entities that ensure external scrutiny of financial institutions, especially auditors, as well as actuaries (in the insurance area). Lack of *coordinated* supervisory intervention in the quality and standards of the external audit of financial groups and failure to share the monitoring of those standards among all the supervisors may in fact generate the wrong incentives in terms of the operational interface between those external auditors and financial supervisors.

183 It is paramount to develop a more interventionist methodology in the context of the relationship between financial supervisors and those auditors – on account of some recent extremely negative deficiencies in external auditors' control of financial groups. However, its actual effectiveness will largely depend on the capacity to develop such a methodology across the whole spectre of the financial sector. Clearly, this should therefore constitute a common area of mandatory intervention by the CNSF, thus ensuring a coordinated interface to the largest extent possible between all the financial supervisors and external auditors or other external entities controlling financial institutions.

184 A fifth area of mandatory intervention by the CNSF, also under the remit of a particular executive sub-committee of this Council, should comprise jointly scheduled and coordinated on-site inspections of financial institutions and action plans in this field. This may involve either joint actions established and implemented though this particular area of intervention of the CNSF, or, predominantly, on-site supervision actions by each of the authorities that are part of the Council, in a duly coordinated form in order to avoid overlaps or other discrepancies or gaps.

185 In any case, it is important to duly establish and implement at such level of jointly coordinated on-site inspections a clear caveat with the *limits* imposed on this national procedure for coordinating inspection or supervision activity that derive from the new powers to act in this field, at the supranational

level, by the Single Supervisory Mechanism (SSM), within the framework of the European Central Bank in the field of banking supervision [as regards significant credit institutions under its direct supervision and currently supervised through the so called *Joint Supervisory Teams* (JST)].

186 A sixth area of mandatory intervention by the CNSF should include measures to combat money laundering, taking as a benchmark here the issues specified as intervention areas attributed to the Joint Committee of the European Supervisory Authorities.

187 A seventh area of mandatory intervention by the CNSF might include the development and provision of an integrated system of regulatory and supervisory information, which might represent an important step towards a truly integrated approach in the management of information for supervisory purposes. This area of intervention should include, *inter alia*, procedures to define minimum requirements for the exchange of information at CNSF level by the three sectoral authorities participating in this Council, as well as the regular review of those minimum duties of exchange of information (as required to properly monitor relevant market developments), and the establishment of specific obligations of exchange of information in case of crisis or of problems in certain financial institutions, pursuant to specially designed warning indicators.

188 Besides microprudential and market conduct supervision aspects, the envisaged reform of the CNSF should also considerably strengthen the role of this Council in macroprudential terms [as this body is better equipped for that purpose than the National Financial Stability Committee (CNEF)]. The CNSF would thus cease to play a purely consultative role (as enshrined in its 2013 reform) and should be empowered to approve – with more pro-active intervention of the various supervisors and of other entities – *guidelines* in this field, to be further *developed and implemented by the national macroprudential supervisory authority*, which would continue to be Banco de Portugal.

189 In the framework of this second pillar of a fully restructured CNSF, encompassing greater institutionalisation of a large sub-area of general safeguard of the financial system as a whole, a greater intervention by this Council in pursuing wider financial stability objectives should also be considered, thereby covering also areas beyond the remit of financial supervision but which are nonetheless deemed to be related or relevant for it, including in particular banking *resolution* aspects.

190 This involves repositioning the restructured CNSF at the centre of the national supervisory system, within a wider context of possible readjustment of the three supervision authorities' fields of intervention in areas beyond supervision *strictu sensu*, especially in what concerns a desirable *readjustment of Banco de Portugal's intervention in resolution matters*.

191 The EU framework sets forth a dual set of requirements that must be observed when ascertaining the available options in such domain of resolution: (i) close coordination and functional interaction between supervisory and resolution authorities and, (ii) "adequate structural arrangements" put in place to ensure operational independence and prevention of conflicts of interest, pursuant to Article 3 (3) of Directive 2014/59/EU (on the recovery and resolution of credit institutions and investment firms).

192 In view of this double requirement of EU regulations, three major options have prevailed in Member States' *praxis*:

- The first option (a) corresponds to the solution adopted in Spain, to create a national resolution authority independent from the banking prudential supervisor, whether this supervisor is located or not within the central bank.

- The second paradigmatic option (b) corresponds to the solution adopted in France, to create a national resolution authority headquartered in the central bank (which also acts as banking prudential supervisor), but as a true subsidiary entity with highly strengthened autonomy, which in France's case takes the form of a dedicated Council within the *Banque de France – Collège de résolution* versus a different *Collège de supervision*. This is a somewhat unique model of establishing an *institution within another institution*, but which undeniably involves a much higher level of autonomy, when compared, for instance, to the model adopted by the Portuguese law.
- The third paradigmatic option (c) corresponds to the solution currently enshrined in the Portuguese law, whereby the functions of the national resolution authority have been fully assigned to Banco de Portugal. These functions cover a complex combination of preventive resolution powers and executive resolution powers, with the latter including powers to *"implement resolution measures and determine the elimination of potential obstacles to the implementation of such measures"*. This area of activity within the Bank is entrusted with autonomy, pursuant to EU law, but not to the level of intensity or with the guarantees of autonomy provided by the French system).

193 In this context, a comparison of the best alternatives that have been used in this field by EU Member States, within the margin of discretion permitted by European legislation, seems to indicate that the Spanish and French cases present important advantages.

194 In view of the highly significant risks associated with conflicts of interest – set forth or implicit in EU legislation – between, on the one hand, the executive component of *resolution* functions (i.e. after the resolution procedure is triggered based on conditions that are essentially detected by the banking supervisor) and, on the other hand, the core prudential *supervisory* functions, it is argued that an appropriate level of separation between the spheres of intervention of resolution (particularly as regards their executive component) and of supervision should be more intensively pursued.

195 Accordingly, it seems that both the Spanish and French options are preferable to the model currently adopted in Portugal, even though the French solution appears more balanced after a careful weighing in abstract terms of the advantages and risks inherent to each solution: the degree of separation of the supervisory and resolution functions is more radical in Spain than in France given the Spanish option for a full institutional separation solution.

196 Actually, such French option reconciles important *'synergies'* between the exercise of resolution and supervisory functions – through a privileged channel of flows of information and assessment of aspects bearing relevance to both functions – with an actual *separation* and elimination of overlapping designed to *prevent conflicts of interest*. It also has the advantage of not adding an additional layer of institutional complexity to the system by creating yet another entirely separate entity – even though it must be acknowledged that this would only replicate the structure created within the framework of the European institutional architecture, involving a separation of functions between the SSM and the Single Resolution Board (SRB), although combined with *ad hoc* mechanisms to ensure the necessary close interaction and cooperation between both entities (namely through the Memorandum of Understanding between the ECB and the SRB of 22 December 2015).

197 On the other hand, the hypothetical advantages of the French solution may be adversely affected by the particularities of the institutional context or dynamics of each jurisdiction, which may hamper the effective operationalisation of a rather complex model

characterised by an *autonomous institution within another institution*. These difficulties tend to build up when this institutional set-up, with its fragile balance, has not been sufficiently tested in the institutional practice of a given jurisdiction (thereby increasing the risks of reaching a satisfactory institutional practice in this area, while amplifying the advantages that a greater institutional clarification designed to avoid conflicts of interest brings as in the Spanish case).

198 Conversely, the solution currently adopted in Portugal seems to be less appropriate for reaching the necessary balance between, on the one hand, the intense operational interaction connecting the resolution and supervisory functions, and, on the other hand, the efficient prevention of conflicts of interest between such functions that would negatively affect supervision. From a normative standpoint, this justifies a transition either towards the French or Spanish solutions (weighing, in the case of Portugal, the different advantages and risks of these options).

199 In any event, an institutional or organisational restructuring such as the one set out herein should have consequences in terms of the way the *resolution function* is represented within the CNSF financial stability pillar.

200 In light of the above, *two solutions* may be put forward for ensuring such *representation of the resolution function in that CNSF pillar*:

- either through the chairman of a future separate national resolution authority, in case of adoption of a solution similar to the Spain one;
- or through a representative of a new specific resolution council within Banco de Portugal, with more autonomy and institutional differentiation from the Bank – to be more specific, such representative should correspond to a member of such council not involved in the supervisory arm of the Bank; this, in case a solution similar to the one adopted in France is contemplated, this representative *should be included in the General Board of a restructured CNSF (as described infra, e.g. 203.), when this Council acts within its particular composition that should correspond to its second pillar of financial stability and macroprudential supervision*.

201 The third crucial aspect of reform envisaged herein for the CNSF involves changes in its organisational structure and decision-making mechanisms and procedures , with a view to ensuring greater continuity and fluidity of its work; as well as a greater balance among the three supervisory authorities that are part of it. Accordingly that is bound to ensure a greater collective accountability of these authorities in terms of effective coordination of supervisory functions and subsequent actions.

202 Against this background, it seems justified to adopt a hybrid solution for the organisational structure and the corresponding coordination of the CNSF and its areas of activity. In line with this solution, Banco de Portugal would cease to take the exclusive lead or coordination of the CNSF (as in the current model), without prejudice to coordination by the Governor of Banco de Portugal of the Board of a reformed CNSF conceived as new legal entity entrusted with public law legal personality. Therefore, the proposed institutionalisation of the CNSF should involve *two organisational levels of operation of this Council*, as a consequence of its new institutional design.

203 A *first organisational level* would correspond to the *General Board* of the new CNSF, somewhat equivalent to the current level of the Council's standing members, and which would be chaired by the Governor of Banco de Portugal. Complementing this, the enhanced institutional structure of a fully reformed CNSF requires a *second organisational level*, corresponding to an *Executive Committee*,

whose coordination should alternate among the Chairs of the three national financial supervisory authorities.

204 A six-month rotation period may be considered adequate for the coordination of the Executive Committee, similarly to the framework adopted for the Joint Committee of European Financial Supervisory Authorities. This *second organisational level* of the new Executive Committee should be the true operational centre of a restructured CNSF, while the General Board would be responsible for establishing and the high level priorities of the CNSF, as well as confirming certain decisions with greater institutional clout, under proposal of the Executive Committee (e.g. the presentation of joint legislative proposals, the creation of new thematic areas of intervention of the CNSF in addition to those set out in the law at each point in time, or the formal exercise of some legally binding powers affecting third parties that may be assigned to the new CNSF).

205 In parallel, the second organisational level of the Executive Committee should comprise *sub-committees* (equivalent to organisational substructures) subject to its general coordination. The main function of these *executive sub-committees* should be to provide an operational framework to the different areas of mandatory intervention by the CNSF that are to be legally typified, as envisaged supra, paragraph175, and following paragraphs (in addition to other working areas which the General Board decides to create, on a permanent or temporary basis, and that may also give rise to dedicated executive sub-committees).

206 This level of organisational structure should also feature a *hybrid solution*, promoting an institutional balance, which is bound to be decisive for ensuring an effective functional commitment of the three participating supervisory authorities to the CNSF (thus correcting certain initial institutional imbalances that failed to incentivise a larger involvement of those authorities in the CNSF).

207 In the context of that hybrid solution, some executive sub-committees – in certain areas – would have a permanent coordinator appointed by one of the three supervisory authorities. Thus, the new legal framework of the CNSF should specify certain areas subject to mandatory intervention by the CNSF, in which a given supervisory authority would be responsible for appointing a representative to coordinate the respective executive sub-committee.

208 Conversely, as regards other areas of mandatory intervention by the CNSF, the respective coordination at the level of the corresponding executive sub-committees would not be permanently assigned, by law, to each authority, but would instead be ensured on a rotation basis by representatives of each of the supervisory authorities, that the latter would appoint for the different periods in question.

209 This organisational structure should also include a permanent Secretary-General of the CNSF, appointed by the Government through a Resolution of the Council of Ministers, who must be subject to a Hearing before the Parliament. This Secretary-General, accountable to the General Board and the Executive Committee, should be responsible for general functions of coordination of the permanent technical staff of the CNSF, which would assist continuously the flows of work of the different executive sub-committees (according to working programs regularly established for that purpose).

210 On another level, since the reformed CNSF would have a second essential pillar corresponding to an area entrusted with the safeguard of financial stability and with macroprudential supervision, the General Board of this new CNSF should have a special composition for that financial stability area.

211 That special composition should comprise, in addition to the Governor of Banco de Portugal and the Chairs of the other

two supervisory authorities, a representative of the Ministry of Finance, of the resolution authority (in its new future organisational form) and a given number of *external members* – to be appointed by the Government through a Resolution of the Council of Ministers, after a prior Hearing before the Parliament and the three financial supervisory authorities – from among persons of recognised standing and adequate professional experience. The appointment of these external members would be in line with the practice in the United Kingdom and France, albeit with different formal contours, of actively involving in the pursuit of macroprudential supervision of independent views of external experts non committed with government functions or at any of the financial supervisory authorities thus widening the capacity for critical and independent assessment of factors pertaining to systemic risk.

212 The institutionalisation of the CNSF now proposed and its mirroring in the organisational structure above described should also take into account the type and extent of public powers that may be conferred on the new Council, as a new independent administrative entity, although chiefly emanating from the three supervisory authorities, as reflected in its General Board.

213 Considering that a new CNSF, as envisaged herein, in spite of the institutional strengthening in question, would be a subsidiary of the three supervisory authorities, it seems appropriate that the legally binding powers granted to it should be limited.

214 In that sense, the initiatives undertaken within the remit of the CNSF should preferably be undertaken under the powers entrusted to the three authorities that are part of the Council.

215 However, it may be considered that, by way of exception, if that is deemed **necessary** to certain types of intervention in the financial sector (especially in light of principles of *necessity* and *proportionality*) the CNSF may be entrusted with the following types of power:

- power to issue its own regulations, with the caveat that its intervention in the banking area is restricted to institutions still subject to the direct supervision of Banco de Portugal, and not interfering in the SSM/ECB's intervention area as regards significant credit institutions (subject to the SSM's direct supervision). It is also important to note, in order to avoid overlaps, that there is also the possibility of intervention by the SSM in non-significant credit institutions, pursuant to Article 6 (5) (b) of Regulation (EU) 1024/2013 (SSM Regulation);
- power to issue certain executive orders to financial institutions – in the form of mandatory adoption of certain measures – similarly to the French *Haut Conseil de Stabilité Financière* (HCSF) (as of 2013), which in fields related to the stability of the financial system holds its own legally binding powers, instead of mere powers to issue recommendations or guidelines;
- direct powers to request information from some entities, even though such power shall or may be satisfactorily exercised through the three supervisory authorities integrating the CNSF.

216 The standard or default solution should, however, correspond to the approval of guidelines by the CNSF with a view to proposing the adoption of regulations, executive orders or the like by the three supervisors comprised in the CNSF, under their own powers.

217 In terms of the overall European context which may limit the scope for reforms of the national financial supervision models of EU Member States (that applying naturally to the Portuguese situation), it must be acknowledged that a true paradigm shift as occurred at two different moments.

218 These moments were (i) the setting up of EBA, EIOPA and ESMA in 2010 and the subsequent development of the banking union and (ii) creation of the SSM from 2013-2014. The European context and outlook were thus profoundly changed as a result of those two key moments in the development of a supranational regulatory and supervisory architecture in the EU.

219 Therefore, the expectations or prospects underpinning the planning for possible reforms of national supervisory models were also drastically shaken in relation to the period of time between 2010-2014.

220 In the context of the creation of the SSM and of the other banking union pillars, we are faced with a series of intertwined elements that give rise to a *new* and more *complex supranational dimension of coordination of multiple elements of banking supervision*, which goes beyond the mere sphere of the SSM's direct supervisory powers over significant credit institutions.

221 Accordingly, this supranational dimension strongly limits the exercise of banking supervision functions by Member States' authorities in the Euro area. As a consequence, it somehow hampers in operational terms the establishment ex novo of national supervisory authorities that might combine these banking supervision functions with other financial supervision segments not subject to the same type of European supranational coordination and intervention. Actually, in such scenarios hypothetical national reforms of the models of financial supervision in EU Member States around those lines would also require an organisational and functional separation of the aforementioned different supervision segments, even if these were formally integrated in the same authority, with the resulting difficulties and inconsistencies.

222 It is, therefore, foreseeable that *supervisory dynamics* of unpredictable consequences will unfold whereby the SSM will seek to obtain other information and assessments incorporating to some extent market conduct supervision data, even if starting from its core typified powers (for *prudential supervision purposes*), and pursuant to the duty of cooperation set forth in Article 6 of the SSM Regulation.

223 Within this European overall context (as described above), in any hypothetical scenario of ex novo creation of national supervisory authorities combining banking supervision functions with other financial supervision segments not subject to the same degree of supranational European constraints, it would ultimately be necessary to organisationally and functionally separate those different supervision segments, even when they were formally integrated in the same authority, with the associated difficulties and inconsistencies that such process would create(depending on the different levels of supranational intervention to which these sectoral segments are subject).

224 In light of *the true paradigm shift* introduced by the creation of the SSM in 2014, it seems clear that the European architecture has not yet stabilised. In fact, the SSM seems to have paved the way to possible overall *dynamics of reform* of that European supervisory architecture, that are prone to be extended to *other sectoral segments* of supervision (in addition to the banking segment). The odds in favour of such developments are even greater because the legal hurdles to this potential expansion of supranational structures of financial supervision related with the so called 'Meroni doctrine' have been gradually fading.

225 Given that such new and potentially overwhelming developments may thus be anticipated in this field, maintaining for the moment basically sectoral supervisory authorities seems to be the most appropriate solution for Portugal, even if with *some appreciable adjustments to their respective powers and areas of intervention* (as contemplated, e.g. in paragraphs 150-153). Such incremental transformations

could generate a true hybrid supervision model in line with the most recent international trends of reform of these models and particularly providing an ex novo legal framework for these authorities which would ensure a *much needed strengthening of the coordination* to be carried out by a profoundly restructured CNSF, along the lines of the normative *reform* proposals herein envisaged.

226 On the whole, this normative solution of a much more mitigated reform is bound to provide the national supervision model with key features of *adaptability* and *responsiveness* that should enable it to better accommodate prospective EU developments in this field. Naturally, such developments should be closely followed on a permanent basis for purposes of any gradual fine-tuning of the national model of financial supervision within this dynamic context.