

**Portugal: Financial Sector Assessment Program—Detailed Assessment of
Observance of the Basel Core Principles for Effective Banking Supervision**

This Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision for Portugal was prepared by a staff team of the International Monetary Fund as background documentation to the Financial Sector Assessment Program with the member country. It is based on the information available at the time it was completed in December 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Portugal or the Executive Board of the IMF.

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FINANCIAL SECTOR ASSESSMENT PROGRAM
PORTUGAL

BASEL CORE PRINCIPLES FOR EFFECTIVE
BANKING SUPERVISION

DETAILED ASSESSMENT OF
OBSERVANCE

DECEMBER 2006

INTERNATIONAL MONETARY FUND
MONETARY AND CAPITAL MARKETS DEPARTMENT

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GLOSSARY

AML	Anti-Money Laundering
APB	Associação Portuguesa de Bancos (Portuguese Banking Association)
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle
BdP	Banco de Portugal
CC	Code of conduct of the BdP
CMVM	Comissão do Mercado de Valores Mobiliários (Stock Exchange Commission)
CNSF	Conselho Nacional de Supervisores Financeiros (National Council of Financial Supervisors)
DSB	Departamento de Supervisão Bancária (Banking Supervision Department)
ECB	European Central Bank
ESCB	European System of Central Banks
FSI	Financial Stability Institute
IFRS	International Financial Reporting Standards
IRB	Internal Rating-Based
ISP	Instituto de Seguros de Portugal (Insurance supervisory and regulatory authority)
IT	Information technology
LFCIFC	Regime Geral das Instituições de Crédito e Sociedades Financeiras (Legal Framework of Credit Institutions and Financial Companies)
MoU	Memorandum of understanding
NPLs	Nonperforming loans
OL	Lei Orgânica do Banco de Portugal (Organic Law of BdP)
OROC	Ordem dos Revisores Oficiais de Contas (Portuguese Statutory Auditor Institute)
ROC	Revisor Oficial de Contas (statutory auditor)
VaR	Value at risk

I. GENERAL

1. The assessment of the Basel Core Principles (BCPs) for Effective Banking Supervision¹ was undertaken as part of the Financial Sector Assessment Program exercise that the IMF has conducted at the request of the Portuguese authorities. The assessment was conducted December 6 – 20, 2005, onsite in Portugal by Marcel Maes (formerly Belgian Banking Commission and IMF) and Alvir Hoffman (IMF-MCM).

II. INFORMATION AND METHODOLOGY USED FOR THE ASSESSMENT

2. The assessment is based on several sources. These include: (i) a self-assessment by the Portuguese central bank (Banco de Portugal—BdP); (ii) detailed interviews with staff from the BdP; (iii) a review of legislation, regulations and other documentation on the supervisory framework and on the structure and development of the Portuguese financial sector; (iv) meetings with other authorities and independent bodies, and the accounting and auditing profession; (v) meetings with the banking industry, the *Associação Portuguesa de Bancos* (Portuguese Bank Association – APB) and individual institutions representing different categories of banks; and (vi) numerous publications available from BdP and background material from various industry sources.

3. The assessment was performed in accordance with the guidelines set out in the BCPs Methodology.² For instance, the guidelines require that the assessment be based on the legal and other documentary evidence in combination with the work of the supervisory authority as well as the implementation of the regulation in the banking sector. Full compliance requires that all these three prerequisites are met. The guidelines allow that a country may fulfill the compliance criteria in a different manner from the ones suggested as long as it can prove that the overriding objectives of each BCP are reached. Conversely, countries may sometimes be required to fulfill more than the minimum standards, e.g., due to structural weaknesses in that country. The BCPs guidelines also state that the assessment is to be made on the factual situation as of the date when the assessment is completed. However, changes, which are clearly underway, e.g., in laws or practices, which will alter compliance with the principles, will be mentioned in the assessment.

4. The assessors have had full cooperation from the Portuguese authorities and have received all information necessary for the assessment.

¹ Issued by the Basel Committee on Banking Supervision (BCBS), 1997.

² Issued by the BCBS and the Core Principles Liaison Group, 1998.

III. OVERVIEW OF THE INSTITUTIONAL AND MACROPRUDENTIAL SETTING AND MARKET STRUCTURE

5. In Portugal, financial intermediation is dominated by banking institutions, the larger of which are organized as financial conglomerates. As of end 2005, there were 61 banks, including 22 branches of institutions authorized in other EU member states, 168 other credit institutions, and 105 financial institutions under the BdP's supervision. The Portuguese state continues to hold a significant stake in the banking sector through the fully state-owned Caixa Geral de Depósitos, one of the two largest banks in the country.

6. Notwithstanding the difficult operating environment of the last few years, marked by slow economic growth and narrowing interest rate margins, Portuguese banks have maintained a solid profitability and strengthened their capital position. As of end-2005, the capital adequacy ratio has reached 11.3 percent; nonperforming loans (NPLs) have fallen to a historically low level of 1.6 percent of total loans while provisions, applying International Financial Reporting Standards (IFRS), stood at 63 percent of NPLs. However, potential vulnerabilities remain, mainly associated with the high level of household and corporate debt as well as the significant concentration of banks' exposure across sectors (especially real estate) and borrowers.

7. The supervisory framework is organized as a combination of a traditional sectoral approach with a partially integrated functional approach. While prudential supervision is entrusted to the BdP (in the case of credit institutions, investment firms and other financial companies) and to the Instituto de Seguros de Portugal (ISP) (in the case of insurance and re-insurance intermediaries and pension funds), cross sectoral supervision of the market rules of conduct of financial intermediaries in the securities market rests in the hands of the Comissão do Mercado de Valores Mobiliários (CMVM). The three Portuguese supervisory agencies coordinate their activities within an overarching high-level committee, the Conselho Nacional de Supervisores Financeiros (CNSF). Bilateral memoranda of understanding (MoU) provide the framework for day-to-day coordination.

IV. GENERAL PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

8. The BdP, which is an integral part of the European System of Central Banks (ESCB), is a public legal entity with administrative and financial autonomy and its own property. The members of the Board of Directors are nominated for renewable terms of five years, and they can only be removed from office under circumstances envisaged by the European Central Bank (ECB) statute. As a result, in performing its tasks, including that of supervisory authority, the BdP enjoys a high degree of independence from government institutions or other forms of political influence. Portugal's framework of laws, accounting, payments, transparency, and financial sector oversight practices is in line with international standards and EU Directives. The law provides a comprehensive and flexible framework to deal with financial institutions in distress and the overall financial safety net is adequate, albeit untested in a major case to date.

V. SUMMARY OF MAIN FINDINGS

9. Portugal's regulatory framework is modern and sound, and highly compliant with international standards. The supervision of Portuguese financial institutions by the BdP is active, professional, and well organized. In particular, the supervision of banks' loan classification and provisioning policies—an area that raised some controversy a few years ago—was assessed to be in full compliance with international best practices, following some regulatory changes in 2002–03. However, there is still room for improvement in the institutions' risk assessment processes and in supervisory risk management and planning, although important progress has been recently made.

Objectives, Autonomy, Powers, and Resources (CP 1)

10. BdP's Organic Law (OL) provides a clear framework, objectives, and responsibilities for carrying out the supervision of credit institutions, financial companies and other entities legally subject to the BdP's regulation. The principle of BdP's independence is enshrined in the ESCB's by-laws and OL provisions. The OL also ensures that the BdP has administrative and financial autonomy and its own property, and is not subject to the financial rules governing the public sector. The BdP derives its income basically from its central bank operations with no fees being levied on supervised institutions.

11. The BdP has the exclusive power to authorize, refuse or withdraw banking licenses. In the cases of branches or subsidiaries of banks authorized in non-EU countries, the BdP examines the proposal and submits its recommendation for the approval of the Minister of Finance (MoF). The OL enables the BdP to take appropriate action to ensure compliance with the laws and maintain the safety and soundness of banking activities. To this end, the BdP can impose, at its discretion, a range of sanctions and remedial actions on a case-by-case basis, depending on the severity of a situation. Legal protection of the BdP staff is ensured by the Legal Framework of Credit Institutions and Financial Companies (LFCIFC). The CNSF and bilateral memoranda of understanding promote cooperation and information sharing with other domestic supervisory agencies.

Licensing and Structure (CPs 2–5)

12. The permissible activities of financial institutions are established in the LFCIFC. The standards for evaluating applications to license establishments, and the criteria for changes in ownership and investments are adequate and strictly applied by the BdP.

Prudential Regulations and Requirements (CPs 6–15)

13. Portuguese banks comply with capital requirements established by Basel I. Risk management techniques used by credit institutions vary considerably in terms of sophistication and complexity, and different risk management tools are used by the same institution to address different risks or portfolios. While banks generally use advanced

techniques, including value-at-risk models, to manage trading book risks, they apply less sophisticated tools to assess banking book risks. The BdP has recently issued a regulation that allows banks to use internal models for market risk and, to date, no bank has submitted its own model to the BdP for validation. However, it is expected that major banks will soon submit credit risk models for BdP's validation. All credit institutions will be also required to implement an internal process for overall capital adequacy assessment. Given these developments, the BdP has to further bolster its internal expertise on model validation and corporate governance evaluation.

14. Banks' loan classification and provisioning policies comply with the BCPs. However, the planned migration from the current dual system of calculating provisions (economic and regulatory provisions; the former is subject to a specific external audit review) to a more comprehensive risk based approach should be accelerated.

Methods of Ongoing Supervision (CPs 16–20)

15. The BdP carries out its supervisory function through an effective mix of off-site and on-site supervision. The information provided by credit institutions to the BdP is comprehensive and timely so as to provide a basis for effective surveillance and early detection of financial weaknesses. Thorough off-site monitoring is conducted on a continuous basis and it is integrated with regular on-site inspections. At the time of the assessment, a comprehensive framework for assessing the risk profile of supervised institutions was still in the process of being finalized. In early 2006, a manual was completed and a pilot test was successfully carried out by applying the methodology to the assessment of a medium-sized bank. The credit risk register, which is managed by the BdP, is a complementary tool for off-site supervision. The electronic platform supporting the register could be improved and better integrated with other available tools for off-site monitoring.

Accounting Standards (CP 21)

16. Accounting rules and regulations are in line with EU Directives, and hence with the IFRS, and financial statements are prepared in accordance with those standards. Implementation of the IFRS rules has brought to the financial statements greater sensitivity to market risk, and has highlighted the relative importance of contingencies for banks' employee pension funds. The BdP is empowered to (i) require all financial information deemed necessary for supervisory purposes, (ii) demand from external auditors specific extensive assessments, and (iii) perform on-site inspections in order to assess the quality of information.

Formal Powers of Supervisors (CP 22)

17. The BdP has broad enforcement powers ranging from moral suasion to imposing penalties upon banks and their management, restricting a bank's current activities, replacing management or restricting their powers, and ultimately revoking the banking license. In the

case of financially distressed institutions, the BdP may require a number of financial recovery and reorganization measures; it may also appoint one or more interim board members with veto powers over shareholders' decisions.

Cross-Border Banking (CPs 23–25)

18. The regulatory framework allows the authorities to undertake globally consolidated supervision over internationally active banking groups. Supervision over the activities abroad of Portuguese banking groups is conducted mainly through on-site inspections at the headquarters and information sharing with host-country authorities. Similarly, at the group level, the overall risk assessment of the foreign institutions operating in Portugal is left to the home supervisor.

VI. PRINCIPLE-BY-PRINCIPLE ASSESSMENT

19. The assessment of each principle is made on a qualitative judgment basis using five categories: compliant, largely compliant, materially non-compliant, non-compliant, and not applicable.

20. A principle will be considered **compliant** whenever all essential criteria are generally met without any significant deficiencies. A principle will be considered **largely compliant** whenever only minor shortcomings are observed, which do not raise any concerns about the authority's ability and intent to achieve full compliance within a prescribed period of time. A principle will be considered **materially non-compliant** whenever, despite progress, the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. A principle will be considered **non-compliant** whenever no substantive progress toward compliance has been achieved. Principles will be considered **not applicable** whenever the BCP does not apply given the legal, structural or institutional features of a country.

21. For each principle there is a descriptive part, which sets out the pertinent laws, regulations, policies and practices. Based on this, and on its implementation, the assessment is concluded. There is also a comment section, specifying the character of any deficiency and providing guidance on how it might be remedied in order to improve compliance with the principle.

Table 1. Detailed Assessment of Compliance with the Basel Core Principles

Principle 1.	<p>Objectives, Autonomy, Powers, and Resources</p> <p>An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking establishments and their ongoing supervision; powers to address compliance with laws, as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>
Principle 1(1)	<p>An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.</p>
Description	<p>The responsibilities and powers of BdP, as supervisory authority, are basically defined in <i>Lei Orgânica do Banco de Portugal</i> (Organic Law – OL), approved by Law No 5/98 of 31 January, 1998), and in <i>Regime Geral das Instituições de Crédito e Sociedades Financeiras</i> (Legal Framework of Credit Institutions and Financial Companies – LFCIFC), approved by Decree-Law No. 298/92 of 31 December, 1992.</p> <p>Pursuant to the provisions of Article 17 of the OL, BdP is responsible for the supervision of credit institutions, financial companies and other entities legally subject to BdP, namely by issuing directives to guide their action under the terms of the legislation governing financial supervision. BdP is the sole entity responsible for banking supervision in Portugal</p> <p>The LFCIFC defines with greater detail the responsibilities and powers of BdP regarding the institutions subject to its supervision, covering in particular the following aspects: authorization process, special registration, appraisal of the suitability of qualifying shareholders, appraisal of the fit and proper character of the members of the management and auditing boards, prudential rules and limits, supervisory instruments, imposition of sanctions, etc.</p> <p>Articles 139 to 153 and 198 of the LFCIFC also authorizes the BdP to impose a number of financial recovery and reorganization measures in order to protect depositors, investors and other creditors and to safeguard the normal operating conditions of the markets. Ultimately, BdP may withdraw the institution's authorization (Articles 22 (1) (b) to (h), 23 (1), 178 and 179 of the LFCIFC), according to the winding-up regime envisaged in the applicable legislation (Article 152 of the LFCIFC).</p> <p>In addition to its participation in the EU legislative process, with the ensuing transposition into Portuguese law of EU legislation, BdP adapts its legal and regulatory framework to national and international developments acknowledging the experience and suggestions of supervised institutions and their representative associations. In this context, BdP participation in several international bodies is also relevant, as mentioned in the answer to BCP24.</p>

	<p>The Board of Directors of the BdP defines a medium-term Strategic Plan. Within that framework, each department establishes a “Strategic Action Plan” setting the main objectives, initiatives and projects for the period concerned. In the specific field of supervision, an Annual Inspection Plan is prepared and approved by the member of the Board concerned.</p> <p>The operations of the BdP are assessed by the Board of Auditors, which consists of four members, three of them appointed by the Minister of Finance (one is the chairman, another is a chartered accountant and the third is a person of recognized competence in economic matters) and one member appointed by the staff of BdP (Articles 41 to 46 of the OL).</p> <p>It is incumbent on the Board of Auditors, in particular, to: monitor regularly the operations of the BdP, check compliance with the applicable laws and regulations, issue its opinion on the balance sheet and annual accounts, call the attention of the Governor or of the Board of Directors to matters worth examining more closely, and issue its opinion on the matters submitted to it by the Governor or by the Board of Directors.</p> <p>There is also an Advisory Board, which consists of the Governor of BdP, the Vice-governors, the former Governors, four persons of recognized competence in economic, financial and business matters, the chairman of APB, the chairman of <i>Instituto de Gestão do Crédito Público</i> (Portuguese Government Debt Agency), a representative of each of the Autonomous Regions of the Azores and Madeira, to be appointed by the competent self-government bodies, and the chairman of the Board of Auditors of BdP. The Advisory Board issues its opinion on the annual report of BdP, before its release, and on the measures taken by BdP within the scope of its functions (Articles 47 to 49 of the OL).</p> <p>The reporting of the operations of the BdP and of the degree of compliance with its responsibilities and objectives also takes place through the regular presence of the Governor before the Economy and Finance Commission of the Assembly of the Republic (the Parliament).</p> <p>The operations of the BdP, including its supervisory function, are also made known through the Annual Report of BdP, which is approved by the Ministry of Finance and is available on BdP’s website and in hard copy.</p> <p>Information about the financial conditions of the banking sector is disclosed through several regular publications.</p> <p>The Annual Report of BdP supplies detailed general information on the banking system and its structure, including analyses of balance sheet developments. Due to the statistical functions of BdP, statistical data are also supplied through aggregate financial data.</p> <p>In addition, the Economic Bulletin (published quarterly) discloses information on the</p>
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	<p>Portuguese financial system, stress being laid on the fact that the autumn issue includes a detailed analysis of the banking system.</p> <p>With regard to the provision of information to the public, BdP has also issued Instruction No. 16/2004 prescribing a minimum standardized framework of indicators that credit institutions should adopt when disclosing data on solvency, credit quality, profitability and efficiency. The publication of these indicators with a uniform methodology does not prevent institutions from presenting any other indicators on the elements mentioned above. Reporting requirements in accordance with the methodology established became compulsory as of 30 September 2004.</p> <p>The BdP has recently launched the publication of a yearly Financial Stability Report, assessing developments in the financial system and in its determining factors. This Report is chiefly based on a short-term analysis, also encompassing, where relevant, structural aspects and focusing, in particular, on the institutions subject to the supervision of BdP. It is divided into two parts: the first one surveys, identifies and assesses the main risks associated with the activities carried out by financial institutions; the second part consists of articles related to the general themes of the Report.</p>
	Compliant
Comments	<p>The audit department of the BdP examines periodically the activity of the <i>Departamento de Supervisão Bancária</i> (DSB – Banking Supervision Department) and submits the report to the Governor of the BdP. This report is also transmitted to the Board of Auditors of the BdP.</p> <p>The BdP may examine the need to further institutionalize and enhance the supervisory procedures through the introduction of a quality control process.</p>
Principle 1(2)	Each such agency should possess operational independence and adequate resources.
Description	<p>There is no evidence of government or banking industry interference in the performance of the supervisory functions of BdP. The independence of BdP is guaranteed by its statute (Article 7 of the Statute of the ESCB and of the ECB, combined with the provisions laid down in Article 3 of the OL). In the performance of its supervisory functions, BdP does not seek or take instructions from governmental bodies, EU institutions or any other body.</p> <p>The independence of BdP is also ensured by other provisions, such as those stipulating that the members of the Board of Directors of BdP shall be in office for renewable terms of five years, and that they can only be relieved from office should any of the circumstances envisaged in Article 14.2 of the ESCB/ECB Statute occur, e.g., if they no longer fulfill the conditions required for the performance of their duties or if they have been guilty of serious misconduct.</p> <p>It should also be noted that the Governor may institute proceedings against such decision (Article 33 (2), (4) and (5) of the OL).</p> <p>In order to prevent any risk of influence in the respective independence, the members</p>

of the Board of Directors and the staff can neither be members of the supervisory and managing bodies of other credit institutions, financial companies or any other institutions subject to the supervision of BdP nor perform any other duties therein, unless representing BdP or its staff (Article 61 (1) of the OL). In addition, without prejudice to other legally envisaged incompatibilities or preventions, the members of the Board of Directors cannot perform any remunerated duties outside BdP, except lecturing at universities, or be members of the supervisory and managing bodies of any company, unless representing BdP's interests or duly authorized by the Board of Directors (Article 61 (2) of the OL).

The BdP Code of Conduct (CC), which is applicable to its staff and to the members of the Board of Directors and is included in the Staff Manual, also contains provisions in terms of professional ethics and behavior. Among others, the need for independence (section 3.1 of the CC) and the prevention of conflicts of interest (section 3.8 of the CC) are explicitly mentioned. The CC has been published in the Official Bulletin of BdP and is available on BdP's website.

No situation has been reported where the integrity or the professionalism of BdP staff, which in general enjoy high technical, professional and personal credibility, has been questioned.

It has been established that BdP staff enjoy high professional credibility and is often invited to participate in initiatives and working groups of other public entities and international organizations.

The independence of BdP is also guaranteed through its financing sources. In accordance with Article 1 of the OL, BdP is a public-law legal person with administrative and financial autonomy and its own property, and it is not subject to the financial rules governing the autonomous funds and services of the Public Sector (Articles 1 and 54 (5) of the OL).

BdP, as the central bank, obtains its income basically from its participation in the results of the currency issue of the ESCB, from interest arising from investments within the scope of monetary policy and from the management of reserves. In accordance with Article 53 (2) of the OL, the profit for the fiscal year is allocated as follows: 10 percent to the legal reserve; 10 percent to other reserves to be decided by the Board of Directors; the remainder to the State or to other reserves proposed by the Board of Directors and approved by the Minister of Finance.

Total staff of the DSB amounts to 167 and is recruited through rigorous selection processes mainly done among the recent graduates (law, economy, management). However, experienced and specialized professionals in the banking and audit fields are also recruited. The current recruitment campaign has attracted five highly qualified staff in order to cope with the introduction and implementation of Basel II. Internal and external training courses are organized.

	<p>The capacity to attract good professionals is also enhanced due to the fact that, despite being based on the salary scale of the banking sector, wage supplements, grants and other social benefits, such as the reimbursement of health care expenses and grants for the acquisition of information technology (IT) equipment, books and other training tools complete the financial package.</p> <p>In view of these conditions, the number of labor contract terminations is reduced. In the 2001/2005 period, only 3 members of the technical staff of DSB left (excluding retirements), while there was a net increase of 14 technical staff in the same period. Currently, DSB's staff number is at 167. Staff with a college qualification represents approximately 70 percent of the total staff of this department, compared with an average of approximately 42 percent for BdP as a whole.</p> <p>With respect to the on-going staff training, BdP has a training program comprising: i) institutional training (aimed at the development of technical, specialized and behavioral competences); ii) training in foreign languages; iii) specific national and international training courses on supervisory matters. Training sessions are also organized by BdP, utilizing external training entities, when training needs cover a large number of technical staff (e.g. courses on IFRS for the Department's technical staff in 2003 and 2004, on Asset Securitization in 2002, etc.). In 2005 the Financial Stability Institute (FSI) Connect online was subscribed for 65 members of the technical staff of DSB. FSI Connect is a web-based training program developed by the Financial Stability Institute specifically for banking supervisors, offering courses on the following topics in particular: Capital adequacy and Basel II; Credit risk; Market risk; and Operational risk.</p> <p>In the 2002/2004 period, the average number of training hours per employee per year reached 35.8 hours.</p>
Assessment	Compliant
Comments	
Principle 1(3)	A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	<p>Articles 16 and 23 of the LFCIFC attribute to the BdP the authorization, refusal of authorization and withdrawal of authorization for the carrying on of banking activity.</p> <p>However, in the case of entities which are branches or subsidiaries of a credit institution having its head office in a non-EU country, or if the latter are controlled or if their capital or corresponding voting rights are in their majority held by natural persons who are not nationals of EU Member States or by legal persons having their head office in non-EU countries, these powers rest with the Minister of Finance. However, in these cases BdP examines the authorization or withdrawal of the authorization, submitting its conclusions for approval to the Minister of Finance (Articles 16 (2), 23-A and 58 of the LFCIFC). This competence may be delegated to BdP.</p> <p>After having been granted the authorization, credit institutions may not commence</p>

	<p>their operations without a special prior registration with BdP. With effect from the date of such registration, they start to be subject to prudential supervision. This two-phased process allows them to update and complete the necessary information.</p> <p>According to Article 17 of the OL, BdP is responsible for the supervision of credit institutions and is authorized to issue directives to that effect.</p> <p>The LFCIFC requires supervised institutions to report periodically to BdP whatever information is deemed necessary, in particular to monitor their degree of liquidity and solvency, the risks they take and the effectiveness of their internal control.</p>
Assessment	Compliant
Comments	
Principle 1(4)	A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws, as well as safety and soundness concerns.
Description	<p>As referred to under Principle 1.1, the legal and regulatory framework of BdP is deemed adequate to its supervisory responsibilities and tasks, and the powers of BdP to ensure compliance with the rules regulating the activities of institutions are provided for in the LFCIFC.</p> <p>With regard in particular to the application of qualitative judgments, it should be noted that supervisory functions entail consideration of several circumstances that may not fully materialize. Therefore, in certain cases, the Portuguese legislator had to resort to a number of concepts, the definition of which is incumbent on BdP. This is the case, for instance, for the definition of "group of interconnected clients".</p> <p>BdP has been granted a set of powers, the exercise of which depends on a case-by-case assessment, leaving room for the taking of decisions. In other words many situations fall within the discretionary scope of BdP, which has to base its decisions according to the criterion of what is deemed most appropriate for the fulfillment of public interest.</p> <p>The understandings and interpretations issued by BdP with regard to the legal and regulatory rules governing the operations of supervised institutions are forwarded directly to the institutions in question and, when deemed necessary, to all institutions, by means of a Circular Letter, published in BdP's Official Bulletin. At the internal level, the decisions and guidelines are transmitted to the staff through the electronic information management system (GESPROC). To facilitate access to all the understandings and promote their consistency, the various interpretations and appraisals by BdP on matters arising from the aforementioned exercise of discretionary powers are being compiled in a database that will soon become fully operational.</p> <p>Supervised institutions must cooperate with BdP, as deemed adequate to the performance of its tasks and make available whatever information deemed necessary for the same purpose. Thus, in accordance with the provisions of Article 120 of LFCIFC, credit institutions will facilitate the on-the-spot verification by BdP of their</p>

	<p>premises and the examination of their books, along with all other data which BdP considers relevant for the verification of prudential items, such as their degree of liquidity and solvency, the risks they take, their administrative organization, the effectiveness of their internal control and data-processing security and control procedures.</p> <p>Where irregularities are detected, BdP may issue recommendations to put an end to such irregularities or impose the sanctions deemed adequate.</p> <p>The usual procedure consists of issuing recommendations to put an end, within a defined period of time, to any irregularities detected both in "off-site" monitoring and in "on-site" inspections (Articles 53, 116 (1) (c) and (d) and 118 of the LFCIFC). In the event of repeated non-compliance or serious misconduct, in addition to the imposition of penalties, extraordinary reorganization measures may be taken (Articles 139 to 153 of the LFCIFC) or, in particularly serious offences, the authorization may be revoked (Articles 22, 23 and 23-A of the LFCIFC).</p>
Assessment	Compliant
Comments	
Principle 1(5)	A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	<p>The legal protection of BdP staff is ensured by Article 12 (3) of the LFCIFC, according to which regarding the decisions that have caused damages to a third party, the personal civil liability of the staff responsible can only be enforced if BdP claims reimbursement from them, and then only if the respective conduct constitutes a crime. This regime differs from the Legal Framework on the extracontractual responsibility of the State towards third parties, guaranteeing larger protection against the judicial processes of BdP staff.</p> <p>The mission has been informed of the institutionalized practice of BdP bearing the judicial costs of actions involving its staff in processes related to the performance of their functions, where it is not proven that they have acted fraudulently against the interests of BdP.</p>
Assessment	Compliant
Comments	
Principle 1(6)	Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	<p>In 1997 the BdP set up a cooperation and information sharing arrangement (MoU) with the Portuguese securities market supervisor (CMVM).</p> <p>This MoU is presently being revised, with the intention of reinforcing and extending the institutional mechanisms that coordinate the actions taken by both supervisory authorities in this particular field.</p> <p>Article 136 of the LFCIFC stipulates that when a credit institution, a financial holding company or a mixed-activity holding company controls one or more subsidiaries subject to the supervision of the ISP, this Institute shall supply BdP with the</p>

	<p>information required for supervision on a consolidated basis.</p> <p>The BdP has also recently concluded a cooperation arrangement with the ISP. This MoU incorporates a chapter on institutional supervision on a permanent basis. With respect to these issues, the exchange of information envisages the aspects deemed relevant to the monitoring of supervised entities, namely as regards economic and financial situations, compliance with regulatory rules, monitoring of changes in the structure of groups and procedures for integration of the respective profit and loss account.</p> <p>In addition, it should be noted that both authorities are committed to exchanging information between each other – where required to do so or at their own initiative –, which is deemed essential or pertinent to the performance of the supervisory tasks, pursuant to the sectoral rules or to the supplementary supervision of financial conglomerates.</p> <p>Given the increasing integration and interdependence of the different financial activity sectors the CNSF (Decree-Law No. 228/2000 of 23 September, 2000) was created in 2000. This council is mandated to coordinate the exchange of information between the three supervisory authorities of the Portuguese financial system (BdP, ISP and CMVM) and to coordinate their activities on issues of common relevance in order to eliminate potential conflicts of competence or regulatory gaps.</p> <p>BdP also exchanges information with authorities, organizations and persons performing equivalent duties in other EU Member States, with central banks and other similar organizations, such as monetary authorities as well as other authorities responsible for the oversight of payment systems and, in the case of supervisory authorities of non-EU Member States, within the scope of a number of reciprocal cooperation agreements (see also BCP 24) concluded between BdP and these authorities, under a reciprocity regime (Article 81 (1) (e), and (f) and (2) of the LFCIFC).</p> <p>The obligation of professional secrecy does not prevent BdP from exchanging information with other financial system supervisory authorities, provided that they are also subject to an identical obligation (Article 81 (1), (2) and (3) of the LFCIFC).</p> <p>The cooperation agreements between BdP and the supervisory authorities of non-EU countries may only be concluded if the information to be disclosed is subject to guarantees of secrecy at least equivalent to those established by Portuguese law and for the purpose of supervisory functions entrusted to the bodies in question (Article 82 of the LFCIFC).</p>
Assessment	Compliant
Comments	

Principle 2.	<p>Permissible Activities</p> <p>The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.</p>
Description	<p>According to Article 2 of the LFCIFC, a “credit institution” is an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account and is also an undertaking which issues means of payment in the form of electronic money.</p> <p>The LFCIFC distinguishes the following types of credit institution (Article 3):</p> <ul style="list-style-type: none"> - Banks; - Caixas económicas (savings banks); - Caixa Central de Crédito Agrícola Mútuo (central mutual agricultural credit bank) and caixas de crédito agrícola mútuo (mutual agricultural credit banks); - Credit financial institutions; - Investment companies; - Financial leasing companies; - Factoring companies; - Credit purchase financing companies; - Mutual guarantee companies; - Electronic money institutions; and - Other undertakings, which, in meeting the previous definition are classified as such according to the law. <p>Only the three first categories of credit institutions mentioned above (banks, savings banks and mutual agricultural credit banks) may accept deposits. Banks may carry out the other activities mentioned in Article 4 of the LFCIFC. All the other types of credit institutions may carry out some of the activities mentioned in Article 4 as defined in their respective legislations.</p> <p>Article 11 of the LFCIFC regarding the truthfulness of company and business names stipulates that only entities qualified as credit institutions or financial companies may include in their company or business name, or use in their operations, expressions which suggest an activity pertaining to credit institutions or financial companies, such as “bank”, “banker”, “credit”, “deposit”, “financial leasing”, “leasing” and “factoring”. These expressions shall always be used in such a manner as not to mislead the public regarding the scope of the operations which the entity is allowed to carry out.</p> <p>Breaches of the rules on the use of company and business names are punishable by fine, according to Article 210 (c) of the LFCIFC.</p>
Assessment	Compliant
Comments	

<p>Principle 3.</p>	<p>Licensing Criteria</p> <p>The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.</p>
<p>Description</p>	<p>The main requirements to be fulfilled in applying for a license for the setting-up of a credit institution are laid down in Articles 14 to 19 of the LFCIFC.</p> <p>The application will be rejected if such requirements are not fulfilled as provided for in Article 20 of the LFCIFC.</p> <p>Article 20 also requires that the effective supervision is not to be prevented due to close links between the credit institution and other natural or legal persons.</p> <p>When assessing the suitability of qualified shareholders, BdP can oppose qualifying holdings unless it is satisfied that the person in question and the business plan will ensure the sound and prudent management of the credit institution. Article 103 of the LFCIFC stipulates that such conditions are considered not to exist in the following circumstances:</p> <ul style="list-style-type: none"> - if the manner in which the person in question habitually does business or the nature of his professional activity indicates a marked tendency to take excessive risks, - if the financial and economic situation of the person concerned is inadequate in relation to the amount of the proposed holding, - if BdP has reason to doubt the legality of the origin of the funds used to acquire the holding, or the true identity of the holder of those funds. - if the structure and characteristics of the business group in which the credit institution would be included do not permit adequate supervision; - if the person in question refuses to meet the conditions required for the financial reorganization of the credit institution and which have been previously established by BdP; - if the person in question has been, within the past five years, the object of a suspension, for a period from 1 year to 10 years, of the exercise of voting rights in credit institutions, financial companies and holding companies subject to supervision by BdP; - in the event of a natural person, if it comes to light that any of the facts indicating lack of suitability, according to Article 30 of the Banking Law, are applicable. <p>The granting of a license further requires that the institution ensures the adequate levels of regulatory own funds and solvency in its prospective accounts and projections. In particular, compliance with the following Articles of the LFCIFC must be demonstrated: Article 94 (according to which institutions must invest their available funds in such a way as to ensure appropriate levels of liquidity and solvency</p>

at all times), Article 95 (related to the minimum capital) and Article 96 (regarding the composition and minimum level of regulatory own funds).

The management board of a credit institution must consist of at least three members, with full powers to run the business of the institution. The day-to-day management of the institution must be the responsibility of at least two members of the management board. (Article 15 of the LFCIFC)

Furthermore, only persons whose suitability and availability ensure sound and prudent management may be members of the management and auditing boards of a credit institution (Articles 30 of the LFCIFC).

In appraising this suitability, BdP takes into account the manner in which the person usually does business or carries on his professional activities, particularly any aspects which show an inability to make wise and judicious decisions, or a tendency not to meet obligations punctually or to behave in a manner incompatible with the maintenance of market confidence. Lack of suitability will also be deemed to exist in cases where the person in question has a record of criminal activities or adverse regulatory judgments. A questionnaire published in an attachment to Instruction No. 103/96, is used to that effect.

BdP also requests information from other Portuguese supervisory authorities (CMVM and ISP), as well as from supervisory authorities from other countries regarding natural persons of the same nationality.

The application for authorization must be accompanied by the documents referred to in Article 17 of the LFCIFC, comprising a business plan, geographical location, internal organization, material, technical and human resources to be used and financial statement forecasts for each of the first three business years. As regards the last element, BdP requests institutions to present the assumptions underlying the accounts' projections.

The application file should also include other supporting documents, such as:

- a detailed description of the internal control system to be implemented according to Instruction No. 72/96;
- a formal declaration issued by a recognized expert attesting the adequacy and sufficiency of the software and hardware to be used for the data to be produced for supervisory purposes.

Apart from this, BdP may request the applicants to provide it with any additional information which may be deemed necessary and respond to any inquiries deemed necessary.

Furthermore, and as stated above, BdP can oppose qualifying holdings if the financial and economic situation of the person concerned is inadequate in relation to the amount of the proposed holding.

	<p>As mentioned under BCP 1.3 above, BdP is not a de-licensing authority in the case of entities which are branches or subsidiaries of a credit institution having its head office in a non-EU country, or if the latter are controlled or the majority of the capital or corresponding voting rights are held, by natural persons who are not nationals of EU Member States or by legal persons having their head office in non-EU countries.</p> <p>However, in these cases BdP examines the authorization or withdrawal of the authorization, submitting its conclusions to the Minister of Finance for approval (Articles 16 (2), 23-A and 58 of the LFCIFC). This competence may be delegated to BdP.</p> <p>The authorization to set up a subsidiary of a foreign bank is subject to prior consultation with the supervisory authority of the country in question. (Article 18 of the LFCIFC)</p> <p>As a prerequisite for the establishment in Portugal of branches of credit institutions authorized in other EU Member States and subject to the supervision of the competent authorities of those States, BdP must receive a notification from the supervisory authority of the home country, accompanied by the items established in Article 49 (1) of the LFCIFC (e.g. program of intended operations, structural organization).</p> <p>As regards the establishment of branches of credit institutions from non-EU countries, the authorization procedure is identical to the procedure applicable to the subsidiaries of non-EU credit institutions, previously mentioned. (Articles 57 and following of the LFCIFC).</p> <p>Even after the authorization is granted, credit institutions may not commence operations without undergoing a special registration with BdP (Article 65 (1) of the LFCIFC). The registration procedure covering the items prescribed in Article 66 aims at verifying compliance with the original authorization requirements and the assessment of the fit and proper character of the members of the management and auditing boards.</p> <p>According to Article 72 (e) of the LFCIFC, registration will be refused when any of the institution's authorization requirements is not met, among other things on the grounds of lack of suitability and experience on the part of the members of the management or auditing boards.</p> <p>According to Article 21 of the LFCIFC, the authorization lapses if the institution fails to commence its operations within a period of twelve months.</p>
Assessment	Compliant
Comments	There is no longer any rationale for giving the Minister of Finance the authorization power for non-EU banks. This power should therefore be transferred to the BdP.

<p>Principle 4.</p>	<p>Ownership Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.</p>
<p>Description</p>	<p>Article 13 (7) of the LFCIFC defines qualifying holding as a direct or indirect holding in an entity, joint or separate, which for any reason makes it possible for its holder, by himself or by virtue of any special links with the voting rights of another participant, to exercise a significant influence over the management of the participated entity. For the purposes of this definition, “significant influence over the management” is presumed whenever the participant holds at least 5 percent of the capital or of the voting rights of the participated entity. This presumption can be refuted by BdP only where the holding is lower than 10 percent, taking into account namely the information provided by the party concerned (Article 13(7) of the LFCIFC).</p> <p>Any natural or legal person who proposes to hold directly or indirectly a qualifying holding in a credit institution must first inform BdP of his intention, even if the result of this initiative is not a foregone conclusion. The same procedure should be adopted regarding acts involving increases in a qualifying holding, whenever such increases result in a proportion reaching or exceeding 5 percent, 10 percent, 20 percent, 33 percent or 50 percent of the capital or of the voting rights held in the participated institution, or when the latter becomes a subsidiary of the acquiring entity (Article 102 (1) and (2) of the LFCIFC).</p> <p>Furthermore, acts or facts resulting in the acquisition of a shareholding which amounts at least to 2 percent of the capital or of the voting rights held in the participated institution must also be communicated to BdP within a period of 15 days. In this event the BdP will inform the interested party, within 30 days, if it considers the holding acquired as a qualifying holding. Moreover, even when BdP considers that the holding is not a qualifying holding, it can at any time request from the respective holder a prior or subsequent communication of any act or fact from which may result or has resulted in the holding of a percentage equal to or higher than 3 percent or 4 percent of the capital or of the voting rights held in the participated institution (Article 102 (4), (5) and (6) of the LFCIFC).</p> <p>On the other hand Article 107 of the LFCIFC sets out the procedure to be followed in the event of a reduction of the qualifying participations.</p> <p>BdP assesses the integrity of shareholders with qualifying holdings and their business intentions through a set of comprehensive information requirements defined in Notice No. 3/94. The required information has to be transmitted before the intended acquisition of qualifying holdings takes effect.</p> <p>Article 103 of the LFCIFC authorizes BdP to oppose the acquisition of a qualifying holding, unless it is satisfied that the person in question and the business plan will ensure the sound and prudent management of the credit institution. Such conditions do not exist in the following circumstances: if the manner in which the person in question</p>

	<p>habitually does business or if the nature of his professional activities indicates a marked tendency to take excessive risks; if the financial and economic situation of the person concerned is inadequate in relation to the amount of the proposed holding; if BdP has reason to doubt the legality of the origin of the funds used to acquire the holding, or the true identity of the holder of those funds; if the structure and characteristics of the business group in which the credit institution would be included do not permit adequate supervision; if the person in question has been, within the past five years, the object of a suspension of the exercise of voting rights in a supervised institution, for a period of 1 to 10 years.</p> <p>Credit institutions, on becoming aware of changes on qualifying holdings, must also inform BdP thereof. Even if no such events occur, credit institutions must periodically inform (April each year) BdP of the identity of their qualifying shareholders and of the size of their holdings. (Article 108 of the LFCIFC)</p> <p>Moreover, the identity of shareholders with qualifying holdings is an item subject to registration in BdP (Article 66 of the LFCIFC).</p>
Assessment	Compliant
Comments	
Principle 5.	<p>Investment Criteria</p> <p>Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>
Description	<p>In general, BdP may notify an institution to abstain from carrying out a given transaction, whenever it is deemed that such transaction may indicate the breach or the aggravation of the breach of applicable prudential rules, or is liable to be in non-compliance with prudent and sound management rules (Article 118 (2) of the LFCIFC).</p> <p>The Portuguese framework in this respect is essentially based on the setting-up of restrictions to certain investments and initiatives.</p> <p>Article 100 limits the participation of credit institutions in non-financial entities. For example, no credit institution can hold a qualifying holding in the capital of a non-financial entity which exceeds 15 percent of the former's own funds and the overall amount of qualifying holdings in such entities must not exceed 60 percent of the participating credit institution's own funds. Exemptions to the calculation of those limits, which are defined in Article 100 of the LFCIFC, concern holdings that have to be covered by the credit institution's own funds.</p> <p>Furthermore Article 101 of the LFCIFC prohibits credit institutions from holding, directly or indirectly, for a continuous or non-continuous period of more than three years, shares giving them more than 25 percent of the voting rights corresponding to the capital of the participated company. These limits will not apply to shareholdings by a credit institution in other financial entities.</p>

	<p>A credit institution having its head office in Portugal and wishing to establish a subsidiary in a non-EU country must notify BdP of this intention in advance, and BdP may refuse the application for grounded reasons, namely where the financial situation of the institution is inadequate for the project. (Article 42-A of the LFCIFC and Notice No. 1/2003).</p> <p>Moreover, a credit institution that has its head office in Portugal and wishes to acquire, directly or indirectly, participations in credit institutions having their head office abroad or in financial institutions abroad representing 10 percent or more of the capital stock of the participated entity or 2 percent or more of the capital stock of the participating institution, must communicate this intention to BdP (Article 43-A of the LFCIFC).</p> <p>The communication must specify the following elements: a) business name and location of the head office of the institution in which a participation is intended to be held; b) type of institution, according to the law of the country in question; c) amount, in euros, of the respective investment and financing mode of the operation; d) percentage of the capital stock and voting rights - of both the participating institution and the participated institution - represented by the participation to be acquired; e) impact of the investment on the fulfillment of ratios and prudential limits applicable, on an individual basis and on a consolidated basis (Notice No. 2/2003).</p> <p>On the other hand, credit institutions cannot, except with the authorization of BdP, acquire real estate other than that required for their establishment and operation or for the pursuance of their business purposes (Article 112 (1) of the LFCIFC). However, according to Article 114 of the LFCIFC, this restriction may be disregarded if the acquisition is the result of repayments of the institution's own credit.</p> <p>Every three months, banks must report all of the equity interests they hold, in Portugal and abroad.</p> <p>Furthermore, in accordance with Article 66, 1) of the LFCIFC, the location and date of the setting-up of branches and subsidiaries are subject to registration. Instruction No. 47/97 defines the requirements regarding the registration of the credit institution's subsidiaries.</p>
Assessment	Compliant
Comments	
Principle 6.	<p>Capital Adequacy</p> <p>Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.</p>
Description	<p>Article 99(a) of the LFCIFC authorizes BdP to issue Notices establishing the relations to be observed by credit institutions on a solo or consolidated basis between own funds and total assets and off-balance sheet items, weighted or not by risk coefficients.</p>

	<p>According to this general power BdP has issued Notices No. 1/93 and No. 7/96 imposing minimum capital adequacy requirements for credit institutions that reflect the risks undertaken by those institutions. The capital ratio includes both on-balance-sheet and off-balance-sheet weighted risks (Notice No. 1/93) and also covers market risks and foreign exchange risks (Notice No. 7/96).</p> <p>The components of eligible capital to absorb losses (own funds) are defined in Notice No. 12/92. They focus on equity capital and reserves (Tier I), which should represent at least 50 percent of eligible capital (Notice No. 12/92 6th).</p> <p>Tier I includes paid up capital and reserves set up or increased by appropriations of retained earnings or other surpluses (e.g. share premiums).</p> <p>This basic definition of capital excludes tangible assets revaluation reserves. Intangible assets and insufficient building up of provisions, among other items, are deducted from Tier I (Notice No. 12/92 from 3rd to 5th).</p> <p>On a consolidated basis, Tier I also includes minority interests in the equity of subsidiaries and adds or subtracts goodwill arising from full consolidation or equity methods (Notice No. 12/92 17th).</p> <p>In accordance with regulation in force, hybrid capital instruments and subordinated debt may be included in Tier II, provided that certain conditions are met (permanence and ability to absorb losses are the main features required) and previously approved by BdP (Notice No. 12/92 3rd (8) and (12)).</p> <p>Concerning this type of eligible capital instrument, a cumulative discount (or amortization) factor of 20 percent per year is applied during the last five years to maturity, to reflect the diminishing stability of those elements (Notice No. 12/92, 16th and Circular Letter 29/97/DSB).</p> <p>Regarding innovative capital instruments eligible for inclusion in Tier I capital, BdP practice is broadly in line with the BCBS press release of October 1998, since a 20 percent limit was established. This limit is applied to all issues, including existing ones (and therefore, regardless of the BCBS' grandfathering clause), but with the introduction of a reduction plan to be reached by the end of 2007.</p> <p>If there are excesses to large exposure limits they can be deducted to own funds, in order to comply with such limits (Notice No. 10/94, 12th).</p> <p>The above-mentioned regulations reflect the transposition of the relevant EU Directives and are in line with the Basel Capital Accord.</p> <p>The minimum capital requirements must not be lower than 8 percent of the total weighted exposure. It applies on a consolidated and on a solo basis (Notices No. 1/93 5th; No. 8/94 1st; No. 7/96 8th). The same capital requirements are applied to financial holding companies, on a consolidated basis.</p>
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	<p>BdP is also empowered to determine the adoption of measures deemed adequate to the balanced distribution of own funds within a banking group (Notice No. 7/96 8th (3)). Regarding this issue, a guideline requires banks included in the consolidated supervision other than the parent entities to comply with a 7 percent capital ratio trending to 8 percent, on a solo basis.</p> <p>Credit institutions report the calculation of capital ratio on a solo basis (quarterly) and on a consolidated basis (semi-annually). Own funds calculated on a solo basis are reported monthly and on a consolidated basis are reported semi-annually.</p> <p>These reports are used as the basis for consistency tests with accounting data, covering the fullness of the on balance sheet risks and off balance sheet risks. Whenever necessary, banks are required to report additional or more detailed information to check the trustworthiness and consistency of the risk-weighting application. Capital requirements are also assessed during on-site examinations.</p> <p>BdP has the authority to take measures should a bank fall below the minimum capital ratio (Articles 22, 96, 116, 141, 142, 210 and 211 of the LFCIFC).</p> <p>Taking into account the bank's risk profile and as allowed by the proviso established in Notice No. 1/93 3rd (2), BdP has exercised its power to determine ratios higher than the minimum threshold of 8 percent.</p> <p>If an institution's own funds fall below the amount of the capital requirement, that institution must forthwith inform BdP of the situation and take appropriate measures to rectify the situation as quickly as possible (Notice No. 7/96 3rd (3)).</p> <p>Furthermore, credit institutions that do not comply with the minimum capital ratio are automatically prohibited from raising the overall value of weighted risks and are required to apply all the necessary procedures in order to solve the situation (Notice No. 1/93 4th). As a general rule, BdP requires an adequate resolution plan.</p> <p>BdP has defined capital in a stricter way than in the Basel Capital Accord by establishing the need for additional deductions (intangible assets and exceeding large exposure limits). This led some banks to publish only the Basel capital adequacy ratio and caused BdP to determine that whenever solvency indicators are disclosed, banks must publish as well the capital ratio according to national rules (Instruction No. 16/2004).</p> <p>In addition to the minimum capital requirements, a minimum absolute amount of initial capital for banks is also required (Article 95 of the LFCIFC) (see also Principle 3). Moreover, the regulatory own funds may not fall below the minimum amount of initial capital.</p>
Assessment	Compliant
Comments	BdP has to be commended for having defined capital in a stricter way than in the Basel

	<p>Capital Accord by establishing the need for additional deductions (intangible assets and exceeding large exposure limits).</p> <p>Regarding innovative instruments eligible for inclusion in Tier I capital, BdP subjects the inclusion to a 20 percent limit. However, in its October 1998 press release the BCBS has determined that acceptance of these instruments for inclusion in Tier I is to be limited to 15 percent of Tier I. Although this condition has not yet been taken up in EU-Directives, most member countries do apply said rule, based either on supervisory practice or on specific regulation. BdP is therefore recommended to review its Tier I inclusion rules.</p> <p>However, BdP has applied the 20 percent limit to all issues, including existing ones, regardless of the grandfathering clause allowed by the BCBS. Furthermore this limit applies to all hybrid instruments, either with a step-up clause or without a step-up clause. Existing step-up clauses are also required to be moderate.</p> <p>A review of the Portuguese Tier I inclusion rules regarding hybrid instruments should benefit from the decision that will be taken by the BCBS in the near future.</p> <p>As a consequence of the adoption of Basel II Rules, credit institutions will be required to have an internal process for assessing the overall capital adequacy in relation to their risk profile and the projected evolution of their businesses.</p> <p>A BdP survey conducted in 2005 showed that half of the surveyed population (credit institutions and investment firms) intends to use Internal Rating-Based (IRB) methods for the calculation of own funds for credit risk. Seventy percent of these will opt for the advanced approach.</p> <p>As to operational risk, the majority of the surveyed population will use the basic indicator method for the calculation of the capital charge. Regarding market risk, more than 40 percent opted for the use of internal models in order to calculate capital requirements (Value at Risk – VaR).</p> <p>The five major banking groups, which account for more than 75 percent of total assets, intend to adopt IRB for credit risk, internal models for market risk and the standard method for operational risk.</p>
Principle 7.	<p>Credit Policies</p> <p>An essential part of any supervisory system is the independent evaluation of a bank's policies, practices, and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.</p>
Description	<p>The regulation concerning internal control (Instruction No. 72/96) requires that banks should control the risks arising from all their activities, especially credit risks, and emphasize the need to involve the Board of Directors of the institution. Explicitly, the Board should approve, implement and periodically review, at least once a year, the strategy and policies adopted relating to credit risk.</p> <p>That Instruction establishes principles/recommendations for the credit risk environment</p>

	<p>and requires the Board of Directors of the institution to generate on a yearly basis, and send to the BdP, a report on the internal control system, which includes the description of credit risk standards implemented by the institution. The opinion of the Board of Auditors must be attached to the report.</p> <p>The annual report received by BdP is assessed and when shortcomings are detected, BdP requires the institution to implement adequate measures to address the deficiencies.</p> <p>The assessment of the credit process and risk management is conducted mainly through on-site supervision, based on the analysis of credit and investment portfolios, the files and reports to the senior management and on meetings with the responsible officers. Credit granting, measurement and ongoing monitoring processes are analyzed, specifically in terms of approval, implementation and regarding the sound practices for management of credit risk.</p> <p>The on-site examinations verify if all banks have written procedures as far as credit granting is concerned, as well as clearly defined levels of authorization.</p> <p>BdP has full access to whatever information is deemed necessary to monitor the risks that banks take and the effectiveness of banks' internal controls (Article 120 of the LFCIFC). In addition, Article 134 of the LFCIFC establishes that institutions must submit to BdP all data required for supervisory purposes.</p> <p>According to the principles and recommendations set out in the credit risk Annex of Instruction No. 72/96, all credit must be granted on an "arm's length" basis. Specifically, credit granted to companies or individuals who are in any way connected to the bank, must be authorized exceptionally and closely monitored, so as to minimize and control the risks of granting loans in "favored" circumstances and/or special conditions.</p> <p>According to Article 85 of the LFCIFC, credit institutions cannot grant credit, in any form or type, including investments and provision of guarantees, either directly or indirectly, to the executive members of their management or to auditing board members, or to companies or other legal persons directly or indirectly controlled by them.</p> <p>In order to monitor compliance with Article 85, credit institutions report to BdP on a yearly basis, a list of all the entities to which such rule is applicable, as well as the credit amounts involved, if any (Instruction No. 2/04).</p> <p>The law also establishes limits to the credit granted to owners of qualifying holdings (Article 109 of the LFCIFC), as detailed in Principle 10.</p> <p>During on-site examinations, the working program for credit includes the assessment of credit granting conditions to shareholders and to other entities with special connections. The credit portfolio is also checked to find if credit has been granted to</p>
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	<p>entities that are not allowed such credit.</p> <p>In the credit risk assessment performed through on-site examinations, the management information system is analyzed and the supervisor verifies the monitoring by management of the total indebtedness of the clients.</p> <p>The Central Credit Register maintained by the BdP is an additional tool used by off-site supervision to cross check credit information, as well as to check consistency with the large exposures report that banks must submit quarterly (Notice No. 10/94).</p> <p>The above mentioned regulation also covers the credit risk arising from the investment portfolios of banks.</p>
Assessment	Compliant
Comments	
Principle 8.	<p>Loan Evaluation and Loan-Loss Provisioning</p> <p>Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan-loss provisions and reserves.</p>
Description	<p>BdP established through Notice No. 3/95 the minimum levels of loan provisions for the coverage of possible bad debts.</p> <p>Credit risk provisioning is required on a solo basis and is built upon minimum levels established for the coverage of general portfolio risk and specific credit risk.</p> <p>As stated in Notice No. 3/95, total credit granted by the institutions is considered for the purposes of building up provisions for general credit risks, including that represented by guarantees and other similar off-balance sheet instruments (Notice No. 3/95 7th (1)). Assets and off-balance sheet exposures on residents of countries considered risk countries are also subject to the building-up of provisions for country-risk (Notice No. 3/95 12th).</p> <p>For problem credits, banks are required to keep specific credit risk provisions for the coverage of overdue credit and other doubtful debts.</p> <p>All credits are accounted as overdue if they are not repaid within a maximum period of 30 days after maturity, or earlier if the institution considers that immediate repayment is not possible (Instruction No. 6/05).</p> <p>Overdue credit is allocated into several risk classes, which reflect the scheduling of credit and interest that has fallen due according to the period elapsed from the respective maturity. The percentages of provisions required depend on the type of loan, the collateral extended and the risk class. Specific credit risk provisions are computed on an individual item basis.</p> <p>Notice No. 8/2003 has substantially modified this provisioning regime, increasing the requirement for provisions.</p>

	<p>The extension or renewal of overdue credits will not interfere with the accruing periods elapsed from maturity nor does it exempt institutions from the building-up of provisions, except where collateral has been appropriately reinforced or the interest and other liabilities fallen due have been fully paid by the debtor (Notice No. 3/95 3rd).</p> <p>Payments falling due related to overdue loans are considered doubtful debts, namely when interest and capital in arrears exceed 25 percent of outstanding capital plus interest in a credit transaction or payments are 6,12 and 24 months overdue in, respectively, 5, 10 and above 10 years maturity loans (Notice No. 3/95 4th). Under these conditions specific provisions equal to those applied to overdue credits are required. Also, payments falling due in respect of all credit granted to an individual client must be considered doubtful debt, when the overall value of payments in arrears exceeds 25 percent of the total outstanding debt.</p> <p>Interests falling due upon overdue loans without collateral are accounted up to 90 days. After that period, the amount registered is cancelled. In the cases covered by a pledge to provide collateral, the interests are accounted up to the limit of the respective collateral and subjected to the general schedule for provisioning.</p> <p>Banks are required to have, on a permanent basis, a management system for problem credits and all past due loans. They should monitor individual loans, as well as ascertain provisioning adequacy (making sure it is consistent with internal ratings, monitoring collateral value, etc) and the quality and the composition of the credit portfolio (identifying risk concentrations – geographical, by economic sector, by counterpart, by type of instrument, by maturity, etc). Banks should set up a system that will allow a quick response to deteriorating credit quality, and define ways of dealing with problem credits (Credit Risk Annex of the Instruction No. 72/96 8, 9, 12 and 16).</p> <p>Therefore, the legal framework establishes the minimum level of provisions, but every credit institution must adopt policies for the provisioning of their assets in line with stricter and more prudent criteria (Notice No. 3/95), if necessary.</p> <p>BdP may determine, on a case-by-case basis, that an institution reinforces its provisioning policy, whenever it deems that the provisions already built up are insufficient in view of the institution's situation or that of the markets or sectors in which the institution is more active (Notice No. 3/95 18th).</p> <p>BdP may also determine, by Circular Letter addressed to all institutions, the mandatory building-up of provisions under conditions other than those laid down in the Notice, where the circumstances justify it, specially when there is reason to doubt the collection of credit from a client or a group of connected clients, due to the deterioration of their solvency position, in particular when special reorganization or bankruptcy measures are adopted (Notice No. 3/95 17th). BdP has used this possibility in some cases.</p> <p>On a semi-annual basis banks' external auditors are required to present a specific report</p>
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	<p>to BdP on the economic provisions necessary for the coverage of the implicit risk in a credit portfolio. If these economic provisions appear to be higher, the BdP will require additional provisioning.</p> <p>In the case of collateralized overdue credits, institutions must verify whether the existence of privileged creditors, the financial situation of the guarantor, or any other circumstance may cause the value of the collateral to be insufficient. Regulation also establishes rules for the periodic evaluation of tangible collateral (Notice No. 3/95 3rd (5) and (6)).</p> <p>Banks should report on provisioning, on a quarterly basis (Instruction No. 9/03). Monthly accounting data provide information on credit classification and status. A quarterly assessment that includes credit indicators and loan loss provision analysis is performed.</p> <p>If insufficient provisioning is detected, banks are required to deduct that amount from Tier I regulatory capital (Notice No. 12/92, 4th (7)).</p> <p>In on-site examinations to the credit portfolio of banks, the procedures, policies and internal organization are analyzed, with special emphasis on the process of identification and ongoing oversight of problem credits. The classification of loans and specially the refinancing of loans are the object of extensive analysis. The evaluation of collateral and its frequency are also assessed.</p> <p>As consequence of these examinations, recommendations are often issued to strengthen the asset evaluation criteria and to increase the level of provisioning, mainly in regard to renewed overdue loans.</p>
Assessment	Compliant
Comments	<p>The minimal provision is calculated accordingly to the following table. The percentage values presented in the table are applicable to the overdue credit as well as to other doubtful credits, which are classified as overdue for the purpose of provisioning. (in percentage)</p>

Length of time in default	WITHOUT GUARANTEE	WITH GUARANTEE				
		Secured by personal guarantee	Non mortgage pledge	Other cases	Mortgage pledge	
					Property occupied by the borrower	
					LTV ≥ 75%	LTV < 75%
Up to 3 months	1	1	1	1	0.5	0.5
3-6 months	25	10	10	10	10	10
6-9 months	50	25	25	25	25	25
9-12 months	75					
12-15 months	100	50	50	50		
15-18 months		75			50	
18-24 months		100	75	75		50
24-30 months					75	
30-36 months			100	100		
36-48 months						75
48-60 months					100	
Over 60 months						100

The experience of BdP, confirmed during meetings with several bankers and external auditors, demonstrates that the minimum provisions required by the regulation has been higher than the economic provisions necessary to cover the implicit risk in a credit portfolio.

Indicators of Asset Quality of the Banking Sector collected by BdP showed the following performance in the last five years:

	2000	2001	2002	2003	2004
NPLs as percent of gross loans	2.18	2.12	2.26	2.40	1.98
Specific provisions as percent of NPL	67.78	66.84	62.79	72.94	83.36
Total provisions as percent of NPL	155.46	152.76	141.45	141.89	167.05
NPL net of specific provisions as percent of gross loans	0.71	0.70	0.84	0.65	0.33

BdP loan loss provisioning rules are not yet underpinned by a risk based system. However, as highlighted under BCP 6, banks are in the process of preparing compliance with Basel II and the models approach.

Pending these changes, the presence in Portugal of a dual system of calculating provisions (economic and regulatory provisions), operated respectively by the banks and by their external auditors, provides an acceptable prudential approach.

	<p>However, it is recommended that Portugal accelerate the migration to a more comprehensive risk based approach for the evaluation of credit.</p> <p>The mission has been informed that BdP is presently revisiting the format of the credit register system (<i>Central de Riscos</i>) in order to enhance its efficiency as a supervisory tool, e.g., banks will be required to communicate the rating attached to credits above EUR 500,000 and BdP will establish the methodology that should underpin this practice. The mission recommends that this amount be lowered (e.g. to EUR 250,000).</p>
Principle 9.	<p>Large Exposure Limits</p> <p>Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.</p>
Description	<p>Prudential limits that restrict bank exposures to single borrowers or groups of related borrowers are established in Notice No. 10/94, which is the result of the transposition of EU Directive (2000/12/EC, Title V, Chapter 2, Section 3).</p> <p>According to that Notice a “group of connected clients” means two or more natural or legal persons who are to be regarded as constituting a single risk, because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties. This relationship exists, in particular, when one of them, directly or indirectly has control over the other or others, or when they are all subsidiaries of the same parent company. When there are common shareholders, associates or managers and cross-collateral, or when the direct business inter-dependence cannot be replaced in the short run, it may indicate the existence of a group of connected clients (Notice No. 10/94 1st (5)).</p> <p>This definition is flexible allowing BdP to determine the inclusion of clients in groups, without the need of a shareholding position, which has been the case in some instances.</p> <p>Institutions must identify the inter-dependencies and connections of their clients, so as to be able to determine the existence of an interconnected group of clients, and must have adequate internal control mechanisms for this purpose (Notice No. 10/94 8th).</p> <p>Exposures include all claims and transactions, on-balance sheet as well as off-balance sheet (Notice No. 10/94 1st (3)), weighted by factors similar to those used for the solvency ratio according to the nature of counterparts or the type of collateral extended.</p> <p>Large exposures, to a client or group of connected clients, are defined as a risk that exceeds 10 percent of the regulatory capital of the institution (Notice No. 10/94 1st (4)). Exposures incurred by institutions are subject to the following limits: an exposure to a client or group of connected clients cannot exceed 25 percent of the institution’s own funds; the previous limit is reduced to 20 percent when the client is the parent company or a subsidiary of the institution or of the parent company or when the group of connected clients includes any of those entities; the total of large exposures incurred by the institution cannot exceed 8 times its own funds (Notice No. 10/94 4th).</p>

	<p>These limits are expanded to 40 percent and 12 times own funds on a solo basis for institutions subject to supervision on a consolidated basis (Notice No.10/94 10th (1)).</p> <p>Such limits must be complied with at all times (Notice No. 10/94 7th), but if, in an exceptional case beyond the institution's control, exposures exceed those limits, that fact, and the circumstances giving rise to it, must be reported without delay to BdP, which will determine the period and conditions for the institution to rectify the situation (Notice No. 10/94 22nd).</p> <p>When a corrective plan is agreed upon and is not complied with, the supervisory practice has been to deduct such excesses from the institution's own funds.</p> <p>In on-site examinations, the information systems set up by the banks in order to identify the total exposures (to a client or group of clients) and the relationships between clients are reviewed, as well as the procedures implemented to monitor compliance with the regulatory limits. These examinations are carried out on both a solo and on a consolidated basis.</p> <p>Banks report the large exposures to a client or a group of clients, quarterly on a solo basis, and semi-annually on a consolidated basis (Notice No. 10/94 20th and 21st). Such reports are analyzed in order to verify compliance with the limits. Consistency tests between the Credit Central Register or other sources and banks' reports are usually performed through off-site supervision.</p> <p>BdP recommends that aggregate exposures to entities established in some geographic areas (Asia Pacific, Latin America and Eastern Europe) are subject to a limit of 30 percent of the bank's own funds (Letter 756/98/DSBRE). These exposures are reported monthly on a solo basis and quarterly on a consolidated basis.</p> <p>Exposure to economic sectors is monitored through the quarterly analysis and the banks' Annual Report.</p>
Assessment	Compliant
Comments	
Principle 10.	<p>Connected Lending</p> <p>In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.</p>
Description	<p>In order to prevent abuses, the LFCIFC Law forbids and/or limits lending to connected parties, especially to board members (Article 85) and to owners of qualifying holdings (Article 109) and Notice No. 10/94 establishes more stringent limits to exposures where the group of clients is the parent company of the institution and/or its subsidiaries.</p> <p>Therefore, credit institutions may not grant credit, in any form or type, including the provision of guarantees, either directly or indirectly, to executive members of their</p>

	<p>management or members of auditing boards, nor to companies or other legal persons directly or indirectly controlled by them (Article 85 (1) of the LFCIFC), except in case of transactions of a social nature or purpose, or arising out of the personnel policy (Article 85 (4) of the LFCIFC). The indirect nature of credit granting is presumed, when the beneficiary is married, related by blood or affinity in the first degree, to any member of the management or auditing boards, or a company directly or indirectly controlled by one or more of these persons (Article 85 (2) of the LFCIFC).</p> <p>BdP may provide for the application of limits to the members of the general council, to non-executive board members and to companies controlled by them and to the members of other bodies, deemed to perform equivalent functions and companies controlled by them (Article 85 (6) of the LFCIFC).</p> <p>Board members, directors and other employees, advisers and representatives of credit institutions cannot intervene in appraisal and decision making on operations in which they, their spouses, relatives by blood, or persons related to them by affinity in the first degree, as well as companies or other collective bodies directly or indirectly controlled by any of these persons, are parties concerned (Articles 85 (8) and 86 of the LFCIFC).</p> <p>Credit to board members, within the legal restrictions, is subject to approval by at least two thirds of the remaining members of the management board, as well as the favorable opinion of the auditing board (Article 85 (8) of the LFCIFC).</p> <p>Regarding lending to owners of qualifying holdings, banking law defines such holdings as a direct or indirect holding in an institution, which makes it possible to exercise a significant influence over the management of the entity, presumed to occur whenever the participant holds at least 5 percent of the capital or the voting rights (Article 13 (7) of the LFCIFC). However, as mentioned in Principle 4, also shareholdings below 5 percent and equal or above 2 percent may be considered by BdP as a qualifying holding (Article 102 (4) and (5) of the LFCIFC).</p> <p>The law establishes that the amount of credit granted, in any form or type, including the provision of guarantees, to a person who owns, directly or indirectly, a qualifying holding in a credit institution (or to companies, directly or indirectly, controlled by such a person, or belonging to the same group as such a person), may not exceed, on the whole and at any time, 10 percent of the institution's own funds. The total amount of credit granted to all owners of qualifying holdings may not exceed, at any time, 30 percent of the bank's regulatory capital (Article 109 of the LFCIFC).</p> <p>As mentioned for credit to Board members, granting credit to qualifying holding owners is subject to approval by at least two thirds of the management board (Article 109 (3) of the LFCIFC).</p> <p>On the other hand, Notice No. 10/94 establishes a limit of 20 percent of own funds to the exposures to the group of clients formed by the parent company and/or its subsidiaries, which is more stringent than limits to other groups of clients (as detailed in principle 9).</p>
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	<p>The definition of a group of connected clients, established by Article 1, 5) of Notice No. 10/94, is mentioned in Principle 9. Banks must identify the inter-dependencies and connections of their clients, so as to determine the existence of an interconnected group of clients, and must have adequate internal control mechanisms for this purpose (Notice No. 10/94 8th).</p> <p>According to the principles and recommendations set out in the credit risk Annex of Instruction No. 72/96, all granting of credit must be done on an “arm’s length” basis. Specifically, credit granted to companies or individuals who are in any way connected to the bank, must be authorized exceptionally and closely monitored, so as to minimize and control the risks of granting loans in “favored” circumstances and/or special conditions.</p> <p>In order to monitor compliance with Article 85 of the LFCIFC, credit institutions report to BdP, on a yearly basis, a list of all the entities to which it is applicable, as well as the credit amounts involved, if any (Instruction No. 2/04). This Instruction also requires that institutions must have an up-to-date list of all entities related with owners of qualifying holdings, with an indication of all existing liabilities.</p> <p>Banks are also obliged to notify BdP about relevant operations with other entities under the same holding company. This notification must be specific, especially about the income obtained and the criteria used to price fixing of the operation (Instruction No. 8/98). Should doubts arise regarding such conditions, BdP requires banks to provide all necessary information in order to have a better assessment of the situation.</p> <p>In on-site examinations the conditions under which credit is granted to shareholders and other entities with special connections are assessed and special attention is given to compliance with the credit limits to owners of qualifying holdings. The credit portfolio is also checked to find eventual credit granted to entities not allowed by the legal framework.</p> <p>Data from the Central Credit Register are an additional tool to check up on these situations, as well as reviewing the large exposures report that banks must submit quarterly (Notice No. 10/94). Special attention is given to compliance with the regulatory limit imposed on the group of clients of the bank’s parent company.</p>
Assessment	Compliant
Comments	
Principle 11.	<p>Country Risk</p> <p>Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring, and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.</p>
Description	<p>Country and transfer risks incurred by the banks are subject to specific provisioning according to Notice No. 3/95 1st (2) f).</p> <p>According to number 12th of the same Notice, all financial assets and off-balance sheet</p>

	<p>items on residents in countries considered risk-countries are subject to the building-up of provisions for country risk, irrespective of the underlying instrument or the nature of the counterpart, with some exceptions, namely shareholdings.</p> <p>As mentioned in the Credit Risk Annex of the Instruction No. 72/96, banks should monitor individual loans, as well as certain provisioning adequacy (making sure it is consistent with internal ratings, monitoring collateral value, etc) and the quality and composition of the credit portfolio (identifying risk concentrations – geographical, by economic sector, by counterpart, by type of instrument, by maturity, etc).</p> <p>Specific rules for country risk provisioning are described in Instruction No. 94/96 and BdP defines periodically, through Circular Letter, the list of countries and territories classified according to five risk groups. To each group a minimum percentage of provision is allocated. If by chance an institution has an exposure to a country or territory not mentioned in that list, it must decide on the appropriate degree of risk and submit it to the assessment of BdP (Instruction No. 94/96 2.5).</p> <p>The countries' risk scores are based on the classifications attributed by the <i>International Country Risk Guide</i>, the <i>Euromoney Country Risk Survey</i> and the <i>Institutional Investor</i> and are updated annually. However, if economic or financial conditions of a country change significantly, its classification is reassessed accordingly.</p> <p>BdP also recommended banks to limit the exposure to entities established in the geographic areas of Asia Pacific, Latin America and Eastern Europe (Circular Letter 756/98/DSBRE). Institutions report on this recommendation monthly and a quarterly analysis of the banking system's aggregate exposure is performed. This issue is also analyzed in the quarterly assessment of individual banks.</p> <p>Quarterly, banks report on country risk provisions. This report is checked, mainly for consistency between assets included for the calculation of said provisions and accounting of foreign items.</p> <p>On-site supervision of international lending and investment activities focuses on policies and procedures for identifying, monitoring and controlling country risk by banks, as well as the evaluation of the reliability of the prudential reports.</p>
Assessment	Compliant
Comments	
Principle 12.	<p>Market Risks</p> <p>Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor, and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposure, if warranted.</p>
Description	<p>The internal control system Instruction No. 72/96 6 – b defines that all credit institutions must, among other things control their market risk. To that effect the internal control system shall ensure the existence of a set of procedures enabling the</p>

	<p>achievement of this objective to be checked through the provision of reliable and timely data on these activities.</p> <p>As already stated under Principle 6, the BdP is authorized to issue Notices establishing the relations to be observed by credit institutions on a solo or consolidated basis between own funds and total assets and off-balance sheet items, weighted or not by risk coefficients.</p> <p>According to this general power BdP has issued Notice No. 7/96 imposing minimum capital adequacy requirements for credit institutions covering market risks and foreign exchange risks (Notice No. 7/96). This Notice, which represents the transposition of the relevant EU Directives, establishes standard methods for the calculation of own funds requirements for position, settlement and counterparty risks associated with the trading book and for foreign exchange risk (Annexes V, VI, VII, VIII).</p> <p>According to these methods, capital requirements computed for the trading book risks comprise the general and specific risk of securities, commodities and other financial instruments.</p> <p>Recently, BdP has issued a regulation that allows the institutions, after proper authorization, to calculate capital requirements for the coverage of trading book position risks and foreign exchange risks through their own internal models (Notice No. 7/96, Annex IX, introduced by Notice No. 8/2005), as an alternative to the standard methods. In such a case, the internal model must fulfill a set of criteria established in the same Notice.</p> <p>Institutions that intend to calculate capital requirements for the coverage of market risks by means of internal models shall request authorization in advance to BdP accompanied by an opinion of the auditing board, and indicating the reasons for their request.</p> <p>The capital requirements to be adopted in such cases must be the highest VaR for the previous day or the average daily VaR over the last 60 business days, multiplied by a factor of at least 3 (Notice No. 7/96, Annex IX – 7).</p> <p>According to the regulation, institutions must assess daily their trading book at market prices (Notice No. 7/96 7th). Also, they must ensure the existence of comprehensive, reliable and timely accounting and financial information, in particular, as regards their recording, keeping and availability (Instruction No. 72/96 6 (d)).</p> <p>The securities inventory that banks file quarterly allows supervisors to assess the market value of the portfolio.</p> <p>The compliance with capital requirements is monitored through specific periodic reports filed by banks and reviewed in the quarterly analysis, which also includes market risks. On a consolidated basis such reports and analysis are made semi-annually.</p>
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	<p>Through on-site examinations, supervisors verify the information, risk management and internal control systems to comply with capital requirements and check whether internal limits are defined as well as adhered to.</p> <p>On the other hand, the annual report on the internal control system contains specific information about market risk and foreign exchange risk, and is reviewed by supervisors.</p> <p>Concerning contingency planning, BdP has recently issued, through Circular-Letter 100/05/DSBDR, a set of High Level Principles on this issue, to be used as guidance for supervised institutions to improve their own contingency planning frameworks.</p>
Assessment	Largely Compliant
Comments	<p>The degree of sophistication and complexity of the risk management techniques used by Portuguese credit institutions is considerably diverse. This heterogeneity not only exists between institutions but also in the risk management tools used by the same institution to address different risks or portfolios.</p> <p>Trading book risks, particularly interest rate risk, equity risk or exchange risk, for example, are usually managed through more advanced techniques, including value-at-risk models, whereas in the banking book less sophisticated tools are generally applied. Interest rate risk in the banking book, for example, mainly makes use of maturity or repricing gaps, eventually complemented with some form of sensitivity analysis. Credit risk stress testing is much rarer. Nevertheless, most of the Portuguese banks were able to perform this kind of test when requested in a recent exercise promoted by the DSB of the BdP.</p> <p>Since the regulation that allows the use of internal models has been recently issued, to date no models have been submitted to BdP for validation, which means that there is scarce practical experience in this field.</p> <p>Requirements relating to banks' scenario analysis, stress testing and contingency planning, as well as periodic validation or testing of the systems to ensure the best practice to measure market risk are developed in Notice No. 7/96, Annex IX and in Instruction No. 22/2005.</p> <p>This Instruction requires institutions to report on their back testing results and if there are numerous overshootings, BdP can revoke the model's recognition for the calculation of capital requirements (Notice No. 7/96, Annex IX –14).</p> <p>The BdP needs to extend its expertise and operational capability in this area. BdP has therefore decided to hire additional experienced staff; the recruitment process has already been launched and five specialized staff will be added in the near future.</p>

Principle 13.	<p>Other Risks</p> <p>Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.</p>
Description	<p>As a general principle, banks must invest their available funds in such a way as to ensure appropriate levels of liquidity and solvency at all times (Article 94 of the LFCIFC).</p> <p>Moreover, Notice No. 7/96 3rd (2) establishes that institutions must cover with own funds other risks similar to the ones already covered by specific rules related to the trading book and banking book (namely credit risk, market risk and foreign-exchange risk).</p> <p>Furthermore, in the design and implementation of their internal control system, institutions must take into account their type and size as well as the nature and risks of the operations carried out. This process must be directly monitored by the Board of Directors of the institution (Instruction No. 72/96 3 and 4).</p> <p>On the other hand, an adequate and effective internal control system must be able to provide the managing body with timely and reliable information about all the institution's activities (Instruction No. 72/96 7 d).</p> <p>Regarding internal disclosure and dissemination of the risk management processes, Instruction No. 72/96 5 states that the fundamental rules of the internal control system, namely those establishing its purposes, procedures and the means necessary to ensure its implementation must be written down and made available to users.</p> <p>The referred Instruction also establishes principles/recommendations for interest rate, liquidity and operational risks based upon the relevant papers issued by the BCBS and requires banks to specify the reasons for any eventual non-compliant situations.</p> <p>According to Notice No. 7/96, institutions are required to demonstrate to BdP that they employ systems which can calculate their financial positions with reasonable accuracy at any time and that they monitor and control specifically the interest rate risk of their entire business (Notice No. 7/96 3rd (4) and (5)).</p> <p>Furthermore, institutions must report detailed information regarding their level of exposure to interest rate risk in the banking book. Additionally, they must file the report set out in the Annex to Instruction No. 19/2005, which was designed to measure the impact on equity and on interest margin of a +/- 200 basis points parallel shift of the yield curve.</p> <p>Credit institutions must report quarterly their liquidity risk both on a solo and consolidated basis (Instruction No. 1/2000). The liquidity ratio focuses on truly liquid</p>

	<p>assets and is calculated considering on- and off-balance sheet items. BdP can determine on a case-by-case basis the level of liquidity considered adequate, regarding the specificity of the institution.</p> <p>Reports on liquidity are checked and mentioned in the quarterly analysis made by supervisors, and are subject to on-site examinations.</p> <p>Bearing in mind the European Commission Recommendation of 23/06/2000, BdP issued an Instruction regarding the disclosure of information on financial instruments and other elements that must be present in the banks' Annual Reports (Instruction No. 22/2001). According to such Instruction, information should be disclosed about risk management practices and policies.</p> <p>During on-site examinations, the adequacy of internal control systems and internal audit reports are reviewed in order to detect possible fragilities of the institutions, namely regarding operational risk.</p>
Assessment	Compliant
Comments	<p>Although not stated in the regulation, BdP recommends on a case by case basis the maintenance of a minimum liquidity ratio.</p> <p>It should be mentioned that the regulation on operational risk will be further developed by BdP as a consequence of the adoption of Basel II Rules on this matter (through EU Directives), which explicitly foresees a capital charge for this type of risk.</p> <p>However, BdP has recently issued, through Circular-Letter 100/05/DSBDR a set of High Level Principles, to be used as guidance for supervised institutions to improve their own contingency planning frameworks.</p>
Principle 14.	<p>Internal Control and Audit</p> <p>Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls, as well as applicable laws and regulations.</p>
Description	<p>The fundamental rules on internal control systems for credit institutions are established in Instruction No. 72/96.</p> <p>Articles 406 and 431 of the Company Law state that the Board of Directors has the responsibility to deliberate over any issue concerning the management of the institution, specially the annual accounting report, important changes in the companies' activities or its organization, cooperation or termination of cooperation with other entities, capital increases and projects involving a merger, split or transformation of the company.</p> <p>The members of the Board of Directors in charge of the day-to-day management of the</p>

credit institution and official auditors belonging to the auditing board must have appropriate experience to perform their functions (Article 31 of the LFCIFC).

To assess their experience BdP requires that prospective board members submit an information form set out in Instruction No. 103/96.

The lack of suitability, experience or availability of management or auditing board members will result in the request for registration being refused (Article 69 (5) of the LFCIFC).

If for any reason the legal or statutory requirements for the normal operation of the management or auditing boards cease to be met, BdP will stipulate a period for the change in the composition of the board in question (Article 32 of the LFCIFC).

The setting up and update of the internal control system, as well as the verification of its effective implementation and efficiency, must be directly monitored by the institution's Board of Directors (Instruction No. 72/96 4).

In designing and implementing the internal control system, account will be taken regarding the type and size of the institution, as well as the nature and risks of the operations it carries out (Instruction No. 72/96 3).

In order to be able to monitor banks' internal control systems BdP annually receives a report (produced by the Board) that covers:

- The organizational structure, including control procedures regarding compliance with the prudential rules, as well as the adequacy of operations carried out with reference to other applicable rules;
- Control procedures over the risks of the institution on credit, interest rate, market, liquidity and settlement of foreign exchange position risks, as well as operational and compliance risks;
- Accounting procedures implemented in order to achieve comprehensive, reliable and timely information;
- Segregation of functions as regards credit and market operations between the authorization, execution, recording, custody of valuables and other documentation and respective control;
- Prevention of the institution's involvement in money laundering related operations;
- Safeguarding of assets through the regular execution and control of inventories.

The above-mentioned report must be accompanied by the opinion of the board of auditors on the internal control system.

The procedures described in the annual Internal Control System Report are validated through on-site supervision.

Information on human resources, audit operations carried out and respective follow-up, as well as the schedule of future auditing works, are required to be reported.

	<p>Official auditors and external auditors of a credit institution have a duty to report promptly to BdP any fact of which they have become aware while carrying out their tasks, whenever such facts may constitute a material breach of laws or regulations, affect the continuous functioning of the institution or lead to the refusal to certify the accounts or to express reservations (LFCIFC, Art. 121).</p>
Assessment	Compliant
Comments	
Principle 15.	<p>Money Laundering Banking supervisors must determine that banks have adequate policies, practices, and procedures in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.</p>
Description	<p>According to Article 13 of the Anti-Money Laundering (AML) Law No. 11/2004 of 27 March, the financial entities covered by the Law include credit institutions, which are also subject to regulations issued by BdP on this issue, namely: i) Instruction No. 26/2005 on Anti-Money Laundering (which replaces previous Instructions), Instruction No. 72/96 on internal control and Notice No. 11/2005 on the opening of deposit accounts (which replaces Instruction No. 48/96).</p> <p>According to Article 11 of AML Law, credit institutions, including their foreign branches and subsidiaries, have to create internal control and reporting mechanisms that enable compliance with the requirements provided for in the law, and prevent the execution of transactions connected with the laundering of funds of illicit origin.</p> <p>According to Article 19 of the AML Law, ensuring compliance with the requirements provided for in the Law is the responsibility of the supervisory authorities within the respective sector. The entities provided for in this Law, are subject to the following responsibilities (Articles 2 to 11): a) to identify suspicious transactions; b) to refuse to carry out such transactions; c) to keep relevant documents; d) to examine relevant documents; e) to report such transactions; f) to abstain from such transactions; g) to cooperate with the authorities; h) to keep secrecy; i) to provide training for staff and have in place appropriate control mechanisms.</p> <p>Therefore, in the performance of its supervisory functions, it is incumbent on BdP, as regards AML, to supervise the activities of credit institutions, to oversee their compliance with the rules governing their activities; to issue recommendations to put an end to any irregularities detected; and to impose penalties on infractions related to BdP regulations.</p> <p>BdP Instruction No. 26/2005 mentioned above requires credit institutions to develop programs against money laundering. These programs must comprise: i) internal policies, procedures and controls, including mechanisms to ensure the monitoring of transactions, such as, electronic systems that allow the detection and control of higher risk transactions; procedures that aim to prevent risk from misuse of technologies that might favor anonymity; ii) adequate procedures to ensure high ethical standards when</p>

	<p>hiring employees; iii) ongoing training programs for management and staff in subjects related to anti-money laundering.</p> <p>As established by Instruction No. 72/96, credit institutions must also have an internal control system that (i) among other main objectives, seeks to ensure the adequacy of the operations carried out by the institution in respect of the relevant legal, regulatory and statutory provisions, internal rules, professional and moral rules and practices, and (ii) seeks to prevent the involvement of the institution in money laundering related operations. These procedures are written down and made available to all staff.</p> <p>Instruction No. 26/2005 requires institutions to (i) appoint an official responsible for the co-ordination of internal control procedures regarding anti-money laundering requirements as well as for the centralization of information and respective reporting to the competent authorities, and (ii) mention his/her place in the organizational structure.</p> <p>Taking into account the different types of risks to which institutions are exposed, including, among others, legal and reputation risks, credit institutions are also required to notify BdP of any relevant situation related to its activities which may have a significant impact on its financial soundness (Instruction No. 19/2004).</p> <p>The disclosure in good faith of information by credit institutions to the competent authorities does not constitute a breach of any legal restriction on disclosure of information and must not involve the persons who disclosed the information in liability of any kind (Article 12 of the AML Law).</p> <p>The DSB of BdP carries out verification through off-site surveillance (mainly by analyzing the annual report on the internal control system) and on-site inspections (either inspections with a general scope or in the context of targeted inspections), the latter being triggered by material deficiencies in the internal control report.</p> <p>In general, the aspects associated with the prevention of the institution's involvement in money-laundering related operations are the subject of inspection. BdP is obliged to inform the Attorney-General of the Republic whenever, in the course of inspections of credit institutions or by any other means, it has knowledge or grounds for suspicion that a laundering offence is being carried out. (Article 19 (2) of the AML Law).</p> <p>BdP provides relevant training programs for their employees, including in subjects related to anti-money laundering.</p>
Assessment	Compliant
Comments	
<p>Principle 16.</p>	<p>On-Site and Off-Site Supervision</p> <p>An effective banking supervisory system should consist of some form of both on-site and off-site supervision.</p>
Description	<p>According to Article 116 of the LFCIFC, financial supervision is the responsibility of the BdP, where it is carried out by the DSB, which is organized into two main divisions:</p> <ul style="list-style-type: none"> • Advising/Consulting Division, with 37 staff members, is responsible for the preparation of prudential and accounting rules and reports, for the

	<p>harmonization of procedures adopted by the institutions and for the enforcement of penalties, among other functions.</p> <ul style="list-style-type: none"> • Supervision/Surveillance Division, with 73 staff members, has technical functions (supported by a team with administrative functions) and is organized into supervisory units. These units are responsible for the monitoring of all entities integrated in a financial group, and for carrying out the on-site and off-site examinations (on a solo and consolidated basis), which are performed by the same staff teams. <p>Financial institutions must provide BdP with whatever information it deems necessary to monitor their degree of liquidity and solvency, the risks they take, the compliance with the laws and regulations governing their activities, their administrative organization, the effectiveness of their internal control, the data-processing security and control procedures and the permanent compliance with the general requirements for credit institutions and its management. This includes access to reports submitted to the board by internal and external auditors (Articles 120 and 197 of the LFCIFC).</p> <p>Financial institutions are also obliged to report immediately to BdP any relevant situation that, directly or indirectly, may affect significantly its profitability or its solvency (Instruction No. 19/04). Official accountants and external auditors also have to report to BdP any facts that constitute material breaches of laws and regulations or affect the continuous functioning of the credit institutions (Articles 121 of the LFCIFC – see also Principle 19).</p> <p>All prudential information necessary to the continuous monitoring of credit institutions' financial condition and compliance with rules and regulations are integrated into several databases, which are available in every supervisor's computer workstation. Information about all bank loan exposures, by type and quality of loan is also available to the supervisors in the Central Credit Register database <i>Central de Riscos</i>, managed by the Statistics Department of BdP. Laws, prudential regulations and internal interpretations, as well as data culled from public documents (rating reports, press and internet Articles) are also available to each supervisor and are used in off-site and on-site examinations.</p> <p>Prudential reports are sent by institutions to DSB in standardized electronic format and integrated into database SEIS, giving supervisors easy access and use of such information, including the aggregation, for comparison purposes, of such information for all or part of the banking system.</p> <p>Off-site supervision is based on a continuous and systematic analysis of accounting, prudential, statistical and management reports, which allows the preparation of monthly reports of the largest/complex banking groups, quarterly reports of individual standard analysis for each institution and banking groups.</p> <p>On a half yearly basis, a consolidated analysis for each parent company under BdP supervision is prepared, together with a comparative analysis of the adequacy of the loan loss provisions calculated from an economic perspective by the external auditors</p>
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	<p>and the minimum regulatory provisions imposed by BdP.</p> <p>Annually, an analysis of the following is undertaken: (i) the level of coverage of liabilities on account of retirement and survivorship pensions of bank employees and compliance with actuarial and financial preconditions; and (ii) the main procedures and controls in place, the deficiencies detected and corrective measures adopted.</p> <p>Off-site surveillance also includes analyses of specific situations, such as: asset securitization and other structured operations, follow up of irregularities detected in on-site examinations, impact analysis motivated by non-current events (acquisitions/mergers, set-up of subsidiaries, strategic changes and others), based on data collected on an ad-hoc basis.</p> <p>Comparison of the loan classification by each bank in the <i>Central de Riscos</i> database with the classification attributed by other banks to the same client (e.g. nonperforming loans), in order to identify potential discrepancies to be analyzed in greater detail in on-site examinations.</p> <p>Off-site surveillance also comprises a continuous dialogue with the credit institution's designated contact, by phone or through meetings. Meetings between the board of directors of BdP and that of major banks are also held regularly.</p> <p>When necessary, collaboration with other supervisory entities is also promoted through meetings and other forms of exchange of information.</p> <p>Off-site surveillance is complemented or reinforced by performing on-site examinations. Results of off-site surveillance serve as an input for on-site inspections and are a determinant for prioritizing the institutions to be included in the annual on-site examinations plan, and for establishing the scope as well as the estimated time to perform each inspection. The annual on-site examination plan also includes follow-up inspections on institutions whose previous inspections showed important and severe irregularities. The plan, proposed by the supervisory heads of units and approved by the Board of Directors of BdP, can be modified as needed.</p> <p>Inspections can be either comprehensive/general or specific. For the largest five banking groups, on-site inspection is almost continuous, focusing on key risk areas, internal control systems, asset quality, liquidity, structured operations and compliance with prudential limits, both on a solo and on a consolidated basis. Inspections of other credit institutions or smaller banks are directed mainly at the assessment of their overall financial condition and compliance with prudential limits.</p> <p>Specific inspections can also be triggered by deterioration in the institution's financial condition or by the need to assess compliance with earlier recommended corrective measures. In the last three years, BdP performed, on average, 41 inspections per year (including 18 banks), of which 22 focused on institutions' specific sectors of activity or risks.</p>
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On-site inspection teams, composed exclusively of BdP staff, are led by the coordinator of each supervisory unit, assisted by two or more examiners belonging to the same supervisory unit and responsible for the off-site surveillance of that same institution. Nevertheless, BdP may require the carrying out of special audits by independent entities appointed by it, at the expense of the audited institution (Article 116 (2) of the LFCIFC).

The carrying-out of an inspection is preceded by preliminary work on collecting data from off-site surveillance reports (in order to compare it with internal information), *Central de Riscos* database (to identify potential discrepancies), prior examination reports (to confirm that irregularities have been corrected during the exam) and other external reports (e.g. rating reports), as well as prior recommendations or determinations of BdP.

On-site work formally begins with an initial meeting between the appropriate institution's senior management or board members and BdP's inspection team (including the senior head of unit), in which the scope, the objectives and the schedule for the examination are explained and an initial data request is presented (entry letter). Institutions have to facilitate on-site verification by BdP of their premises and examination of their books, along with all other data which BdP considers relevant for the assessment of the aspects mentioned in the foregoing paragraph. BdP may also take copies and transcripts of all the relevant documentation (Article 120 (2) and (3) of the LFCIFC). This includes the right to have access to copies of reports submitted to the board by both internal and external auditors.

During the examination, periodic meetings with bank management take place to discuss key issues and preliminary findings, in order to prevent misunderstandings and ensure that conclusions are derived from sound and accurate information. Ongoing communication is maintained with the senior coordinator of the supervisory unit (to keep track of developments) and with the advising division (to clarify legal, accounting and prudential issues). A quarterly report on all the on-site examinations, identifying the main weaknesses detected, is presented to the Board of Directors of BdP.

Inspections are especially important to assess the exact condition of the institution and the adequacy of its internal control system. It allows for a better identification of the risks (credit, liquidity, operational, foreign exchange, interest rate, and others) that may affect the institutions' activities, for an evaluation of regulatory and management reporting adequacy and for the performance of internal and external audit. On-site examination procedures and objectives are described in the Inspection Guide and areas to be covered by the inspection include capital adequacy, asset quality, management, earnings, liquidity, sensitivity to market risk, as well as compliance with the law and regulations, depending on the scope of the exam.

When the examination is completed, an exit meeting takes place between BdP (inspection team and the senior coordinator of the supervisory unit) and the senior

	<p>management or the board of directors of the inspected institution, to which the main examination findings and preliminary conclusions are transmitted and discussed.</p> <p>The comprehensive inspection report, revised and approved ultimately by BdP's Board of Directors, is sent to the Board of Directors of the examined institution and to the parent company when applicable, together with a covering letter requiring comments on the report, recommending the correction of the irregularities detected and setting a time frame for it, and imposing sanctions, if necessary. The covering letter is signed by the Department's Management or, in certain circumstances, by the Board of Directors of BdP. In general, the report is also sent to the board of auditors to present them with the irregularities detected and to ask for comments.</p> <p>The follow-up of the corrective actions is monitored by the supervisory unit, through periodic reports, meetings or, if necessary, by the scheduling of a new inspection.</p> <p>Quarterly analyses of off- and on-site activities, together with the integration of all information produced/received in GESPROC database, allows BdP's hierarchic structure to control and monitor the supervisory activities performed.</p>
Assessment	Largely Compliant
Comments	<p>The assessment of this Principle was done in conjunction with Principles 17 through 20, as recommended by the BCP Methodology issued by the BCBS in October 1998. Although those Principles were considered "Compliant", the present "Largely compliant" assessment reflects the existence of some small shortcomings identified in the overall assessment.</p> <p>Based on the Annex to the BCBS Methodology paper (items 6 and 9, page 51), it is expected that, in the context of European integration, and given the state of banking intermediation in Portugal and the risk profile of the banking industry, the essential and additional criteria are not sufficient to achieve the objective of the principle and therefore other measures, as practiced by other EU members, are necessary to determine whether compliance has been achieved. Furthermore, the definition of "Largely compliant" means "that only minor shortcoming are observed that are not sufficient to raise doubts about the authority's ability's to achieve the objective of that principle". Therefore, the general conclusion is that supervision is performed according to very high standards.</p> <p>The remaining areas to be covered concern the implementation of a formal risk rating system reflecting the assessment of the risk profile of credit institutions and financial companies. This risk rating system has been already designed and approved and is expected to achieve the full implementation of a consistent risk-based approach to supervision as it will be used primarily as a basis for the definition of the institution's risk profile and its rating. Although a risk analysis already exists and is embodied in the planning of the supervisory work, the future system is expected to deliver a more standard and eventually cost-efficient process for such activity. The risk-rating system is expected to be implemented during 2006.</p> <p>The risk rating system will enable BdP to enhance the systematic nature of its supervision activities and have its internal risk management process migrate towards a risk based supervision. It will also allow the supervisory priorities to be established based on the financial institution rating and calibrate the intensity of supervision of</p>

	<p>each financial intermediary.</p> <p>As a tool for off-site supervision, the electronic platform running the credit risk register is still not very user friendly. Data accessibility is limited or cumbersome and not integrated with other tools available for off-site work.</p>
Principle 17.	<p>Bank Management Contact</p> <p>Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.</p>
Description	<p>Meetings provide complementary information to the process of supervising credit institutions and are particularly important to explain the more complex aspects of banking activities and to get a qualitative view of the management.</p> <p>The frequency of contacts and the intensity of the supervisory effort carried out by BdP are established based on the risk profile of the institution, its significance in the banking system and the adequacy of its internal controls.</p> <p>Overall, contacts between BdP and the institutions have been frequent and different types of meetings are held:</p> <ul style="list-style-type: none"> • Meetings held between the Board of Directors and senior management of BdP and that of banking institutions to discuss strategic plans, corrective actions, recent developments, quarterly results or any other significant issues that may have arisen. The schedule of these meetings depends on the size and risk profile of the institution. • Ad-hoc meetings held in the course of the off-site surveillance between supervisors and banks' management at the different levels. The purpose of these meetings is to clarify technical matters on specific subjects, both from an operational and from a policy point of view, or to monitor the correction of irregularities. • Meetings covering several types of issues are held before, during and after on-site inspections in order to clarify any request or findings related to the ongoing inspection. <p>Those meetings provide the supervisors with the opportunity to meet with bank managers from different areas and to assess the overall management quality, specially its capacity to conceive and implement a sound strategy for the institution. After completing the on-site exam, and before sending the final inspection report to the Board of Directors of the examined institution, the inspecting team conducts a meeting with the bank's senior management/Board of Directors to present them with the preliminary conclusions of the exam. Given that the process of inspecting the largest banking groups is on a continuous basis, meetings are held with higher frequency than those held with smaller banks.</p> <p>Meetings are also held with the institution's external auditors or with its board of auditors to discuss specific matters that arise from the off and on-site examinations.</p> <p>At BdP institutional level, meetings are regularly held with the board of the APB in</p>

	order to discuss the evolution of the banking system and, by means of working groups, the implementation of new regulations (New Accounting Standards, New Capital Accord and others).
Assessment	Compliant
Comments	
Principle 18.	Off-Site Supervision Banking supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.
Description	<p>In accordance with the provisions laid down in Article 120 (1) of the LFCIFC, credit institutions and financial companies must provide BdP with whatever information it deems necessary to monitor their degree of liquidity and solvency, the risks they take, the compliance with the laws and regulations governing their activities, their administrative organization, the effectiveness of their internal control and data-processing security and control procedures. In addition, entities other than credit institutions, which own qualifying holdings in the capital of credit institutions, must supply BdP with all the data and information which it considers relevant for the supervision of the institution in which they own holdings (Article 120 (4) of the LFCIFC).</p> <p>Institutions subject to supervision on a consolidated basis are also bound to submit to BdP all the data required for the supervision and relating to companies in which they hold participations (Article 134 of the LFCIFC).</p> <p>Within the scope of the accounting harmonization laid down in Regulation No 1606/2002 of the European Parliament and of the Council, BdP, under the terms of Decree-Law No. 35/05, established through Notice No. 1/2005 that, starting on 1 January 2005, the institutions subject to its supervision must prepare their financial statements on an individual basis and on a consolidated basis, in accordance with IFRS, with the exception of small-sized savings institutions, group purchase management companies and exchange offices (that account for less than 0.1 percent of total assets of the Portuguese banking system), which continue to be governed by the provisions of Instructions No. 4/96 and No. 71/96.</p> <p>Within the scope of supervision on an individual basis, banks must periodically report to BdP:</p> <ol style="list-style-type: none"> i. monthly, detailed accounting data, prepared in accordance with the accounting rules (Instructions No. 4/96 and No. 23/2004), according to the accounting regime applicable to them (Notice No. 1/2005) and exposure of institutions to certain countries (Letter issued in February 1998); ii. quarterly, reports on capital adequacy for the coverage of risks associated with the banking and trading portfolio (market risks), large exposures and foreign-exchange risks (Instruction No. 25/97), minimum provisioning levels of credit and other assets (Instruction No. 9/2003) inventory of securities (Instruction No. 4/96), and liquidity level (Instruction No. 1/2000); iii. half-yearly, the level of exposure to interest-rate risk (Instruction No. 19/2005)

	<p>and quantification of economic provisions (Circular Letter 17/2002); and</p> <p>iv. annually, charges with retirement and survivors pensions (Instruction No. 4/2002) and annual accounts, which must be duly certified by a statutory auditor (<i>Revisor Oficial de Contas</i> – ROC) (Instructions No. 4/96 and No. 18/2005, and Notice No. 6/2003).</p> <p>The above data are also reported by non-bank credit institutions and financial companies, although their frequency may be lower and their applicability varies according to the risk profile and activity developed by each type of entity, as defined in the specific regulations issued by BdP.</p> <p>Within the scope of supervision on a consolidated basis, the leading institution of each group must report to BdP:</p> <p>i. quarterly, accounting data, depending on the accounting regime applicable to them (Instructions No. 23/2004 and No. 36/2000), liquidity level (Instruction No. 1/2000) and institutions' exposure vis-à-vis certain countries (Letter issued in February 1998), (ii) half-yearly, data on the capital adequacy level for the coverage of risks associated with the banking and trading portfolio (market risks), large exposures and foreign-exchange risks (Instruction No. 25/97), and level of exposure to interest rate risk (Instruction No. 19/2005) and</p> <p>ii. annually, consolidated accounts, which must be duly certified by a statutory auditor (Instructions No. 71/96 and No. 18/2005, and Notice No. 6/2003).</p> <p>In addition, parent entities must report half-yearly to BdP the composition of their groups, which are incorporated in a database containing data on the composition of financial groups (CGF data base) and enabling the automatic production of organization charts with the structure of the group (Instruction No. 10/2001). Institutions must notify BdP of the operations carried out with other entities of the group (Instruction No. 8/98).</p> <p>The majority of the data periodically reported to BdP is standardized and received in electronic format. The validation process was enhanced through the implementation of a network dedicated to the circulation of information between BdP and the institutions (BPnet), which is a secure channel for the transmission of confidential data.</p> <p>Statistical and prudential information necessary to an ongoing monitoring of the condition and performance of institutions is integrated into the following data-bases:</p> <p>SEIS – accounting and prudential data supplied by institutions.</p> <p>RAF – registrations that institutions must keep with BdP, which include, namely, the identification elements of the institution, the identification of the owners of holdings and qualifying shareholders, management and auditing board members, subsidiaries, branches and agencies, para-social agreements.</p> <p>CGF – composition of financial groups, including a certain degree of detail about percentages held, origin and amount of the capital stock and type of activity carried out.</p>
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	<p>GESPROC – system for the management of the Banking Supervision Department’s documents, containing the registration and storage of all external correspondence, as well as of all internally produced documents and the decisions taken.</p> <p>Other internally developed databases, in particular, related to legislation and understandings relevant to the supervision exercise, containing information made available by rating agencies.</p> <p>The DSB has also access to other BdP data-bases containing relevant information for supervision:</p> <p>BDIE - statistical database containing economic data, provided by different departments, and including information on exchange rates, interest rates and other macroeconomic indicators.</p> <p>CRC - central credit register containing the list of borrowers of credit operations in Portugal, broken down by lending institution, type and classification of credit (outstanding or fallen due);</p> <p>CB - central balance sheet data office containing the financial statements of non-financial corporations.</p> <p>In addition, the DSB has also access to some external databases, such as the Reuters services, Fitch, Standard Poor’s, Moody’s and Bankscope and to the restricted area of the International Accounting Standards Board – IASB website.</p> <p>Moreover, there is a set of established ratios and indicators, as well as standardized models for the monitoring and control of the activity of the several institutions, both at individual and consolidated level, as well as for the banking system, which enable time comparisons to be made for each institution, between institutions, banking groups and at the banking system level.</p>
Assessment	Compliant
Comments	
Principle 19.	<p>Validation of Supervisory Information</p> <p>Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.</p>
Description	<p>The monitoring of the activity of institutions supervised by BdP and the verification of compliance with the rules governing their activities are made through the analysis of the prudential data periodically reported to BdP, within the scope of the off-site monitoring, and by on-site inspections, the latter being mainly intended to verify the quality of reported data.</p> <p>In this context, supervised institutions must facilitate the on-site verification by BdP of their premises along with all other data which BdP considers relevant (Article 120 (2) of the LFCIFC). During the inspections, information is usually obtained directly from the IT system of the inspected institution for a better validation of the information reported to BdP.</p> <p>BdP may also require that the independent institutions or entities present, at the expense of the audited institution, progress reports related to prudential supervision</p>

	<p>(Article 116 (2) and Article 120 (6) of the LFCIFC). The exercise of this competence will be implemented through an Instruction, pursuant to which institutions must compulsorily send to BdP, every three years, an audit report relating to their information systems, carried out by an external, duly qualified and independent entity. Audits must be made on a consolidated basis, covering all entities included in the same composition of consolidation for supervisory purposes.</p> <p>According to <i>Código das Sociedades Comerciais</i> (Corporate Law) the accounts of the majority of the companies supervised by BdP (some small-sized companies being an exception) are certified by a statutory auditor (ROC), acting individually, or by an official statutory auditors firm (<i>Sociedade de Revisores Oficiais de Contas</i>). In addition to other obligations to which they are subject by the general law, statutory auditors are liable to the Portuguese Statutory Auditor Institute (<i>Ordem dos Revisores Oficiais de Contas – OROC</i>), being subject to a code of conduct and to a set of rules issued by OROC. BdP has legal powers to require the presentation of the respective legal certification (Article 115 (3) of the LFCIFC).</p> <p>BdP requires the validation of some prudential issues, including the adequacy of the internal control system by the board of auditors (see comments to Principles 14 and 21), the adequacy of economic provisions by the external auditor (see comments to Principles 8 and 21) and calculation of the actuarial retirement pension liabilities. When needed, BdP confronts the board of auditors and the external auditors of the supervised institutions with the irregularities detected in the inspections made, requesting the issuance of their own opinion on them and monitors the corrective measures implemented by the institution. The external auditors and the statutory auditors have the legal obligation to report to BdP any fact of which they may have become aware while carrying out their tasks, whenever such facts constitute a material breach of the laws or regulations (Article 121 of the LFCIFC).</p> <p>BdP can oppose the nomination of the members of the auditing boards of institutions or request subsequently their replacement, based on their lack of suitability and professional experience or on the number of positions they accumulate (Articles 30 to 33 of the LFCIFC).</p>
Assessment	Compliant
Comments	
Principle 20.	<p>Consolidated Supervision</p> <p>An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.</p>
Description	<p>According to Article 130 of the LFCIFC, BdP has the legal competence to supervise credit institutions on a consolidated basis. For this purpose, financial holding companies are assimilated to credit institutions.</p> <p>It is incumbent on BdP to establish the appropriate rules governing supervision on a consolidated basis, which includes: a) the definition of the areas in which the supervision is to take place, b) the form and extent of consolidation and c) internal control procedures of companies supervised on a consolidated basis, specially those</p>

	<p>necessary to ensure the availability and quality of information that may be considered relevant for the purposes of supervision (Article 133 of the LFCIFC).</p> <p>The scope of supervision on a consolidated basis is defined in Articles 131 and 132 of the LFCIFC and in Notice No. 8/94. In general terms, without prejudice to supervision on a solo basis, credit institutions having their head office in Portugal and possessing one or more credit institutions as subsidiaries or holding a participation in such institutions, are subject to supervision on the basis of their consolidated financial situation.</p> <p>The consolidation scope criteria for supervisory purposes and the methods of consolidation for credit institutions are established in Decree-Law No. 36/92, together with Notice No. 8/94. The parent company and all its subsidiaries, wherever they are located, must be included in the consolidated supervisory scope, although companies with a different nature of activity (e.g. insurance, agricultural and commercial companies) are excluded (Notice No. 8/94 2nd (2)).</p> <p>Additionally, BdP may, whenever it deems it more appropriate for supervision purposes, determine the inclusion in consolidated supervision of:</p> <ul style="list-style-type: none"> - credit institutions that: a) even without being owned by another credit institution, are significantly influenced by it, b) are placed under single management together with credit institutions, c) share a majority of common members in the management or auditing boards (Article 131 of the LFCIFC). - an entity which would otherwise be excluded, in particular, on the basis of its activity (insurance, agricultural and commercial companies) (Notice No. 8/94 2nd (4)). <p>BdP may also exclude credit institutions from consolidation if their head office is situated in a country where there are legal impediments preventing the exchange of information relevant for the purpose of consolidation, if it is of negligible interest with respect to the objectives of supervision or if its incorporation is inappropriate or misleading, as far as the objectives of supervision are concerned. Exclusion may result from an initiative of BdP or from a proposal that is presented to it, whereas the final decision is always is BdP's (Notice No. 8/94 4th).</p> <p>The understanding of the overall structure of banking groups and of their main activities is assured through a set of regulatory rules and procedures.</p> <p>The banking group's structure is communicated to BdP on a half yearly basis (or more often if significant changes in the group occur). The location and date of the setting-up of branches, subsidiaries, and agencies of credit institutions having their head office in Portugal is subject to registration in BdP (Article 66 of the LFCIFC), and, therefore, subject to compliance with a set of requirements (e.g. "fit and proper" standards – Principle 3).</p> <p>Portuguese credit institutions wishing to acquire, direct or indirectly, an interest in foreign credit institutions or in foreign financial institutions that represents 10 percent</p>
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or more of its share capital (or 2 percent or more of the share capital of the participating institution), have to communicate in advance such intention to BdP. The establishment of subsidiaries (or branches) in non-EU countries also has to be notified in advance to BdP, and it may be refused for good reasons, namely when the financial situation of the institution is inadequate for the project (Articles 42, 42-A and 43-A of the LFCIFC).

As a general rule, institutions subject to consolidated supervision (including financial holding companies) must submit to BdP all the information required for the supervision of companies in which they hold interests. In answer to Principle 18 there is a description of all the information on a consolidated basis that the holding has to report to BdP. Additionally, companies in which institutions hold participations are obliged to provide those institutions with whatever information may be necessary for compliance with the provisions of the foregoing paragraph. When the parent company of one or more credit institutions is a financial holding company or a mixed-activity holding company, these and their subsidiaries are obliged to supply BdP with all the information which may be relevant for supervision. (Article 134 (1), (2), and (3) of LFCIFC).

The institutions, including holding companies, are also obliged to submit to BdP all the transactions made with entities that are linked by a control relationship or a joint control, if they exceed 0.5 million euros or 1 percent of own funds' (Instruction No. 8/98).

According to Notice No. 8/94 1st, credit institutions must comply with prudential regulations on a consolidated basis, or, in certain circumstances, on a sub-consolidated basis at the level of the banking organization. Such regulations relate to limits on capital adequacy, concentration of risks, minimum provisions covering financial fixed asset losses, relationship between holdings and own funds, relationship between shareholdings and participated companies and fixed assets ratio and acquisition of shareholdings (Articles 99, 100, 101 and 113 of the LFCIFC).

In practice, supervisory activities are predominantly performed on a consolidated basis with the objective of assessing the overall solvency and liquidity of financial groups. All the prudential information necessary to the continuous monitoring of banking groups' condition and compliance with rules and regulations is integrated, mostly in electronic support, into several databases, which are available on every supervisor's computer (the consolidated information received by BdP is described in more detail in Principle 18).

Off and on-site examination processes are performed with the objective of supervising the entire activities of the group, whether they are carried out directly or by means of subsidiaries and/or affiliates, and of evaluating all significant risks incurred, including risks derived from non-banking activities that may be considered significant for the group as a whole.

	<p>Risks on non-banking activities are limited and regulated by Articles 99, 100, 101 and 113 of the LFCIFC, which establish the following:</p> <ul style="list-style-type: none"> • no credit institution may hold a qualifying holding in the capital of a company which exceeds 15 percent of the former's own funds (except for financial institutions); • the overall amount of qualifying holdings in companies cannot exceed 60 percent of the participating credit institution's own funds; • participation of credit institutions in non-financial companies is limited to 25 percent of its capital (even though there is a grace period of three years); • limits on risk concentration (see Principle 9); • limits on the value of the fixed assets of credit institutions, as well as of the total value of shares and other equity capital of any companies not included in the above assets that credit institutions may hold (Notice No. 5/03). <p>BdP has the authority to establish and enforce "fit and proper" criteria concerning the senior management of parent companies (Articles 69 and 30 of the LFCIFC) and the owners of qualifying holdings (Article 103 of the LFCIFC), namely if the structure and characteristics of the business group in which the credit institution would be included does not permit adequate supervision.</p>
Assessment	Compliant
Comments	
Principle 21.	<p>Accounting Standards</p> <p>Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.</p>
Description	<p>It is incumbent on BdP, without prejudice to the tasks entrusted to the <i>Comissão de Normalização Contabilística</i> (the Portuguese Accounting Standards Board) and to the provisions of the <i>Código dos Valores Mobiliários</i> (the Securities Code), to set forth accounting standards to be applied to institutions subject to its supervision, as well as to define the financial information that the same institutions must submit to it and those that they must publish (Article 115 (1) of the LFCIFC).</p> <p>In accordance with the provisions laid down in Regulation No 1606/2002 of the European Parliament and of the Council of 19 July 2002, and in Decree-Law No. 35/2005, BdP established, through Notice No. 1/2005, the accounting standards with which most entities subject to its supervision must comply, are based on IFRS.</p> <p>The valuation rules are basically those defined in the IFRS, and the financial statements must be prepared in accordance with the international accounting standards' framework (Notice No. 1/2005 2nd).</p> <p>In the preparation of the financial statements on an individual basis, the amount of credit to clients and receivables from other debtors must be adjusted according to accurateness and prudence criteria, in order to reflect, at each moment, its realizable</p>

value; this adjustment shall not be lower than the one established in a Notice of BdP as the minimum reference value for the setting up of specific and general provisions (Notice No. 3/95). BdP has also established that tangible assets shall be valued at acquisition cost and that institutions cannot choose to apply the revaluation model envisaged in IFRS (Notice No. 1/2005 3rd (2) and (4)).

As the complexity of the IFRS is not compatible with the type of activity and/or with the size of certain institutions (e.g. exchange offices), BdP has established through Instructions No. 4/96 (individual basis) and No. 71/96 (consolidated basis), the accounting principles and valuation rules to be observed by those institutions (which basically consist of the recognition and subsequent measurement of assets/liabilities at historical cost), as well as their information reporting obligations.

In the preparation of the consolidated financial statements, the consolidation scope relevant for prudential purposes is stricter than the one resulting from the application of IFRS, since insurance companies and non-financial corporations, whose activities differ from those subject to the supervision of BdP, are excluded (Notice No. 8/94 2nd (2) – see comments to Principle 20).

The institutions subject to the supervision of BdP must publish their accounts under the terms and with the frequency defined in a Notice of BdP, which may require the respective legal certification (Article 115 (3) of the LFCIFC). Thus, through Notice No. 6/2003 1st and 3rd, BdP laid down that the annual accounts on an individual and on a consolidated basis, must be published in full in *Diário da República* (Official Gazette), including the following documents:

- a) Balance sheet and profit and loss account;
- b) Notes to the accounts;
- c) Management report;
- d) Legal certification of accounts, where applicable under the terms of the general law (this applies to the large majority of institutions under the supervision of BdP);
- e) Opinion of the auditing board, should such a board exist (this applies to the large majority of institutions under the supervision of BdP).

In addition, institutions must provide proof, to BdP, of the publication of their annual accounts (Notice No. 6/2003 4th).

Most entities subject to the supervision of BdP must also forward for publication in the Official Gazette the balance sheet regarding their overall activity, including the provisional results, as at the end of each of the first three quarters of the year, within 60 days as of the date to which it refers, and must provide proof thereof to BdP within 10 days after remittance for publication (Notice No. 6/2003 2nd and 4th).

BdP has also laid down that institutions must include a previously defined minimum set of indicators, whenever they publish quantitative information on one of the following issues: solvency, credit quality, profitability and efficiency (Instruction

	<p>No. 16/2004).</p> <p>The verification of the implementation by institutions of the rules defined by BdP is made within the scope of on-site and off-site supervision, mainly, through the analysis of provisions values, accounting data, financial statements and reports on the internal control system (see comments to Principle 16).</p> <p>Within the scope of the off-site supervision, economic and financial analysis are made quarterly to each institution, and the changes in values – in particular the most significant ones – in each account are examined. The receipt of the accounting reports is automatically controlled and measures are taken in the event of delay. These measures may range from a mere warning to the imposition of sanctions. The officials responsible for the institution may also be notified to appear before BdP to give the required explanations.</p> <p>In this context, the annual accounting documents are also analyzed, including the legal certification issued by the ROC. Although BdP has no powers to impede the publication of accounts, if it has doubts and reservations about their reliability, it may persuade the institutions to introduce corrections. In the event of non-conformity, sanctions may be imposed, especially the prohibition from being a member of the management or auditing boards and from holding corporate, managerial and supervisory posts (Article 210 (f), Article 211 (g), and Article 212 (c) of the LFCIFC).</p> <p>During the on-site examinations, the accounting records are analyzed in order to verify their authenticity and consistency, cross-checking the support documents with the respective accounting data, based on a sample of operations. On-site supervision is carried out according to an annual examination program, but they can also be performed outside the scope of that program, when, during the off-site supervision, any situation is detected justifying such examination (see comments to Principle 16).</p> <p>In the event of non-observance of the accounting standards and procedures set forth by law or by BdP and of failure to provide this Bank with the required information and communications within the established time limits, as well as in the case of false or incomplete information, fraudulent accounting or lack of organized accounting, BdP may impose sanctions on the members of the management board of such institutions (Article 210 (f) and (h), and Article 211 (g) and (r) of the LFCIFC).</p> <p>Following on-site examinations, a copy of the respective report is sent to the auditing board (which includes ROC in most cases), and comments are required if it was supposed that any irregularity detected should have come to the knowledge of this entity and that it should have taken action inside the institution or informed BdP thereon.</p> <p>BdP may communicate with the external auditors (including ROC), namely in order to obtain explanations or comments (see comments to Principle 19) and may participate in working groups on several issues, such as the publication of accounting and</p>
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prudential regulations.

On the other hand, the external auditors (including ROC) have a duty to report promptly to BdP, any fact concerning the institutions where they provide services, of which they may have become aware while carrying out their tasks, whenever such facts may: (i) constitute a serious breach of the laws or regulations, which lay down the conditions governing authorization or which specifically govern the pursuit of the activities of the institution; (ii) affect the continuous functioning of the institution; or (iii) lead to refusal to certify the accounts or to the expression of reservations (Article 121 (1) of the LFCIFC).

This duty is also applicable to the facts that come to the knowledge of the external auditors (including ROC) in the exercise of a similar task, but in an entity having close links resulting from a control relationship with the credit institution within which the above-mentioned task is carried out (Article 121 (2) of the LFCIFC).

The reporting requirement referred to above prevails over any restriction imposed by contract or by any legislative provision on the disclosure of information and shall not involve such persons in liability of any kind (Article 121 (3) of the LFCIFC).

Although BdP does not define any guidelines for ROC concerning the issue of the legal certification, the OROC issues regulations laying down the rules that must be complied with, concerning which the OROC Manual is particularly important. This Manual follows the international rules on this matter (International Standards on Auditing), containing specific rules on the audit work of ROC in banks. Thus, due to the fact that these rules are known and generally accepted, BdP considers that, at this stage, no recommendations should be added.

However, BdP may require that credit institutions provide specific reports related to prudential supervision, carried out by a duly authorized entity (external auditors, including ROC) and accepted by BdP for that purpose (Article 120 (6) of the LFCIFC), defining in such cases guidelines that must be observed in the respective audit work.

For some institutions (such as the Mutual Agricultural Credit Banks (*Caixas de Crédito Agrícola Mútuo*) not included in the Integrated Mutual Agricultural Credit System (*Sistema Integrado de Crédito Agrícola Mútuo*)), BdP has determined that an audit report must be annually produced by ROC focusing on relevant aspects of their activities, covering at least: (i) asset quality, in particular, the credit portfolio; (ii) resources from third parties (concentration); (iii) prudential limits and ratios (reporting tables to BdP); (iv) management and internal organization, highlighting any deficiencies in the internal control; and (v) specific applicable regulations.

Considering that the institutions' auditing boards must include a ROC, where applicable under the general law (which is the case for the majority of the institutions subject to the supervision of BdP), and that their members are subject to registration (Articles 66 (h) and 69 of the LFCIFC), BdP may refuse the respective registration on

	<p>the grounds of lack of suitability, experience or availability (Articles 69 and 72 (e) of the LFCIFC).</p> <p>If for any reason the legal or statutory requirements for the regular operation of the auditing board cease to be met, BdP will establish a period for a change in the composition of the board (Article 32 (1) of the LFCIFC) and it may cancel the respective individual registrations (Article 70 (4) of the LFCIFC).</p> <p>Finally, it should be mentioned that BdP is subject to an obligation of professional secrecy (Article 80 of the LFCIFC) that covers its staff as well as all the persons providing services to it on a temporary or permanent basis. Thus, the confidentiality of information collected by BdP is safeguarded in so far as third parties are concerned.</p> <p>In addition, where necessary, the documentation management system of the DSB (see comments to Principle 18) allows for the classification of documents as confidential, restricting their access to a limited number of users, duly authorized for the purpose. Thus, it is incumbent on the management of this department to classify as confidential the information produced as well as external documents. The criteria for the classification of a document as confidential are internally defined in <i>Norma de Aplicação Permanente</i> No 2002/012.</p>
Assessment	Compliant
Comments	<p>As regards the obligation to disclose information for the purpose of market discipline, it should be underlined that the rules on Pillar III of the new Basel Capital Accord will be applied to the Portuguese financial system through the EU Directives.</p> <p>As regards the interpretation of IFRS, it should be stressed that BdP participates in the Committee of European Securities Regulators' database that collates all enforcement decisions relating to financial information, and this may be used as a benchmark. The essential criterion no.11 is not applicable in the national context because BdP has internal resources that assure the conduct of on-site and off-site examinations</p>
Principle 22.	<p>Remedial Measures</p> <p>Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.</p>
Description	<p>BdP has at its disposal a range of supervisory measures and procedures enabling it to take an appropriate range of remedial actions, and impose penalties when there are legal or regulatory violations, such as failure to meet prudential requirements.</p> <p>The legal framework governing the exercise of supervisory functions lays down a broad set of corrective procedures to which BdP may resort, particularly in the case of prudential aspects related with the management of the entities under its supervision.</p> <p>The following corrective measures can be highlighted:</p>

	<ul style="list-style-type: none"> • Credit institutions that do not comply with the solvency ratio will be automatically prohibited from raising the overall value of their risk assets (Notice No. 1/93 4th; Article 99 of the LFCIFC) • BdP, on the basis of well-grounded fears that the influence exercised by the holder of a qualifying holding may prejudice the sound and prudent management of the participated credit institution, is authorized to prohibit the exercise of the voting rights attached to this participation (Article 106 (1) of the LFCIFC). • If the conditions under which a credit institution carries out its activities do not comply with the rules for sound and prudent management, BdP may impose a period in order to amend its management procedures or to take appropriate steps in order to restore or strengthen the financial equilibrium. (Article 118 (1) of the LFCIFC) • Whenever a transaction by a credit institution may imply the breach or the aggravation of the breach of applicable prudential rules, or is liable to non-compliance with prudent and sound management rules, BdP may instruct that institution to abstain from carrying out such transaction. (Article 118 (2) of the LFCIFC). • If the legal or statutory requirements for the regular operation of the management or auditing boards cease to be met, BdP will establish a period for the change in the composition of the board in question, and, if the situation is not settled, authorization may be withdrawn under the terms of Article 22 of the LFCIFC (Article 32 of the LFCIFC). <p>When a credit institution is in a financially unbalanced situation, BdP may require that any or all of the following financial reorganization measures be taken (Articles 139 – 153 of the LFCIFC):</p> <ul style="list-style-type: none"> • Presentation by the institution in question of a financial recovery and reorganization plan; • Restrictions on the exercise of specific types of activity; • Restrictions on the exercise of specific types of transactions (granting of credit, investment of funds in specific types of assets and taking of deposits); • Building-up of special provisions; • Prohibition or limitation of the distribution of dividends; • Submission of certain transactions or activities for the prior approval of BdP; • Appointment of interim members of the board and/or an auditing commission; • Temporary waiving of compliance with the rules on prudential control; • Temporary waiving of the timely fulfillment of obligations contracted previously; • Temporary closure of any premises where transactions with the public take place; • Increase in share capital according to BdP's determinations; • Active cooperation by the Deposit Guarantee Fund, particularly by granting monetary or financial support;
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	<ul style="list-style-type: none"> • General meeting of shareholders called by BdP. <p>The relevant corrective measures, particularly those resulting from facts detected on-site or when serious irregularities are at stake, are reported to the Board of Directors of the institutions (in writing or during meetings formally convened for the purpose, held on BdP's premises). Comments on the subject and/or a corrective plan must be submitted to BdP.</p> <p>BdP oversees compliance with the time limit established for institutions to take corrective measures, either through off-site control (directly by the person responsible for overseeing the institution) or through on-site follow-up initiatives.</p> <p>If, despite the extraordinary measures adopted, it proves impossible to rescue the institution, the authorization to carry out its activities will be withdrawn and the liquidation regulations will be applied, as established in the relevant legislation (Article 152 of the LFCIFC).</p> <p>The adoption of extraordinary reorganization measures by BdP does not preclude, in cases of infraction by the entity in question, the application of the penalties provided for by law (Article 149 of the LFCIFC).</p> <p>Pursuant to Articles 202, 203, and 204 of the LFCIFC, legal persons may be held responsible for the practice of the offences, as well as natural persons when these are:</p> <ul style="list-style-type: none"> • members of the boards; • holders of executive, supervisory or managerial posts; • representatives of the legal person; • shareholders <p>As regards the types of offence and the applicable fines, the LFCIFC establishes two different levels, depending on the objective seriousness of the offence (Articles 210 and 211 of the LFCIFC).</p> <p>In addition, BdP may also apply ancillary penalties to offenders, such as, for instance, the prohibition from being a member of the management or auditing boards in supervised institutions or publication of the sanction that was applied (Article 212 of the LFCIFC).</p> <p>Decisions taken by BdP imposing sanctions are subject to appeal to a Criminal Court. In a number of circumstances BdP may also withdraw the authorization granted to any supervised institution. The withdrawal decision is not defined as a sanction and therefore appeals against it are to be lodged to the Administrative Court. Regarding appeals against decisions taken by BdP within the scope of its supervisory activity, it is presumed, in the absence of evidence to the contrary, that the suspension of enforcement seriously injures the public interest (Article 12(2) of the LFCIFC).</p>
Assessment	Compliant
Comments	

<p>Principle 23.</p>	<p>Globally Consolidated Supervision Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.</p>
<p>Description</p>	<p>Under the LFCIFC, BdP is also responsible for the supervision of the activities abroad of credit institutions and financial companies (Articles 93 (1) and 197). As regards the scope of consolidated supervision, this has been thoroughly described in the self-assessment to Principle 20, Articles 131 and 132 of the LFCIFC and Notice No. 8/94 sets out the most relevant rules.</p> <p>Pursuant to Article 132(3) of the LFCIFC, BdP may come to an agreement with the supervisory authority of credit institutions from other EU Member States on the redistribution of responsibilities for consolidated supervision.</p> <p>Institutions covered by consolidated supervision are bound to submit to BdP all the data required for such purpose and relating to companies in which they hold participations (Article 134(1) of the LFCIFC), including therefore their overseas activities.</p> <p>Moreover, also the prudential limits and ratios, the supervision of solvency and of the adequacy of own funds and the control of large exposures, among others, are exercised on a consolidated basis.</p> <p>Whenever deemed necessary for the supervision on a consolidated basis of credit institutions, BdP may carry out or commission verifications and expert examinations, in financial holding companies or in mixed-activity holding companies and their subsidiaries, as well as in ancillary services companies (Article no. 134(5) of the LFCIFC).</p> <p>Foreign branches of Portuguese banks, not being separate legal entities (according to Article 13(5) of the LFCIFC), are considered to be an integral part of the Portuguese bank itself and are supervised on that basis (under the general terms prescribed by Article 93 of the LFCIFC):</p> <p>The responsibility for supervising the financial soundness of a branch established in another EU Member State, and in particular its solvency, rests with BdP; according to the “EU Passport” regime, the host Member State's competent authority retains responsibility for the supervision of liquidity. Branches established in a non-Member State are supervised in accordance with the general rules applicable to credit institutions (Article 93 of the LFCIFC).</p> <p>Regarding the establishment of a branch, whether within the territory of another EU Member State or in a non-Member State, by a credit institution having its head office</p>

	<p>in Portugal, BdP must be previously notified of this intention. BdP may refuse the application for the establishment of a subsidiary when the financial situation of the credit institution is not adequate for the project (Article 42-A (2) of the LFCIFC).</p> <p>Monitoring of branches abroad is, in practice, performed on a quarterly basis in the context of the global supervision of credit institutions (please refer to comments to Principle 16). For that purpose, BdP makes use of the elements that institutions are required to report to it.</p> <p>The annual plan of inspections of BdP usually includes on-site inspections of overseas branches of Portuguese institutions. These inspections are normally general in scope and are determined by the share of the activities of a certain branch in the overall activities of the institution or by the amount of risk involved or even as a result of certain doubts raised in the context of off-site surveillance. The local supervisory authority is informed of the on-site inspection in advance and its conclusions are presented both to the authority and to the managers of the branch at the end of the on-site work.</p> <p>Moreover, it must be mentioned that in the context of inspections of institutions which are significantly engaged in international activities, BdP usually analyses the internal audit reports of branches abroad, as well as their follow-up.</p> <p>As regards subsidiaries abroad, these are obliged to report to BdP information on an individual basis, if required. This information is submitted to BdP through the parent company. Furthermore, in the context of the cooperation agreements with local supervisory authorities, there is a frequent exchange of information, both as a result of inspections performed by the authorities and for clarifying possible doubts.</p> <p>Despite the authority conferred on BdP by Article 134 (5) of the LFCIFC, no specific on-site inspections of subsidiaries have been carried out.</p> <p>With regard to internal controls and banks' management of specific types of risk, it is required that banks view their risks on a consolidated basis, including all their foreign subsidiaries and branches.</p> <p>According to paragraph 8 of the Notice No. 8/94, all companies included in consolidated supervision must implement internal control procedures appropriate for (i) attesting compliance, at any moment, with the relations and prudential limits, and (ii) ensuring the reliability of the information supplied to BdP.</p> <p>The most relevant markets for Portuguese credit institutions are placed within the EU, in which the regulation concerning banking supervision is harmonized. In this context a systematic assessment of the host country's supervision over foreign branches and subsidiaries of Portuguese credit institutions is not performed.</p> <p>The MoUs concluded between BdP and supervisory authorities of other countries</p>
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	<p>provide for means and ways of cooperation towards the exercise of consolidated supervision, namely through the exchange of information.</p> <p>Regarding the cross border implications of the implementation of Basel II, BdP has participated in several initiatives with other supervisory authorities. These initiatives are intended to cover either the foreign supervisory jurisdictions, which have establishments in Portugal or in which Portuguese banks have establishments. From the first perspective, BdP attended meetings organized by Bundesanstalt für Finanzdienstleistungsaufsicht (Germany), De Nederlandsche Bank (Netherlands), Commission Bancaire Financière et des Assurance (Belgium) and Banco de España (Spain). From the second perspective, it is planned to organize meetings for the Portuguese banking groups that have establishments abroad. The first has taken place during the last quarter of 2005.</p> <p>Meanwhile, it is important to stress that BdP has answered to other requests for information from foreign supervisory authorities regarding banks' approaches to be followed in the calculation of capital requirements.</p>
Assessment	Compliant
Comments	
Principle 24.	<p>Host Country Supervision</p> <p>A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.</p>
Description	<p>BdP may exchange information with the supervisory authorities of other countries in which Portuguese credit institutions have established foreign branches or subsidiaries. This information comprises relevant matters concerning consolidated supervision of cross-border establishments.</p> <p>Under this framework, BdP has concluded several MoUs providing for mutual cooperation regarding consolidated supervision. In particular, BdP has established bilateral agreements with the supervisory authorities of the following countries: Spain; France; Belgium; Luxembourg; United Kingdom; Netherlands; Germany, Macao and Mozambique. Formal agreements with the similar authorities of other countries, namely Turkey, Slovakia, Romania and Brazil are under negotiation. It should be stressed that an MoU between BdP and the supervisory authority of Poland is at an advanced stage of conclusion.</p> <p>Criteria for the signing of MoUs are mainly based on the relevance of a certain country to the activities of Portuguese institutions. Such is the case, for example, of EU-Member States, Macao and Brazil.</p> <p>Regular contact and periodic meetings facilitate the exchange of information in order to exercise consolidated supervision.</p> <p>As for non-EU Member States, co-operation with other supervisory authorities for the purpose of consolidated supervision must always be made in the context of an MoU (Article 138 of the LFCIFC).</p>

As noted above, counterparts in the MoUs assist each other in carrying out on-site inspections of cross-border establishments as well as in keeping each other informed of its results. In particular, the home country authority may provide the host authority with a report on the findings which bear relevance to the latter.

BdP may refuse the application of a credit institution having its head office in Portugal to establish a branch or a subsidiary in a non-EU country, namely where the financial situation of the institution is inadequate for the project (Articles 42 and 42-A of the LFCIFC).

On the other hand, a credit institution having its head office in Portugal and wishing to acquire, directly or indirectly, participations in credit institutions having their head office abroad or in financial institutions representing 10 percent or more of the capital stock of the participated entity or 2 percent or more of the capital stock of the participating institution, must communicate this intention to BdP (Article 43-A of the LFCIFC).

For the purpose of supervision on a consolidated basis of credit institutions having their head office in other EU Member States, BdP will supply the competent supervisory authorities with whatever information it possesses or may obtain information in respect of the institutions which it supervises and in which those institutions have participations. Furthermore, if the supervisory authority of another EU Member State requests the checking of information relating to institutions which are subject to the supervision of BdP and have their head office within the Portuguese territory, BdP will carry out this check or allow it to be carried out by the authority which requested it (Article 137 of the LFCIFC). Such collaboration may likewise take place with the supervisory authorities of non-EU Member States, within the scope of reciprocal cooperation agreements which may have been concluded, provided the information is subject to guarantees of secrecy and the purpose of such exchange of information is in the performance of supervisory functions (Article 138 of the LFCIFC).

According to the MoUs concluded by BdP, counterparts inform each other if they come to know about a crisis looming over a particular credit institution with branches in the other State. The same applies if the crisis is limited to the branch but has the potential to affect the parent company. In either case, counterparts will collaborate if special measures are to be taken by them concerning this matter.

Furthermore, a multilateral MoU on co-operation in financial crisis situations is in place between the banking supervisory authorities, the central banks and the Finance Ministries of the EU Member States. The framework defined in the MoU will apply in crisis situations with a possible cross-border impact involving individual credit institutions or banking groups. This MoU sets out principles concerning the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level.

	<p>Moreover, BdP usually responds favorably to third country authorities' requests for a commitment regarding the communication of information on Portuguese credit institutions, in case these would be in a distressed condition, which might potentially impact on the condition of subsidiaries established in that country.</p> <p>Under the initiatives regarding the cross border implications of Basel II, BdP has informed the other supervisory authorities involved that it is interested in following the process and in exchanging information even when it relates to non-systemic banking groups for the Portuguese banking system.</p>
Assessment	Compliant
Comments	The mission identified the presence of a branch from a non-European country with no formal arrangements for exchange of information in place since the home supervisor was unable to assure the same level of confidentiality protection as provided by Portuguese law. Although, in this particular case, the foreign branch's level of exposure in the Portuguese banking system is very limited, the BdP is recommended to put in place a framework enabling home and host supervisors to exchange a minimal level of information.
Principle 25.	<p>Supervision Over Foreign Banks' Establishments</p> <p>Banking supervisors must require the local operations of foreign banks to be conducted with the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.</p>
Description	<p>In accordance with the harmonized "single market regime" established at EU level, credit institutions authorized in other EU Member States which carry on activities in Portugal through a branch are not subject to prudential supervision by BdP, provided they are subject to supervision by their home authorities (Article 122(1) of the LFCIFC).</p> <p>Notwithstanding, BdP is responsible for the supervision of their liquidity, in cooperation with the competent authorities of the home Member States (Article 122 (2) of the LFCIFC). This principle follows the European regulatory framework relating to the "EU passport". In particular, those branches (if they are deposit takers) must report, on a quarterly basis, the data established in the Instruction No. 1/2000 (please refer to Principle 13).</p> <p>Furthermore, in accordance with Instruction No. 24/2005, branches from credit institutions authorized in another EU-Member State are exempted from compliance with the accounting rules defined by BdP. Nevertheless, these branches must report to BdP, on a quarterly basis, an analytical set of accounts.</p> <p>According to the LFCIFC, BdP shall cooperate with the competent authorities of home Member States to ensure that the branches of credit institutions authorized in other EU countries take the appropriate steps to cover risks arising out of open positions where such risks result from transactions carried out on the Portuguese financial market (Article 122 (3) of the LFCIFC).</p>

	<p>Moreover, the aforesaid branches are subject to any decisions and other measures that the Portuguese authorities may take within the scope of the financial and exchange-rate policy, and to rules applicable in the interest of the general good (Article 122 (4) of the LFCIFC).</p> <p>As for the subsidiaries of credit institutions having their head office abroad and the branches of credit institutions authorized in non-EU Member States, these are subject to the supervision of BdP (Article 122 of the LFCIFC, <i>a contrario sensu</i>). Those institutions must hence ensure compliance with all legal and regulatory obligations (as of regarding their solvency, capital adequacy and large exposures) established for credit institutions authorized in Portugal, being subject to both on-site and off-site verification. In fact, BdP frequently organizes on-site inspections of the subsidiaries of foreign banks and of branches of credit institutions authorized in non-EU Member States, (as for Portuguese banks) and produces periodically assessments based on prudential reports laid down on Instruction No. 25/97 for national banks and which are also applicable to those institutions (considering that subsidiaries of credit institutions having their head office abroad and the branches of credit institutions authorized in non-EU Member States are subject to the same prudential rules as Portuguese institutions, detailed information on requirements, limits and other regulations applicable to the former can be found in the self-assessment to the previous Principles).</p> <p>Pursuant to Article 124 of the LFCIFC, the supervisory authorities of other EU Member States may carry out inspections of branches whose credit institutions authorized in those Member States have been established within the Portuguese territory. This verification may also be carried out by BdP, at the request of the home-country authorities. However this has not been a common procedure, given that the abovementioned branches are not significant in the banking group to which they belong.</p> <p>Furthermore, for the purpose of supervision on a consolidated basis, the supervisory authority of another EU Member State may request the checking of information relating to institutions which are subject to the supervision of BdP and have their head office within the Portuguese territory. In these circumstances, BdP will carry out this check or allow it to be carried out by the authority which requested it (Article 137(2) of the LFCIFC).</p> <p>It should be noted that the MoUs concluded by BdP also impose the reciprocal exchange of information of any remedial action undertaken by the host country authority regarding the operations of a credit institution having its head office in the other party's territory.</p> <p>In general, information regarding the banking group to which branches and subsidiaries established in Portugal belong is obtained under the procedures established in the MoUs concluded by BdP and the EU Directives. As for third countries, information is exchanged whenever deemed relevant.</p>
Assessment	Compliant
Comments	

Table 2. Summary Compliance of the Basel Core Principles

Core Principle	C ^{1/}	LC ^{2/}	MNC ^{3/}	NC ^{4/}	NA ^{5/}
1. Objectives, Autonomy, Powers, and Resources					
1.1 Objectives	X				
1.2 Independence	X				
1.3 Legal framework	X				
1.4 Enforcement powers	X				
1.5 Legal protection	X				
1.6 Information sharing	X				
2. Permissible Activities	X				
3. Licensing Criteria	X				
4. Ownership	X				
5. Investment Criteria	X				
6. Capital Adequacy	X				
7. Credit Policies	X				
8. Loan Evaluation and Loan-Loss Provisioning	X				
9. Large Exposure Limits	X				
10. Connected Lending	X				
11. Country Risk	X				
12. Market Risks		X			
13. Other Risks	X				
14. Internal Control and Audit	X				
15. Money Laundering	X				
16. On-Site and Off-Site Supervision		X			
17. Bank Management Contact	X				
18. Off-Site Supervision	X				
19. Validation of Supervisory Information	X				
20. Consolidated Supervision	X				
21. Accounting Standards	X				
22. Remedial Measures	X				
23. Globally Consolidated Supervision	X				
24. Host Country Supervision	X				
25. Supervision Over Foreign Banks' Establishments	X				

^{1/} C: Compliant.

^{2/} LC: Largely compliant.

^{3/} MNC: Materially non-compliant.

^{4/} NC: Non-compliant.

^{5/} NA: Not applicable.

VII. RECOMMENDED ACTION PLAN AND AUTHORITIES' RESPONSE TO THE ASSESSMENT

Recommended action plan

Table 3. Recommended Action Plan to Improve Compliance of the Basel Core Principles

Reference Principle	Recommended Action
CP 12 – Market Risk	Enhance systems to measure, monitor and control market risk
CP 16 – On-Site and Off-Site Supervision	<ol style="list-style-type: none"> 1. Fully implement the comprehensive framework for assessing banks' and credit institutions' risk profile. 2. Enhance access to Credit Register data and further integrate the database with other off-site supervision tools.
CP 24 – Host Country Supervision	Although already judged as compliant, it is recommended that BdP implement a framework with all home supervisors to exchange information that would improve the quality of risk assessment.

Authorities' response to the assessment

22. Banco de Portugal expresses its appreciation for the thorough and rigorous assessment of the Portuguese regulatory and supervisory regimes that was conducted by the IMF experts' team.

23. Banco de Portugal is particularly satisfied that the main findings of this assessment generally endorse its own findings and welcomes the overall judgment that prudential regulation and supervision in Portugal are highly compliant with the Basel Core Principles for Effective Banking Supervision.

24. Banco de Portugal considers the IMF recommendations generally adequate and reflecting a fair and comprehensive understanding of the Portuguese regulatory and supervisory framework.

25. Nevertheless, Banco de Portugal wishes to qualify some of the IMF's assessments and recommendations.

26. First of all, Banco de Portugal does not agree with the rating of Core Principle 16. It considers that the Principle should be rated “Compliant” instead of “Largely Compliant” for the following reasons:

- Indeed, a risk focused supervisory approach already exists and it is embodied in the planning and execution of the supervisory work, although not formalized in a risk rating system. The current supervisory framework, which combines on-site and off-site work, already allows Banco de Portugal to properly assess each institution’s risk profile and thus to plan its supervisory activity in a risk-focused way. Moreover, a formalized methodology to introduce ratings in the supervisory process has been designed and will be implemented soon.
- Requiring the existence of “... a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed ...” is an additional criteria and not an essential one of Core Principle 16. Therefore, BdP considers that overall compliance with the criteria of this Principle should have been acknowledged by the IMF.

27. Concerning the recommendation on the enhancement of the access to the Banco de Portugal’s Credit Risk Register and on the integration of this database with off-site supervisory tools, Banco de Portugal stresses that its Credit Risk Register is already used for supervisory purposes where it has proved to be a very effective tool in providing extensive information on credit exposures.

28. Finally, as regards the recommendation on the implementation of a framework for information-sharing with all home supervisors, Banco de Portugal expresses that – as acknowledged in the assessment of Core Principle 24 – it has been committed to sign bilateral Memoranda of Understanding with the supervisory authorities of every country which it considers to be relevant taking into account the mutual presence of each countries’ banks. Accordingly, Banco de Portugal has established bilateral agreements with the supervisory authorities of the following countries: Spain, France, Belgium, Luxembourg, United Kingdom, Netherlands, Germany, Poland, Macao, and Mozambique. A Memorandum between Banco de Portugal and the supervisory authority of Brazil is at an advanced stage of conclusion and formal agreements with other countries’ authorities are also under consideration.