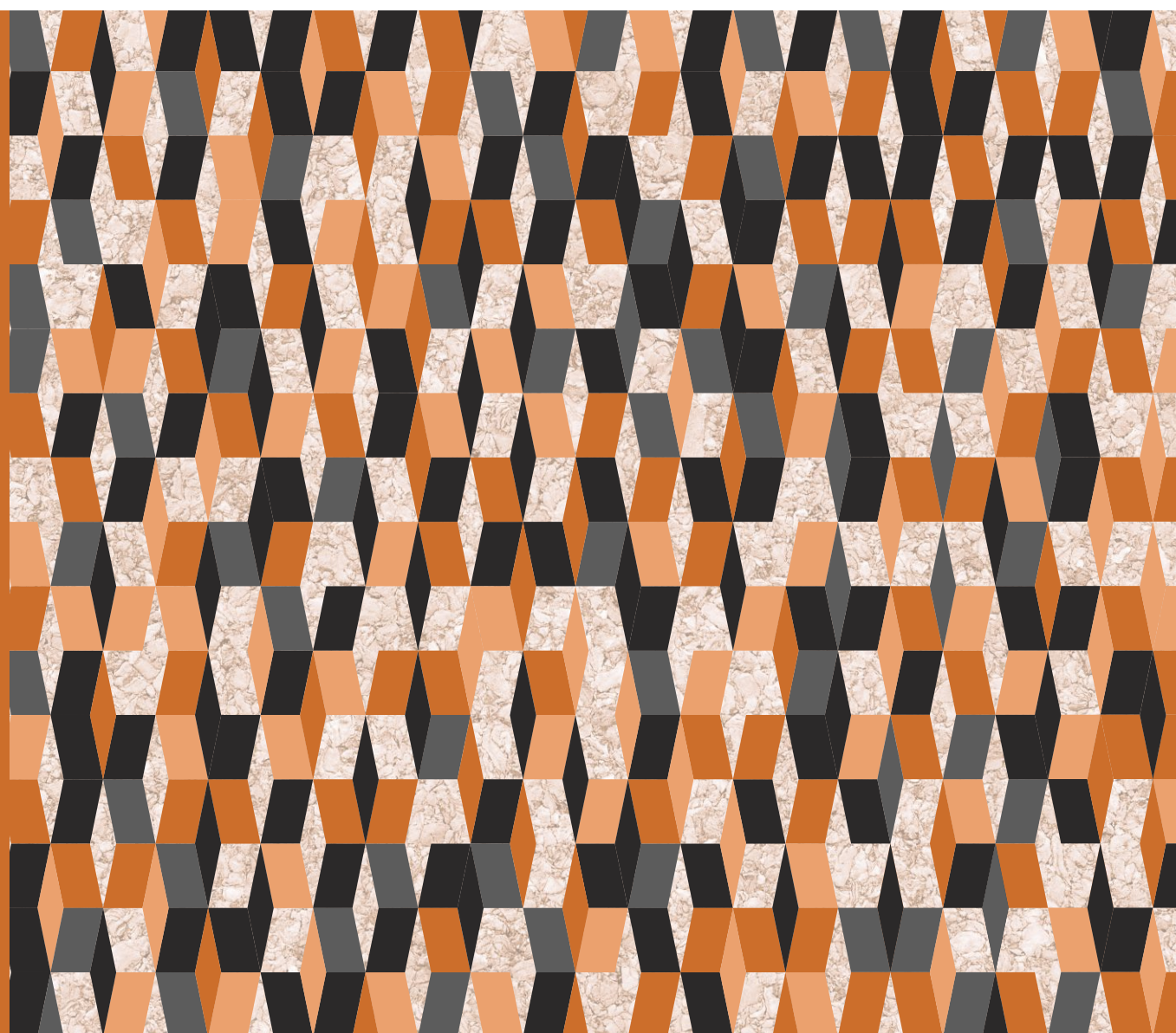


Banking Conduct Supervision Report

2016



BANCO DE PORTUGAL
EUROSYSTEM



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Executive summary

In the 2016 Banking Conduct Supervision Report, Banco de Portugal describes the supervisory activities carried out in the course of the year in retail banking markets, and focuses on the sale of banking products and services via digital channels.

Chapter I looks into the regulation and supervision challenges posed by the sale of banking products and services through digital channels, and presents the results of a questionnaire sent to institutions on the use of digital channels in Portugal.

Chapter II describes the topics associated with the digitalisation of financial services that have been discussed in the various international fora where Banco de Portugal participates.

Chapter III presents the results of the implementation of the general arrears regime in the prevention and settlement of over-indebtedness on mortgages and consumer credit agreements with household customers.

Chapter IV describes Banco de Portugal's supervisory activities in 2016, including systematic monitoring, inspections, the analysis of draft agreements and management of bank customer complaints. It also reviews the initiatives taken towards the correction and sanctioning of detected irregularities.

Chapter V summarises the financial information and education activities carried out by Banco de Portugal and analyses the main results of the Survey on the Financial Literacy of the Portuguese Population conducted in 2015, and compares them with the 2010 survey.

Challenges facing regulation and supervision from the use of digital channels in the sale of retail banking products

The strong growth in supply and demand of banking products and services via digital channels poses regulation and supervisory challenges. Banco de Portugal's biggest challenge as regulator is to ensure that bank customers

have the same level of protection regardless of the channel used to acquire products and services and, at the same time, to identify and mitigate further risks, preserving the confidence placed by customers and the incentives to innovation in the financial sector. Banco de Portugal must ensure that institutions put in place robust and resilient security mechanisms to monitor transactions and post alerts on suspected irregularities.

Banco de Portugal must also ensure that processes such as opening a deposit account or entering into loans via digital channels meet all requirements in terms of soundness, quality and completeness in customer identification and pre-contractual information provided to them. It is also necessary to reflect on whether supervisory instruments are the best fit for the digital ecosystem, particularly taking into account the breakdown of physical and digital frontiers.

The supervisory authority must recruit human resources with high technological skills and set up multidisciplinary, agile teams, tapping into the benefits of technology to make processes more efficient.

In this domain, it is particularly crucial to foster financial literacy among bank customers. Bank customers must be aware of the importance of adopting security procedures, even if this makes the use of financial services somewhat less convenient.

Results of the questionnaire sent to institutions on the sale of retail banking products in Portugal via digital channels

In this report, Banco de Portugal presents the results of the questionnaire sent to institutions for an initial survey on the digitalisation of retail banking products and services in Portugal.

This questionnaire is among the initiatives aimed at monitoring retail banking products and services provided via digital channels, and was sent by Banco de Portugal in December

2016 to 34 market-representative institutions. Amid strong growth in supply and demand of banking products and services via digital channels, Banco de Portugal intended to assess the obstacles to their development, in terms of both demand and supply, more specifically, possible legal and regulatory constraints.

At the end of 2016, nearly all respondent institutions (approximately 90 per cent) provided banking products and services to individual customers via their online channels. Although supply via mobile applications (apps) is less frequent (62 per cent), over one-quarter (29 per cent) of these institutions plan to adopt it in the future.

The vast majority (82 per cent) of institutions mentioned that customers' loyalty was one of the main reasons to invest in digitalisation of banking products and services. The second most significant factor was customer acquisition (64 per cent).

On the demand side, data reported indicate that the take-up rates of customers are higher via the online channel than in apps. Corporate customers join the online channel the most, while individual customers mostly use apps. However, not all customers that join digital channels use them, with corporate customers posting lower disparity between take-up and utilisation rates. In the online channel, the utilisation rate for corporate customers is higher than for individual customers.

Institutions expect higher growth in demand for digital channels over the next few years. This may be constrained by customer concerns over the security and sharing of personal data.

Respondent institutions also referred to obstacles, on the supply side, to the provision of digital channels, chiefly regulatory.

All participating banks claimed that it was impossible to provide all the necessary procedures to open a deposit account via digital channels. Nevertheless, in half of these banks it is possible start this process in the online channel, with customers manually inserting their personal data.

However, opening an account digitally is expected to evolve significantly. Banks plan to expand the capture of digitalised signatures in customers' tablets/smartphones and the use of biometric data. More than half of these banks indicated that they plan to make it possible for customers to use their electronic signature, digital identification and authentication via videoconference and one time passwords. In this domain, the main legal obstacle (according to 70 per cent of banks) is the need to confirm the customer's identification data via original documents or their certified copies, due to rules on anti-money laundering and terrorist financing.

Nearly half of the institutions (43 per cent) allow customers to launch a request for consumer loans via the online channel. According to the institutions, the main obstacles to the digitalisation of this process relate to digital signatures' compatibility with legal rules on the signature of credit agreements, the pledging of collateral in credit agreements and the admissibility of agreements signed via digital channels for judicial execution.

All participating banks and payment and e money institutions provide payment services via home-banking. More than half of institutions (56 per cent) provide payment services via apps.

Virtual cards may be issued by more than half (56 per cent) of institutions via their online channel. In turn, three in every four banks already issue virtual cards. By contrast to the opening of a deposit account or the provision of consumer loans, institutions consider that applicable legislation does not raise significant obstacles to digitalisation in payment services.

Institutions were also surveyed on the main security risks in the use of digital channels and the mechanisms put in place to mitigate them. Phishing attacks are the main security risk, according to most respondent institutions (88 per cent), followed by identity theft (68 per cent) and malware (56 per cent).

To mitigate such risks, institutions have implemented several mechanisms, including a login timeout option (88 per cent of institutions), the

validation of transactions by entering a code generated via token (81 per cent) and the use of information encryption methods (81 per cent). Biometric and geolocation data are also used, but less frequently.

The digital transformation of banking on the international agenda

Regulatory and supervisory authorities worldwide have tried to keep up with the digital transformation of the financial sector.

In 2016, the European Commission created a task force to analyse the digital transformation of the financial sector (Task Force on Financial Technology). In early 2017, following the publication of the Green Paper on Retail Financial Services, the Commission put forward an action plan to improve access to financial services in the EU, and launched a public consultation regarding the impact of technology on the sector.

According to the Commission, innovative online services may foster integration in the financial services market. The European

Commission wants every consumer to be able to choose freely from a wide range of financial services provided across the EU and to get the best quality/price ratio.

The European Banking Authority (EBA) has also analysed various phenomena associated with the digital transformation of retail banking. The EBA's reflection on digitalisation in banking follows the development of its mandates under the new Payment Services Directive (PSD2). In 2016, the EBA prepared and submitted for public consultation the draft regulatory technical standards on strong customer authentication and common and secure communication between operators, as foreseen in the new Payment Services Directive. It also submitted for public consultation a paper identifying risks and benefits of financial institutions' use of consumer data for non-traditional purposes.

The Joint Committee of European Supervisory Authorities published a report on automated financial advice and a discussion paper on the use of big data by financial institutions.

The identification of emerging risks in digitalisation and existing mitigation strategies is also of great interest to the International Financial Consumer Protection Organisation (FinCoNet). Its work plan for 2017-18 includes, inter alia, the establishment of two task forces, one on short-term consumer loans bearing high costs sold via digital channels and the other on supervisory practices and tools best suited to the digital age. In 2017, FinCoNet will carry on with its work on payments via the Internet and mobile devices and undertake a more in depth analysis of banking conduct supervisory instruments.

Turning to the OECD, its task force on financial consumer protection included in its work plan for 2017-2018 the assessment of emerging risks posed by the digitalisation of financial services and the main trends in this area.

International bodies directed especially towards financial inclusion and education issues have also paid particular attention to the challenges posed by digital channels, and recognised that, given the swift developments in technology and the rise of digital financial services, financial and digital literacy must be strengthened, thereby fostering financial inclusion while ensuring adequate consumer protection. In 2016, the G20/GPFI (Global Partnership for Financial Inclusion) approved the G20 High-Level Principles for Digital Financial Inclusion. The OECD International Network on Financial Education (INFE) published a report entitled Ensuring Financial Education and Protection for all in the Digital Age.

Implementation of the general arrears regime

In this report, Banco de Portugal presents an update of the main indicators on the implementation of the general arrears regime based on the information reported on a monthly basis by credit institutions. In 2016, the number of Out-of-court Arrears Settlements (OASP) initiated by credit institutions involving consumer credit agreements increased. Mortgage credit proceedings decreased from the previous year.

The share of consumer credit agreement proceedings that led to the settlement of arrears increased, due to the payment of overdue debt by customers and agreements being settled between customers and institutions. In mortgage credit proceedings, the percentage of arrears settlement proceedings that were concluded was similar to 2015.

The most commonly agreed solution under the OASP continued to be the renegotiation of credit agreements between customers and institutions.

In mortgage credit proceedings, renegotiations mostly focused on the introduction of a grace period for the principal and/or interest. In consumer credit agreements, this involved the deferral of payment of a residual value in the last instalment and the extension of their maturity.

Systematic monitoring

In 2016, Banco de Portugal assessed compliance with information requirements in price lists for 726 fees and expenses leaflets and 496 interest rate leaflets of 87 institutions.

Due to the larger number of campaigns carried out by institutions, Banco de Portugal monitored more advertising campaigns on banking products and services (13 per cent more than in 2015), with consumer credit products accounting for a larger share (72 per cent).

Banco de Portugal checked 197 information leaflets on indexed and dual deposits for compliance, which had been submitted by 12 institutions, 24 per cent less than in 2015. This was due to a drop in the number of indexed and dual deposits sold in the course of the year.

It also analysed information reported on 1.58 million credit agreements, provided by 56 institutions to check maximum rates in consumer credit agreements for compliance.

Inspections conducted

In 2016, Banco de Portugal focused on compliance with the legal framework by credit institutions in terms of consumer credit, given that this market has become increasingly buoyant.

Banco de Portugal assessed product features and marketing practices, particularly revolving credit products (credit cards, overdraft facilities and overrunning). In its inspections of institutions, it checked compliance of processes for contracting credit, as well as their conformity with the maximum rate regime. In its inspections, it assessed compliance with the regulatory framework applicable to arrears and default on household credit agreements.

Banco de Portugal also checked the institutions' implementation of recent regulatory changes, more specifically the obligation to send an 'invoice-receipt' to their customers on an annual basis, listing all fees and expenses associated with the deposit account and payment services charged in the previous year. Compliance with reporting requirements was also assessed in the consumer credit statements provided to consumers. In the wake of the revision of the basic bank account regime at the end of 2015, whereby a wider set of institutions was required to provide a basic bank account, Banco de Portugal conducted 'mystery shopping' actions in various branches of institutions, and checked for the appropriate disclosure of information. At the end of 2016, there were 34,953 basic bank accounts, 45 per cent more than at the end of the previous year.

Analysis of draft agreement

In 2016, Banco de Portugal analysed 69 draft agreements from 26 credit institutions for revolving credit in the form of overdraft facilities, credit lines and current accounts.

In its analysis, it did not detect substantial irregularities in terms of compliance with mandatory rules, i.e. rules that cannot be changed on request by credit institutions or bank customers. Nevertheless, it identified non-compliance with rules on the deadline for free revocation, the frequency in which the benchmark rate is reviewed and the possibility of charging a fee on early repayment in agreements in the form of overdraft facilities.

With regard to information duties, the most serious irregularities were associated with the description of credit operations' features (e.g. interest rate, amount of credit granted and its conditions) and reference to complaint proceedings and alternative dispute resolution mechanisms.

Complaints management

In 2016, Banco de Portugal received 14,141 bank customer complaints, 4.8 per cent more than in 2015. This was chiefly due to complaints regarding deposit accounts.

Complaints mostly pertained to matters associated with contract clauses, fees charged on products and services, the collection of overdue debts and information provided in the Central Credit Register.

On average, complaints were closed within 38 days in 2016, 21 days less than in 2015. 64 per cent of complaints were closed with no signs of infringement. In the remaining 36 per cent of complaints, the situation was solved by the institution on its own initiative or on Banco de Portugal's intervention.

In the wake of the complaints closed, Banco de Portugal took action regarding 405 complaints, by issuing 106 specific orders requiring the correction of irregularities, and initiated 137 administrative proceedings for infringement of rules.

Correction of irregularities and sanctions

Banco de Portugal issued 1,020 recommendations and specific orders requiring 73 institutions to correct the irregularities detected in the pursuit of its supervisory activities. Irregularities were chiefly linked to the marketing of consumer loans, which reflects Banco de Portugal's monitoring priorities for 2016.

Banco de Portugal initiated 155 administrative proceedings against 29 institutions: 90 per cent of which stemmed from the analysis of 208 bank customer complaints. In 2016, administrative proceedings increased regarding institutions' incorrect reporting on behalf of their customers to the Central Credit Register.

Financial information and education

In 2016, Banco de Portugal increased the number of financial education initiatives organised via its regional network, thus expanding its action in this area. In the course of the year, it organised 350 financial education courses (75 per cent more than in 2015), with a total of 12,122 participants. These courses mostly targeted pre-school to secondary school students and chiefly focused on the importance of saving and the preparation of a family budget.

Within the scope of the National Council of Financial Supervisors, of which Banco de Portugal is a member, the National Plan for Financial Education's strategic guidelines were released for 2016-20, following up on the strategy set for the previous five years and reinforcing the commitment of supervisory authorities to financial education.

With regard to the National Plan for Financial Education, the results of the second Survey on the Financial Literacy of the Portuguese Population were published, making it possible to identify the population groups with the highest financial literacy deficit and to analyse the evolution compared with the results obtained in the first survey in 2010. According to the survey, improvements have been observed in the Portuguese population's access to the banking system (which is now high), savings habits and confidence in advice provided by institutions when choosing financial products. Financial knowledge among the population has also improved slightly.

Banking conduct supervision in numbers – 2016

Arrears regime monitoring:

- Information analysed on 718,479 proceedings under the OASP on housing credit and consumer credit agreements;
- 439 complaints received on issues pertaining to the arrears regimes;
- 48 information requests by bank customers on the general arrears regime.

Systematic monitoring:

- Monitored 1,222 price lists (726 fees and expenses leaflets and 496 interest rate leaflets) of 102 institutions;
- Analysed 8,572 advertising campaigns of 59 institutions;
- Conducted prior inspections of 197 information leaflets on indexed and dual deposits offered by 12 institutions;
- Checked the calculation of returns on 223 matured indexed and dual deposits;
- Assessed compliance with maximum rates, based on information reported by 56 institutions on 1,582,788 consumer credit agreements.

Inspections conducted:

- 132 inspections of branches from 22 institutions, of which 106 were 'mystery shopping' inspections and 26 were on-site identified inspections. Of the 132 inspections of branches, 58 focused on consumer credit and 32 on basic bank account regime;
- 66 inspections of the central services of 12 institutions, of which 56 focused on the consumer credit regime;
- 612 off-site inspections of 105 institutions, of which 166 focused on fees, 132 on price lists and 105 on information provided on alternative dispute resolution mechanisms.

Basic bank accounts:

- 34,953 basic bank accounts were reported by 22 institutions, of which 12,736 were opened in 2016;
- 32 'mystery shopping' inspections on information provided regarding basic bank accounts;
- 7 off-site inspections on the basic bank accounts regime.

Draft agreements:

- Analysed 49 draft agreements for overdraft facilities, from 20 institutions;
- Analysed 13 draft agreements for credit lines, from 5 institutions;
- Analysed 7 draft agreements for current accounts, from 5 institutions.

Complaints management:

- 14,141 complaints received, with a monthly average of 1,178, of which 18.3 per cent were linked to contract clauses, 15.7 per cent to fees, 12.5 per cent to the collection of overdue debts and 9.6 per cent to information provided to the Central Credit Register;
- 64 per cent of complaints closed with no signs of infringement and 36 per cent with the complaint being solved by the institution on its own initiative or on Banco de Portugal's intervention;
- Complaints closed on average within 38 days (23 days for complaints from the official complaints book and 54 days for other complaints).

Information requests:

- 1,279 information requests received from bank customers, a monthly average of 107.

Correction of irregularities and sanctions:

- 1,020 recommendations and specific orders issued requiring 73 institutions to correct irregularities;
- 155 administrative proceedings initiated against 29 institutions for breach of rules.

Financial education initiatives via the regional network:

- 350 courses involved 12,122 participants, of which 42 per cent targeted secondary school students and 218 courses on topics linked to family budget management.

