2002
ANNUAL REPORT

RAHOITUSTARKASTUS
FINANSINSPEKTIONEN
FINANCIAL SUPERVISION

Contents

Director General's review

For the Finnish economy, 2002 was a year of sluggish growth. Economic performance was however better here than in the euro area countries on average. Retail banking continued to generate robust profits, while other banking activities lagged behind. Hightened competition put a squeeze on interest rate margins in retail banking. The housing market continued to heat up, largely because of low interest rates across the euro area, and abetted by rising prices in the Greater Helsinki area and some other growth centres.

In terms of stability, interest rate margins on housing loans are becoming excessively narrow. Interest rate positions of banks in Finland are generally such that any further decline in the level of interest rates would reduce net interest income. There is practically no room for further reductions in deposit rates and, since loan rates are generally tied to market rates, further declines in market rates will directly squeeze banks' profitability. In this situation, any further narrowing of the interest rate margin would be detrimental to the economy, especially since economic growth could slow further, which could result in an increase in loan losses. The banks are now in a tight situation and are well advised to focus on maintaining and strengthening their solvency, most importantly by ensuring adequate levels of equity. Certainly, a degree of restraint is in order as regards dividend policy, and the same is true for market-share bravado.

The securities markets experienced another dismal year in 2002. With falling share prices, companies showed little interest in getting listed on the exchange, nor was the year upbeat for the investment services sector. Mergers and acquisitions resulted in a decrease in the number of quoted companies in Finland, and the trend seems to be continuing. Share trading has concentrated on Nokia and a few forest industry companies. Because of Finland's faraway location and small markets and companies, foreign investors have not been attracted even by falling prices. Over the long run, it may be that European stock markets will have no choice but to become more efficient, provide more liquidity, and offer companies' better prospects for raising equity capital. Helsinki's position within this scenario remains to be seen.

The EU has set the goal of creating a single financial market by 2005. Although progress has been made, it is now clear that more time will be needed. Because banking systems in continental Europe are still structurally clumsy and inefficient, large-scale restructurings are still to come. The Lamfalussy process aimed at more effective regulation and supervision of securities markets was initialed in 2002, but not until sometime in 2003 will we see the first concrete results for system operations. Enlargement of the EU by ten countries brings more challenges, as many of these countries are poorly prepared or have not deep-down accepted the demise of national markets and the need to integrate these markets into a single EU market. Getting beyond grand political pronouncements to practical realities is a long and painful process, as each country may have give up its own – even if highly regarded – special system features.

Finland too has its problems, at the practical level, in changing rules and structures in accord with international recommendations and decisions. It has not been easy to adjust to the idea of an independent financial supervisory body with commensurate authority. At the time of writing, Parliament has just approved a new Act on the Financial Supervision Authority. Changes made to the law during the legislative process add up to a significant step in the right direction, but we are now only at an intermediate stage. The new post-election Parliament and Government will have to deal with the implementation of EU directives promoting financial integration, reform of financial institutions' capital adequacy requirements, and International Accounting Standards as applied to financial statements. In this connection, Finland will have to decide how it will safeguard the remit, resources, and financing of supervisory officials within restrictions on the actions of administrative officials as prescribed in a new constitution.

I become more and more convinced that a unified market cannot be created without thoroughly harmonised and unified regulations and supervision. A network of national supervisors may not be enough. That network will at some time have to be tightened into an alliance if we are serious about achieving the announced goal. Presently, national perspectives are still so prominent and national differences so great that it will take years yet to achieve the goal.

The signs indicate that economic conditions are getting worse. The growth slump of the European – and hence Finnish – economy, combined with EU enlargement, will provide a hard test for the current cooperation structures and agreements. It must be hoped that the EU intergovernmental conference will consider the development of cooperation as regards structures and regulations for economic cooperation. Without a functionally unified economy, we will not be realistically positioned to build a dynamic and free union of European communities.

Finland is still facing pressures for structural change in the financial system. Competition among banks, investment firms and insurance corporations in the markets for long-terms savings and investment products has led to the establishment of new banks, both within and outside of present alliances. The process of corporate expansion within the Nordic countries and more broadly has surely not yet come to an end. Legal and tax-related obstacles to true cross-border mergers continue to force companies to set up organisational structures involving complicated holding companies, which have little to do with actual corporate governance. This presents especially difficult challenges for both management and supervisors. In good times, legal structures have little significance but, in times of crisis, responsibilities and those responsible are divided along legal – not business – lines. We should make haste to remove all obstacles to the unification of legal structures and business operating procedures.

The Financial Supervision Authority is working to improve its readiness to meet the future by upgrading its cooperation with foreign – especially Nordic and EU – supervisors and, in Finland, with the Insurance Supervision Authority. We are revamping our organisation in accord with the new legislation on financial supervision and with the challenges of a changing environment. Our goal is to increase efficiency using the resources at our disposal. I wish to close with a 'thank you' to the good people working in our organisation - for their highly motivated efforts - and with a hope for more of the same.

February 2003

The Financial Supervision Authority's operating strategy

The FSA's operating strategy

The Financial Supervision Authority's (FSA) activities are intended to promote financial stability and public confidence in the operation of supervised entities and financial markets.

The economic environment has a considerable impact on financial market stability. With time, problems in the environment will inevitably feed over into the financial markets and weaken the operating conditions of financial market participants. Financial stability is, however, also a fundamental condition for a well-functioning economy. In their capacity as key financial intermediaries, credit institutions play an important role in the maintenance of market stability.

Supervision to focus on risk-prone institutions and systems of key importance for market stability

In keeping with its strategic directions, the FSA expressly focuses on the supervision of risk-prone institutions and systems of key importance for market stability. An element of risk is always inherent in credit institution activities. Financial stability requires controlled risk taking that does not exceed the institution's risk taking capacity. The more risks the credit institution takes the better risk management systems and more capital against losses it ought to have.

In order to implement its stated strategy, the FSA must identify key institutions and risks in terms of supervision and has, therefore, in recent years developed measures enabling such identification. They are based on both utilisation of the results and alarm limits of reporting systems and extensive analysis of the risk bearing capacity of individual institutions. Risk assessments are based on all information on the credit institution and its financial environment that are available to the FSA. During the past few years, the FSA has developed the risk assessment methodology and devised a systematic evaluation process. In 2002 risk analyses were for the first time demonstrated to major credit institutions.

The emergence of electronic financial intermediation and service provision, together with the contagion sensitivity of possible disruptions, place high demands on system reliability and disruption management. For several years now, the FSA has undertaken regular inspections of the IT and payment systems of major supervised entities, focusing especially on business continuity as well as risk identification and risk management. Many supervised entities have indeed improved their processes and increased the efficiency of their systems.

FSA reviews internal control and corporate governance in supervised entities

Failure of internal control is one of the most common reasons for the collapse of financial institutions. Not even good control and risk management systems are of any help if the organisation does not observe them or monitor compliance with them. Internal corporate governance practices are decisive for ensuring that the organisation promotes adopted objectives and operating principles.

The FSA has systematically developed tools for the inspection and evaluation of the effectiveness of supervised entities' corporate governance, internal control and risk management practices. Inspections have focused special attention on the division of responsibilities between organisational units, as well as on decision-making practices, reporting systems, the independence of risk taking and risk management practices and the various processes of the operation. In response to structural changes among supervised entities, many supervised entities are currently working to harmonise their systems.

Efforts devoted to national and international supervisory cooperation

The Act on the supervision of financial and insurance conglomerates, which took effect in February 2002, confirmed established practice in the supervision of domestic financial conglomerates. The authorities concerned are working together to improve supervisory practices further to better provide for an overall review of supervised entities.

Different approaches to supervision are a challenge for the supervision of Nordic financial conglomerates. The Directive on financial conglomerates was adopted towards the end of 2002. As it has not yet been implemented in national legislation, supervision must still be based on existing national legislation of the individual countries concerned. In the course of 2002 the Nordic supervisory authorities tried to clarify the relationship between legal supervisory responsibility and practical supervisory work and reviewed the principles for division of responsibilities as regards the risk assessment of supervised entities. Supervisory cooperation with the Nordic central banks was tightened up.

Greater focus on monitoring listed companies' compliance with disclosure requirements

The efficient functioning of markets essentially involves strict compliance with disclosure requirements on the part of listed companies and other companies that raise capital on the market. Investors must be able to rely on the adequacy, consistency and truthfulness of the information received.

Maintenance of investor confidence in markets is also important for issuers, as doubts about the adequacy of the information impair the company's prospects of raising capital on the market. Errors or omissions in complying with disclosure requirements have shown that isolated cases of malpractice may have an adverse effect on the market as a whole, to the extent of affecting the international economic development. Compliance monitoring must therefore be efficient enough so as to prevent malpractice.

The FSA's operating strategy

The FSA seeks to actively influence the quality of information disclosure for example through thematic inspections and intensified monitoring of the disclosure practices of newly listed companies and other issuers that raise financing from the public.

The FSA's strategy also gives priority to the monitoring and investigation of abuse in the securities markets. The proactive influence of investigations, however, remained limited in 2002 for several reasons. The FSA did not have the right to impose administrative sanctions and could only issue admonitions that were unofficial and therefore usually not public. Furthermore, police criminal investigations are critically backlogged, which partly explains why the investigation of suspected cases of abuse has taken several years. This was, indeed, a particularly dissatisfactory situation in terms of supervisory guidance.

Appropriate conduct of business a necessary condition for investor confidence

Appropriate conduct of business rules regarding customer relationships are a key condition for investor and customer confidence in service providers. Customers and investors must be able to rely on service providers to provide them with adequate information as a basis for investment decisions and to recognise customer interests in their activities. The FSA especially monitors market practices to ensure that they are lawful and adequate. The settlement of disputes between individual customers and service providers does not fall within the FSA's responsibilities.

Regulation and supervision of conduct of business rules is increasingly based on common European standards. Essentially this means the provisions of the Investment Services Directive, as specified by the recommendations of the Committee of European Securities Regulators (CESR). The recommendations issued by CESR are designed to ensure adoption of similar conduct of business regimes covering customer relationships, irrespective of the service provider's or customer's home country.

In connection with inspections of asset management practices, the FSA has highlighted, for example, shortcomings in customer reporting and service providers' practices for categorising between professional and non-professional investors.

The FSA welcomes the establishment of the Finnish Securities Complaint Board, which started operations in spring 2002, and finds it to be in the interests of sound securities market practice and investor protection. The Board was set up to settle disputes between service providers and non-professional investors. The large number of complaints filed with the Board has already proven its necessity. The initiative on the establishment of the Board was taken by the FSA.

Achievement of the objectives set for supervision of conduct of business rules and of investor protection requires as far-reaching harmonisation as possible of the marketing, conduct of business regime and supervision of all investment instruments (securities as well as unit linked insurance products and deposits).

Action plan on company law discussed by the EU

In a single financial market, both practices in the field of service provision and corporate governance models are revised and harmonised. Regulations too must reflect changes in market structure.

The European Commission has opened the discussion on guidelines for developing EU company law and considers the adoption of a separate action plan on company law, based on the proposals of the Winter Group, which are circulating for comment.

The Winter Group advocates increased corporate restructuring and mobility as well as cross-border mergers and acquisitions. Along with binding regulations, alternative regulatory practices (for example 'comply or explain' practices) are necessary. The Group also encourages a debate on and evaluation of the need for a European corporate governance model within the EU.

FSA contributes to development of International Accounting Standards

As of 2005, International Accounting Standards (IAS) will become applicable to accounting practices within the EU. The adoption of harmonised standards is especially designed to improve the comparability of financial statements and the information to investors. The FSA aims to be one of the Finnish authorities playing a role in the development of these standards. This means that the FSA will take part in international working groups set up to further elaborate and comment on the standards and closely monitors their activities to ensure that the contents of the standards reflect the supervisor's views.

The adoption of new accounting standards requires both the learning of a new set of rules and reform of accounting regulations and financial reporting. Those involved in standards development and consultation must also reform their practices.

Regulatory activities based on proactivity, transparency and legal safety

Changes in financial markets have forced an assessment – at both EU and national level – of what type of regulatory and supervisory framework is best suited to efficiently meeting the challenges these pose. Laws and regulations must be kept up to date and need to be able to respond to changes in the operating environment swiftly and flexibly.

The Financial Services Action Plan (FSAP) launched by the European Commission promotes the completion of the single market and the adoption of a legal system which accounts for changes in the operating environment. Securities market regulations are developed in line with the Lamfalussy framework (see page 33). The Lamfalussy framework is also expected to be extended to the banking sector.

The FSA fosters harmonisation of legislation, supervision and practices within the EU and promotes the EU's objectives of introducing more flexible regulations and speeding up law drafting. The FSA's regulations also reflect these objectives to the extent possible within the framework of the Finnish legislative structure.

The FSA's regulations highlight legal safety, proactivity and transparency. In connection with the current revision of the set of regulations, the FSA gives special consideration to clarity of regulatory outlines and their correspondence with the international and EU regulatory framework. The FSA also works to ensure the transparency and consistency of decision-making.

Financial markets in 2002

World economy recovered rapidly in early 2002. Production growth continued even after the first few months of the year, albeit more slowly in spring than expected. By autumn, economic prospects had weakened in many countries and the overall optimism awakened in spring was replaced by pessimism. Uncertainty was further aggravated by the threat of military action that was expected to be launched against Iraq and was clearly reflected on the stock market, with prices declining rapidly during early autumn. The world economy is nonetheless forecasted to recover gradually during 2003, and growth is estimated to intensify further during 2004.[1] However, it is possible that growth may be weaker than expected.

OPERATING ENVIRONMENT AND ITS IMPACT ON FINANCIAL MARKETS

Euro area economic conditions weakened

Overall economic growth in the euro area remained below 1% in 2002. Despite accelerating growth at the beginning of the year, overall development was modest and became subdued towards the end of the year. Growth in euro area economic activity was supported by exports and consumption. Investment continued to fall and may be delayed even further, as business confidence in economic growth has remained weak.[2]

According to forecasts by international organisations, euro area economic growth will recover progressively during 2003 in the wake of improving global economy. Growth will be supported by private consumption and investment in inventories, later also by a pick-up in fixed investment. Euro area private consumption will be driven by households' modest indebtedness, steady development in holdings of housing assets and low interest rates.[3]

Profitability of the euro area banking sector weakened

Poorer economic conditions were reflected in the profitability of European banks, which weakened mainly due to growth in loan loss provisions and a decline in income from securities. However, the banks' capital adequacy remained stable at least for the first half of 2002.

The main concern for the European banking sector in the future is the potential realisation of credit risk in the event that economic recovery fails to meet expectations. There are also concerns over the fact that banks have granted

[1–3] Source: Bank of Finland.

significant credits to the IT sector, which continues to be highly exposed to bankruptcy risk. Insolvencies of global conglomerates could also cause extensive losses in the banking sector.

For many years, financial deregulation, advances in technology and globalisation have contributed to the transformation of the financial market. Following changes in operating conditions, banks are under increased pressure to improve efficiency. The banking system in particular has been accused of over-capacity and inefficiency. For this reason, cost cutting has become an overriding theme throughout Europe. The severe banking crisis of the early 1990s forced Finland and other Nordic countries to take radical measures to restructure their banking structures. Hence, in recent years the profitability and efficiency of Finnish banks has been outstanding in comparison to other European banks.

In addition to changes in euro area banks' operating environment, the nature and type of risks relating to the banking industry have also changed. True, increased use of securitisation and credit risk transfer instruments such as credit derivatives, expansion into securities trading and insurance services and the trend to form increasingly larger and more complex financial conglomerates have improved banks' capacity to spread risks; yet they have also given rise to new risks. For example, with the plummet of share prices in 2002 insurance companies and financial conglomerates involved in the insurance services business have had problems to face.

Slight increase in Finnish economy

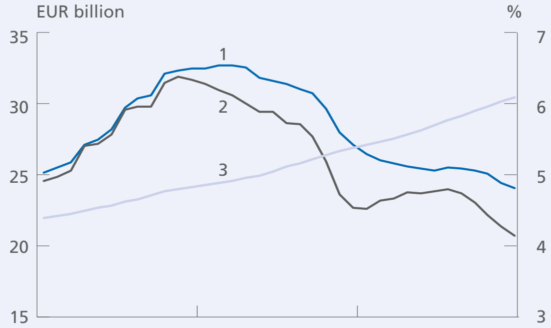
During 2002, the Finnish economy experienced a slow turnaround for the positive, mainly driven by exports and private consumption. Output was particularly noticeable in the electronics industry, and slight growth was also seen in the rest of the metal industry and the forest industry. In 2001, Finnish economic growth had remained just over 0.5%, in contrast to 1.6% in 2002. If world economy picks up as expected, Finnish economic growth is anticipated to strengthen in future years. The unemployment rate is close to 9–9.5%, while the growth rate of consumer prices is expected to hover around 1.5%.[4]

Growth of credit risk slower than elsewhere in Europe

The profitability of banks weakened in 2002 as expenses increased and income declined. In contrast, credit losses have, for several years already, been very small in Finland, highlighting the expansion of credit risk as being less apparent in comparison to the rest of Europe.

[4] Source: Bank of Finland.

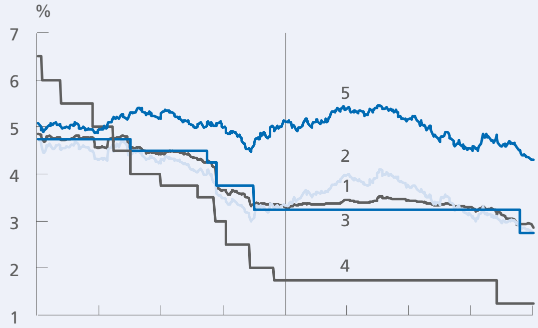
Chart 1.
Banks' outstanding housing loans and changes in average mortgage interest rate on housing loans, 2000–2002



1 Outstanding housing loans, average interest rate, %
2 New housing loans, average interest rate, %
3 Stock of housing loans

Source: Bank of Finland.

Chart 2.
Financial markets, changing interest rates, 2001–2002



1 3 month EURIBOR
2 12 month EURIBOR
3 Monetary policy rate
4 USA FED funds target rate
5 SF10 Covernment bond

Source: Financial Supervision Authority.

Furthermore, Finnish banks' claims on emerging countries are relatively insignificant. However, bankruptcies and payment defaults are on the increase. The FSA monitors closely developments in banks' risk exposures and credit losses.

On the basis of available information, credit risks do not give rise to any great concerns. However, if the anticipated slow economic growth fails to materialise, the prospects of bank customers to manage their loans in accordance with contracts will diminish and banks' credit losses will increase.

Banks present income performance also gives reason to concern. The primary income item, ie net income from financial operations, has diminished due to more severe competition and a fall in interest rates, even though lending has expanded strongly. As a result, banks' profitability is under major pressure.

Lending to households was brisk

Lending to households has increased in recent years. Households' indebtedness (share of bank loans of disposable income) is expected to continue to grow. The rise in lending was driven by house purchases, which remained brisk throughout 2002, boosted by the low level of interest rates and households' solid confidence in the economy. The stock of housing loans are also expanding in the wake of increasingly longer maturity periods.

Banks' outstanding housing loans rose by 12.7% during 2002, amounting to EUR 30.6 billion at the end of the year (see Chart 1).

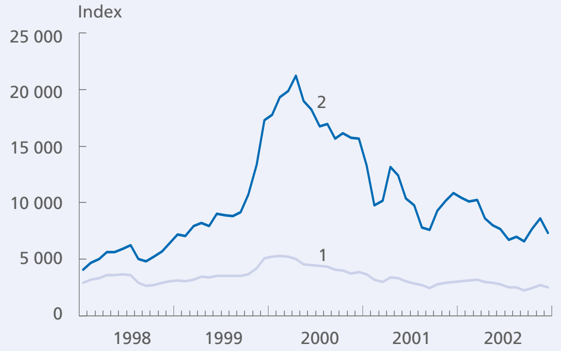
Banks' interest margins narrowed as interest rates continued to fall

Of the key interest rates, the 3-month Euribor rose throughout the early part of 2002 up until the middle of May, when it started to fall, closing at 2.87% at the end of the year. Correspondingly, the 12-month Euribor had fallen to 2.75% by the end of the year (see Chart 2).

In response to the slackening inflation, the European Central Bank lowered its key interest rate by 0.5 percentage points to 2.75% in December, after which the banks announced that they would reduce their prime interest rates with effect from the beginning of 2003. Interest rates are expected to increase after the middle of 2003 as a result of slow economic recovery driven by the United States.

Finnish banks' interest rate margins have continued to narrow in the wake of falling interest rates. Banks' net income from financing operations has so far been broadly unaffected, however, as the declining profitability of lending has generally been compensated for by growth in outstanding debt. Tightening competition over credit market shares and decreasing interest rates will further reduce banks' interest rate margin

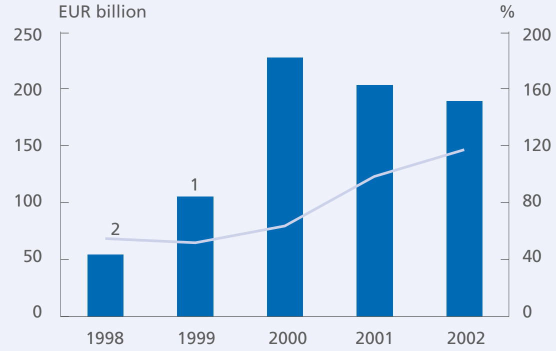
Chart 3.
Stock market indices 1998–2002



1 HEX Portfolio Index
2 HEX All Share Index

Source: Helsinki Exchanges.

Chart 4.
Share turnover on the Helsinki Exchanges 1998–2002



1 Turnover in listed shares EUR billion, left-hand scale
2 Ratio of turnover in listed shares to market capitalisation, right-hand scale

Source: Helsinki Exchanges.

during 2003, unless the general interest rate level begins to improve in the wake of economic recovery.

Share prices fell for the third consecutive year and turnover on the Helsinki Exchanges declined

The slackening of the share market continued in 2002. HEX All-Share Index fell for the third consecutive year in the wake of falling US share prices. The Standard & Poor's index, a composite index measuring the performance of 500 shares, dropped by 23% over the course of 2002. Dow Jones, a measure of traditional industrial companies, fell by 17%, while Nasdaq, which contains a high proportion of technology shares, sank by as much as 31%.

HEX All-Share Index, which is led by Nokia and tracks the Nasdaq index in particular, fell by 33% during 2002. In contrast, HEX Portfolio Index, in which the weight of an individual share can amount to 10% at the maximum, dropped by slightly more than 17% (see Chart 3). Investor confidence in the share market was mainly shaken by the accounting scandals of some US companies and the imminent threat of military action against Iraq.

Nokia shares in the HEX All-Share Index had almost a 60% weighting in 2002, with the weight of the entire data communications sector ranging from 53% to 65%. The share of foreign ownership of Nasdaq-listed Nokia has for long been close to 90%.

Despite the overall decline in share prices, some shares were quoted at values tens of percents higher at the end of the year in comparison to their value at the beginning of the year. Sectors where share performance was contrary to the HEX All-Share Index were, for example, other industry, investment, energy, transportation and traffic. In addition, indices of the retail, food stuffs and construction industries as well as those of large conglomerates improved by the end of the year.

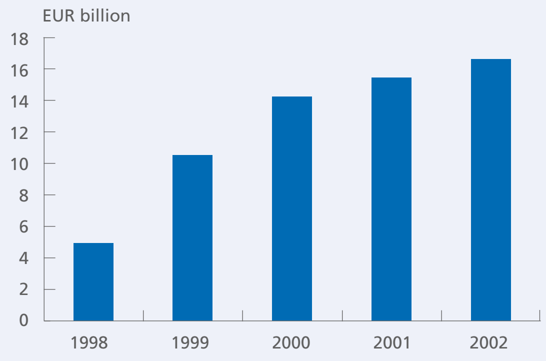
The decline in share prices was also reflected in the overall turnover on the Helsinki Exchanges. In 2002, the total trading value amounted to EUR 189 billion, down EUR 14 billion on the previous year. The all-time high trading value of EUR 227 billion, recorded in 2000, has declined by EUR 38 billion (Chart 4).

At the end of 2002, the total market capitalisation of Helsinki Exchanges totalled EUR 151 billion, down EUR 66 billion on the year-end figure for 2001 (EUR 217 billion).

Fewer listed companies, more remote brokers

The number of listed companies also decreased for the second year running. At the end of 2002,

Chart 5.
Net assets of Mutual funds, 1998–2002



Source: Financial Supervision Authority.

there were a total of 149 listed companies on the Helsinki Exchanges, 6 less than at the end of 2001 (155).

In contrast, the number of trading members grew in the wake of an increase in the number of remote brokers. At the end of 2002, there were a total of 43 trading members on the Helsinki Exchanges, up 5 on the previous year (38). During the year, 6 new remote brokers joined the Helsinki Exchanges, increasing the total number from 20 to 26.

The share of remote brokers of all trading has expanded over the past four years. While in 1999, remote brokers accounted for less than 10% of the euro-denominated trading volume on the Helsinki Exchanges, by 2002 nearly one-half of all share transactions were made by remote brokers.

Primary markets were quiet

Sluggish share markets and poorer economic prospects of companies were also reflected on the primary market. Only one new company was listed on the Helsinki Exchanges during 2002. Companies raised equity capital mainly in the form of secondary public offerings, targeted at existing shareholders. There were a total of 8 share issues.

A total of 61 bond issues were launched in 2002. Of these a particularly large share was accounted for by structured loans, whose return and even principal can be linked to the performance of one generally known share index or to some selected shares. Structured loans come in various types, and there can be great variety in terms and conditions. For this reason, it is very difficult for investors to compare products.

The range of covered warrants has expanded following the launch of a so-called spread warrant, where a limit has been set to maximum return. In addition to the normal redemption price, a maximum price (call warrants) or a minimum redemption price (put warrants) has also been set to spread warrants. The FSA received many enquiries regarding the market guarantee of covered warrants.

Many listed companies have become lucrative acquisition targets as share prices have fallen. Tender offers and redemption offers were made for a total of six listed companies during 2002, respectively.

Influx of assets to short-term funds in an uncertain economic environment

The volume of capital invested in Finnish mutual funds varied at pace with the world economic outlook and the performance of share markets (see Chart 5). The net assets of mutual funds are affected by money flowing in as subscriptions and flowing out as redemptions of mutual fund units as well as by changes in the performances of underlying instruments. During 2002, inflow of money to mutual funds exceeded outflow, except for the month of December, when outflow was greater mainly due to taxation.

Owing to uncertain market conditions, short-term funds attracted increasingly more assets and particularly subscriptions. These funds are considered safer investment targets in times of uncertainty than equity funds, long-term funds or combination funds.

Investment firms trimmed and adjusted their operations

The decline and uncertainty of share markets have made markets challenging for providers of investment services. Many major European investment services providers have had to trim and adjust their operations.

Uncertain economic conditions have also been demanding for investment firms authorised to operate in Finland. More than half of trading on the Helsinki Exchanges was accounted for by intermediaries authorised abroad. In addition, domestic investment firms were driven to adjust their operations in the wake of diminishing income and deteriorating profitability.

MARKET RESTRUCTURING UNDER WAY

Major banking groups carried out internal restructuring arrangements designed to simplify organisational structures and rationalise operations. Endeavours were made to improve profitability by concentrating on selected core businesses. Banks also developed mobile paying solutions by entering into agreements with tele-operators.

Cooperation in the provision of financial and insurance services was enhanced throughout the banking sector. The only financial and insurance conglomerate as referred to in the Act on the supervision of financial conglomerates operating on the Finnish market is Sampo, whose holding company owns credit institutions, investment firms and an insurance company. Other banks also had shares in insurance companies and vice versa, but they were not yet considered to form a financial conglomerate as referred to in the Act. Mutual holdings among banks and insurance companies expanded cooperation between OKO Bank Consolidated and insurance companies. Savings banks also joined forces with the insurance sector in the provision of services.

The applications for authorisation during 2002 were not from general banks aiming to provide a wide range of banking services. Instead, applicants notified of their intention to start the provision of the selected banking services in which they are proficient. Another reason for establishing a new bank was to supplement the provision of investment or financing services available from the same group by introducing, for example, a deposit facility. Payments transmission is another example of a service not included in the range offered by all new banks. The income of such banks is thus mainly composed of the provision of investment services, not of new lending.

New operators will emerge on the financial markets following the introduction of the directive on electronic money. Payment organisations will be authorised to engage in payment transmission and other payment transfers as well as in the issuance of electronic money. They will not, however, be authorised to accept deposits, which will continue to be the exclusive right of deposit banks.

Retail establishments will be able to accept deposits to customer accounts as payment for purchases of goods and services. The maximum limit to deposits accepted from a single customer is EUR 3,000. The funds on these accounts are not covered by the deposit guarantee scheme.

Companies operating without a proper authorisation are permitted to accept deposits to customer accounts from the same customer only up to a sum not exceeding EUR 3,000.

Supervision

The key aim of the FSA's supervision is to identify pressures for change and the risks inherent in financial markets as well as promote the development of market structures and practices supporting stability and confidence. Particularly in proactive supervision it is essential to react in a timely and efficient manner to disruptions in the financial markets.

The FSA seeks to promote the development of internal control cultures in the supervised entities, particularly the functioning of control and risk management systems. The purpose of the supervision executed by authorities is to ensure that the supervised entities are professionally managed and that they operate according to ethically and professionally qualitative business principles and practices.

SUPERVISION OF CREDIT INSTITUTIONS

Weaker profitability among largest banks

Utilising the credit institutions' regular reporting, the FSA assessed their profitability, capital adequacy and risk exposure on a continuous basis. The identification and monitoring of risks in financial conglomerates at group level posed a significant challenge.

The profitability of the largest banks weakened in 2002 mainly due to a decreased net interest income and increased expenses. This downturn was brought about by the unfavourable developments in market rates and security prices.

The FSA supervised the developments in banks' nonperforming assets and large risk concentrations. The monitoring revealed some alarming cases, as a result of which inspection visits were paid to some local banks. In the course of these inspections, no threats were found that would jeopardise the capital adequacy of the banks. However, it was established that the situation still requires close monitoring due to, among other things, increased risks of loan losses. The FSA urged the banks to prepare a sufficient number of capital adequacy assessments based on alternative economic prospects to be able to ensure the necessary capital adequacy in future, too.

Improved financial reporting by major banks

Financial reporting is supervised for the general purpose of improving the reliability of the supervised entities' financial information. In addition, the FSA monitors that the supervised entities disclose sufficient information on their operations in their annual financial statements.

According to the findings of the FSA, the major Finnish banks provided information on their risk management in their financial statements, but they could have disclosed more information concerning risk volumes than they actually did. Taken as a whole, the largest banks' financial reporting met sound international levels. In general terms, local cooperative banks, savings banks and other credit institutions improved their financial reporting. However, due to individual shortcomings, the FSA still urged some supervised entities to correct their reporting.

Shortcomings in banks' arrangement of internal control and risk management

Through inspections, the FSA assessed the supervised entities' internal control and risk management systems. The inspections focused on the operative management system and arrangement of internal control as a whole. Credit risk management and general IT and payment system risks were among the items checked in the risk management inspections. In the course of the inspections, operational risks were also examined, such as risks related to personnel, IT systems or accounting systems.

The shortcomings found in banks' internal control and risk management were, however, insignificant in relation to the scale of banks' operations. There were shortcomings such as insufficient internal instructions, inadequate risk reporting, insufficient control of operational risks, problems in the credit risk rating systems as well as deficient continuity plans for IT systems and business activities. The methods for capital adequacy assessment were also under development in the banks. Most of the problems that were found increased the banks' operational risks, but they did not cause direct losses. The FSA urged the banks to remedy the shortcomings identified.

In spring 2002, the Allied Irish Bank (AIB) case brought about an FSA survey of the functioning of internal control and level of operational risk management in Finnish banks.[5] The survey involved examination of internal controls, internal instructions and the documentation of product processes. The survey showed that the banks, in their FX trading processes, took account of the risk management controls that had been missing in the AIB case. In addition, operational instructions were continuously updated. Although the survey did not give rise to any special measures, the FSA still decided to start paying increased attention in their own inspections to operational risks in trading activities.[6]

Bank risks still small in problem sectors

In autumn 2002, the FSA surveyed the largest banks' credit risks in problem sectors. The survey focused on information technology (IT), real estate investments, transport, construction, hotel and restaurant services, and sawmill industry. The income and investments of these sectors represented about one third of the income and investments of banking groups' corporate customers and a little less than 13% of all banking group customers' total amount of income and investments.

The credit risks of the sectors selected for the survey were somewhat larger than the corporate sector's credit risks on average. This was reflected in the fact that banks' problem claims on the surveyed sectors were larger than on the corporate sector on average. The IT sector's liabilities to the banks had somewhat decreased compared to the previous FSA survey performed in February 2001. The risk ratings of the corporations in the sector had weakened a little in the banks' internal rating systems. However, in relation to the banks' risk-bearing capacity, the credit risks were not alarming.[7]

[5] In February 2002, AIB reported that they had suffered a significant foreign exchange loss in one of its subsidiaries. The loss-incurring operations were largely caused by shortcomings in the internal control of the FX trading process, eg in the trade confirmation procedure, segregation of duties and reconciliation of positions.
[6] See FSA Newsline 2/2002.
[7] See FSA Newsline 4/2002.

SUPERVISION OF CAPITAL MARKET PARTICIPANTS

Profitability problems in investment firms and management companies

During the year, the FSA, both in its continuous supervision and in the inspections conducted, paid special attention to the profitability of investment firms and management companies. The sector solved its profitability problems through sales of business areas, mergers and other corporate restructuring, adjustment of activities and increased capital investments by owners. Actual bankruptcies were avoided.

In its inspections, the FSA focused on customer protection as well as orderly transfer and wind-up of business operations. The sector's adjustment to decreased business activity is an urgent question also in 2003. The FSA continues to monitor the situation closely.

Inspections of asset management continued

The asset management inspections embarked on in 2001 were continued in 2002. As in 2001, shortcomings were found concerning contracts, customer reporting and corporate internal control. Deficiencies also appeared in IT systems, trade allocation and control of investment limits. There were significant differences between the firms concerning the quality level of handling matters. The FSA urged the asset managers to remedy the problems revealed.

Intermediaries' risk management requires improvement

Intermediaries' risk management in securities trading was inspected in securities houses. The intermediary is responsible for the settlement of securities trades executed by the customer. If the customer cannot deliver securities or money, the intermediary may be exposed to a credit risk. In the course of the inspections, shortcomings were found in the management of this type of risk and in the setting of risk limits, and intermediaries were urged to improve their risk management.

Upgrading of securities clearing and settlement under way

The upgrading project for clearing and settlement of securities, HEXClear, reached its implementation phase in 2002. The FSA monitored the progress of the project in the central securities depository, banks and securities intermediaries, who act as clearing and settlement parties and operators of the book-entry accounts.

The time schedule for the large project was too tight for the parties, and thus it was adjusted in late 2002. The system will be introduced, according to plan, in the end of 2003. The central principles and technical implementation of the new securities clearing and settlement have been agreed, but there are still details that need to be adjusted. Otherwise the implementation of the project appeared to proceed as planned.

Funds' risk profiles still not free from deficiencies

After a few years' break, the FSA again systematically inspected all fund prospectuses in summer 2002. The fund prospectus is a key source of information to the investor in comparing different funds. To guarantee the comparability, minimum contents have been stipulated for the prospectus. In the course of the inspection, deficiencies were found in the description of funds' risk profiles. The FSA urged the management companies to remedy the problems revealed.

MONITORING OF PAYMENT AND IT SYSTEMS

The FSA focused its payment and IT system inspections on the largest banks' international payments and on the outsourcing of banks' IT services. In early 2002, the FSA closely monitored the euro conversion in the banking sector, whereas the inspection of banks' business continuity planning was commenced towards the end of the year. Cooperation with the Bank of Finland in oversight and supervision of payment and settlement systems continued according to the adopted practice.

No significant risks or deficiencies in international payments

The FSA inspected international payment services in the major Finnish banks. The purpose was to obtain an overall picture of the strategy, control, organisation and risk management of the banks' international payment services and of the impact of international payments on the banks' profitability and liquidity. The inspections also covered documentary payments, which were excluded in previous corresponding inspections. In addition, the FSA considered the bank management's role in international payment services and the division of duties and responsibilities between separate units.

The inspections showed that the inspected banks had not surveyed the risks related to their international payment services comprehensively. Departmental continuity plans were also missing in nearly all departments providing international payment services, nor did the banks have sufficient departmental instructions on internal control and prevention of money laundering. The FSA requested the banks to remedy these shortcomings before a specified deadline.

Partly inadequate instructions on outsourcing of IT services

The inspection visits concerning outsourcing of IT services that were started in autumn 2001 were continued in 2002. The purpose was to get a general picture of the principles applied by the banks in their outsourcing of IT services and of the scale of outsourcing. Particularly the monitoring of outsourced IT functions, the assessment and management of risks related to outsourcing, and the ensuring of outsourced functions' continuity, ie the availability of services in case of possible disruption situations for the service provider, were investigated.

In the course of the inspections, the FSA found some shortcomings in banks' outsourcing instructions and requested the banks to revise their instructions and compile all existing instructions into one single set. In addition, the FSA urged the banks to describe their outsourcing processes and to ensure the continuity of the outsourced services.

No larger problems for banks and Automatia in euro conversion

Banks' and Automatia's euro conversions at the turn of the year and in early 2002 were carried out without any larger disruptions. Some minor problems mainly concerned errors in the updating to euro in the systems; markka transactions were incorrectly treated as euro in the systems and vice versa.

At the turn of the year 2001/2002, the FSA studied delays and errors in the banks' counting of coins in connection with the euro cash introduction.[8] Once the backlog had been eliminated, there were hardly any more delays. Cases of errors in the counting were few, according to the FSA's study. The frontloading of new euro banknotes and coins went successfully and according to plan.

Inspections of continuity planning started

In late autumn 2002, the FSA started to inspect the continuity plans of the largest banks. Inspections will be continued in 2003. The purpose is to examine the organisation and general principles of the banks' continuity planning and IT system recovery planning as well as the process of preparing the continuity plans. The continuity plans for the most important business lines will also be inspected.

SUPERVISION OF PROPER PRACTICE

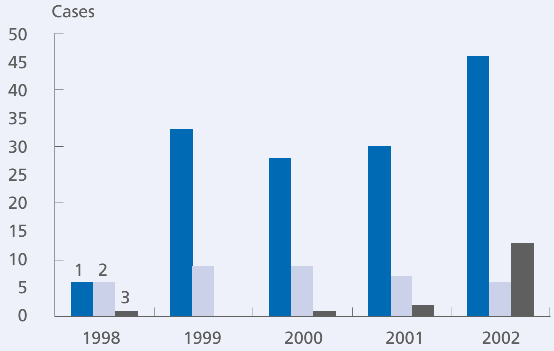
The FSA supervises that institutions in their marketing, contract terms, and other customer activities comply with sound and proper practice. In the supervision of proper practice, account is taken to adequate and reasonable customer contracts and to informative, timely and sufficient information on customer services.

Increase in customer complaints on banking activities

In 2002, the FSA received a total of 177 requests for investigation (168 in 2001). Of those 164

[8] See the FSA Annual Report 2001.

Chart 6.
Cases of suspected market abuse, investigated by FSA, 1998–2002



1 Investigated, no action taken
2 Investigation request submitted to police
3 Admonitions

Source: Financial Supervision Authority.

(2001: 136) concerned banking activities and 10 (32) securities investments.

The number of written customer complaints on banking activities rose by 28 from the previous year, but the number of telephone enquiries declined as more enquiries than before went to the Advisory Office for Bank Customers. In the course of the year the Advisory Office received 2,208 (2001: 1,940) enquiries, most of which focused on uses of accounts and payments (37%) as well as lending (33%). Most customer complaints received by the FSA still concerned lending, collateral and collection.

The customer complaints that the FSA received on securities investments focused on contract terms, practices and procedures of the service provider and information provided on the object of investment. In 2002, the number of written complaints fell by 22, but by contrast the number of telephone complaints rose.

The Securities Complaint Board, functioning in conjunction with the Advisory Office for Bank Customers, received 291 enquiries in total. About one fourth of the enquiries were accepted for consideration by the Complaint Board. The Board issued 23 public recommendations. The most common issues subject to complaint included terms and conditions of securities trading contracts, practices and procedures in connection with purchase and exchange offers for securities, information on investment instruments and investment advice. The reasons for complaints filed on asset management and investment insurance has often been that investments have not performed according to customer expectations.

The FSA also intervened concerning the methods employed by Nordea Bank Finland, Sampo Bank and the member cooperative banks of the OKO Bank Group in marketing insurance products and mutual fund units. The banks had started to market the products of their own banking group's insurance company or mutual fund when customers were visiting the bank offices in order to pay for a product provided by a company belonging to another banking group.

MARKET SUPERVISION

The FSA's market supervision comprises both listed companies' disclosure obligations and supervision of securities trading. Through its supervision the FSA promotes market discipline, markets' access to information and market transparency, which, in turn, increase investor confidence in the functioning of the securities markets.

The objective of compliance monitoring of the disclosure obligations is ensuring that investors have access to essential and adequate information in order to allow a reasoned assessment of a security and its issuer.

Monitoring of financial condition of supervised entities

The FSA monitors the financial condition of the supervised entities by assessing their profitability, capital adequacy, risk position and risk-bearing capacity. The FSA collects the necessary data for the monitoring in three ways:

1. The supervised entities regularly report quantitative data to the FSA in accordance with the FSA's instructions.
2. The FSA conducts inspections, during the course of which it acquires qualitative data on site.
3. The FSA analyses corporations' internal reports and thus it acquires detailed information on strategy, internal risk position assessments and management methods.

The ongoing monitoring makes use of institution-specific information, utilising it to formulate and upgrade an assessment of the corporation's risk profile. Once a year a critical assessment is executed, in which relevant information from external and internal sources is collected on the environment, the financial sector and individual institutions.

The FSA will publish its analyses of the supervised entities' financial condition in the analysis issues of the FSA Newsline published on the FSA's website (www.rata.bof.fi). The first analysis issue will be prepared on the situation of 31 December 2002 and the second on the situation of 30 June 2003.

Trading supervision mainly focuses on insider investigations and investigations of securities price manipulation. Insider investigations also comprise compliance monitoring of declarations of insider holdings. Possible abuses are monitored and investigated in order to increase the pro-active effect of supervision.

Record number of suspected abuse cases investigated

In 2002, the FSA in its market supervision investigated 65 (2001: 30) suspected cases of abuse. Of these 11 concerned suspected securities price manipulation, 24 suspected abuse of insider information, 23 listed companies' regular reporting requirements or ongoing disclosure obligation and 7 the obligation to provide information in connection with securities offerings (Chart 6). Investigation of compliance with reporting and disclosure requirements was one of the areas focused on in the market supervision.

There were 6 investigation requests (2001: 7) submitted to the police during the year; in 4 of them the FSA suspected abuse of insider information and 2 concerned suspected neglect of the obligation to provide information. In addition, the FSA sent 13 (3) letters of admonition or guidance. The letters concerned, for example, inappropriate trading principles or such influence on securities prices, listed companies' disclosure obligations, and issuing of securities without prospectus.

Private limited companies informed about obligations under the Securities Markets Act

At the beginning of July 2002, the obligation to prepare prospectuses was extended to include private limited companies. Owing to the amendment of the relevant act, the FSA investigated several cases in which there was reason to suspect that private limited companies' securities had been offered to the public without an approved prospectus. Based on these investigations, the FSA sought to inform the companies on their obligations according to the Securities Markets Act. The FSA also prepared an information package on the issue.[9]

In December 2002, the FSA decided to start publishing on its website the names of corporations that offer securities to the public without an approved prospectus.

[9] The information package has been posted on the FSA's website www.rata.bof.fi.

Delayed declarations of insider holdings by 72% of listed companies

In summer 2002, the FSA inspected the registers of insider holdings maintained by listed companies to see if the registers were up to date. The FSA asked the listed companies to provide information in their capacity as registrars on all delayed declarations of insider holdings submitted in January–May. According to the inspections, 72% of the companies had delayed declarations to report. They reported 2–10 delayed declarations each. The periods of delay varied from one day to over a year.[10]

Better quality required in pro forma financial information

The FSA also reviewed listed companies' financial statement announcements and interim reports to establish the extent and practices of pro forma reporting.

The findings showed that use of pro forma information as such was not very widespread (21 companies). By contrast, several listed companies disclosed key figures restated from the official financial information. As to pro forma information issued in order to illustrate the effects of corporate reorganisations, the quality of issued information varied. Above all, disclosure of the principles for preparing this information needs development. Nor did it always work to keep the pro forma financial information clearly separate from the official financial information.[11]

Information on incentives systems mostly adequate

In summer 2002, the FSA inspected listed companies' information on their option programmes. The inspections focused on the comprehensiveness and clarity of the companies' information on their systems of incentives. According to the FSA, companies' information on their incentives systems was mostly comprehensive and in compliance with valid regulations. However, the clarity of information varied from one company to another.

[10–11] See the FSA Newsline 4/2002.

Supervision of banking and insurance conglomerates

The ever-closer cooperation between the financial and insurance sectors increasingly emphasises the need for joint banking and insurance monitoring in the supervision of all banking groups.

The Sampo Group is jointly supervised by the Financial Supervision Authority and the Insurance Supervision Authority, with the FSA acting as the coordinating authority. Identification of risks at conglomerate level and assessment of their significance to the whole conglomerate are the most important tasks in the supervision of financial and insurance conglomerates.

The Nordea Group is supervised jointly by the supervisory authorities of the Nordic countries. The objective is to supervise the Group's risk areas, taking the risks of the Group's various companies operating in several countries into consideration and thus allowing comprehensive supervision of group-level risks. The supervisory responsibilities are divided between the authorities of the different countries largely according to the structure of the Group. Responsibilities and segregation of duties may change due to reorganisations of this structure. In addition to the FSA, the amalgamation of cooperative banks is also supervised by the OKO Bank Group Central Cooperative. The FSA's supervision focuses on the amalgamation as a whole. Here it is important to identify the significant risks of the amalgamation. The FSA emphasises the responsibility of the amalgamation's central institution in the supervision of the individual member cooperative banks. Considering the management of overall risks in the amalgamation, the central institution must have adequate supervisory rights in relation to the individual member banks of the amalgamation.

The Savings Bank Inspectorate supervises the savings banks, and the FSA guides and supervises the inspectorate. Structural plans of the group of savings banks influence the allocation of supervision so that proper account is taken already at the planning stage to identifying and managing risks related to the arrangements.

What is the HEXClear system?

HEX is currently preparing a new securities clearing and settlement system. The new HEXClear system will speed up the clearing and settlement of securities and significantly decrease systemic risk in the securities markets.

In the new HEXClear system, which is still at the development phase, securities will be settled individually as soon as the terms of trade are fulfilled. The trades are executed immediately once the buyer has deposited the necessary sum of money on the Finnish Central Securities Depository's (APK) account in the Bank of Finland and the seller has the book entries available for settlement on its book-entry account in the centralised register. Money and assets are transferred according to the delivery-versus-payment principle. HEXClear also enables clearing and settlement of a group of several trades at the same time.

Under the new system, trades are no longer chained, and as a result a settlement failure of one party does not affect the settlement of other parties' trades. At no stage will the APK become the counterparty of the settlements or otherwise ensure the realisation of the trades. For this reason there is no need for the counter-parties to provide collateral.

The purpose of the new system is to replace the present system still in use, under which the securities are settled once a day in batch runs. According to the present system, settlements are chained and the trade prices netted by counterparty. The counterparties must pay the netted payments before the trades are settled.

Regulation

The Financial Supervision Authority's (FSA) objective is to promote a regulatory framework based on flexibility and accountability. In its regulatory work, the FSA emphasises not only flexibility but also the accountability and transparency of individual participants and the exercise of discretion by the supervisor within the limits of generally recognised rules of conduct. Regulations are closely integrated with international core principles. The FSA's set of regulations serves both as a regulatory tool and as a supervisory tool.

The FSA supports the EU's objectives of increased flexibility in legislation, more rapid response in the drafting of legislation and improved enforcement coordination. The FSA recognises these objectives in its own regulatory activities to the extent possible. The FSA also makes an active contribution to the harmonisation of legislation, supervision and procedures at EU level.

New Act on the Financial Supervision Authority to grant the FSA broader powers

The FSA's powers will be extended with the adoption of the Act on the Financial Supervision Authority (FSA Act) currently under discussion by Parliament.

The legislative reform provides for more effective supervisory activities by expanding the FSA's powers in respect of access to information and right of inspection.

The new FSA Act would give the FSA authorisation to bar a person failing to comply with the statutory fit and proper criteria from acting as a Board member or managing director of a credit institution or investment firm. The new Act would also give the FSA the right to issue a disclosure ban on persons being investigated in connection with securities market offences, or on other persons.

In the interest of more effective supervision, the FSA would also be given powers to impose administrative sanctions, ie public admonitions and warnings, on supervised entities and other financial market participants guilty of minor offences.

The investigative and supervisory powers of competent supervisory authorities are also extended by the Market Abuse Directive[12]. Such powers include the right to have access to any document and to receive a copy of it, the right to demand information from any person and, if necessary, to summon and hear any such person, the right to require existing telephone and data

[12] The Directive must be implemented by member states within 18 months from its adoption. The Directive obliges member states to draw up rules for the prevention, detection and investigation of market abuse as well as for administrative sanctions.

traffic records and the right to request the freezing and/or sequestration of assets.

According to the Directive, the competent authority would exercise its powers either directly itself or in collaboration with other authorities or with the market undertakings. The competent authority could also refer the matter to the competent judicial authorities.

The implementation of the Directive steps up international cooperation between supervisory authorities in the detection and investigation of market abuse.

Parliamentary Supervisory Council to supervise appropriateness and efficiency of FSA operations

The Parliamentary Supervisory Council will be given a more precise role as the highest supervisor of the FSA's operations. Adoption of the new FSA Act will impose a general obligation on the Parliamentary Supervisory Council to supervise the overall appropriateness and efficiency of the FSA's operations, thereby also enhancing their transparency and social accountability. The responsibilities so far held by the Parliamentary Supervisory Council have related to the FSA's administration and will remain unchanged.

The new FSA Act would also emphasise the Board's role in the FSA's decision-making procedure. In addition to having responsibility for overall strategic direction, the Board would also be responsible for discussing decisions on the exercise of the FSA's powers. It could also decide on matters that may have a significant impact on financial stability or overall financial market developments.

The composition of the FSA's Board would be changed so as to include six instead of the current five Board members. The sixth Board member would be appointed on the basis of a proposal by the Ministry of Finance.

FSA to take over licensing authority

Under the new FSA Act, the licensing authority in respect of credit institutions, investment firms and pawnbrokers is to be transferred from the Ministry of Finance to the FSA. However, the Ministry of Finance is to retain licensing and regulatory authority over deposit and guarantee funds, the investor compensation fund, stock exchanges and the Finnish Central Securities Depository (APK).

Competition neutrality between different investment outlets enhanced

The competition neutrality between savings, investment and life insurance products will be

Table 1.
The main laws for which compliance is supervised by the FSA

Credit Institutions Act (30.12.1993/1607, Ra 107)
Act on Commercial Banks and other Limited Liability Credit Institutions (28.12.2001/1501, Ra 108)
Savings Bank Act (28.12.2001/1502, Ra 109)
Act on Cooperative Banks and other Cooperative Credit Institutions (28.12.2001/1504, Ra 110)
Act on Foreign Credit and Financial Institutions in Finland (30.12.1993/1608, Ra 112)
Mortgage Bank Act (27.12.1999/1240, Ra 112 a)
Act on Mortgage Societies (8.12.1978/936, Ra 113)
Securities Market Act (26.5.1989/495, Ra 116)
Act on Trading in Standardized Options and Futures (26.8.1988/772, Ra 117)
Mutual Funds Act (29.1.1999/48, Ra 118)
Investment Firms Act (26.7.1996/579, Ra 119)
Act on Foreign Investment Firms' Right to Provide Investment Services in Finland (26.7.1996/580, Ra 119 a)
Act on Book Entry System (17.5.1991/826, Ra 120)
Act on Book Entry Accounts (17.5.1991/827, Ra 122)
Act on the Supervision of Finance and Insurance Conglomerates (25.1.2002/44, RA 115); joint supervision with the Insurance Supervision Authority
Act on the Prevention and Detection of Money Laundering (30.1.1998/68, Ri 308); burden of responsibility with supervised entity

Source: Financial Supervision Authority.

enhanced. The working group set up by the Council of State in May 2002 to explore this issue published its preliminary views in February 2003 on how to improve the equal treatment of different investment vehicles.

The working group takes the view that better competition neutrality between savings, investment and life insurance products could be achieved for example through tax reforms. Key development needs in terms of customer and investor protection include ensuring proper market practice and fair contract terms, improving product comparability and clarifying service providers' marketing responsibility. Another important goal set by the working group is better comparability and transparency of the expenses incurred by various savings products. In response to recent product developments, the working group also plans to adjust the field of application of the deposit guarantee scheme.

The FSA acknowledges the significance of the working group's objective of harmonising marketing regulations so as to ensure that the offering of similar investment products to the public would automatically result in a similar disclosure obligation. Another major improvement concerns the harmonisation of service providers' responsibilities, which would automatically be reflected in the information issued to investors.

The working group's mandate expires at the end of November 2003. The working group includes representatives of the Bank of Finland, the Ministry of Finance, the Ministry of Social Affairs and Health, the Ministry of Justice, the Financial Supervision Authority, the Insurance Supervision Authority, the Office of Free Competition and the National Consumer Administration.

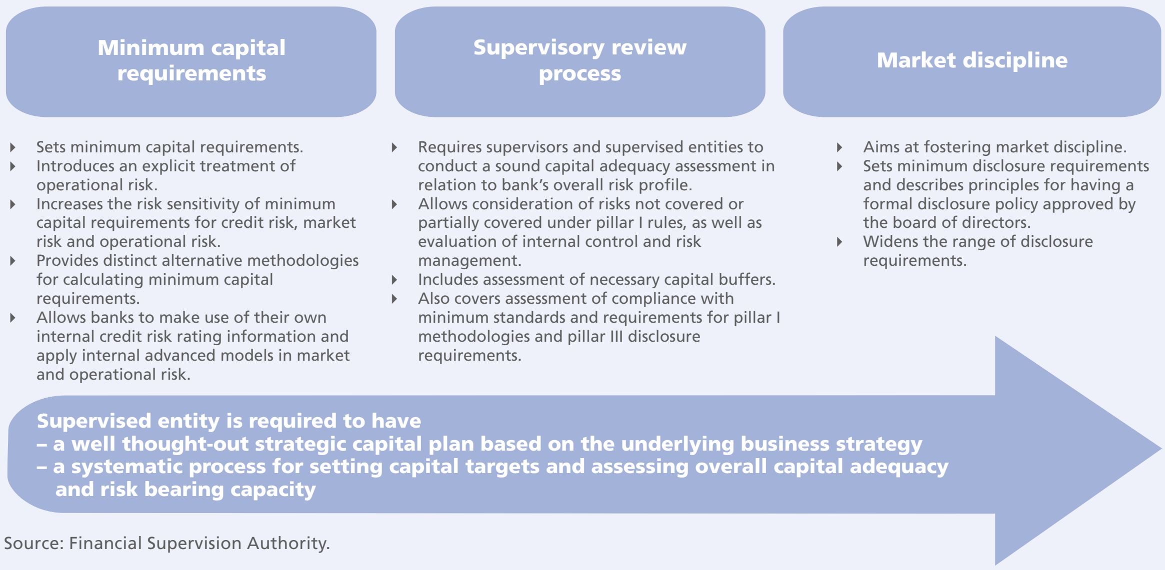
Right to accept customer funds extended

The Electronic Money Directive was transposed into Finnish law by amending the Credit Institutions Act to include provisions on payment organisations and their activities. Payment organisations may only engage in the issue of electronic money or general payment transmission and to this effect require authorisation to operate as a credit institution. The right of investment firms to accept repayable funds from the public was also extended. Payment organisations will be subject to supervision by the FSA.

The legislative amendment also guarantees natural persons the right to basic banking services. This means that banks may not refuse to open an ordinary deposit account and provide the medium for its use or to discharge a payment order, unless there are weighty reasons for such refusal.

Shops will also be given the right to administer customer funds accounts in the

Chart 7. **New capital adequacy framework pillars (Basel II)**



Source: Financial Supervision Authority.

maximum amount of EUR 3,000 per customer. If shops decide to issue electronic money, the maximum amount to be stored in a data medium is EUR 150. Funds deposited on customer accounts held by shops are not covered by the deposit guarantee scheme.

Capital adequacy reform progressed rapidly

Preparations for the review of the capital adequacy framework by the Basel Committee on Banking Supervision (Basel Committee) and the European Commission took great leaps forward in the course of 2002. A cornerstone of the reform is that capital requirements on banks must comprehensively reflect all material risks inherent in their business and that own funds adequacy should be ensured under all circumstances (Chart 7).The proposal of the Basel Committee for a new capital adequacy framework[13] will be finalised towards the end of 2003, and the revised framework will be introduced for implementation on 31 December 2006.

The Basel Committee published its most recent proposal in early October, when the Third Quantitative Impact Study (QIS 3) of the effects of the new framework on banks' own funds and capital adequacy requirements was also launched. The study covers more than 200 banks from 40 countries, among them Finnish banks.The findings of the study will be taken into account in the preparation of the final Basel II Accord. Already before October the Basel Committee had published sound practices for the management and supervision of operational risk

The capital adequacy framework of the European Union is built on the recommendations of the Basel Committee.The European Commission has drafted new European legislation to implement the new capital adequacy framework, which will apply to all credit institutions and investment firms within the EU.The EU Directives will be introduced for implementation at the same time as the Basel Accord.

FSA assisted in collecting the Finnish contribution to the European Commission's structured dialogue on the capital adequacy regime

In November 2002, the European Commission launched an extensive dialogue on the proposed new capital adequacy regime with a number of stakeholders.The Commission was responsible for the dialogue at EU level, while the national supervisors assisted with its practical organisation in member states.The FSA launched the dialogue in Finland.

[13] The Basel II Accord.

The progress towards completion of the capital adequacy framework and the required new regulations was reflected in the FSA's operations in 2002 in many ways. Finland participates in the drafting of the capital adequacy directive by the European Commission through membership of various committees and working groups. The FSA allocated increasing resources to background preparations for participation in committees and working groups concerned with EU provisions, tentative design of the structure and contents of the new national regulatory framework, exploration of the challenges facing the application of the new framework and to contacts with the industry and other supervisors.

In the course of the year, the FSA organised a series of information and discussion meetings for credit institutions and investment firms to report on the progress of the work of the Basel Committee and the European Union. The Third Quantitative Impact Study, QIS 3, with its comprehensive calculation instructions and a number of interpretation issues, constituted one of the most significant and laborious intermediary stages in late 2002. The FSA arranged several meetings with supervised entities to get the study started, collected and verified the data provided by Finnish banks and compiled it into a country report. The study also required close cooperation between all Nordic supervisors, for example on the choices left to national discretion and on the treatment of banking groups.

Easier for companies to raise capital throughout the EU

The new Directive on prospectuses, which is expected to take effect in late spring 2003, will make it easier for companies to raise capital throughout the EU. Securities may be offered to the public throughout the European Union after the prospectus has been approved in one of the member states, without having to subject the prospectus to approval by all member states. In cross-border offerings, securities issuers or offerors may issue an English-language prospectus, together with a summary of the prospectus in the language of each country concerned.

The Prospectus Directive is designed to harmonise the prospectus requirements applicable to securities offerings and listings and facilitate cross-border securities offerings throughout the EU. The more precise requirements concerning the contents of prospectuses, together with other implementing measures, will be issued through a committee procedure, with the Committee of European Securities Regulators (CESR) being responsible for preparations. The requirements concerning contents are based on IOSCO disclosure standards.

Prospectuses produced in line with the Directive also increase the amount of information made available to investors in the context of securities offerings.

IAS to become applicable to listed companies' consolidated financial statements

Publicly listed companies must prepare their consolidated financial statements in accordance with International Accounting Standards (IAS) starting with financial periods commencing on or after 1 January 2005. This requirement applies to companies whose securities have been admitted to trading on regulated markets in an EU member state.

In keeping with the Regulation on International Accounting Standards[14] in September 2002, member states may also permit or require companies other than listed companies to prepare their financial statements in accordance with International Accounting Standards. Furthermore, member states may defer the mandatory application of the standards until 2007 at the very latest for certain companies. Such deferment may be granted to companies with only debt securities admitted to public trading as well as to companies whose securities are publicly listed in the United States and who for this reason prepared their financial statements in accordance with U.S. GAAP regulations before publication of the Regulation.

In January 2003, a working group set up by the Finnish Ministry of Trade and Industry published an interim report with their preliminary position on the field of application

[14] The Regulation on the application of international accounting standards is directly binding on all EU member states and its (mandatory) provisions do not have to be separately implemented in national legislation.

of the Regulation on International Accounting Standards and the Fair Value Directive[15]. The working group is currently exploring the need for amendments to the Accounting Act and related sectoral legislation, paying special attention to recent developments in the EU accounting framework.

The working group takes the view that all those companies who wish to may prepare both consolidated and individual financial statements in accordance with international standards (IAS and IFRS[16]) (on a 'no restriction, no obligation' basis). However, publicly traded companies must always prepare financial statements in accordance with international standards, irrespective of whether the company prepares a consolidated financial statement or not. Publicly traded companies may not affect the information to investors through mergers or acquisitions.

Where unlisted companies voluntarily prepare their financial statements in accordance with international standards, the financial statements must, in the working group's opinion, always be audited by a certified auditor. If only the company's debt securities have been admitted to public trading, such financial statement must be prepared in 2007 at the very latest.

In the opinion of the working group, the Fair Value Directive should also be implemented on a 'no restriction, no obligation' basis. Companies would have the right but no obligation to apply fair value accounting to their financial instruments in accordance with the Directive as regards both individual and consolidated financial statements. All credit institutions must, however, apply the valuation rules of the Fair Value Directive. As most of the assets of credit institutions are financial instruments, the working group takes the view that credit institutions should not be allowed to choose whether or not to apply the Directive.

Common approach to enforcement of listed companies' financial information in Europe

The European Commission seeks to harmonise the enforcement regime of international accounting standards (IAS and IFRS). It finds further development of the enforcement mechanism necessary in order to remove variations and inadequacies in certain member states. Investors must be able to have confidence in the financial information disclosed by listed companies and its comparability in European securities markets. The European Commission expects the Committee of European Securities Regulators (CESR) to take part in the implementation of its financial reporting strategy for example by improving and harmonising the enforcement methods for financial information.

In autumn 2002, CESR released the Proposed Statement of Principles of Enforcement of Accounting Standards in Europe prepared by its standing committee (CESR-Fin). This is a statement in principle of the features of institutional oversight and the enforcement methods and processes necessary for achieving the objectives set in the European Commission's financial reporting strategy.

CESR recommends that EU member states adopt enforcement regimes that are as harmonised as possible to ensure effective practical enforcement in an increasingly international environment. In accordance with the CESR enforcement principles, the enforcer should be an administrative authority independent of political decision-making and market participants and with adequate resources and powers to carry out its enforcement duties.

The FSA is represented on the CESR-Fin working group which prepared the statement of principles and continues to develop the enforcement principles further. The FSA seeks to ensure that the enforcement principles are considered in the best way possible in the establishment of the national enforcement regime. The FSA also participates in the working group set up by the Ministry of Trade and Industry at the end of 2002 to draft a proposal for an appropriate Finnish enforcement regime for monitoring compliance with international accounting standards (IAS and IFRS) and for the competent authority.

[15] Member states must transpose the Fair Value Directive into national law by the beginning of 2004. The Directive provides for a revision of the valuation principles applicable to financial instruments to allow for fair value accounting.
[16] International Financial Reporting Standards.

Revised anti-money laundering recommendations specify due diligence in customer relations

The Financial Action Task Force on Money Laundering (FATF) is in the process of revising its 40 recommendations, which have gained the status of international standard. The FATF recommendations have, inter alia, been incorporated in the country evaluations performed by the International Monetary Fund and the World Bank under the Financial Sector Assessment Program (FSAP). It has been proposed that more detailed requirements regarding customer identification and due diligence (CDD) procedures be included in the new FATF recommendations, which are scheduled for adoption in 2003. The FSA will take the recommendations into account in the new standards.

In Finland, the reporting requirements concerning money laundering will be extended to also cover any suspicions of assets being used for the financing of terrorism. The reporting requirements will start to apply to non-financial groups, including independent legal professionals, external auditors, accountants, car dealers, traders in valuables and auctioneers. The Government bill with a proposal for amending the Act on the prevention and detection of money laundering has been approved by Parliament. The Act, which is expected to take effect in the course of spring 2003, will implement the Second EU Anti-Money Laundering Directive and nearly all the Special Recommendations against the financing of terrorism adopted by FATF into Finnish law.

The regulations on international economic sanctions decided by the UN Security Council and the EU were amended several times in 2002. The funds and financial resources subject to economic sanction can be frozen directly on the basis of regulations, as EU regulations and their annexes are directly applicable law in all EU member states. Assets to be frozen have not been found in the possession of entities supervised by the FSA.

Securities Markets Act also applicable to private limited companies

The scope of application of the Securities Markets Act was extended at the beginning of 2002 to cover private limited companies. Accordingly, private limited companies offering securities to the public must hereinafter publish a prospectus as referred to in the Securities Markets Act. They must also observe other provisions on marketing and disclosure requirements contained in the Securities Markets Act.

FSA to move over to subject-specific regulations

In 2002, the FSA's regulatory practice focused on the revision of the set of regulations. The FSA has decided to abandon institution-specific regulations in favour of subject-specific regulations, in which legally binding rules and recommendatory guidance are combined. The reform will clarify the FSA's regulatory practice and improve the usability of its set of regulations. The reforms introduced by the FSA aim at avoiding too detailed regulations, as far as is possible, thereby highlighting market participants' own responsibility and market discipline.

The new regulation structure and regulatory outlines took effect in October. Over the year, work started on the binding and recommendatory provisions of the regulation set, ie the standards. The standards set the level of quality to be met by supervised entities and other market participants. The current FSA guidelines and regulations will remain in force until the provisions contained in them are incorporated with the new standards.

In order to enhance the usability of the FSA's set of regulations, the legally binding and recommendatory provisions have been combined in a collection of subject-specific standards.

Several working groups are currently working on the new standards and the first drafts have already been circulated for comment. Most of the standards will be prepared in the course of 2003, except for those to be issued in connection with the revision of the capital adequacy framework and International Accounting Standards (IAS).

To achieve greater external visibility and better electronic usability of the set of regulations, the Regulation directory of the FSA's Finnish-language website was redesigned almost completely, to first and foremost serve as a source of information for the entities supervised by the FSA.

International activities

Through its international activities, the Financial Supervision Authority (FSA) seeks to actively contribute to the convergence of market practices as well as regulation and supervision, especially at EU level.

A common regulatory and supervisory framework is a prerequisite for the existence of a level playing field for all financial institutions, providers of investment services and issuers of securities throughout the European Union. The aim is to make it easier for investors and users of financial services to benefit from the provision of financial services on an EU-wide basis.

The FSA participates in various international fora and cooperates with the supervisory authorities of other countries. The most important fora for the FSA are in Europe. They comprise the Committee of European Securities Regulators (CESR), the Banking Supervision Committee (BSC) of the European System of Central Banks, the Banking Advisory Committee (BAC) of the European Commission and Groupe de Contact, a forum for banking supervisors from EEA countries.

EU financial regulation and supervision to become more effective

At the request of Ecofin, the EU's Economic and Financial Committee (EFC) produced a report[17] containing proposals for more effective financial regulation and supervision at EU level. The proposed reforms are designed to intensify and speed up EU legislative procedures in the context of financial market issues, strengthen supervisory practices in EU financial markets and promote the harmonisation of supervisory and regulatory practices within the EU. A further aim is the fostering of cooperation between sectoral authorities with a view to promoting financial stability.

The report proposes, for example, the establishment of three regulatory committees and two committees of supervisors. The proposals are largely based on the report of the Committee of Wise Men, also known as the Lamfalussy Group, prepared in February 2001 and including proposals for reforming EU securities market regulation and supervision. According to the proposal, the Lamfalussy structure would also be extended to banking, insurance and financial conglomerates.

In October-November, the European Commission launched a round of consultations on the suggested improvements. Discussions with the European Parliament and other relevant organisations are currently in progress.

[17] EFC report on financial regulation, supervision and stability.

International fora in the field of banking supervision and regulation focus on capital adequacy

The Banking Advisory Committee (BAC) subordinate to the European Commission was involved especially in two major projects: revision of the capital adequacy framework for credit institutions and investment firms and issues related to accounting and financial reporting provisions applicable to credit institutions. The Committee also familiarised itself with the financial sectors and financial supervision of the EU candidate countries. The FSA participated in the work of the Committee, together with the Bank of Finland and the Ministry of Finance.

The FSA, in conjunction with the Bank of Finland, also took part in the work of the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB). The Banking Supervision Committee investigated trends in the banking and financial system and the stability of the banking sector, and promoted general information exchange between banking supervisors and central banks, for example on financial stability issues.

In 2002, Groupe de Contact, the independent body for cooperation between the banking supervisory authorities of the EEA countries, prepared core supervisory principles for the revision of the EU capital adequacy framework, as well as the annual report on the capital adequacy of European banks. The FSA participated in the group's work.

The biennial International Conference of Banking Supervisors (ICBS) was held in South Africa. The main themes of the conference were the review of the Capital Accord prepared by the Basel Committee and promotion of financial stability in emerging market economies. Finland was represented by the FSA and the Bank of Finland.

CESR commenced operations

The Committee of European Securities Regulators (CESR) established in late 2001 commenced operations in 2002. The Committee focused on measures related to the Lamfalussy process, on the one hand, and on making preparations for the start of operations, on the other.

The preparations for the start of operations related to the changeover from the Forum of European Securities Commissions (FESCO) to the Committee of European Securities Regulators (CESR). In practice this meant financial independence through a separate budget, a full-time secretariat, own offices and increased consultation of market participants.

The Committee's policy is to consult market participants during the various stages of preparation of recommendations and other proposals. A Public Statement on Consultation Practices was adopted and a panel of experts[18] established to promote interaction between different participants. The panel has eleven members, representing different expertise.

The European Securities Committee (ESC) commenced operations at the same time as CESR. The ESC assists the European Commission in the preparation of directives and makes decisions on commitology issues. The ministries of finance are represented on the ESC. It took on the functions of the existing High Level Securities Supervisors Committee, which convened at the summons of the European Commission.

CESR proposal for implementation of market abuse directive submitted to the Commission

The Committee of European Securities Regulators (CESR) issued recommendations on stabilisation and allotment in connection with securities offerings, recommendations for alternative trading systems (ATS) and rules of conduct for investor protection equally applicable to retail and professional investors. The mission of a working group set up in spring to review the transparency of securities trading was to present the common position of CESR to the European Commission on account of amending the Investment Services Directive.

In the course of the year the so-called Lamfalussy process was applied to four directive proposals, including the Market Abuse Directive, the Prospectus Directive, the Investment Services Directive and the Directive on the regular reporting requirements of securities issuers.

[18] Market Participants Consultative Panel.

The Lamfalussy process explained

Within the EU the aim has been to reform securities market regulation in line with the approach proposed by the Committee of Wise Men. This approach is also referred to as the Lamfalussy process. It is designed to improve and speed up the preparation and application of EU legislation. To ensure greater transparency, extensive consultation of market participants should be undertaken in the course of the preparatory stages of EU legislation.

In keeping with the four-level approach of the Lamfalussy process, the EU's primary legislation, ie Directives and Regulations, should focus on key provisions only (Level 1), whereas more detailed technical implementing measures would be adopted through the commitology procedure (Level 2). The European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR) assist the Commission with proposals for implementing measures.

Securities markets supervisors should upgrade cooperation to achieve greater harmonisation and efficiency of the implementation of EU legislation in member states (Level 3). Supervisory cooperation is coordinated by CESR, which can also issue common administrative guidelines, recommendations for interpretation and standards.

Level 4 concerns the monitoring of compliance with EU securities market legislation. The European Commission in particular should in the future efficiently supervise implementation of securities market legislation in member states.

The Lamfalussy framework is also expected to be extended to the banking sector.

CESR prepared Level 2 implementing measures for these directives. A proposal for the implementation of the Market abuse directive was submitted to the European Commission at the end of 2002. The CESR proposal for measures implementing the Prospectus Directive has been sent round for consultation.

The adoption of the Lamfalussy framework and the commencement of operations of CESR have intensified cooperation between EU securities market supervisors and highlighted the importance of such cooperation. Work on Level 2 implementing measures is designed to draft provisions that will later become EU legislation that is binding on all member states. A considerable number of the Committee's recommendations for ATSs and investor protection have been acknowledged in the proposal amending the Investment Services Directive prepared by the European Commission.

Regulatory improvements also need to be coupled with closer cooperation in the field of supervision. For cooperation purposes, CESR has two permanent working groups, CESR-Pol and CESR-Fin. CESR-Pol has worked towards adopting a common position on cooperation with countries outside of the EU (for example Switzerland and the Channel Islands). To ensure seamless cooperation, the investigative powers and sanctions available to national supervisory authorities must be sufficiently similar in similar situations. Harmonisation of these powers and sanctions represents an essential element of the EU directives under preparation.

CESR-Fin is responsible for coordinating the measures of CESR in the context of monitoring listed companies' compliance with financial reporting requirements, especially International Accounting Standards (IAS and IFRS). CESR-Fin has two sub working groups. One of them reviews proposals for standards from the perspective of securities market supervision and conveys the group's opinions to the bodies involved in the standards approval process in Europe. The mission of the other sub working group is to design common core principles for monitoring listed companies' compliance with financial reporting requirements.

Development of the FSA's activities

Changes in the financial markets, EU legislation and the operating environment in general place increasing demands on supervision and put a strain on the FSA's resources. Implementation of the international accounting standards (IAS) and the new capital adequacy (CAD) regime will, in addition to day-to-day market supervisory duties, require considerable resources over the next few years. The reforms will give rise to regulatory changes and pose further challenges on practical supervision.

In 2002, the objective of developing the FSA's activities was to further enhance the supervision authority's readiness to respond to the changes in the markets and the supervised entities' activities in an improved and more cost-efficient manner. Preparatory work was focused on the introduction of the IAS standards and the new CAD regime.

More efficient operating procedures and organisational structures

The FSA evaluated the adequacy of its resources and the need for skills development by means of proactive human resource planning, which was a management tool that had been introduced in 2001. Possible methods for managing the pressures and demands on resources were also discussed. The FSA's modes of operation and organisational structures are to be enhanced in 2003. The operational strength of the FSA is projected to grow by five persons. Skills development continues with focus on CAD and IAS competence.

The FSA decided to restructure its organisation to more adequately reflect the supervisory requirements set by the new CAD framework. It was proposed to the FSA Board that from early 2003 onwards the sector-based supervisory structure be replaced by a model that breaks down the FSA's supervisory activities into institutions and markets supervision. Making preparations for the reforms also calls for strict prioritisation of supervisory tasks.

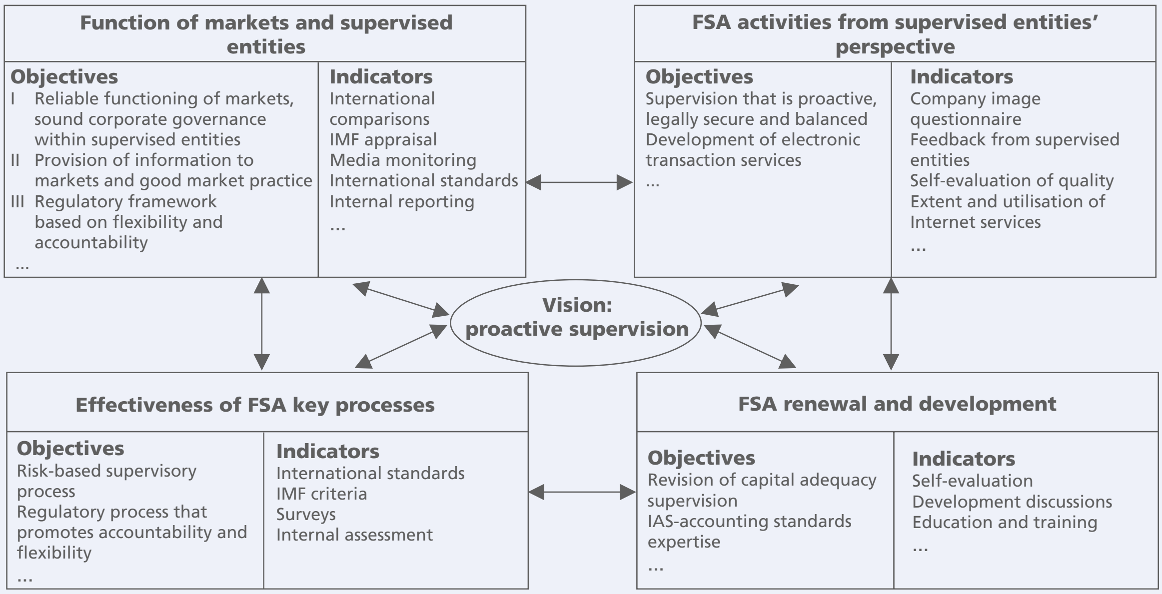
On 1 June 2002, a regulation strategy unit was set up to intensify the management of the regulatory process.

The FSA continued to evaluate the results of proactive human resource planning and draw conclusions from it.

Goal achievement evaluated on the basis of a framework undergoing further adjustment

Performance evaluation was further developed in line with the objectives and guiding principles adopted by the FSA Board. The aim is to obtain an evaluation procedure that directs operations to matters of strategic importance. The assessment

Chart 8. **Evaluation model for fulfilling FSA strategic objectives (Balanced Score Card)**



is based on indicators reflecting developments in the operating environment as well as international and domestic surveys. Whenever necessary, separate inquiries are carried out in order to receive feedback.

Although it is difficult to discern the effects of the FSA's actions on financial stability and confidence, performance evaluation nevertheless provides a useful discussion basis for intensified cooperation between authorities. The performance evaluation undertaken in 2002 showed that progress had been made on strategically important matters and that input had been made in targeted and prioritised areas of cooperation.

In 2002, achievement of objectives was evaluated for the second time on the basis of the balanced score card framework, which is undergoing further development (Chart 8). Development of evaluation criteria and measures continues. However, evaluation requires clearly defined goals against which a sound assessment of achievement can be made.

Skills development focused on CAD requirements and IAS standards

Major areas that pose challenges on the competence of the entire staff are the new capital adequacy (CAD) requirements, the international accounting standards (IAS) and the participation in the Committee of European Securities Regulators (CESR).

The Basel Committee's proposal regarding a new capital adequacy regime and the EU Commission's proposal for Europe-wide legislation based on the Basel Accord, were outlined in greater detail in 2002. The FSA arranged a total of eight information sessions for credit institutions and investments firms. Its meetings with other major stakeholders also continued.

The FSA held two open seminars for the supervision authorities of the Nordic countries in 2002. In this context, representatives of the financial supervision authorities of the United Kingdom and the United States gave supervisory reviews of capital adequacy evaluation and operational risk management. Other external training included sessions on credit rating processes. In-house training on Basel II focused on key elements of the new capital adequacy framework.

Several in-house training courses were arranged in order to enhance the FSA staff's expertise on IAS standards. The competence of the staff was further developed through participation in external development projects, for example, in the translation of the new standards (into Finnish). Special input was made to increase the staff competence level as regards issues related to financial instruments and financial information on the securities markets.

In September, the FSA arranged a seminar with the keynote speech given by an EU Commission representative on the background and progress of IAS harmonisation and other current issues.

Internet-based applications for reporting of data to authorities

In November, the FSA, Bank of Finland and Statistics Finland launched a joint Internet service for reporting of data (the Jakelu Service). The Jakelu Service enables reporting institutions to load down the applications they need from the Internet for the compilation of reports to authorities. In addition to the joint reporting to the three authorities (Virati reporting), the Jakelu service covers the Bank of Finland's balance of payments surveys. By the end of 2002, about a hundred institutions had used the Jakelu service. This became the first extranet application that the FSA has made available to supervised entities.

The FSA's website reconstructed

The FSA's redesigned website opened in early January (the English pages are to be updated in the near future). The aim of the reconstruction was to make the website user-friendlier and the menu structure more lucid. In addition, the bond register maintained by the FSA was made available to the public via the Internet.

The Finnish-language 'Regulation' section was restructured in the autumn in connection with the reform of the set of regulations and guidelines. Almost all the existing information on supervision and regulation designed to serve the supervised entities was placed into this section.

In January 2003, the FSA started to display prospectuses (listing particulars and public-offer prospectuses) issued in compliance with the Finnish Securities Markets Act and approved by the FSA. The Finnish-language FSA website also contains a list of all prospectuses approved by the competent authorities of EEA countries and acknowledged by the FSA.

The FSA in brief

The FSA was established in connection with the Bank of Finland in 1993. The predecessor of the FSA was the Banking Supervision Office, which functioned under the Ministry of Finance from 1922 to 1993.

The FSA is connected administratively with the Bank of Finland, but it is an autonomous authority responsible for the supervision of the financial markets. The FSA purchases services from the Bank of Finland, these cover services relating to personnel and financial administration, information management, security and other areas of general administration.

Decision-making and management

The FSA is independent in its decision-making with decisions being made by the Director General. However, the Director General makes decisions on important issues in Management Group meetings in consultation with the Management Group. Each member of the Management Group is entitled to make decisions relating to his own sector in accordance with the division of responsibilities decided by the Director General.

The FSA Board's responsibilities include confirming regulations and guidelines that are significant or important in principle and far-reaching from the viewpoint of supervision and deciding on important matters of principle that the Director General submits to the Board. The Board decides upon the general operating principles, the action plan and supervision fees. In addition, the Board adopts the FSA's annual budget before presenting it to the Bank of Finland Board and submits an annual report on the FSA's activities to the Parliamentary Supervisory Board.

The FSA Board consists of five ordinary members and three deputy members. The Parliamentary Supervisory Council appoints three members of the FSA Board on the basis of proposals by the Ministry of Finance, the Bank of Finland and the Ministry of Health and Social Affairs for three years at a time. The Director General of the Financial Supervision Authority and the Director General of the Insurance Supervision Authority are ex officio members of the FSA Board. The Parliamentary Supervisory Council also appoints the chairman and the vice-chairman of the Board.

The FSA is divided into a regulation strategy unit and three departments, ie the credit institutions, capital markets and the support services departments.[19] The Management Group consists of the Director General, the Deputy Directors, the Staff Unit Head, the Chief Legal Counsel and the Chief Legal Adviser.

The internal audit of the FSA is performed by the internal audit unit of the Bank of Finland.

[19] The FSA is undergoing a reform of its organisational structure (see p. 34).

Personnel

At the end of 2002, the FSA had an operational strength of 136 persons (125 in 2001); 124 (113) employees had permanent positions. A total of 61 (56) employees worked in the Credit Institutions Department, 36 (37) in the Capital Markets Department, 30 (27) in the Support Services Department, 7 (0) in the Regulation Strategy Unit and 2 (5) on the Director General's staff.

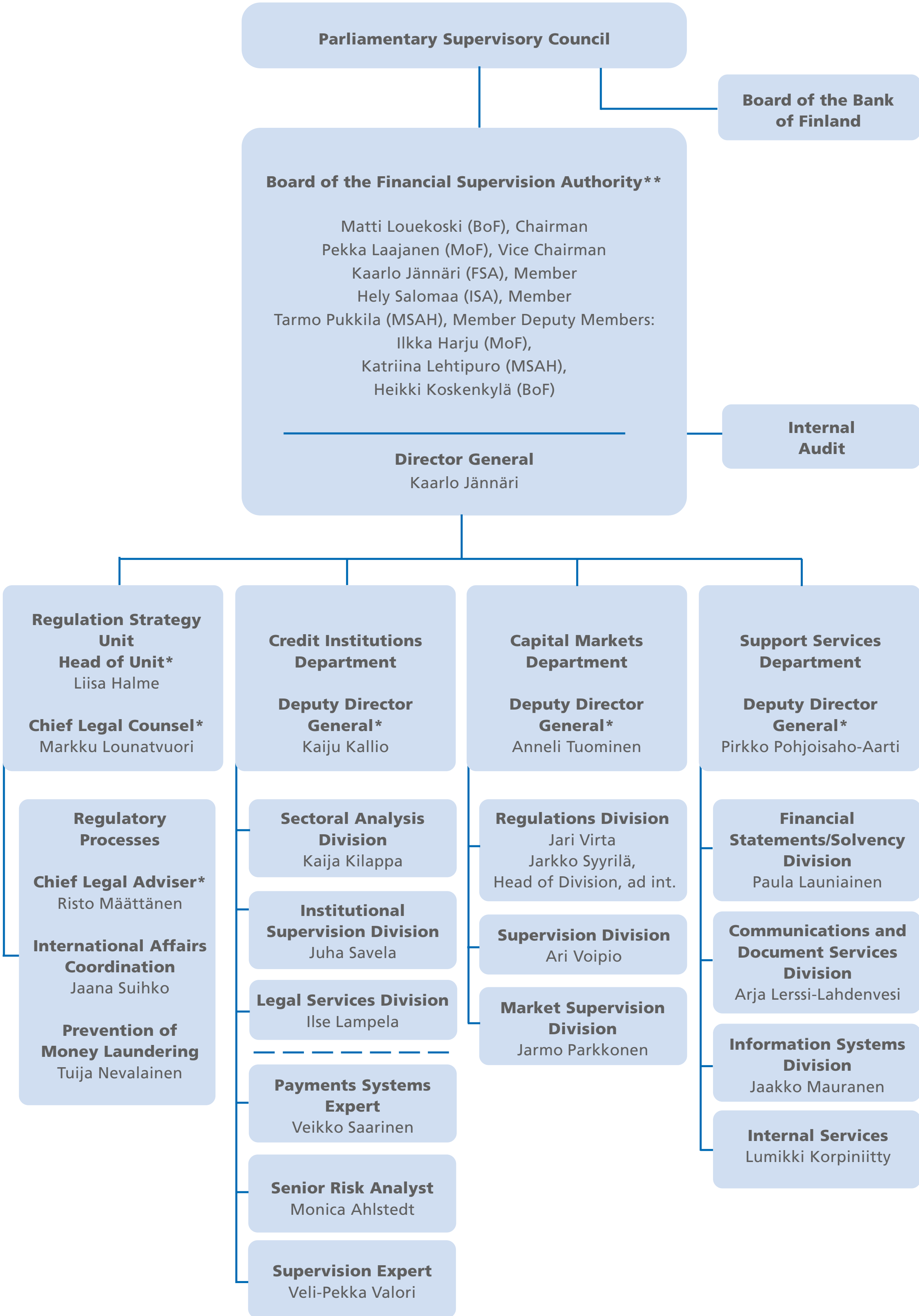
In 2002, the average turnover rate was 11% (14%) for those entering the FSA's service and 7% (13%) for those leaving the FSA. The average age of the FSA's employees was 43 (42).

Financing

The FSA finances its operations by levying supervision fees and processing fees. Supervision fees are charged to supervised entities and issuers of securities. Some FSA decisions and other measures are subject to processing fees.

In 2002, costs arising from the operations of the FSA amounted to EUR 14.2 million (EUR 12.4 million in 2001). The costs were covered by supervision fees amounting to EUR 13.7 million and processing fees amounting to EUR 0.5 million (EUR 0.6 million), ie 3.5% (5%) of total expenses.

Chart 9.
Financial Supervision Authority Organisation 31 December 2002



* Member of the advisory Management Group.
** BoF = Bank of Finland, MoF = Ministry of Finance, FSA = Financial Supervision Authority, ISA = Insurance Supervision Authority, MSAH = Ministry of Social Affairs and Health.

Table 2.
Financial Supervision Authority: expenses and income in 2001 and 2002, EUR thousands

	Actual 2001	**Actual 2002**	Budgeted 2003
Expenses			
STAFF EXPENSES			
Wages			
Permanent employees	5 517	**6 012**	6 834
Fixed-term employees	560	**684**	544
Holiday substitutes	99	**86**	107
Other fees	64	**81**	100
	6 240	**6 864**	7 586
Other staff expenses			
Staff-related expenses	2 002	**2 236**	2 321
Other staff expenses	121	**109**	207
	2 123	**2 345**	2 528
Total staff expenses	8 363	**9 209**	10 113
OTHER EXPENSES			
Training	312	**302**	392
Travel	319	**442**	440
IT expenses	807	**817**	843
Office expenses	666	**590**	651
Real estate rents and maintenance costs	1 176	**1 630**	1 656
Other expenses	713	**1 151**	1 891
	3 993	**4 932**	5 873
DEPRECIATION			
Machinery and fittings	11	**25**	47
	11	**25**	47
Total expenses	12 366	**14 166**	16 033
Income			
SUPERVISION FEES			
Periodical fees	–11 720	**-13 659**	–15 458
Processing fees	–637	**–493**	–573
	–12 357	**–14 152**	–16 031
OTHER INCOME			
Miscellaneous income	–10	**–14**	–1
	–10	**–14**	–1
Total income	–12 366	**–14 166**	–16 033

Table 3.
Fees charges to supervised entities in 2001 and 2002, EUR thousands

	2002	2001
Credit market fees		
Commercial banks	**5 782**	5 065
OKO Bank Group central Cooperative, member banks	**1 347**	1 287
Local cooperative banks	**154**	146
Savings banks	**221**	204
Aktia Savings Bank	**171**	155
Other credit institutions	**826**	563
Guarantee funds	**31**	32
Representative offices and branches of foreign credit institutions	**53**	50
Credit institutions' holding	**13**	13
Pawnshops	**8**	8
Total	**8 606**	7 523
Capital market fees		
Marketplaces	**532**	449
Firms offering investment services	**1 987**	1 707
Management companies	**780**	656
Book-entry system	**403**	325
Issuers	**1 107**	871
Keepers of insider registers	**244**	189
Total	**5 053**	4 197
Processing fees		
Management companies	**158**	238
Issuers	**308**	343
Others	**27**	56
Total	**493**	637
Total fees	**14 152**	12 357

Appendices

STRATEGIC DIRECTIONS 2003–2005

Mission statement

We are committed to fostering financial stability and public confidence in the operation of financial markets and supervised entities.

Our vision is to be a proactive supervisor

We will identify pressures for change and risks in financial markets, contribute to the development of market structures and practices fostering stability and public confidence and respond promptly efficiently to financial market disruptions.

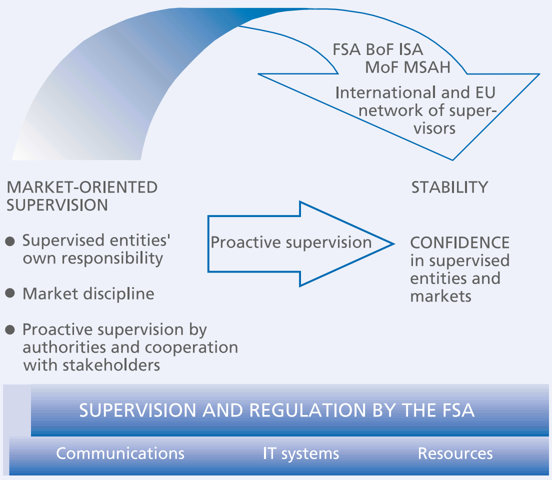
Strategy (to achieve our vision)[1]

Our activities focus on market-oriented supervision, promoting:

I the reliable functioning of markets and good corporate governance in supervised entities

II the markets' access to information and sound market practices

III a regulatory framework based on flexibility and accountability



BoF = Bank of Finland
ISA = Insurance Supervision Authority
MoF = Ministry of Finance
MSAH = Ministry of Social Affairs and Health

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[1] Market-oriented supervision means supervised entities taking primary responsibility for their own behaviour. Market discipline highlights supervised entities' and other market participants' own responsibility. Market discipline requires a competitive market and adequate disclosure and transparency of information. Accordingly, market participants will be aware of the risks and benefits associated with their investment decisions. Proactive supervision by the authorities complements market discipline and the responsibility of supervised entities. Proactive supervision seeks to identify, prevent and redress problems as early as possible.

The strategic pillars comprise: Institutional supervision strategy

I We will promote the reliable functioning of markets and good corporate governance in supervised entities

- With a view to reducing system risk, we will focus supervisory resources on the most risk sensitive institutions and systems that are of key importance for market stability and efficiency.
- We will see to it that supervised entities have adequate risk carrying capacity in relation to their risk taking as well as adequate risk management systems.
- We will seek to ensure that corporate governance[2] in supervised entities is based on sound and transparent business and monitoring principles and will work to tackle criminal market misconduct.

Market supervision strategy

II We will foster markets' access to information and sound market practices

- Together with other involved Finnish parties, we will contribute to the development of the International Accounting Standards (IAS) and related compliance monitoring. We will see to it that supervised entities comply with accounting standards and other recommendations. We will especially seek to ensure that supervised entities publish material and adequate information on their activities, products and financial position, in keeping with international recommendations and standards.
- We will seek to ensure that offerors of securities and listed companies comply with their disclosure requirements consistently, timely and in readily understandable terms.
- We will seek to ensure that supervised entities comply with law, international requirements and good practices in their customer relations.
- We will focus supervisory activities on monitoring and investigating abuse in the securities market to ensure a higher bias towards proactivity.
- We will publish our supervisory measures and opinions on supervision-related issues, with a view to reforming market practices and improving legal security. We will also regularly publish information on the state of the banking system, the risks involved and the operation of markets. We will produce information to promote public understanding of the content of financial services and the risks involved.

[2] 'Corporate governance' also applies to the compliance culture of listed companies.

Regulatory framework strategy

III We are committed to fostering a regulatory framework based on flexibility and accountability[3]

- We will seek to build a regulatory framework that guides changes in market structures and strengthens the supervision approach and that can adapt to the market as it evolves.
- We will promote a regulatory approach based on regulatory principles rather than detailed rules. Along with issuing regulations, we will focus on good practice. We will encourage self-regulation within the limits allowed by market structures.
- We will elaborate and make known clearly defined principles and evaluation criteria[4] for the exercise of supervisory powers.
- We will make an active contribution to the harmonisation of legislation, supervision and procedures at EU level.

Supporting Strategies

- We will reform and improve our practices, leadership and organisation to ensure that we will be able to meet the requirements of the operating environment building on approximately the existing staff resources.
- We will develop employee skills, especially the skills required for the forthcoming reform of the capital adequacy framework and the introduction of International Accounting Standards, and improve our understanding of market practices, products and services.
- We will improve our communications system to ensure that the information produced and disclosed by us is made available to our stakeholders swiftly and easily.
- We will enhance the accessibility and utility of information in IT services and ensure system reliability.

We approach our work on the basis of the FSA's values. As an organisation, we are

Independent,
Open,
Productive and
Skilled.

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[3] Key aspects of a regulatory framework based on flexibility and accountability:
– Supervisory powers allow the supervisor to exercise discretion within the limits of generally recognised rules of conduct.
– Supervisory powers are exercised credibly, explicitly and promptly.
– The supervisor is accountable for its activities vis-à-vis both the legislator and supervised entities and markets.

[4] This means that civil and human rights will also be considered in the exercise of supervisory powers.

Journal 2002

Main items of the Journal:	2002	2001
Internal matters	45	47
Administration of supervised entities	375	588
Supervision	370	475
Risk management	51	52
Accounting, annual accounts and auditing	11	24
Customer protection and safeguarding	233	221
Inspections	65	59
Other matters concerning supervised entities	39	58
Other external matters	117	101
Total	1306	1625

Major categories of journal entries:	2002	2001
Investigation requests concerning customer protection	166	170
Listing particulars	151	171
Notifications	139	239
Regulations related matters	99	172
Inspections by plan	63	57
International cooperation	59	65
Domestic cooperation	51	32
Contractual terms	44	37
Prospectuses	42	58

Items recorded in the journal 2002 of the Financial Supervision Authority amounted to 1,306 matters, broken down by departments as follows: Capital Markets Department 739, Credit Institutions department 439, Support Services Department 61 and the Regulation Strategy Unit 67.

Supervised institutions 1998–2002

31 Dec	LP	OPR	POP	SPY	SP	LL	VR	PLL	UE	ULS	AOJ	SIPA	MP	RY	Others	Total	Branch offices total
1998	9	251	43	1	39	19	3	14	6	14	11	46	3	22	15	496	1591
1999	9	246	43	1	39	17	4	13	5	18	11	45	2	25	13	491	1545
2000	9	244	43	1	39	17	4	13	6	18	12	48	1	26	13	494	1543
2001	9	244	42	1	39	16	4	13	7	19	12	50	1	24	13	494	1575
2002	11	243	42	1	39	16	4	13	4	20	11	46	1	23	13	487	1572

LP	Commercial banks
OPR	Amalgamation of cooperative banks
POP	Local cooperative banks
SPY	Limited company savings banks
SP	Savings banks
LL	Credit institutions
VR	Banks' security funds
PLL	Pawnshops
UE	Finnish representative offices of foreign credit institutions
ULS	Finnish branches of foreign credit institutions
AOJ	Book-entry system participants
SIPA	Investment firms
MP	Marketplaces
RY	Management companies
SK	Branch offices
Others	Deposit guarantee fund (1), Investor compensation fund (1), Holding companies of investment firms (7), Holding companies of credit institutions (3), OKO Bank Group Central Cooperative (1)

Representative offices abroad

	1998	1999	2000	2001	2002
Subsidiaries	4	4	4	7	10
Representative offices	17	16	16	11	7
Branch offices	9	8	9	11	11

PUBLICATIONS 2002

These publications were released in English and can be found on the Financial Supervision Authority's website www.rata.bof.fi.

Guidelines and regulations

105.14
Reporting to the Financial Supervision Authority of intra-group transactions between companies in a banking or investment firm group, and between companies within a financial and insurance conglomerate

203.30
Reporting to the Financial Supervision Authority of intra-group transactions between companies in a banking or investment firm group, and between companies within a financial and insurance conglomerate

Statements and interpretations

- Interpretation of the provisions on securities offerings in the Securities Markets Act
- Interpretation of the provisions on the ongoing disclosure obligation under the Finnish Securities Markets Act
- Interpretation of the provisions concerning the obligation to disclose major holdings in the Securities Markets Act
- Interpretation of the provisions on tender offers and redemption offers in the Securities Markets Act
- Statement on disclosure of pro forma and restated comparative financial information in listing particulars

Notifications

- Russia removed from FATF's list of non-cooperative countries and territories
- The Basel Committee on banking supervision's proposed revision of the capital adequacy framework: Quantitative impact study
- The Financial Supervision Authority renews its set of regulations
- FATF updated its list of countries with inadequate anti-money laundering practices
- FATF invites comments on the review of the FATF forty recommendations for combating money laundering
- The Ministry of the Interior issues a detailed decree on the contents of counter-measures
- Debt security programmes

INTERNATIONAL COMMITTEES AND WORKING GROUPS

BAC (Banking Advisory Committee)

The BAC is subordinate to the European Commission and assists it in the preparation of EU legislation on financial institutions and provides advice and guidance on other matters related to EU banking regulation and supervision. It also assists the European Commission in practical aspects of implementation of EU banking directives.

BSC (Banking Supervision Committee)

The BSC is subordinate to the ESCB and assists it in tasks related to the supervision of credit institutions and financial stability. It also assists the ECB in the preparation of opinions on financial matters.

CESR (Committee of European Securities Regulators)

ECOFIN Council

The ECOFIN Council is the EU Council meeting in the composition of the Ministers of Finance and Economy.

EFC (Economic and Financial Committee)

The EFC is subordinate to the EU.

ESC (European Securities Committee)

FATF (Financial Action Task Force on Money Laundering)

FATF is an international anti-money laundering and anti-terrorist organisation.

Groupe de Contact

Groupe de Contact is an unofficial body that promotes cooperation and exchange of information between banking supervisors. It compares supervisory practices and working methods in different countries in order to converge supervision practices in EEA countries. In recent years, Groupe de Contact has increasingly assumed the role of establisher of supervisory principles and best practices in the field of supervision.

ICBS (International Conference of Banking Supervisors)

IOSCO (International Organisation of Securities Commissions)

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