

2003

ANNUAL REPORT



RAHOITUSTARKASTUS
FINANSINSPEKTIONEN
FINANCIAL SUPERVISION

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► Director General's review

Director
General's
review

Regrettably, in financial market terms, 2003 can be described as the year of market abuse scandals. From the point of view of an efficient market economy, public confidence in financial markets is essential. The result of several accounting scandals, however, is a reduction in confidence levels. Even though the cases have been clear examples of deliberate criminal and fraudulent acts, which have been difficult – if not impossible – for the respective supervisory authorities to discover at the time, the instances of Enron, Skandia and Parmalat have provided cause for concern as to how the security mechanisms within market economy systems still need to be improved in order that there would be a decrease in the probability of such situations repeating themselves as well as a reduction in the severity of their repercussions. Despite the size of these cases, the objectionable nature of each of them does not, as such, mean that they necessarily would pose a destabilising or systemic risk to the financial system. Confidence in the system has inevitably suffered a blow, which in turn has weakened the efficiency of the financial system by increasing the cost of capital. This, in turn, may cause sluggish growth and a slowing in the global market's ability to create new jobs and improve living standards.

4 It is therefore understandable that the decision-makers of many industrialised nations are seeking

ways of reinforcing supervision, accounting, auditing and overall corporate governance rules. There is always the danger, of course, that the regulatory process could go too far and find itself being the cause of a decline in the efficiency of the functioning of the markets. Finding the balance is indeed a challenging task.

There are currently several key projects being undertaken, not only at EU level but also globally, that aim at ensuring the reliability of the financial system. The most important of these are probably the new directives created to improve the securities markets, implementation of the IFRS/IAS financial reporting standards and the development of supervisory procedures associated with these standards, improved auditing approaches, new company law initiatives as well as the Basel Committee's New Capital Adequacy Accord concerning banks and investment firms. These are all bound by the common thread of an increase in the market's access to information and an enhancement in transparency. Not to mention the aim of gaining improvements in the quality and reliability of information.

The past year was less dramatic for Finland than for many other countries. However, there were – regrettably – many cases of suspected insider trading and similar misdemeanours that needed to be investigated. Occasionally it felt as if ethics and integrity were words whose meaning had been forgotten altogether by too many of

those in leading positions. Or is it merely that the exploitation of insider information is still not understood to be a crime?

From the Financial Supervision Authority's perspective, the most significant events of 2003 were, however, the restructuring that occurred in Finland's financial market and the regulatory developments that were brought about. The stability of the financial system was not under threat in any way. Banks' profitability in 2003 was good. Intensifying competition on the housing loans market led to overheating which has been evident in rising housing prices in Finland's growth centres. It is to be hoped that economic growth would continue its steady upward trend, as an increase in unemployment rates and a rise in interest rates could, at worst, drive many households into dire straits with their housing loans. Even during the banking crisis of the 1990s, banks did not experience a lot of loan losses on housing loans and are probably not going to be faced with many now, either. However, social problems could be exacerbated if many families were faced with giving up their homes with the market value of the home falling below its collateral value. Caution becomes the by-word on the housing loan market; for both the granters and receivers of the loans.

The debt ratio for Finnish companies remains relatively low. It is to be hoped that the proposed tax reforms do not significantly weaken the companies' funding structures. One would also hope that demand for business credit would pick up to finance productive investments rather than for the funding of dividend payments. The European Union's Financial Services Action Plan (FSAP) is progressing well. The objective of the Action Plan is the achievement of a single financial market. There is, however, a long way to go yet before that has been fully accomplished. Although the principle behind the creation of the single financial market is the unity of it, still supervision is driven by the home-country control principle. In my opinion we should question whether this approach will work within the framework of a unified market, once it is achieved. A single, unified financial market requires unified supervision and regulatory frameworks. This is, indeed, the objective of the so-called Lamfalussy Process through which supervisory authorities, using a

harmonised committee approach, make proposals for legislation and European Union-level regulations. Cooperative mechanisms in banking and insurance supervision are taking shape. As far as the securities markets are concerned, these mechanisms are somewhat further developed and the Committee of European Securities Regulators (CESR) has achieved concrete results. Despite this, it is not yet possible to say whether the key supervisory issues within the EU have been resolved yet. For the integration of the financial markets into a 27-country group (25 EU countries, as of 1 May 2004, as well as Iceland and Norway) a considerably more robust joint supervisory and regulatory framework is required, in which it is possible to centralise decisions concerning the region. A consensus-style approach and cooperation based on recommendations does not suffice, particularly should there be crises that were to threaten the stability of the financial system. One might fear that only once the supervisory and regulatory framework is faced with a crisis that moves would be made to bring about a renewal.

A concrete example of the problems associated with the changing structure of a converging financial market can be found in Nordea Group's plans to merge its various parts into one bank, domiciled in Sweden, and creating a so-called European Company with branch offices in other countries. There are many practical obstacles before the plan can be realized and, accordingly, it will probably be completed in 2006, at the earliest. It is, without doubt, a good thing that the bank's juridical and business operational structures are nearing each other. This can only clarify the division of responsibilities and enhance the bank's operations.

Nordea holds more than a third of the market share in Finland while it is also a significant market participant in Sweden, Denmark and Norway. In the branch office model, home country supervision principles leads to supervisory responsibility being transferred to the Swedish authorities for the entire group. Apparently it is also possible that consideration regarding emergency funding by a central bank would also be transferred to the remit of the Swedish central bank and consequently, in a crisis situation, the Swedish Government would have to debate any possible capital support. An additional

Director
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issue is the nationality of the deposit guarantee funds. The existing regulations regarding deposit cover is, juridically, considered to be the responsibility of the home country. With the change in nature of the banks to the branch office approach, all Nordea's deposits would come under the protection of Swedish deposit guarantee arrangements. For the Swedish deposit guarantee system this would mean a notable addition to its burden of responsibility. At the same time, the funds Nordea has paid into the Finnish, Norwegian and Danish deposit guarantee systems would be left to secure the deposits of the remaining banks in these countries. It is quite clear that this is not a wholly satisfactory situation; rather it may serve to hinder a sound plan to establish a branch office network. The Nordea case has implications for the European market as whole, as it has brought to light how EU national systems and regulations are not sufficiently up-to-date, if the real aim is to achieve a single financial market.

The statute governing the new European Company format enables, at least in principle, a significant pan-European bank to switch home country without bigger difficulties and therefore switch over to another supervisory authority. The supervisory authority in the new home country may not possess the resources or interest, necessarily, to supervise a banking colossus whose main operations are situated elsewhere in the European Union, if not further afield. We need new European supervisory structures. The creation of such structures would, however, take years to complete and in the meantime it is vital to establish a cooperative Nordic solution to the supervision of the Nordea Group.

These arguments are equally as valid in terms of the convergence of the securities markets. With the Stockholm and Helsinki stock exchanges coming under the joint ownership of OMHEX Ltd, a listed company in Sweden, we have to agree on their supervision and create a joint supervisory practice. It is unlikely that these developments will stop with the Nordic and Baltic countries. The Sampo Group is also in the process of becoming a more international financial conglomerate. It already owns noteworthy banking operations in Finland and the Baltic countries. In addition it is returning back to holding significant market shares in the Norwegian and Swedish markets

when it announced its intention to buy a clear majority holding in the Swedish non-life insurance company If. At the same time, Sampo plans to distribute record dividends. These actions, however, place a strain not only on the capital adequacy of the Group but also on its funding. The FSA will intensify its close cooperation with the Finnish Insurance Supervision Authority as well as the Swedish, Norwegian and Baltic supervisors over ensuring effective supervision of the Sampo Group as a whole.

The European Union's single financial market and currency - the euro - have led to the situation where the Finnish financial market, in the strict sense of the word, does not exist, as such. In terms of regulation and supervision this is the cause of considerable adjustment pressures. There is a particular emphasis on EU-level cooperation. For small countries like Finland, the resources and costs required for cooperation pose a challenge. As cross-border branching-out and the cross-border supply of financial services gains greater market shares, it is not possible to downgrade supervision at the same rate as the resources available for it diminish. There are some hard choices ahead of us. What is the balance we wish to strike in Finland's participation levels at the European level regarding supervisory and regulatory activities within the financial markets and who will pay for participation if the significance of Finland as legal domicile for financial enterprises is considerably reduced? The challenges facing us help to maintain a sharp focus on our work. The challenges posed to the FSA and the focus they bring seem set to bringing intensified motivation to the organisation for the foreseeable future. The entire staff of the Financial Supervision Authority deserves thanks for the way in which they are rising to meet these challenges. This seems to be the pattern set for the future, too.

Helsinki, February 2004



► The Financial Supervision Authority's operating strategy

In July 2003, the new Act on the Financial Supervision Authority came into force. The provisions of the FSA Act have enhanced the Financial Supervision Authority's position as an authority. Under the new act, the FSA has been issued new powers which improve its abilities to perform its legislative mandate effectively. These powers require of the FSA that it demonstrates transparency in its operations and decision-making procedures, good corporate governance and adequate control systems.

For the very first time, the Financial Supervision Authority's mission is now defined by legislation. The objective is to maintain financial stability and promote public confidence in financial market operations. In order to achieve this aim it is necessary to identify the 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. With such a proactive approach it is essential to react in a timely and efficient manner to disruptions in the financial markets.

The FSA emphasises both the supervised entities' responsibility for their actions as well as overall market discipline. As such the Authority compliments the stated objective of proactive supervision. According to its operating strategies, the FSA promotes the reliable functioning of the financial markets

and good corporate governance in the supervised entities, advances the markets' access to information and sound market practices as well as having a regulatory framework based on flexibility and accountability.

The FSA's
operating
strategy

RELIABLE FUNCTIONING OF MARKETS AND GOOD CORPORATE GOVERNANCE IN SUPERVISED ENTITIES

A general sense of uncertainty and expectancy characterised the financial markets of 2003, in particular the war and subsequent military operations in Iraq, sluggish growth in the euro area and uncertainty over economic development in the United States. In such a situation it is crucial that credit institutions have adequate risk-bearing capacity, capable of coping with any unforeseen losses that may occur.

Supervised entities' risk bearing capacity considered satisfactory

The situation within the individual credit institutions in Finland in 2003 was sound and held no unseen surprises. Also when held up to international comparison, the situation in Finland was extremely stable. At the same time, credit losses and nonperforming assets were extremely low. In this period of continuing uncertain economic development, the Finnish financial system's ability

OPERATING STRATEGY 2004–2006

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

Strategic directions

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

- We will focus supervision on risk-prone institutions and systems of key importance for market stability and efficiency. We will contribute to supervisory cooperation at the Nordic and EU levels with a view to harmonising and enhancing supervision of financial conglomerates and cross-border arrangements.
- We will ensure that supervised entities have adequate risk carrying capacity in relation to their risk taking and adequate risk management practices and that they design a systematic and solid process for evaluation of the adequacy of capital and risk carrying capacity.
- We will seek to ensure that corporate governance in supervised entities is based on sound, transparent and clear monitoring principles and will work to tackle criminal market misconduct.

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

- We will ensure that supervised entities comply with accounting standards and other recommendations. We will especially monitor that supervised entities publish material and adequate information on their activities, products and financial position, in accordance with international recommendations and standards. Together with other involved Finnish parties, we will contribute to the development of International Accounting Standards and their enforcement.
- We will seek to ensure that offerers of securities and listed companies comply with their disclosure requirements consistently, timely and in readily understandable terms.
- We will seek to ensure that, in their dealings with customers, supervised entities apply conduct of business rules that comply with law, international requirements and good practices.
- We will focus supervisory resources on monitoring and investigating abuse in the securities market to ensure an increasing tendency towards proactivity.
- With a view to reforming market practices and improving legal security, we will publish our supervisory measures and opinions on supervision-related issues. We will 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.

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

- We will seek to ensure that the regulatory framework reflects changes in market structure in a timely manner and strengthens the conditions for the performance of supervision.
- We will promote a regulatory framework based on regulatory principles rather than detailed rules. We will complement binding regulations with codes of conduct and application guidelines.
- We will elaborate and make known clearly defined principles and evaluation criteria for the exercise of supervisory powers.
- We will influence the national implementation of the provisions adopted under the EU's committee procedures with a view to developing effective and efficient transposition practices.

Supporting Strategies

- We will continue to improve our practices, leadership and organisation to ensure that we will be able to meet the requirements of the operating environment with 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 promptly and easily.
- We will design IT systems facilitating electronic contacts and information services to enhance the FSA's supervisory activities and supervised entities' contacts with the FSA.

to withstand external disruptions looks more than satisfactory.

The FSA also monitors the supervised entities' risk bearing capacity in relation to their risk profile is adequate and that the risk management systems they have in place are appropriate. According to the risk analyses undertaken by the FSA in 2003, supervised entities in Finland have implemented satisfactory risk management systems. The assessment and management systems associated with operational risk are still in the process of development in many of the supervised entities and continue to require attention in the coming years.

Supervision directed at key and more risk-sensitive institutions and systems

During the year, the Financial Supervision Authority paid particular attention to recognising market risk factors and analysis of their effect on the supervised entities. Competition in the market for housing loans, the narrowing of the interest margins and the failure of banks to meet collateral requirement levels have attracted the supervisors' concern regarding the risk around correct pricing. For the present, however, the housing loan situation has not given rise to loan losses.

The electronification of payments transfers and payment services as well as contagion sensitivity to outside disruptions has set high thresholds of expectations on the management of data and payment systems, operating under both normal and contingency operating conditions. The FSA has made regularly inspections of the larger supervised entities' payment systems and their continuity plans. The systems have been tested by both power cuts and computer virus attacks, which have served to reveal the shortcomings of the systems. However, no economic damage was caused to their customers.

Tight competition has forced credit institutions to undergo rationalisation of their operations by pruning back the overgrowth and moving towards centralisation. The production of many of the services provided has been outsourced, with cost efficiency in mind. Outsourcing can be associated with certain risks that have not previously occurred. Some of the more usual examples of which can be the uncer-

tainty in the provision of the service concerned, the tenability of the contract itself and the question of duty to the customer. Were outsourcing to become even more generalised than is presently the situation, the FSA would be faced with informing the supervised entities of the specific outsourcing-related problem areas and bringing the associated risks under control.

Corporate governance becomes key area of supervisors' monitoring

The supervised entities' internal control and monitoring procedures have a significant role to play in getting the organisation to work within the bounds of reinforced objectives and operating principles. Internationally, failure of internal controls and unclear divisions of responsibility are the most common reasons behind the problems experienced by credit institutions.

On the basis of information accumulated from its inspection visits, the FSA has gathered the impression that the supervised entities' internal control mechanisms and risk management procedures are currently operating at a satisfactory level. In the future, the FSA plans to also pay particular attention to the reliability of the supervised entities' corporate governance and the role played by the organisations' various bodies.

Already for several years, the FSA's emphasis in its supervisory function has been directed at the monitoring of internal control, corporate-level risk management and evaluation of the functionality of the internal control processes that are in place. The FSA's most recent standard in its new set of regulations on the establishment and maintenance of internal control and risk management brings greater systemisation and elasticity to this assessment area.

Cross-border sectoral restructuring raises question of future supervisory requirements

The European Union's objective is to help foster the creation of a single financial market.¹ The establishment of cross-border companies is

¹ This is supported by the action plans drawn up for the development of financial services and company law as well as strategies concerning financial reports and auditing.

progressing and the so-called 'European Company' format for a limited company will be possible from autumn 2004.

In various contexts, in both domestic and EU fora, the Financial Supervision Authority has brought up the issue of the challenges posed by an organisation established in the European Company format regarding both regulation and supervision. Nordea has become the first to make the decision to become a European Company. The company's plans include transfer of the group's parent company to Sweden and continuation of banking activities in the other Nordic countries through its network of branch offices. This will have a noticeable effect on the division of duties for the Nordic countries' supervisory authorities and poses a central challenge to the effectiveness of home state supervision within the EU. Similarly, the authorities will find they have to assess whether deposit guarantee systems that have been based on the national framework are actually capable of adaptation to the requirements and accompanying demands of a company operating at the pan-European level.

Within the Nordic countries, action is currently underway to propose feasible solutions for the supervision of Nordea. Meanwhile, at the ECB, following a Nordic initiative, investigation is being made concerning the question of problems related to deposit guarantee arrangements. As regards Nordea, the FSA's objective is to find a supervisory solution that enables the Authority to acquire the information and influence it needs to ensure financial market stability.

Another significant cross-border supervisory challenge is that of the integration of the Helsinki and Stockholm stock exchanges. From early autumn 2003 these two stock exchanges have been under the ownership of the Swedish public limited holding company OMHEX. The FSA has negotiated the supervisory duties concerning the group with the Swedish supervisory authority. The aim has been to ensure that each of the supervisory authorities is ensured adequate opportunities for information acquisition from the holding company.

PROMOTION OF MARKETS' ACCESS TO INFORMATION AND SOUND MARKET PRACTICES

In its operations, the FSA fosters markets' access to information and sound market practice. The FSA places particular emphasis on maintaining the existing high level of confidence in Finland that is placed in financial information. Preservation of confidence relies on financial information guided by clear and sound regulations. It is also essential that the management of issuers is committed to following regulations and that supervisors have effective regulatory tools enabling them to intervene if any anomaly is discovered.

During 2003, the FSA took part in several EU-level regulatory projects whose objective was the harmonisation of the disclosure requirements placed on issuers and financial service providers. The objective of harmonisation was also to ensure equal investor protection when offering investment services or securities cross-border as well as to enhance market functions through greater comparability of the companies involved. This work included harmonisation of the disclosure requirements concerning listing particulars, implementation of the IFRS/IAS accounting standards and definition of information requirements in a simplified mutual fund prospectus. On top of which, the Committee of European Securities Regulators (CESR) finalised its recommendations on how listed companies should be informed of the changeover to the international accounting standards prior to their becoming mandatory in 2005.

In terms of the monitoring of issuers' disclosure requirements, the FSA's objective is to ensure that investors have access to essential and adequate information in order to allow a reasoned assessment of a security and its issuer. In 2003 the Financial Supervision Authority undertook a survey to establish to what extent listed companies comply with disclosure requirements in their interim reports. The results of the survey confirmed that the level of compliance with the disclosure requirements in these interim reports was generally good. There were, however, some shortcomings regarding the statements on the companies' forecasts and in the evaluation of some of the operational risks. The new self-regulatory

Chart 1.
The efficient implementation process of financial reporting standards



Source: Financial Supervision Authority.

corporate governance recommendation will serve to improve the companies' transparency, harmonisation of information given to investors as well as to enhance the flow of information in general.

The FSA has been actively involved in improving investors' awareness levels of the risks associated with financial services, by participating in various events directed at investors and by publishing informative pieces on its Internet site, under the auspices of the FSA Newline. The Authority aims to set up a comprehensive and user-friendly information site, sometime during 2004, through which it can reach the banks' clients and retail investors alike.

Comparable, reliable and transparent financial reporting as the basis for well-founded investment decisions

According to the international accounting standards (IFRS/IAS), the primary role of financial reporting is to support the investor's decision-making process. The comparability, reliability and transparency of financial reports are all prerequisites for providing investors with the means for making informed investment decisions on securities offered by companies operating in various countries.

The FSA monitors the preparations being made by listed companies to conform to the forthcoming accounting standards (IFRS/IAS), as publicly

traded companies are to prepare their financial reports in accordance with the standards by the beginning of the financial period starting in 2005.

Supervision of the compliance of the financial information with the IFRS standards is currently being set up in Finland. In spring 2003, the Ministry of Trade and Industry's IAS working group proposed that the Financial Supervision Authority be responsible for this function. According to the proposal, the FSA could also request opinions from the Finnish Accounting Board on issues before it. The working group proposal broadens the supervision of disclosure obligations imposed on listed companies, to include the supervision of the accounting issues. The FSA is already responsible for supervision of accounting issues in credit institutions and investment firms. The preparation of the legislation started at the beginning of 2004.

Implementation of the International Financial Reporting Standards and related supervision is one part of the European Commission's Financial Services Action Plan (FSAP), which aims at creating an efficient and competitive capital market in Europe. In addition to the high level financial reporting standards and monitoring by supervisors, statutory audit as well as timely interpretations and implementation guidance are seen as being part of an efficient enforcement infrastructure (Chart 1).

The FSA's operating strategy

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International Financial Reporting Standards emphasise managements' responsibility for providing information to investors

Implementation of the International Financial Reporting Standards (IFRS/IAS) is part of the European Commission's Action Plan, aimed at creating competitive, efficient and transparent capital markets in Europe by 2005. A central prerequisite of which is that companies' financial reporting is based on high quality accounting standards, the compliance of which is also supervised.

The IFRS/IAS standards highlight the responsibility held by a company's management when producing information for investors. Management is accountable to investors and, in turn, investors make decisions on both their holdings and on issues that directly affect management based on the information they receive. The underscoring of the responsibilities borne by management is expected to lead to an improvement in companies' corporate governance and to an enhancement in the quality of information issued to the markets.

The FSA's
operating
strategy

FSA aim to intervene in worst cases of business conduct breaches

A prerequisite of customer confidence in the financial markets is their belief that the financial service provider's conduct of business practices is sound.

The Financial Supervision Authority intervened in what it identified as bad conduct of business both using inspection procedures as well as through its participation in the Advisory Office for Bank Customer and the Securities Complaints Board. The shortcomings in service providers' conduct of business have not been severe and have mainly concerned the documentation of the application of the 'Know-Your Customer' principle (KYC) and the information to be provided to customers as well as some shortfalls in internal control and risk management in investment services. More importantly, the FSA was faced with the fact that there was an increase in the provision of financial services without the proper license. In such cases the FSA was in contact with the home country supervisory authority as well as the service provider in question.

The Securities Complaint Board is considered as playing a significant guiding role in the conduct of business of the financial service providers. The Board has already been operating for just over a year, during which time it has made almost 50 recommendations in response to customer complaints.

Focus on importance of neutrality in competition between financial services providers

A representative from the Financial Supervision Authority has been actively involved in the so-called SIVA Working Group, whose objective is to promote a level playing-field across the financial sector (see page 39). The FSA's standpoint in the working group has been that promotion of competitive neutrality and of investor protection, independent of the service provider. The FSA also takes the stance that all service providers ought to meet similar requirements as to information to be provided to customers. Offering long-term savings products backed by tax incentives should be allowed, not only to life insurance companies, but also to banks, fund management companies and investment firms. Similarly, investors should be given the opportunity to channel these types of long-term pension savings with the support of equivalent tax incentives, into not only life insurance but also deposits, fund units and other securities and, where so desired, to change the service provider they use.

Suspected market abuse inspection – rights of access to information and to hear persons

The Market Abuse Directive is currently being implemented into Finnish national legislation. It is the Financial Supervision Authority's opinion that the implementation procedure should be accompanied by the granting of adequate rights to the respective authorities to have access to information and to have the right to hear persons, which would enable supervisory and investigative work to proceed in a plausible manner. In its investigative work, the FSA ought to be able to acquire sufficient and adequate evidence and the investigative procedure should be brought to a prompt conclusion, in order to have a preventative effect.

As in earlier years, the FSA took an active role in investigating suspected cases of market abuse. Of particular concern to the FSA was the need to make extensive investigations of suspected abuse of insider information in connection with almost every take-over bid.

PROMOTION OF REGULATORY SYSTEM BASED ON FLEXIBILITY AND ACCOUNTABILITY

Legal certainty, proactivity and transparency as the foundation for regulations

From the supervised entities' perspective it is essential to be able to know in advance what the FSA expects from a sound and cautious business operator and on what grounds the supervisory authority makes its decisions. For this reason the FSA underlines proactivity, transparency and consistency in its set of regulations which all serve to the goal of legal certainty for the entities supervised by the FSA. The FSA's ongoing renewal of its set of regulations has been characterised by the attention paid to the clarity of the regulations and guidelines being issued and to bringing them as closely as possible in line with the principles laid out in similar regulations both within the European Union and more broadly, internationally. The renewal has been used to align sound corporate governance and the boundaries of permissible business activity, to clarify the

guidelines steering market practices as well as to go over the principles concerning disclosure and progress in the comparability of the financial reports produced by the so-called IAS and non-IAS banks. The new capital adequacy framework influences such processes that allow supervisors to evaluate the relationship between the supervised entities' risk-taking and risk-bearing capacities. Sound risk management procedures and strategies covering the acquisition of equity capital are emphasised, in particular.

On top of which, the FSA ensures that its own findings are established explicitly and consistently. The Authority emphasises continuous dialogue and consultation with the market participants in the development of the regulations and interpretation of the legislation. The FSA has also adopted the so-called statement of response approach, whereby it informs those concerned of the manner in which the details and issues gathered have been taken into account when forming the new set of regulations and guidelines.

The FSA's
operating
strategy

Principles behind supervisory powers are clear

The new Act on the Financial Supervision Authority came into force at the beginning of July, bringing with it new supervisory powers. These include the right to issue public admonitions or warnings and the right to bar a person from acting as board member or managing director of a financial institution. The FSA was also granted the right to grant or cancel the operating licences issued to credit institutions, investment firms and pawnbrokers.

The Financial Supervision Authority has placed emphasis on the principles behind the use of these new powers as much as on the creation of systematic licensing and disciplinary processes. A particular priority has been placed on the application of these rights within the constraints of fundamental civil and human rights.

FSA has influence on national enforcement of EU legislation

Within the European Union, the procedure to establish a new constitution is currently under way. The aim of the European Constitution is to

simplify the Union's statutes and separate them from legislative power and implementation powers from each other. The FSA through its membership of the European supervisory network has the stated objective of using its influence to ensure that the implementation of regulations under the new European Constitution meet national requirements.

In particular, the FSA has directed its energies towards work involved in the development of directives on the securities markets and renewal of capital adequacy requirements. It has also placed emphasis on developing a national system equivalent to the committology approach to the so-called Lamfalussy process for implementing a securities market regulatory system (see page 30).

The FSA's
operating
strategy

► Operating environment in 2003

In the first half of 2003, global economic developments were clouded by various uncertainties, such as the Iraq war and the SARS epidemic. However, economic growth picked up considerably from the early autumn, mainly driven by the improved outlook for the US economy. Towards the end of the year growth was also affected by improved prospects for Asian countries, especially China and India. As for the financial sector, the key factor is the sustainability of the US economic growth because of the risks still contained in it.

US economy grew – uncertainty about the sustainability of growth remained

Economic growth in the United States strengthened markedly towards the end of 2003. Growth was consumption-driven and resulted mainly from low interest rates and growth of household purchasing power, fuelled by tax reductions. In addition, stock price increases strengthened consumer confidence in the future and boosted consumer demand. Industrial production picked up from June, leading main industrial confidence indicators to improve markedly towards the end of the year.

Despite signs of recovery, US corporate investment remained weak owing to low level of capacity utilisation. Investment in ICT technology

increased, whereas investment in machinery and equipment had not yet started to recover. Housing construction was also seen to increase. Competitiveness in the United States remained robust as the dollar depreciated, productivity growth strengthened and unit labour costs decreased. This did not, however, contribute to US exports significantly.

The main risks to the sustainability of the US economic growth stem from the notable fiscal deficit and employment developments. Job vacancies increased towards the end of the year and unemployment rate started to decline. Fiscal and current account deficits worsened during the year, contributing to a weakening of the dollar and a rise in interest rates.

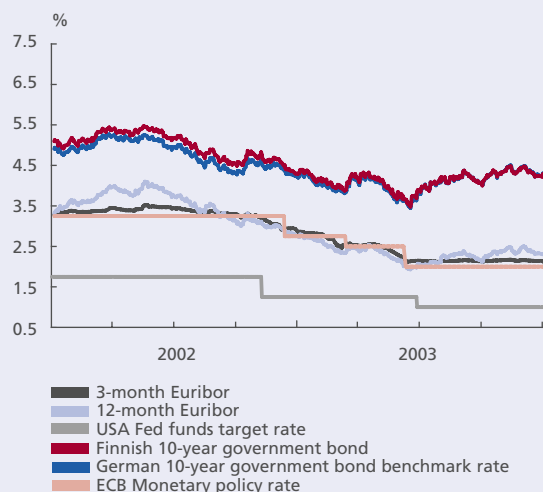
Euro area growth still sluggish

Euro area economic growth was weak in the first half of 2003, although some signs of recovery could be seen during the second half of the year. The moderate improvement in economic growth was reflected in consumer and business indicators. Consumer confidence strengthened only slightly, however, and the indicators remained at low levels. In contrast, somewhat clearer improvement was observed in the business indicators with share prices rising towards the end of the year.

Private consumption strengthened somewhat at the end of 2003, compared with the previous

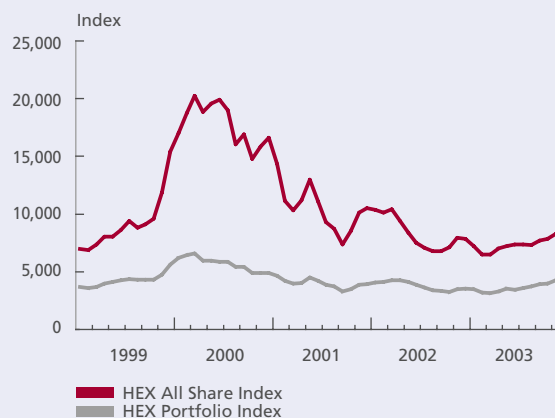
Operating environment in 2003

Chart 2.
Financial markets, changing interest rates,
2002–2003



Source: Financial Supervision Authority.

Chart 3.
Stock market indices
1999–2003



Source: Helsinki Exchanges.

Operating
environment
in 2003

year. Private consumption has important implications for economic growth since it accounts almost for 60% of the euro area GDP. Euro area unemployment remained slightly below 9% in 2003.

Finland's economic growth followed world economic developments

As expected, the growth of GDP in Finland was sluggish at the beginning of 2003, owing to weak global economic developments reducing exports and to decreasing investments. Growth improved slightly during the second half of the year. Export prices fell markedly during 2003 and, at the same time, imports remained weak. Companies also invested carefully; investments were mainly directed at sustaining output, rather than at increasing capacity.

Despite the acceleration in economic growth towards the end of 2003, employment fell slightly. Unemployment did not increase, however, as people left the labour force and became students, for instance. Labour demand in the private sector was restricted by low product sales and higher-than-expected real wage increases. The labour supply remained broadly unchanged.

Household confidence in their own financial situation remained high, which supported private consumption. Housing demand continued to be robust, driven by low interest rates, stable income

developments and banks' competition on lending rates. The increase in house prices moderated only slightly from 2002. Household indebtedness rose somewhat in 2003.

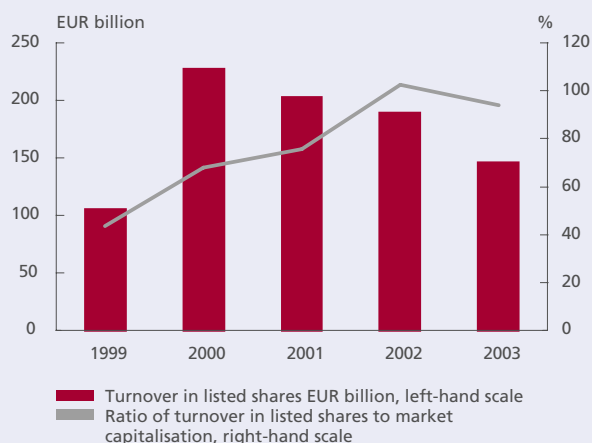
Industrial production developments were subdued, largely due to problems faced by exports. Output in the electronics industry continued to fluctuate significantly, in turn affecting overall industrial production figures. According to the Business Outlook Indicator of the Confederation of Finnish Industry and Employers, industrial companies' business outlook improved somewhat in autumn. There were, however, significant differences between industrial branches.

Corporate lending increased rapidly in 2003. However, corporate indebtedness was significantly lower than at the beginning of 1990s. According to the Bank Barometer of the Finnish Bankers' Association, banks expect the amount of corporate lending to rise further in the near future. In the period between January and November 2003, the number of bankruptcies declined by 4.2% from the same period a year ago.

Longer-term money market rates increased at end-2003

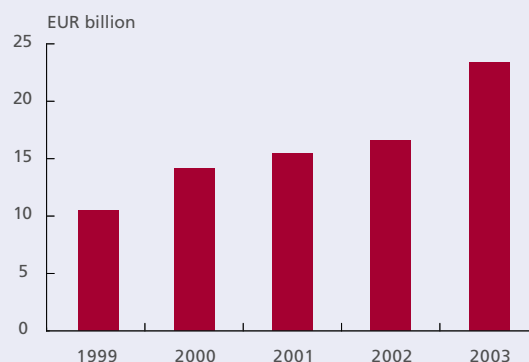
Money market rate developments showed an uneven pattern in 2003. Short-term money market rates were higher than longer-term money market rates at the beginning of the year. Until June, both

Chart 4.
Share turnover on the Helsinki Exchanges
1999–2003



Source: Helsinki Exchanges.

Chart 5.
Net assets of Mutual funds,
1999–2003



Source: Financial Supervision Authority.

short and longer-term money market rates fell smoothly. The fall came to a halt in the last half of 2003 as a result of favourable economic outlooks. Short-term money market rates remained broadly unchanged during the rest of the year, whereas the longer-term money market rates started to rise. The slope of the money market yield curve turned positive in August. At the end of 2003, the twelve-month and three-month Euribor stood at 2.305% and 2.124% respectively.

Owing to reduced inflationary pressures, the European Central Bank lowered its key interest rates twice during 2003. At the beginning of March they were reduced by 25 basis points to 2.50%, and a further reduction of 50 basis points followed in June. After the reduction in June, the key ECB interest rates remained unchanged at 2.00% until the end of the year.

Bond yields increased in euro area and the United States

As with money market rates, the developments of long-term bond yields were also contrasting in the euro area and the US in 2003. Except for a short-lived increase from March to April, ten-year bond yields declined at the beginning of 2003. From June onwards long-term interest rates rose, as the global economic growth showed signs of improvement. At the end of 2003, German ten-year government bond yield, which is used as the

euro area reference, stood at 4.29% and the comparable US government bond yield at 4.25% (Chart 2).

Operating environment in 2003

Euro strengthened markedly against the dollar in the fourth quarter of 2003

The euro appreciated significantly against the dollar in 2003, by a good 20%. This was associated with market concerns regarding growing US fiscal and current account deficits. The strong exchange rate of the euro weakened corporate price competitiveness in the euro area relative to the US, which was mainly reflected in sluggish exports. The euro appreciated against the Japanese yen in the second half of the year in particular, despite an improved outlook for economic growth in Japan. At the end of 2003, the euro stood at USD 1.2630 and JPY 135.05.

Fall in share prices came to a halt but share turnover declined

After three consecutive years of falling share prices, the expectations of economic recovery pushed share prices upwards on the Helsinki Exchange. The HEX-All-Share Index increased by almost 5% during 2003. The rise was not as strong as in other world exchanges, since it was dampened by the fall in the price of Nokia shares. The

HEX-Portfolio Index, in which the weight of an individual share can amount to 10% at maximum, rose by 16% during the year (Chart 3). The total market capitalisation of Helsinki Exchanges grew to EUR 150 billion in 2003 (EUR 151 billion in 2002).

Almost all sectoral indices rose in 2003. The most pronounced increase was experienced by the media and publishing index, which rose by almost 70%. The banking and finance index rose by 20%. In contrast, telecommunication and electronics index fell by few percentages.

Despite the share price increases in the second half of 2003, the total turnover on the Helsinki Exchange declined by over one-fifth, to stand at EUR 146 billion, down from EUR 189 billion in 2002 (Chart 4). The number of trades in shares declined by almost 10%, but the increase of trades in warrants kept the trade volume on a level close to that of 2002. The number of derivatives trades grew somewhat during 2003. In contrast, trade volumes in Finnish derivatives on EUREX fell by one-third.

At the end of 2003, there were 44 intermediaries operating on the Helsinki Exchange (43 at the end of 2002), 28 (26) of which were remote brokers. Remote brokers increased their share in the trading on the Helsinki Exchange. In 2003 they accounted for over 50% of the total turnover on the Exchange. The share of banks and investment firms belonging to bank groups in the total trading on the Exchange was about 20% at end-2002, ie few percentage points higher than in the previous year.

The number of listed companies continued to fall and, at the end of 2003, there were in all 145 listed companies on the Helsinki Exchange (149 in 2002). As a result of corporate restructuring, five companies delisted and one company listed on the Exchange. Corporate restructuring saw a new phenomenon in the form of competing public bids. Public bids were made for two companies.

Primary market remained subdued

There were only few initial public offerings and share issues in 2003 owing to a lack of faith in market demand. The number of public offerings declined further. Shares were mainly offered to

long-standing shareholders or as a consideration as part of a corporate restructuring package.

Public financing was primarily sought via bond markets. In terms of volume, central government sector was the dominant issuing sector. The financial institution sector was another important issuer, whereas new corporate bond issues remained weak.

Mutual funds investment continued to grow

The volume of capital invested in mutual fund assets increased by 40% to EUR 23.3 billion in 2003 (Chart 5). The difference between mutual fund subscriptions and redemptions grew markedly from the previous year, and most of the growth of mutual fund assets originated in new subscriptions. Short-term funds maintained their attractiveness under the volatile market conditions prevailing in early 2003. In the autumn, however, new subscriptions shifted towards equity funds.

Supervised entities' future prospects positive

Finnish banks were highly resilient during the economic slowdown. The profitability and capital adequacy of the banking sector remained good, and, in spite of the slowdown, loan losses remained very low. The low level of interest rates contributed to easing of loan servicing but, on the other hand, reduced banks' net income from financial operations. Banks' present share holdings are quite limited, but fluctuations in share prices are transmitted to financial conglomerates through share holdings of life insurance companies. Thus, share price increases in 2003 improved the profitability of financial conglomerates. In contrast, at that time, some investment firms were still unable to recover from the difficult market situation. There were still problems in this sector, but they should unwind once the market situation starts to improve.

Supervised entities appear to operate in a brighter environment at the beginning of 2004 than a year ago. There have been signs of improvement in both US and euro area economies. Finnish economic growth has also started to follow an

upward trend. Share price developments support the view of a turn in the business cycle. The financial sector will naturally profit from the economic recovery, as customers' debt serving ability improves and the demand for financial services increases during economic upswing. Future prospects for supervised entities can be considered positive as long as economic growth develops as expected.

According to the European Central Bank (ECB), the EU-area banking sector profitability is generally satisfactory. Economic recovery is the main factor affecting bank profitability in the future. The expected gradual improvement in economic activity also strengthens the EU-area banking sector. In addition, cost control, if contin-

ued, would also support banking sectors' stability over the medium and longer term. Over the past few years banking sector has seen structural reforms in the EU area and especially in Germany. Banks have reduced the number of branches and staff sizes which has led to a marked improvement in their cost efficiency.

Weaker than expected economic growth would have implications for important income sources in retail banking. The quality of banks' credit portfolios is not regarded as very problematic in the EU area at the moment. However, some branches and the rapid growth of household credit are still considered to contain risks in certain countries.

Operating
environment
in 2003

► Supervision

Supervision

The FSA aims to identify pressures for change and risks inherent in the financial markets and contribute to the development of market structures and practices supporting stability and confidence.

The FSA seeks to promote the development of a culture of corporate governance in the supervised entities, particularly regarding the functioning of control and risk management systems. The purpose of the regulatory supervision is to ensure that the supervised entities are professionally managed and that they operate according to ethically and professionally qualitative business principles and practices.

PRUDENTIAL SUPERVISION

The FSA focused its prudential supervision particularly on entities of importance to financial stability. The most important risk areas were determined on the basis of the new capital adequacy accord under revision in the Basel Committee on Banking Supervision and the EU. These risk areas are credit risks, market risks, liquidity risk and operational risks. Risk assessment was also more clearly extended to the supervised entities' governance and control functions, such as management, organisation and internal control. On its inspection visits, the FSA started to examine how the supervised entities develop their Capital Adequacy Assessment

Processes (CAAP), which are processes of significant importance in the proposed framework for capital adequacy supervision.

The financial status and risks of banks and credit institutions were monitored and analysed regularly on the basis of the reports submitted by the supervised entities. The inspections of the largest supervised entities focused on management, organisation of internal control and risk management, credit risks, market risks, and business continuity planning. Inspection of operational risks was commenced as part of the inspection of all risk areas and functions. On its inspection visits, the FSA also examined how banks had prepared for the changeover to compliance with the international financial reporting standards (IFRS/IAS).

Supervisory information submitted by the Savings Bank Inspectorate was utilised in the supervision of savings banks. In the supervision of local cooperative banks, the FSA not only monitored the banks itself but also utilised the supervisory findings of the association of local cooperative banks. Regular discussions between the FSA and the management of supervised entities on the strategies of the entities were introduced. This new practice makes it easier for the FSA to communicate its supervisory goals to the supervised entities.

Narrow interest rate margins burdened bank profitability

Due to the low level of interest rates, there was a strong growth in new bank loans. Housing loans increased by 14% compared to the previous year. The tight competition for customers kept loan margins low. Thus the increase in loans did not improve bank profitability, which largely remained at 2002 levels.

There were no large unexpected loan losses and the recoveries of previous losses were larger than the new losses incurred. However, during the ongoing supervision it was found that banks, in their competition for customers, occasionally had lowered their requirement of collateral for loans. The FSA assessed this as an increased risk of loan losses and a threat against bank profitability in the longer term. On its inspection visits the FSA commented on situations where the banks' internal instructions on collateral were inadequate with respect to the market situation.

On average, the relative interest rate risk of the banking sector for the year remained at the end-2002 level. Banks were only able to partly finance the rapid credit growth with deposits, while part of it was financed through issuing certificates of deposit. Although this caused the banks no liquidity problems, the FSA considered it necessary to check, in the course of its inspection visits, that the internal control of the liquidity risk was sufficiently well organised in the banks.

Investment firms' income was mainly attributable to fee income, the development of which was affected by the turnover and price development in the securities market. On average, the income was at the 2002 level, but it varied significantly from one company to another. The FSA monitored investment firms reporting the lowest profitability particularly closely, meaning that the effects of profitability on the capital adequacy could be estimated at an early stage.

Banks' risk-bearing capacity still sufficient

The FSA supervises that the banks' risk-bearing capacity is sufficient in relation to their risk taking. The risk-bearing capacity is affected by the bank's degree of risk taking, the quality of the risk

management systems, and the capital buffers for covering the risks.

On average, the capital adequacy of the banking sector remained very good and the capital buffers were sufficient in relation to bank risks.²

Similarly, the average capital adequacy ratio of investment firms was also good. However, the capital adequacy of some investment firms deteriorated so much in the unfavourable market conditions that the FSA required the firms to attend to the situation.

Credit risks under control

Loan losses in the banking sector were very low and nonperforming assets smaller than in the previous year. In the course of the inspection visits it was found that the risk for loan losses from corporate loans had increased slightly, but generally in individual fields of activity. The growth in new bank loans focused on housing loans, which generally involve no high risk of loan losses due to the real collateral.

The inspections revealed some shortcomings in the systems for management of credit risks. The banks' risk management systems did not fulfil all requirements of independent risk control and the credit granting process was not always clear and comprehensive. In some banks shortcomings were revealed in the internal control of credit risks, and the FSA demanded that they be corrected.

Systems for management of operational risks are currently being designed

According to the proposed new capital adequacy framework, the supervised entities should have capital to cover their operational risks as well. There are operational risks in nearly all banking functions, such as IT systems, accounting systems and personnel.

Operational risks were found when inspecting credit and market risks, payment systems, and business continuity plans. The observed risks were for example deficiencies in internal instructions, in the organisation of risk control and in risk reduction. They caused the supervised

² In September 2003, the capital adequacy ratio of the banking sector was 19.9%.

What are operational risks?

Operational risks refer to risk of loss resulting from inadequate or failed internal processes, people and systems or external events. Such losses are not always measurable and some risks can also materialise after a time lag, causing indirect effects, for example through tarnished reputation or less appreciation.

By nature, operational risks deviate from credit and market risks. As a rule, they are managed through minimisation. However, a distinction between different risk areas is not always possible. For example the various stages of the credit granting and trading processes comprise both operational risks and credit and market risks.

Supervision

entities a risk of loss, but they did not lead to any significant losses. Although the banks made increased efforts to manage the operational risks, the control of them in the banks is not yet at the level required in international standards.

Banks report on their risk management more comprehensively

Once a year, the FSA studies how banks report on their risks and risk management in their financial statements. In 2003, the FSA also surveyed how comprehensively they reported on their corporate governance systems, that is on their governance structures, the tasks of their different bodies, the election system for selecting members to the bodies and the bonus and control systems.

The FSA survey, which focused on the largest banks, showed that those banks reported on their risk management systems fairly comprehensively and that the financial information as a whole represented European average.

The quantity of corporate governance information in the financial statements varied considerably. As a rule, enough information was provided on the operations of the board of directors, but on the other hand the information on the bonus systems for the top management was very scarce. Neither was the information on the banks' internal control systems particularly extensive, except for the risk management.

According to the FSA, banks should start providing more information on corporate governance. The FSA standards on corporate governance and sound management currently under preparation will lay the foundation for a better provision of information.

The financial information of local cooperative banks and savings banks improved, because the shortcomings of previous years had been corrected at the request of the FSA.

MARKET SUPERVISION

Code of conduct

As one of its tasks, the FSA supervises the code of conduct of the service suppliers under its supervision both in their mutual relations as well as in their dealing with customers. The code of conduct shall comply with laws, international standards and sound practice. A clear and uniform code of market conduct facilitates the activities of the counterparties and reduces conflicts. It also provides a common basis for all service suppliers to pursue their business.

In 2003, in its ongoing supervision and inspections, the FSA paid special attention to the adequacy of its supervised entities' internal control and code of conduct.

Minor flaws in methods of calculating net asset value of mutual funds

In 2003, the FSA inspected the method of calculating the net asset value of mutual funds in 12 management companies. The purpose was to check the functioning of the net asset value (NAV) calculation. The FSA also wanted to examine how the management companies ensure the reliability of their NAV calculation, meaning how the internal control of the calculation works in the companies.

The inspections revealed minor flaws in internal control and methods of NAV calculation. On the basis of its inspection findings, the FSA gave the management companies recommendations concerning internal instructions on the NAV calculation, the audit trail of the phases of the NAV calculation, the role of the Board of Directors in internal control, and the correction of errors in the NAV calculation.

Preparation for pending changes in the Mutual Funds Act

The FSA made preparations for the pending changes in the Mutual Funds Act by meeting representatives of all management companies and examining what projects on the amendments of the act the management companies had under way. In cooperation with the Finnish Association of Mutual Funds a seminar on the amendments was arranged for all management companies and other interested parties.

A revision of the reporting on mutual funds was started in 2003. In the new system, the relevant information is automatically transferred from the management companies' own systems to the reporting program. The collected information also becomes more comprehensive and satisfactorily meets the FSA's, the Bank of Finland's and Statistics Finland's needs for reports in the future.

Investment firms' internal control was surveyed

In a separate enquiry, the FSA surveyed investment firms' internal control and system for control of legal compliance and compliance to internal instructions.³ The enquiry will be followed by individual inspection visits in 2004. The goal of the enquiry and inspections is to examine the level of the internal

control and, above all, the compliance control in investment firms. Attention is paid in particular to the management of risks in corporate governance and legal compliance of operations.

According to preliminary information, investment firms' internal control do not yet fully fulfil the requirements set by the FSA in its standard on establishment and maintenance of internal control and risk management. Shortcomings and the need for additional effort mainly seem to exist in perceiving how extensive the control of operational risks and compliance to internal instructions is and how it should be taken into consideration.

Banks' conduct in supplying investment services to non-professional investors was inspected

In spring and late autumn an inspection was carried out on banks' conduct in supplying investment services, in their offices and units, to non-professional investors. The inspection comprised an analysis of the mechanisms with which the banks try to ensure that the investment services are supplied to customers in compliance with valid legislation and of the setup of banks' risk management and internal control from this viewpoint. The inspection will be continued in 2004.

The inspection revealed that, when providing investment services, banks comply with the 'Know-Your-Customer' principle and the duty to provide information to the customer, as specified in the Securities Markets Act. In addition, banks have switched to computer-based investor and/or risk profile surveys to ensure a uniform practice.

However, reason for improvements was found in the documentation of the application of the 'Know-Your-Customer' principle and the information to be provided to customers, in the management of the risks in investment services and in internal control.

Number of written requests for investigation continued to fall

The number of written requests for investigation received by the FSA fell clearly and amounted to a

³ In the compliance control, attention should be paid to that external rules and appropriate methods are complied with internally and in customer relations. The control shall be reliable and independent.

Supervision

The Advisory Office for Bank Customers and the Securities Complaint Board

The services of the Advisory Office for Bank Customers are accessible to private and small corporate customers in questions concerning banking activities. Advice is provided for example on the interpretation of agreements between the bank and its customers. The Advisory Office also provides information on the contents of the banking legislation, the application of terms of agreement, and other matters of banking practice. The Advisory Office's services are provided to customers free of charge.

The Securities Complaint Board gives recommendations on decisions in disagreements about security investments. It gives advice and assistance in questions concerning the contents of the securities markets legislation and related official regulations and the application of terms of agreement, sound securities trading practice, and other securities-related topics. The service is free of charge and it is available to all non-professional investors that are customers of any bank, investment firm or management company providing investment or fund services.

The Advisory Office for Bank Customers was established by the Consumer Agency, the Finnish Bankers' Association and the FSA. The Securities Complaint Board was set up by the FSA, the Finnish Bankers' Association, the Finnish Association of Securities Dealers, the Finnish Association of Mutual Funds and the Finnish Shareholders' Association.

Advisory Office for Bank Customers, Museokatu 8 A 7, 00100 Helsinki
Open Mon–Fri 9am–2pm, Tel. +358 9 4056 1230, Fax +358 9 4056 1235
E-mail: pankkialan.asiakasneuvonta@rahoitusalan.fi

The Securities Complaint Board, Museokatu 8 A 7, 00100 Helsinki, Tel. +358 9 4056 1230, www.arvopaperitk.net/eng

Supervision

total of 100 (177 in 2002). Of the requests 91 (167 in 2002) concerned credit institution activities and 9 (10 in 2002) securities markets activities.

The customer complaints focused on deposits, insurance savings and insurance investments. In the area of securities markets activities, the major customer complaints concerned domestic and foreign service providers' illicit service supply.

Telephone enquiries on the operations of credit institutions were mostly directed to the Advisory Office for Bank Customers, which decreased the number of calls received by the FSA. The Advisory Office was approached 2,084 times (2,208 in 2002). Most of the approaches concerned use of accounts, payments and loans.

FSA commented on bank marketing

On several occasions during the year the FSA commented on the marketing undertaken by some banks. The FSA requested the banks to comply with an appropriate code of conduct for example in their marketing of insurance products and mutual fund units, in the use of the bank's name in the marketing, and in the transfer of customers from one bank to another.

The basis for calculating exchange rates in foreign currency purchases and withdrawals was also commented on. The transactions in question had been made using payment and credit cards.

24 The FSA recommended that the basis for calculat-

ing exchange rates be specified in the banks' payment card agreements and marketing material. The consumer ombudsman also commented on the same matter.

In its ongoing supervision, the FSA emphasised the importance of a uniform and detailed code of conduct concerning customer identification and Know-Your-Customer awareness. Such a code is necessary for example for assignment of web login credentials and for the increasingly common telephone services of various kinds. The FSA continues to monitor the situation.

MARKETPLACES AND MARKET SYSTEMS

Inspections of payment and IT systems focused on the domestic payment systems of the most important banks and on their business continuity plans. In late 2003, the foreign exchange settlement risks in the largest banks were inspected. Cooperation with the Bank of Finland in oversight and supervision of payment and settlement systems continued according to adopted practice.

No significant risks or deficiencies in domestic payments

In 2003, the FSA reinspected banks' domestic payment systems, which had previously been inspected 3-4 years earlier. The purpose was to

gain an idea of what measures the banks had taken with regard to the admonitions arisen out of the previous inspection, particularly concerning risk management, internal control and continuity planning. In addition, the division of responsibilities and activities between the banks' different departments was checked. The FSA also inspected banks' monitoring of covering funds in customers' payment accounts and how banks manage the risks in those payment accounts that have no intraday monitoring.

The inspections revealed some relatively insignificant deficiencies in banks' payment systems, in their management of risks in payment transfer, their continuity plans and practical internal control. The banks were requested to remedy these deficiencies before specified deadlines. They were also requested to conduct regular tests and drills based on their continuity plans for the various departments. For managing the risks arising from not monitoring covering funds in customers' payment accounts, the banks used intraday limits.

Continuity planning increasingly important in the banks

In 2003, the FSA continued its series of inspections of banks' continuity planning, begun in late autumn 2002. The purpose was to examine the banks' organisation, general principles and process for preparing their business continuity plans as well as their IT system recovery planning. In addition, the continuity plans established for some of the most important business areas were also inspected.

The inspections revealed that banks have increased their efforts in continuity planning with planning projects being established as well as continuity plans being updated. However, the work was not yet completed. Deficiencies were found in the coordination of the continuity planning and in carrying out tests and drills concerning individual continuity plans. In addition, it was noted that some continuity plans should be more detailed and steer the operations more accurately in possible disruptive situations. In the course of the inspections, the FSA emphasised that the continuity planning should not be looked upon as a non-recurrent project but as an ongoing process.

Banks' foreign exchange settlement risks have decreased

In late 2003, the FSA conducted follow-up inspections of the foreign exchange settlement risks in the four largest banks. The purpose was to examine how the banks had changed their definition, measurement, systems for and monitoring of settlement risks since the previous inspections and to what extent the banks had been able to reduce their settlement risks and lower the limits reducing them. Earlier corresponding inspections had been carried out in 1997 and 2000. The inspections are part of the common international efforts of central banks and supervisory authorities to decrease the FX settlement risks and thus the danger of systemic risk in the financial markets.

The inspections revealed that the banks, through measures of their own, had reduced their FX settlement risks considerably. In addition, two of the banks use the settlement service of the international CLS Bank (Continuous Linked Settlement Bank). Settlement risks are expected to continue to decrease with the growing use of the services of the CLS Bank and the increased supply of settlement currencies.

Supervision

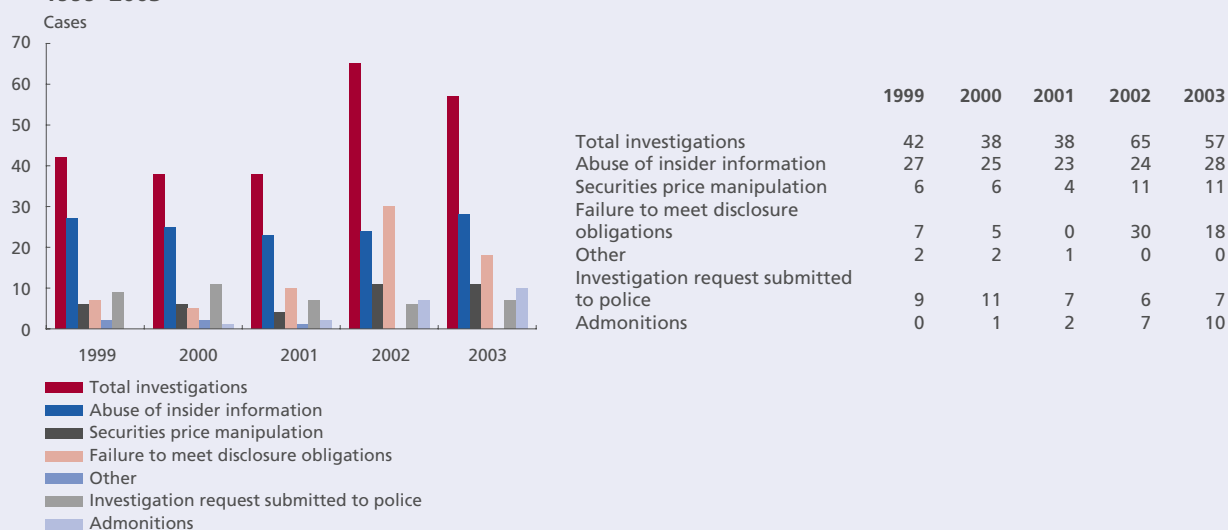
Integration of OM and HEX closely monitored

The FSA closely monitored the progress of the integration of the OMHEX group. The purpose was to ensure that the necessary conditions for supervision also remain in the new group structure.

Introduction of the new HEXClear securities clearing and settlement system

In November-December HEX switched to the new HEXClear system for clearing and settlement of securities. At the same time it was a switch from settlement once a day to a new system where the transactions can be settled both through real-time gross settlement and through batch settlement. The introduction of the new clearing and settlement system reduced the settlement risks significantly, because in the new system the Finnish Central Securities Depository (APK) is no longer

Chart 6 and Table 1.
Cases of suspected market abuse, investigated by FSA,
1999–2003



Source: Financial Supervision Authority.

Supervision

responsible for the net payments of the transactions or, for that matter, for the security deliveries.

The FSA supervised the development and introduction of the new system both in the APK and through inspection visits at the participants of the system. The postponement of the introduction from the original time in spring 2003 to the autumn gave the participants enough time to prepare themselves for the new system. The changeover went without major disturbances.

MARKETS

Increased number of suspected cases of abuse of insider information

In 2003, the FSA investigated 57 (65 in 2002) suspected cases of abuse or negligence in the securities market sector. Of them, 28 (24) were suspected cases of abuse of insider information, 11 (11) suspected manipulations and 18 (30) suspected cases of negligence of the disclosure obligations. Based on these investigations, 7 (6) requests for investigation were submitted to the police and 10 (13) informal admonition letters sent off (see Chart 6 and Table 1).

As compared to previous years, an increased number of suspected cases of abuse of insider information occurred in 2003. Partly this was due to the increased number of public bids. Several bids were preceded by price hikes and raised

volumes before the bid was published, which indicates use of unpublished information.

Due to the increased market share of remote brokers and the increased number of systems for order routing,⁴ the FSA increasingly had to turn to foreign authorities to gain information on the beneficial owners in the transactions. The FSA submitted 14 requests for judicial assistance to foreign authorities. Sometimes these requests could form long chains, as in some cases additional intermediaries in a third or even fourth country could be revealed behind the first foreign counterparty. These requests for foreign assistance extended the investigation times. The number of investigated cases of disclosure of information on listed companies was slightly smaller.

The significance of international cooperation in the supervision of securities trading and disclosure obligations concerning listed companies has increased. An efficient investigation of market abuse requires official cross-border cooperation.

Variations in listed companies' preparedness for international financial reporting standards

In spring 2003, the FSA surveyed how listed companies were preparing to commence applying

⁴ Order routing is a technical system, in which the investors' electronic orders are automatically transferred via the intermediary's system to the trading system of the stock exchange.

Table 2.

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 Markets Act (26.5.1989/495, Ra 116)
Act on Trading in Standardised Options and Futures (26.8.1988/772, Ra 117)
Mutual Funds Act (29.1.1999/48, Ra 118)
Investment Firms Act (27.7.1996/579, Ra 119)
Act on Foreign Investment Firms' Right to Provide Investment Services in Finland (26.7.1996/580, Ra 119 a)
Act on the Book Entry System (17.5.1991/826, Ra 120)
Act on the 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
Pawnshops Act (18.12.1992/1353, Yr 204)
Act on the Prevention and Detection of Money Laundering (30.1.1998/68, Ri 308); burden of responsibility with supervision entity

Source: Financial Supervision Authority.

the IFRS/IAS standards. The purpose of the survey was to get a general view of how the companies prepare for the transition to the standards and what problems possibly adhere to the implementation and application of the standards.

According to the survey, some listed companies plan to switch to IFRS/IAS-based reporting earlier than requested. However, most of the companies have informed that they will prepare their first IFRS/IAS financial statements for 2005. Small listed companies with a turnover below EUR 100 million had started to prepare their changeover plans and thus embarked on their projects quite recently, while the projects of large listed companies had progressed further. The answers revealed that the companies postponed acquainting themselves with the standards because they were not completely updated.

Listed companies' interim reports basically satisfactory – information essential to investors could be improved

The FSA also surveyed how listed companies fulfil the requirements of regular reporting. The survey comprised 32 listed companies' interim reports for the period 1 January 2002 – 31 March 2003. It gave an assessment of how well the reports fulfilled the requirements on the contents of the reporting. In particular, the survey focused on the explanatory statement of the reports and on how

well the information provided by listed companies fulfil the needs of the investors for data for decision-making.

According to the results of the survey, the interim reports mostly fulfil the requirements on regular reporting fairly well, but the rationale behind the information disclosed should be more extensive.

As a rule, the information on the division of the turnover was comprehensive and up to date. Most companies provided quite a lot of information on the division of operations between their different units. The companies' description of their financial status fulfilled the official requirements in several cases, but for example the structure of their cash flow and related factors had not been analysed very clearly.

Most companies had sought to analyse their prospects, but there were obvious deficiencies in the rationale behind the estimates. The companies should try to provide a more exhaustive description of the changes in their environment and the factors affecting their profitability. In practice, the interim reports contain no comments at all on business risks. Although there are no official requirements on the disclosure of such information in the interim reports, as opposed to the requirements on prospectuses, the FSA considers such information significant to the investors.

Supervision

► International activities

International activities

International cooperation in the field of EU financial market supervision and regulation is becoming increasingly important. The need for common regulatory frameworks, a code of conduct for supervision and the exchange of information is growing all the time.

Pressure for international harmonisation of supervision and regulation stems from three sources. First, the supervision and regulation of financial companies and conglomerates, which have come into being as a result of cross-border and cross-sector mergers, poses growing challenges to supervisory authorities, calling for closely targeted cooperation. This is true today for example of financial conglomerates and will, in the future, also be true of European companies.

Second, the aim is to make it easier for investors and customers to benefit from the provision of financial services on an EU-wide basis. This, however, calls for harmonised codes of business conduct in the context of cross-border trading and in the provision of investment and banking services. The long-term objective should be to harmonise consumer and investor protection as well as deposit guarantee schemes throughout the EU, to the extent possible.

Third, a common regulatory and supervisory framework is a prerequisite for the existence of an effective level playing field for all financial institutions, providers of investment services and issuers of securities throughout the European

Union. Regulatory arbitrage, which means that financial companies move their businesses to countries with less stringent supervision and regulation, should, however, be kept to a minimum at the same time.

Principles for international cooperation

The principles for international cooperation were adopted by the board of the Financial Supervision Authority (FSA) in November (see page 33).

In accordance with the guidelines of the board, the FSA will focus in particular on European cooperation. In the field of banking supervision, it takes part in the work of the European System of Central Banks (ESCB) within the framework of the Banking Supervision Committee (BSC). It also contributes to the Groupe de Contact, the body for cooperation between the banking supervisory authorities of the EEA countries, and to the Committee of European Banking Supervisors (CEBS) that commenced operations at the beginning of 2004.

In the supervision of securities markets, the FSA is represented on the Committee of European Securities Regulators (CESR).

The Member States of the European Union also cooperate in the working groups of the European Council and the European Commission. Furthermore, the FSA is involved in the work of

the Money Laundering Contact Committee of the European Commission, attends the meetings of the Financial Action Task Force on Money Laundering (FATF) and participates in the work of the FATF Committee for Finland. In addition to the European Union, other cooperation partners of major importance to the FSA include the International Monetary Fund, the World Bank, the Bank for International Settlements, the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions (IOSCO).

Commission proposals for more effective EU financial regulation and supervision

In the European Commission's most recent assessment of November 2003, the objective of the European Council to have all the projects of the Financial Services Action Plan (FSAP) completed by the end of 2005 will be achieved according to plan. However, because of the interruption caused by the European parliamentary election, it is well advised to complete all pending projects in April 2004, ie before the election.

The aim of the EU is to harmonise financial supervision and regulation and to develop EU legislation towards greater flexibility. For this reason, it has been proposed that the Lamfalussy model be extended to banking and insurance in accordance with the example set by the regulation and supervision of securities markets. In November 2003, the European Commission issued a proposal for measures extending the Lamfalussy process to the entire financial sector. The proposals are largely based on the report⁵ prepared by the EU's Economic and Financial Committee (EFC) at the request of Ecofin.

The report proposes the establishment of two new committees of supervisors. One of them, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), started work towards the end of November 2003, whereas the other new committee, the Committee of European Banking Supervisors (CEBS), commenced operations at the beginning of 2004. Both new committees are level three

⁵ EFC report on financial regulation, supervision and stability, 28 November 2002.

committees, ie of the same level as the Committee of European Securities Regulators (CESR).

Next step for EU: global integration of financial markets

Within the EU, the focus has so far been on the harmonisation of regulation and supervision in the EU area and the creation of a single market. The following step will be to encourage global integration, which means the emergence of a global financial market and greater harmonisation of supervisory and regulatory practices across the world.

The FSA contributes to the work of the global groups through direct involvement, as well as indirectly through the EU. Although the FSA, either because of membership restrictions or lack of resources, cannot participate directly in the activities of all these fora, it nevertheless endeavours to observe, in its activities, the standards and recommendations adopted by the international community.

International activities

Work of committees in the field of banking supervision and regulation

In 2003, the main area of responsibility of the Banking Advisory Committee (BAC) was the revision of the capital adequacy framework applicable to credit institutions and investment firms. Another major task was the work on the financial reporting regulations applicable to credit institutions. The FSA participated in the work of the Banking Advisory Committee, together with the Bank of Finland and the Ministry of Finance. The BAC assists the European Commission in the preparation of EU legislation on financial institutions and provides advice and guidance on other matters related to EU banking regulation and supervision.

The FSA also, together with the Bank of Finland, takes part in the work of the Banking Supervision Committee (BSC) of the ESCB. One of the key responsibilities of the Committee was to analyse the trends in the financial system and banking sector stability. The European Central Bank published two reports on banking sector stability⁶ prepared by the BSC. The reports assess the

⁶ EU banking sector stability, 24 February 2003 and 19 November 2003.

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Other proposals from the European Commission

The European Commission has proposed that the current Banking Advisory Committee (BAC) be replaced with the European Banking Committee (EBC), which would be a level two regulatory committee.

The Commission also proposes the transfer of matters concerning the supervision and regulation of mutual funds to the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR). These issues are currently dealt with by the UCITS Contact Committee.

International
activities

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The Lamfalussy process explained

Within the EU the aim has been to reform regulation and supervision of financial markets in line with the approach proposed by the Committee of Wise Men. This approach is also referred to as the Lamfalussy model. The proposed reforms are designed to intensify and speed up the preparation and application of EU regulation 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. To ensure greater transparency, extensive consultation of market participants should be undertaken in the course of the various 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 committee procedure (Level 2). The various committees of regulators and supervisors assist the Commission with proposals for implementing measures. Supervisory authorities should upgrade cooperation and issue common administrative guidelines, recommendations for interpretation and standards to achieve greater harmonisation of supervisory measures (Level 3). Level 4 concerns the monitoring of compliance with EU legislation, which is the responsibility of the European Commission, in particular.

An evaluation of the effectiveness of the Lamfalussy process is undertaken by the Inter-Institutional Monitoring Committee, which includes experts nominated by the European Commission, the European Council and the European Parliament. It will publish its report in 2004.

financial position and risk bearing capacity of the EU banking sector.

Another important achievement of the Banking Supervision Committee was the conclusion of a Memorandum of Understanding (MoU) on high-level principles of cooperation in crisis management situations between the banking supervisors and central banks of the European Union at the beginning of March 2003. The cooperation is aimed at pursuing the common objective of banking supervisors and central banks of ensuring the stability of the financial system. The MoU sets out the principles and procedures for cross-border cooperation between banking supervisors and central banks in crisis situations. These principles concern eg the identification of the authorities responsible for crisis management, the exchange of information between the authorities involved and the practical conditions for sharing information at the cross-border level. The MoU is not a public document.

In 2003, Groupe de Contact, the unofficial body for cooperation between the banking supervisory authorities of the EEA countries, prepared core principles for supervision in the context of the revision of the EU capital adequacy framework. The FSA participated in the group's work. The mission of Groupe de Contact is to promote cooperation and the exchange of information between banking supervisors. Comparisons of national supervisory practices and working methods are undertaken with a view to harmonising banking supervisory practices between EEA member states. In recent years, Groupe de Contact has increasingly assumed the role of formulator of supervisory principles and best practices in the field of supervision. Within the new organisational structure of EU banking supervision built upon the Lamfalussy process, Groupe de Contact will be subordinate to the Committee of European Banking Supervisors (CEBS).

First implementing measures under commitology procedure adopted by European Securities Committee

In the course of autumn 2003, the European Securities Committee (ESC) adopted part of the technical implementing measures under the Market Abuse Directive (MAD) and the Prospectus

Directive in the form of Commission Directives and a Commission Regulation. The Committee of European Securities Regulators (CESR) advised the Commission on the drafting of the proposals by issuing their substantiated opinions on areas of regulation. The work of the Committee of European Securities Regulators is essentially characterised by transparency and consultation with various market participants during various stages of the work. Transparency is aimed at by providing for rounds of consultation and hearings and by setting up Consultative Working Groups consisting of professional market participants with special expertise in the areas concerned.

The detailed provisions issued on the basis of the Market Abuse Directive relate to the definitions of inside information and market manipulation, the issuer's obligation to disclose inside information, the requirements concerning the production and dissemination of investment analyses and the safe harbour provisions applicable to share buy back programmes for own shares and stabilisation of financial instruments. The advice of CESR on the Prospectus Directive were, in turn, related to the content requirements for a prospectus, the format of a prospectus, publication and availability, the information that can be incorporated by reference into a prospectus, the method of publication of the annual document, and advertising of securities being issued or admitted to public trading in a regulated market.

Discussion of the EU Investment Services Directive (ISD) continued in the EU Council and Parliament. The Directive will contain a number of areas which are subject to implementing measures under the commitology procedure. In preparation of the consultation procedure, the Committee of European Securities Regulators (CESR) set up three working groups. The Intermediaries Group concentrates on the organisation of the activities of investment services providers and the code of business conduct applicable to the provision of these services. The Markets Group focuses on trading and the requirements for admitting securities to trading on a regulated market. The Cooperation and Enforcement Group addresses cooperation between the authorities and the reporting of securities transactions to the authorities. The mandate given by the Commission to CESR in

International activities

early 2004 sets out the key contents of the assignments of the various working groups and the deadline for consultations.

In the course of autumn 2003, public consultations were launched on the proposals of the joint working group of the Committee of European Securities Regulators and the European Central Bank on standards for securities clearing and settlement systems in the European Union. The work is based on the recommendations of the BIS Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions (IOSCO), which are designed to minimise systemic risk and ensure secure clearing and settlement. Respondents paid special attention to the working group's proposal to expand the scope of application of the recommendations beyond clearinghouses to also include major custodian banks, with a view to ensuring a level playing field.

In addition to the consultation procedure, CESR also engages in supervisory cooperation within the framework of two permanent committees, CESR-Pol and CESR-Fin. In the year, CESR-Pol focused on the formulation and harmonisation of procedures in the context of cross-border information flow requests and joint investigations. Other responsibilities of the working group included revision of the multilateral Memorandum of Understanding (MoU), definition of uniform investigation criteria, development of supervisory practices for on-line securities transactions, and relations with non-cooperative states. The working group focused special attention on the challenges posed by the European Convention of Human Rights to securities market supervision. A decision was taken to start to exchange information on pending cases.

CESR-Fin, in turn, coordinates the cooperation of supervisory authorities in the enforcement of listed companies' financial statements, interim reports and other financial reporting. The aim is to design common enforcement principles that will be observed by all the member organisations of the Committee of European Securities Regulators as well by other supervisory authorities. Closer cooperation between supervisory authorities is warranted as the introduction of harmonised IFRS/IAS financial reporting standards requires consistent supervisory decisions and actions by European

supervisors. This serves to promote uniform application of international financial reporting standards by listed companies and to prevent the emergence of national interpretations. The enforcement principles are set out in the standards issued by the Committee of European Securities Regulators. Enhancement of the enforcement of financial information standards is also closely related to the standard setting process. Among other things, CESR-Fin comments on the draft standards of the IASB (International Accounting Standards Board) from the perspective of the European securities markets, seeking to influence the contents of the standards to ensure that the financial reporting standards that will be in use in Europe as of 2005 will be of as high quality as possible, giving due consideration to investors.

Committee of European Securities Regulators reviews implementation of its recommendations

In order to ensure effective financial markets within the EU it is vital that the necessary provisions have been implemented by all Member States and that the supervisory authorities of individual member states apply the same procedures and evaluation principles in their activities. The European Commission bears primary responsibility for the enforcement of EU legislation. However, CESR plays an important role in ensuring appropriate harmonisation of the practices of supervisory authorities. CESR also prepares and adopts recommendations of its own, the harmonised compliance with which by all member states is necessary.

CESR set up a panel to review the implementation and degree of harmonisation of regulations across member states. The review panel is chaired by Kaarlo Jännäri, Director General of the FSA. The first tasks undertaken by the panel were reviews of the Standards for Alternative Trading Systems (ATS) adopted by the Committee as well as of compliance with the Standards for the European Regime of Investor Protection. The panel agreed on uniform review principles. The results, which are based on self-assessment undertaken by each member of CESR, will be published on the Committee's website in early 2004.

The Financial Supervision Authority's principles for international cooperation

Under section 10, paragraph 3, of the Act on the Financial Supervision Authority, the Board shall decide on the principles to be employed by the Financial Supervision Authority (FSA) in international cooperation. In keeping with the opinion of the Economic Committee of Parliament, the provision shall be applied so that the Board decides on the general principles to be employed by the FSA in the preparation of EU regulations and in any other international cooperation in which coordinated preparations across the relevant authorities is necessary for Finland to be able to exercise an active influence (Economic Committee Report 27/2002).

International cooperation of the Financial Supervision Authority (FSA) here refers to the FSA's involvement in international bodies and other international cooperation in the field of financial market supervision and regulation.

The FSA engages in international cooperation as an independent and impartial supervisory authority. The FSA's Director General or a person appointed by him represents the FSA in international bodies.

The Director General informs the Board of matters that have surfaced in the context of international cooperation and refers the strategic directions on international cooperation, as well as other major principle guidelines, for review by the Board.

The principles for international cooperation are based on the FSA's strategic directions on supervision and regulation adopted by the Board by virtue of section 10, paragraph 1 of the Act on the Financial Supervision Authority. Accordingly, the following objectives of international cooperation apply:

Regional prioritisation

- The FSA prioritises supervisory and regulatory cooperation at European and Nordic levels.
- The FSA also contributes to the development of a global financial market through its involvement in selected supervisory and regulatory projects (eg IASB, FATF, Basel Committee on Banking Supervision and IOSCO).

International activities

An integrated EU: towards effective financial markets

- The FSA seeks to actively promote harmonisation of supervision, regulation and the code of market conduct across the European Economic Area.
- The FSA supports the efforts to provide investors with more effective and secure investment outlets in a transparent market and to improve European companies' prospects for raising capital.
- In its capacity as national supervisory authority and member of the EU network of supervisory authorities, the FSA promotes financial stability within the EU and sustained confidence in the operation of EU financial markets.

Finnish financial markets: a competitive part of the EU

- The FSA promotes the efficiency of Finnish financial markets, with a view to ensuring that Finnish financial markets are a competitive part of the EU single market.
- The FSA promotes legal certainty and a clear code of market conduct in Finnish financial markets within the framework of European integration.
- The FSA seeks to contribute to a level playing field in the national implementation of EU supervisory and regulatory principles.
- The FSA contributes to ensuring that the special characteristics of Finnish financial markets and legislation are recognized in the formulation of EU supervisory and regulatory principles.

Organisation of EU supervision

- The FSA supports the efforts to enhance EU financial market supervision and the organisational structure of supervision towards greater efficiency.
- The FSA fosters the debate on the adequacy of the principle of home country supervision.

Continues on the following page.

Crisis prevention and management

- In cooperation with other authorities, the FSA promotes the formulation of clear principles of crisis prevention and management and a clearer division of responsibilities at EU level, with particular focus on the Nordic countries.

Cooperation with other authorities

- The FSA maintains active, effective and synergetic relations with other Finnish authorities. Major cooperation partners include the Ministry of Finance, the Ministry of Social Affairs and Health, the Ministry of Justice, the Ministry of Trade and Industry, the Bank of Finland and the Insurance Supervisory Authority, in particular.
- In the context of international cooperation, the FSA contributes to ensuring adequate advance preparations and maintaining an open flow of information between the national authorities. The FSA puts forward its own opinions actively and at as early a stage of domestic preparation of national and EU regulations as possible to ensure that Parliament and the Council of State will be able to consider them in their legislative work.

Openness

- The FSA promotes the openness of the EU regulatory process and regulatory guidelines.
- In its involvement in the drafting of new regulations within the EU network of supervisory authorities, the FSA seeks to ensure broad consultation.

Influence

- The FSA seeks to actively advocate its competence and experience (eg in the context of cross-border supervision), particularly in the various EU committees of supervisors.
- The FSA supports the secondment of its own experts to EU bodies and for other international supervisory and regulatory duties.
- The FSA maintains an effective dialogue with key committees of the Finnish and European Parliaments.
- In the field of training cooperation, the FSA focuses on cooperation with neighbouring areas. Training cooperation is adjusted to the financial resources available.

International
activities

► Regulation

The Financial Supervision Authority's (FSA) objective is to promote a regulatory framework based on flexibility and accountability. This means that the FSA's approach to regulation is that of regulatory principles rather than detailed rules and that a binding regulatory framework is supplemented by procedural guidelines and instructions for application. Regulation based on flexibility and accountability also highlights the following aspects:

- Supervisory powers enable the exercise of discretion by the supervisor within the limits of generally recognised rules of conduct.
- The exercise of powers by the supervisor is credible.
- The supervisor is accountable for its actions both vis-à-vis legislators and the supervised entities and the markets. This calls for transparency, predictability and legal certainty in the activities pursued by the supervisor.

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, as broadly as possible, in its own regulatory activities. It also makes an active contribution to the harmonisation of legislation, supervision and procedures at EU level.

Regulation by the FSA is closely integrated with international supervisory and regulatory

principles. The FSA's set of regulations, which is currently under review, serves both as a regulatory tool and as a supervisory tool. In 2003, three standards were issued under the new set of regulations. These standards concern organisation of internal control and risk management, supervision of financial and insurance conglomerates as well as reporting of large exposures and risk concentrations.

The new Act on the Financial Supervision Authority (FSA Act) became effective in early July 2003. The Act extended the FSA's powers, entitling the FSA, for example, to impose administrative sanctions, such as public admonitions and warnings, on supervised entities and other financial market participants defined in the Act.

DISCLOSURE REQUIREMENTS

Easier access to capital within the EU

The new 'Prospectus Directive' that entered into force in December 2003⁷ facilitates access to capital in the EU as a whole and also lowers the costs incurred by issuers and offerors of securities.

⁷ Directive (2003/71/EC) of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC. The changes required under the Directive must be implemented in national legislation no later than June 2005.

New FSA Act effective on 1 July 2003

The new Act on the Financial Supervision Authority that entered into force in early July was instrumental in enhancing the accountability and transparency of the FSA's activities by incorporating a provision on the objectives of the FSA's operations, by extending the role of the Parliamentary Supervisory Council as the supervisor of the FSA's operations and by clarifying the FSA's governance and management system. In addition, the FSA was entrusted with new powers.

Objective of the FSA's activities:

- The objective of the FSA's activities is to promote financial stability and public confidence in the operation of financial markets.

Role of the Parliamentary Supervisory Council:

- The Parliamentary Supervisory Council supervises the overall appropriateness and efficiency of the FSA's operations.
- The Parliamentary Supervisory Council assesses how the FSA has managed to meet its statutory objectives and how its staff levels and budgets have evolved in relation to its tasks and changes caused by legislative and market developments.
- The main supervisory tools available to the Supervisory Council are the FSA's annual report and the Board's report on the objectives set for the activities of the FSA and their achievement.

Governance and management system:

- The Board has overall policy and supervisory responsibility for the FSA's operations. It decides, for example, on the FSA's long-term stance of operations and objectives, and the principles for international activities.
- The operations of the FSA are managed by the Director General. He is responsible for an efficient and appropriate discharge of duties devolving on the FSA, in accordance with Board instructions.
- The Board deals with matters on the exercise of new powers prior to final decision by the Director General.

The FSA has powers to

- grant, restrict and annul licences;
- impose public admonitions and warnings;
- prohibit a person from acting as a board member, deputy member, managing director or deputy managing director;
- order a prohibition on revealing any ongoing investigation.

In addition, the FSA has more extensive powers than before to perform inspections and obtain information.

The purpose of the Directive is to harmonise requirements for the prospectus to be published when securities are offered to the public or admitted to trading and to facilitate securities offerings in a cross-border context within the EU.

A prospectus approved in a single EU Member State allows future offering of securities in the EU as a whole, without an obligation to apply for separate approval of the prospectus in each Member State. The costs to the issuer or offeror are also thereby lowered by the fact that in cross-border offerings it will be possible to use an English-language prospectus with a summary of the prospectus translated into the language of the relevant country. Moreover, the opportunity to incorporate information in the prospectus by referring to one or more previously or simultaneously published documents (incorporation by reference) lowers the costs of raising capital. From the point of view of investors, a prospectus complying with this Directive will increase the amount of information in connection with securities offerings.

The Prospectus Directive replaces previous directives on listing particulars and public offer prospectuses.

A draft 'Transparency Directive' on the obligation to provide information and the obligation to disclose major holdings

In March 2003, the European Commission submitted its proposal for a 'Transparency Directive' on listed companies' obligation to provide information and to disclose major holdings as well as related monitoring. With respect to the obligation to provide information, the Directive would regulate the contents and publication of annual financial reports and half-yearly financial reports. In addition to annual and half-yearly financial reporting, the issuer should, during each half-year, provide at least a verbal description of business development and of the main events during the period under review and their implications on the issuer's financial standing. The Directive would also reform the disclosure requirements for major holdings. It also seeks to organise the dissemination and easy availability of information for investors throughout the EU.

Currently, it seems that the Directive would become effective in autumn 2004, and the required legislative changes to the Member States' respective national laws should be implemented in autumn 2006 at the latest.

International Financial Reporting Standards to be adopted as part of Finnish accounting legislation

Listed companies are required to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS/IAS) as from the accounting period starting in 2005. The requirement applies to companies whose securities have been admitted to trading on regulated markets. Furthermore, the Committee of European Securities Regulators (CESR) has issued a recommendation on how companies should, prior to 2005, communicate on their transition to the International Financial Reporting Standards.

In the course of 2003, the FSA participated in the development of IFRSs especially via European cooperation fora, the Securities Regulators Committee and the Banking Advisory Committee. CESR prepared comments on the standards and interpretations proposed by the International Accounting Standards Board (IASB). In contrast to normal procedure, the Banking Advisory Committee issued its comments on macrohedging of interest rate risk directly to the IASB, as this materially affects the banking sector's hedge accounting. The FSA also addressed its written comments on the matter to the IASB.

An IAS Working Group set up by the Ministry of Trade and Industry to consider the transposition in Finnish law of the IFRS Regulation, the Fair Value Directive and the 'Modernisation Directive' of accounting rules, finalised its proposal in June.

As credit institutions are both publicly quoted and non-quoted companies, in the future there will be both credit institutions complying with IFRSs and credit institutions complying with national financial reporting requirements. In order to ascertain comparability of financial reporting, it is proposed that Finnish legislation include provisions under which all credit institutions and investment firms should comply with the Fair Value Directive for treatment of financial instru-

Regulation

ments in accounting and in respect of their separate and consolidated financial statements. Furthermore, it is proposed that, on the basis of the 'Modernisation Directive', they could value their investment property using either the acquisition cost or the fair value.

Enforcement of financial information standards being set up

The FSA has taken part at EU level in the development of procedures, coordination and cooperation for the enforcement of financial information standards. The Committee of European Securities Regulators (CESR) published in spring 2003 its first standard on the enforcement of financial information on the EU securities markets. The purpose of this standard is to harmonise and develop supervision of listed companies' financial information and, in particular the compliance with IFRSs in Europe. The Committee published a draft for a second enforcement standard in the latter part of the year. The standard deals with the need to step up coordination activities among supervisors in the enforcement of financial information.

The FSA was a member of a working group set up by the Ministry of Trade and Industry that gave in March 2003 its proposal on how the enforcement of IFRSs by supervisory authorities should be organised in Finland. According to the working group's proposal, the FSA would be the authority responsible for monitoring compliance with IFRSs in Finland. The Finnish Accounting Board would, in turn, be the body who, upon request from a supervisory authority, could give an opinion on a relevant issue, if needed. Such monitoring would cover all those companies who are obliged to prepare their financial statements in accordance with the IFRSs. The working group's proposal is based on enforcement principles issued by CESR.

Legislative preparations on organising the enforcement mechanism for financial information commenced in early 2004.

Desire to enhance reliability of financial information

A working group set up by the Ministry of Trade and Industry, that had been reflecting upon new auditing legislation, wants to impose stricter requirements on auditors' work in order to ensure reliability of financial information. In its legislative proposal submitted in November 2003, the working group emphasises the independence of auditors and the contents of audit reports. In exercising auditing tasks, lay auditors would no longer be qualified to attend to the interests of shareholders and other interest groups.

The legislative proposal is currently being circulated for comment. New auditing legislation is under preparation in 2004, and the act itself is scheduled to become effective in 2005, at the earliest.⁸

FUNCTIONING OF MARKETS AND COMPETITION NEUTRALITY

Better competitiveness of mutual funds business

The competitiveness of the mutual funds business is being improved through amendments proposed to the Mutual Funds Act, which will implement the amendments to the directive on laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (the UCITS Directive) into Finnish law. The aim is to provide the framework for mutual fund product development and development of other activities of fund management companies, at the same time ensuring implementation of adequate investor protection.

The revised Mutual Funds Act will extend the permitted scope of business for fund management companies from mutual funds business to the provision of individual portfolio management services. Furthermore, fund management companies will get a European passport for carrying on business in other member states of the European Economic Area. To ensure investor protection, provisions on the capital adequacy and risk

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⁸ Further details in the FSA Neswline 6/2003.

management required of fund management companies will be written into the Act.

To improve the information provided to investors, a simplified prospectus must, in the future, be published on each mutual fund. The prospectus must include material and adequate information on the objectives of the fund's investment activities and related risks, cost structure and administration. The changes are scheduled to come into effect in February 2004.⁹

SIVA working group report published

The SIVA working group set up to review the competition neutrality between savings, investment and life insurance products was able to complete its work in December 2003. The working group proposes that the right to a tax deduction on contributions for personal pension plans should be extended to investments made under bound long-term savings contracts in deposits and mutual fund units, as well as direct investments in securities. These products are regarded as mutually competing savings products. Besides insurance companies, other service providers would include deposit banks, investment firms and fund management companies. Savings accounts accruing from long-term savings would not be covered by the deposit guarantee scheme.

According to the proposal, the obligation to provide and request information adopted in the securities markets would be extended to cover investment instruments linked to pension insurance. Contrary to the present conditions, the pension insurance contract and the bound long-term savings contract proposed would be subject to termination at least at regular intervals. The aim is to allow for change of service provider or insurance company during the validity of the bound long-term savings contract.

In terms of competition neutrality and customer protection, the Financial Supervision Authority (FSA) encourages the use of all mutually competing savings products as permitted investment instruments. The FSA is in favour of a wide freedom of choice to change service provider, neutral taxation, a higher capital requirement for service providers to ensure reliability of operations and uniform obligations to provide informa-

tion when investors are offered identical products investment wise.

The FSA finds the broad and general approach to the review of competition neutrality and customer protection under the mandate of the working group to be of significance. Although this time the working group primarily addressed bound long-term savings only, the broader approach should later be returned to, especially without forgetting cross-sector examination of regulations on the provision of investment advice.¹⁰

Revision of Investment Services Directive enters final phase

One of the key projects of the EU Financial Services Action Plan (FSAP) yet to be completed is the revision of the Investment Services Directive (ISD). The Commission issued its proposal for amendment of the Directive in November 2002 and final adoption of the Directive is set by April 2004.¹¹ The current Directive from 1993 is outdated at least in two senses. First of all, it is too narrow in scope and therefore does not correspond to developments in market structures. Secondly, the provisions of the Directive, such as compliance with host-country provisions and the 'concentration rule', ie the mandatory execution of transactions on a regulated exchange, do not promote competition between the financial service providers in the market, nor the emergence of a single market.

The new Investment Services Directive regulates the provision of investment services by investment firms and credit institutions as well as the operation of markets. The revised ISD will include more detailed provisions on the conditions for authorisation of investment firms, for instance on the management of conflicts of interest. The provisions on conduct of business (COB) rules governing relationships with customers will also be considerably extended. The COB rules are based on the recommendations adopted by the Committee of European Securities Regulators (CESR). The Directive will include new

Regulation

⁹⁻¹⁰ Further details in the FSA Newsline 6/2003.

¹¹ The Directive must be transposed in national law within 2 years from its adoption.

rules on the provision of investment advice, which will be defined as core investment service subject to authorisation, as well as on commodity derivatives, which will be covered by the scope of the Directive, subject to certain exemptions.

The provisions on the conditions for authorisation of regulated markets and the organisation of market operations will be much more detailed than in the present Directive. Likewise, there will be new rules on market transparency.

The major amendment to the Directive relates to transparency and regulation of different trading venues. Except for provisions on regulated markets, the Directive also includes rules on the operation of Multilateral Trading Facilities (MTF). Regulated markets and MTFs will, in principle, be subject to equal transparency requirements. On the one hand, this means, publication of buy and sell offers (pre-trade transparency), while providing, on the other hand, for the prompt reporting of the volumes and prices of executed trades (post-trade transparency), with some exemptions. In addition, during the various stages of preparation of the Directive, views have differed as to the extent to which these transparency requirements (especially pre-trade transparency) should apply to investment service providers executing their customers' orders within the company, outside a regulated market or an MTF (so-called internalisation).

Working group proposal for a new Companies Act

The working group set up by the Ministry of Justice issued its proposal for a new Companies Act in May 2003. A key objective of the proposed Act is to provide sound operating conditions for small and growing companies.

In its proposal, the working group found the enactment of a new Companies Act necessary. The operating conditions of limited liability companies should be improved by removing and relaxing formal requirements, as well as increasing regulated operational alternatives and discretionary provisions. The position of creditors and minority shareholders would be safeguarded by emphasising the meaning of general principles, developing clear and effective legal safeguards and clarifying regulations. The proposal also

embodies a move towards a more flexible capital system, the exemption of small companies from statutory audit and restriction of the publicity of holdings.

In their comments, the FSA voiced some reservations to the working group proposal. In the FSA's view, it is important for the sake of investor protection that companies' financial statements are audited and that the audits are conducted by approved auditors. The corporate governance of supervised entities and listed companies, in particular, should be regulated in line with the proposals of the European Commission. This would enhance financial stability and confidence building in the financial markets.

Work on the preparation of the new Companies Act continues. The proposal for a new Act is scheduled for introduction to Parliament in the course of 2004. The drafting of the Act has been closely related to work performed within the EU.¹²

CONTROL OF MARKET ABUSE

Market Abuse Directive broadens powers of investigation and enforcement

The Market Abuse Directive (Directive on inside trading and market manipulation) which provides for broader powers of investigation and enforcement to competent authorities took effect in April 2003. Under the new Directive, the competent authorities must be provided with all the powers of investigation and enforcement necessary for the performance of their duties.

The competent authority may exercise the powers under the Directive either directly itself or together with other authorities, or it may refer the matter to the competent judicial authority. It remains to be seen how the exercise of these powers will be provided for in practice in Finnish national legislation in connection with the implementation of the Directive. The Directive is likely to broaden the FSA's current powers of investigation and enforcement, at least in some respects.

¹² Further details in the FSA Newsline 5/2003.

The Market Abuse Directive obliges Member States to ensure that they have in place the powers to take administrative action or introduce administrative sanctions should the provisions issued under the Directive be violated. In practice, this could mean, for example, that the FSA would, under certain circumstances, be granted the power to impose administrative sanctions as a remedy for the violation of rules issued under the Directive.¹³

The Directive itself and other Directives and Regulations of the European Commission issued by virtue thereof must be implemented in Member States by October 2004. A working group set up by the Ministry of Finance is currently drafting the necessary amendments to the national legislation.

Anti-money laundering regulations revised

Amendments to the Anti-Money Laundering Act took effect in June 2003. The amendments concern the scope of application, extension of the reporting requirements to also cover non-financial professions, as well as reporting requirements. The amendments reflect the EU Second Anti-Money Laundering Directive¹⁴ and the Special Recommendations against the financing of terrorism issued by the Financial Action Task Force on Money Laundering (FATF).

The scope of application and objective of the Act was enlarged to include not only the prevention and detection of money laundering but also the prevention of the financing of terrorism. The reporting requirements now apply both to transactions suspected of being linked to money laundering and to transactions suspected of being linked to the financing of terrorism.

The Penal Code was amended in April in respect of the provisions on, for example, accounting offences, offences by debtors and money laundering offences. The amendments seek to ensure more effective detection of financial crime. Under the new Act, a person may

also be sentenced for negligent money laundering. The Penal Code now provides for specific crime designations for money laundering offences. The definition of money laundering was extended to include conveyance of funds of criminal origin and provision of assistance to another person in the transfer of the funds and obliteration of the origin of the funds.

The Financial Action Task Force on Money Laundering (FATF) adopted 40 new recommendations in June. The recommendations have gained world-wide recognition as standard rules for anti-money laundering regimes and legislation. Although the new recommendations allow for the exercise of national discretion in their application, they call for revision of the Finnish regulations, as well. The recommendations impose more detailed requirements on the exercise of customer due diligence (CDD), ie customer identification and Know-Your-Customer (KYC) procedures, as well as on risk management. A working group was set up by the Ministry of the Interior in the autumn to draft amendments to the anti-money laundering legislation and regulations. A representative of the FSA participates in the working group.

Regulation

REVISION OF THE CAPITAL ADEQUACY FRAMEWORK

Revision of capital adequacy requirements still in progress

Work on the new capital adequacy framework, Basel II, advanced as planned in the early part of the year. The reform is designed to enhance the stability of international financial markets by closely aligning banks' capital requirement with the actual level of risks and by encouraging banks to adopt a more advanced approach to risk management. The reform will place higher demands on the transparency and accountability of operations. One major aspect of the new framework is that banks must have a systematic process for assessing how much capital they need based on their overall risk profile and a strategy to maintain their capital levels. For supervisors, Basel II introduces a requirement to review and evaluate banks' internal assessments and to consider own funds adequacy, taking into account the special features and uncertainties of each institu-

¹³ Further details in the FSA Newsline 1/2003.

¹⁴ Directive 2001/97/EC of the European Parliament and of the Council amending Council Directive 91/308/EC on prevention of the use of the financial system for the purpose of money laundering.

tion's risk profile. The supervisor will have the right to set supervised entities a capital adequacy ratio higher than 8%.

In early 2003, the Basel Committee on Banking Supervision explored the effects of the reform on banks' capital adequacy and own funds requirements (Third Quantitative Impact Study or QIS 3). It also launched consultations on its most recent detailed proposal for a capital adequacy framework built on three pillars¹⁵ and published the results of the Third Quantitative Impact Study.¹⁶

The responses to the Basel proposal support the objective of the reform as addressing risks in financial operations more comprehensively and achieving better allocation of capital costs. The growing risk sensitivity of capital charges is widely accepted. Efforts to provide incentives for banks to improve on their risk management and internal control processes on an ongoing basis were also welcomed. The New Basel Capital Accord allows banks to move from simplified to more accurate and advanced approaches to calculating capital requirements, in line with the sophistication of risk management systems.¹⁷ Banks can also make wider use of credit risk mitigation techniques.

However, the proposal was criticised for the profusion of detail and the costs arising from its implementation. The various national discretion options and possibilities for interpretations may make the implementation of prudential supervision more heterogeneous. The potential procyclical effects of the framework have also been criticised, as have the rules of calculation for operational risk charge and possible additional capital requirements under Pillar 2. In several responses, major changes were proposed to the treatment of expected losses under the Internal Ratings-Based Approach of credit risk, while minor

changes were suggested to the treatment of credit card receivables and securitisation and the calculation of certain credit risk mitigation techniques.

In October, the Basel Committee on Banking Supervision announced that it would, on the basis of the responses received, allocate a maximum of six additional months to the finalisation of the proposal and publish its final proposal by the end of June 2004. The Basel Committee announced no changes to the planned implementation of the reform, which is 31 December 2006.

European Commission draft directive on capital adequacy prepared in step with Basel Accord

At the beginning of July 2003, the European Commission issued a draft proposal for a Directive on a rules-based capital adequacy regime,¹⁸ which is basically in line with the New Accord proposed by the Basel Committee, although there are some differences.

The EU reform will cover all banks and investment firms, irrespective of their size, whereas the Basel Accord will apply to large internationally active banks only. The Commission seeks to ensure that the framework will also be applicable to small institutions with restricted operations and to consider the special features of EU financial markets in other respects, as well. Similarly, the Commission seeks to promote cooperation between supervisory authorities in the prudential supervision of groups operating in several countries and to enhance the transparency of the activities of supervisory authorities.

The FSA has actively contributed to the finalisation of EU regulations within the framework of several working groups and committees, taken part in Nordic cooperation with a view to harmonising implementation and participated in the background work for the Basel II Accord undertaken by Groupe de Contact. The FSA has also been responsible for collecting and analysing the Finnish contribution to the QIS3 study and coordinated the Finnish authorities' responses to

¹⁵ Pillar 1 includes capital charges for credit, market and operational risks, together with alternative methods of calculation. Pillar 2 requires that banks assess capital adequacy in relation to all material risks stemming from business activities and risks in the external environment as well as to the level of risk management and internal control. The supervisor's duty is to analyse banks' capital assessment processes and methods and address the issue of own funds adequacy in relation to risk-taking. Pillar 3 widens the range of disclosure requirements and enhances the detail of contents with the aim of fostering market discipline.

¹⁶ The publications of the Basel Committee are available on the Committee's website (www.bis.org/bcb).

¹⁷ Further details on the reform in the Bank of Finland Bulletin 4/2003.

¹⁸ The draft directive of the European Commission, the EU results of the impact study and the responses to the draft directive are available on the Commission's website (http://europa.eu.int/comm/internal_market/).

both the Basel Committee and the European Commission. A joint capital review working group of the Finnish authorities started its work at the beginning of 2003. Its main tasks are to draft national legislation necessitated by the capital adequacy reform, prepare the authorities' common responses and opinions and launch and undertake impact studies.

As in 2002, the FSA organised regular information and discussion meetings on the capital adequacy reform for financial market participants. It also interviewed representatives of the industry on the current status of their internal capital adequacy assessment processes and on the preparations for meeting Pillar 2 requirements. Towards the end of 2003, work started on the preparation of advance guidance (interpretations) on the choices for national options, minimum requirements under advanced credit risk approaches and minimum requirements for the internal capital adequacy assessment processes.

Capital adequacy requirements legislated for financial conglomerates

In the future, capital adequacy should also be calculated at financial conglomerate level. Under the provisions of the present Act, conglomerates are not subject to a quantitative capital adequacy requirement that is now proposed in a bill designed to implement the capital adequacy provisions of the Financial Conglomerate Directive in national law. It has been proposed

that detailed provisions on the calculation of the capital adequacy of a financial conglomerate be issued in a Council of State decree.

According to the proposal, the total own funds of a financial conglomerate must meet the capital adequacy requirements applicable to the conglomerate. The total own funds of the conglomerate shall be calculated in accordance with the principles of the sectoral rules governing the financial and insurance companies in the conglomerate, while own funds adequacy shall be calculated on the basis of the sectoral capital adequacy requirements. In a multinational conglomerate, the methods for calculating capital adequacy would be based on the legislation of the home state of the company heading the conglomerate.

The Directive is designed to harmonise the supervisory practices applicable to financial conglomerates across EU member states. The proposal put forward to revise the Finnish Act focuses on the cooperation between the supervisory authorities of different member states in the supervision of multinational financial conglomerates, in particular. In drafting the legislative proposal, Finland worked together with the other Nordic countries to ensure uniform interpretation of the Directive requirements. One of the aims is to harmonise national legislation in line with the legislation of the other Nordic countries and to avoid overlapping supervision of Nordic multinational conglomerates. To this effect, the scope of application of the Act will be adjusted.¹⁹

Regulation

¹⁹ Further details in the FSA Newslines 6/2003.

► Development of the FSA's activities

Development
of the FSA's
activities

Intensifying integration and changes in EU legislation and the operating environment in general place increasing demands on supervision. Implementation of the international accounting standards (IAS) and the new capital adequacy (CAD) regime as well as several projects relating to market supervision will, in addition to day-to-day market supervisory duties, require considerable resources over the next few years.

In 2003, the objective of developing the FSA's activities was to further enhance the supervision authority's readiness to respond to 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, as well as on carrying out projects relating to the EU's Financial Services Action Plan.

Revision of corporate governance structure

The FSA's modes of operation are being enhanced on the basis of the requirements posed by the operating environment and the new Act on the Financial Supervision Authority. The revised act broadened the FSA's scope of competence and added to its social responsibility, thus requiring a first-rate corporate governance framework.

The FSA revised its entire corporate governance structure in accordance with the good practices laid down by international standards and the IMF's recommendation on openness, and published the new structure on its website. The FSA's corporate governance structure is defined in the Act on the Financial Supervision Authority. In defining and disclosing its corporate governance structure, the FSA observes, where applicable, the same international standards²⁰ on good practices that are applicable to its supervised entities.

Organisational restructuring

The FSA announced its revised organisation structure at the beginning of June. The restructuring was designed to enhance the FSA's mode of operation and prepare the Authority for increasing supervisory requirements especially in view of the new CAD regime. The new organisation structure reflects a division along functional lines instead of the former division into operational sectors.

The functions of the former Credit Institutions Department and the Capital Markets Department were divided into two new departments. The capital adequacy supervision of all supervised entities was assigned to the new

²⁰ Enhancing Corporate Governance for banking Organisations, Basel Committee on Banking Supervision, September 1999, and the IMF's Code of Good Practices in Transparency in Monetary and Financial Policies.

Prudential Supervision Department, while the new Market Supervision Department encompasses market supervision, supervision of conduct of business and of marketplaces and systems as well as supervision of the HEX Group.

Assigning responsibility for capital adequacy supervision to one single department ensures equal supervisory treatment irrespective of type of institution. Likewise, transferring market supervision and supervision of conduct of business and of marketplaces and systems to one department enhances uniform supervision of the modes of operation of all service providers, thereby enabling more efficient analysis of market infrastructure as a single whole.

Evaluation of achievement of supervisory goals enhanced

Performance evaluation was further developed in line with the objectives adopted by the FSA Board. The new Act on the Financial Supervision Authority also requires that the achievement of goals set for the operations be evaluated. The act further requires that the Parliamentary Supervisory Council monitors the appropriateness and efficiency of the FSA's operations. In monitoring the overall appropriateness of operations, the Parliamentary Supervisory Council must 'focus on evaluating how the FSA has succeeded in meeting its statutory objective in so far as it has been able to affect its performance within the scope of its statutory duties'. Observing the overall efficiency of operations means 'focus on monitoring overall developments in the FSA's number of personnel and annual budget in relation to the FSA's functions and to any changes thereof, resulting from changes in legislation and market environment'.

The FSA aims to enhance performance evaluation with a view of providing the Parliamentary Supervisory Council and the FSA Board with sufficient information to evaluate the appropriateness of the FSA's operations. A further aim is to obtain an evaluation procedure that directs operations to matters of strategic importance.

Key supervisory tools for the Parliamentary Supervisory Council are the Board's review of the FSA's performance in goal achievement, given at least once a year, as well as the annual report.

Improved use of new technology enhances supervision and cuts costs

The standard on large exposures and risk concentrations became effective at the end of September 2003. The related technical data collection system was revised and complemented with a new reporting application, which can be downloaded from the Internet service for reporting of data known as the Jakelu service.

Jakelu was actively used throughout 2003, with 606 companies registering with the service during its first operating year and the number of application downloads amounting to 4,602. The service enables reporting institutions to download spreadsheet-based applications they need for the compilation of reports and statistics to authorities. The service has been of great help to both authorities and reporting institutions as previously all reporting applications had to be provided by disks. The service is available from the FSA's website, and it was jointly designed by the FSA, the Bank of Finland and Statistics Finland.

During 2003, the FSA conducted a preliminary study on how to compile data on securities transactions and trading parties, as in the future it will no longer be possible to obtain such broad-based information via the securities settlement system as it is now. Regulations on supervision and the compilation of transaction data will also change in line with the EU's harmonisation requirements. When weighing the available options, different trading and settlement parties were interviewed and an outline of the new system was presented to them. The implementation of the new system known as KAVAKE was postponed until 2004. As a consequence, compilation of data under the new system is likely to begin in 2005 at the earliest.

During 2003, the FSA started online distribution of its key publications such as standards, information releases to supervised entities and the FSA Newline. In this connection, the FSA Newline became an online publication only.

FSA rated by stakeholders

In summer 2003, the FSA conducted an image survey among stakeholders. According to the survey, the FSA has made progress in goal achieve-

Development of the FSA's activities

ment, and the overall image associated with the FSA has also improved somewhat. On a scale from 4 to 10, the FSA was given a 7.9 grade, up from the 7.8 grade it received in 1999.

Of the interested parties surveyed, particularly the supervised entities as well as authorities appreciated the FSA's activities, while representatives of the press and to some extent of listed companies expressed a more critical attitude.

The respondents hoped that the FSA would be more proactive and open in its approach. Although FSA communications were considered functional, it was hoped that communications would continue to develop a more active approach with improved clarity and understandability.²¹

Focus areas in competence development

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

More resources were allocated to internal preparations relating to the Basel II development project, comprehensive project steering and more effective use of project management tools.

Internal training was arranged on the contents of the new CAD framework and the main features of the necessary supervision processes, and increasingly more staff members participated in the reform projects relating to regulation and supervision. Members of FSA staff also participated in trainings on Basel II and on best practices employed in banks' risk management and capital planning both in Finland and abroad.

Knowledge of the IAS standards was enhanced by arranging internal training and by participating in modifying national legislation and in international cooperation. The FSA also contributed to developing supervision of financial information relating to European securities markets.

Internal training was further arranged on supervision of payment systems, the new Investment Services Directive and the amended Mutual Funds Act. Competence on securities settlement systems was enhanced at workshops arranged jointly with the Ministry of Finance, the Ministry of Justice and the Bank of Finland.

Members of FSA staff also participated in international trainings on banking supervision arranged by the Basel Committee and the Fed.

Competence development was made more systematic by preparing personal competence development plans for the entire staff.

Development
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activities

The FSA in brief

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

The FSA is connected administratively with the Bank of Finland, but is an autonomous authority in its decision-making and supervision activities. The FSA receives services from the Bank of Finland, covering, for example, personnel and financial administration, information management, security and other areas of general administration.

Administration and supervision of operations

The FSA's corporate governance system, defined in the Act on the Financial Supervision Authority, is supplemented by an audit performed by the Bank of Finland's auditors, selected by the Parliament, an independent internal audit as well as an internal guidance and control procedure. The internal audit is carried out by the Bank of Finland's Internal Audit Unit in accordance with the principles adopted by the FSA Board, which also adopts the internal guidance and control procedure.

The Parliamentary Supervision Council supervises the overall appropriateness and efficiency of the FSA. A key supervision tool is the

FSA's annual report as well as a report prepared by the FSA Board at least once a year on the FSA's progress in achieving the goals set for the operations. The Parliamentary Supervisory Council may, at its discretion, include issues dealt with in this report in its own report on the Bank of Finland it presents to Parliament. The Parliamentary Supervisory Council also nominates the members, deputy members, chairman and vice chairman of the FSA Board and confirms its procedural rules.

The FSA Board is responsible for the steering and supervision of the FSA's operations, decides on long-term operating principles and objectives and monitors their achievement. It also takes decisions on matters likely to have a crucial impact on the activities of supervised entities or the stability of the financial markets or affecting their development in some other manner. The Board also decides on the organisation and operating units of the FSA.

The FSA Board consists of six ordinary members and three deputy members, appointed on the basis of proposals by the Bank of Finland, the Ministry of Finance and the Ministry of Health and Social Security. The Director General of the FSA and the Director General of the Insurance Supervision Authority are *ex officio* members of the FSA Board. The Board members have a three-year term in office.

The FSA is a monocratic organisation, with responsibility for the operations resting with the

The FSA
in brief

Director General. The Director General is in charge of all matters not specifically assigned to the Board. In this role he is responsible for ensuring that the FSA performs all its duties in an efficient and appropriate manner and in compliance with the instructions given by the Board in order to achieve its statutory objective. However, the Director General makes decisions on important issues in Management Group meetings in consultation with the Management Group.

The Management Group is composed of the Director General of the FSA, all Deputy Director Generals, Head of Regulatory Governance, Chief Legal Counsel and Advisor.

The Bank of Finland's Internal Audit Unit, which is independent of the FSA, performs the internal audit of the FSA according to the principles and annual audit plan approved by the FSA Board.

The audit is performed by the Bank of Finland's auditors, which have been selected by the Parliament. The auditors report to the Parliamentary Supervisory Council.

The internal guidance and control procedure is part of the FSA's corporate governance, and it must provide the management with adequate information for the basis of decision-making and performance evaluation. The principles of internal guidance and control are adopted by the FSA Board. The FSA Management Group is responsible for ensuring that internal control and risk management are sufficient in view of the nature of activities. The internal control and risk management procedures are revised annually.

Organisation and personnel

The supervisory functions concerning the markets and supervised entities have been assigned to two departments: Prudential Supervision and Market Supervision. Prudential

Supervision is centrally responsible for the prudential supervision of all supervised entities, while Market Supervision is responsible for market supervision, supervision of conduct of business and of marketplaces and systems, supervision of the HEX Group as well as for related regulation and its development. The Regulatory Governance Unit is in charge of the preparation of strategic objectives and principles for regulation and of guiding and controlling the achievement of these objectives. It is also responsible for granting authorisations and imposing sanctions. The Supervision Support Department is responsible for the regulation of financial statements and capital adequacy, communication and document services, information systems as well as planning and internal control.

At the end of 2003, the FSA had an operational strength of 138 persons (136 in 2002). A total of 54 employees worked in the Prudential Supervision Department, 47 in Market Supervision, 30 in Supervision Support and 9 in Regulatory Governance.

In 2003, the average turnover rate²² was 6.5% (11.5%) for those entering the FSA's service and 5% (7%) for those leaving the FSA. FSA's employees were 43 years old, on average.

Financing

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

In 2003, costs arising from the operations of the FSA amounted to approximately EUR 15 million (EUR 14.2 million in 2002). Of these, EUR 14.6 million were covered by periodic fees, EUR 0.5 million by processing fees (3.1%) and EUR 0.008 million by other income (0.1%).

²² Turnover rate for those entering the FSA's service = Number of recruited employees / average operational strength of personnel x 100. Turnover rate for those leaving the FSA's service = Number of employees who left the FSA's service / average operational strength of personnel x 100.



Table 3.

FSA staff, income and expenses 2000–2003

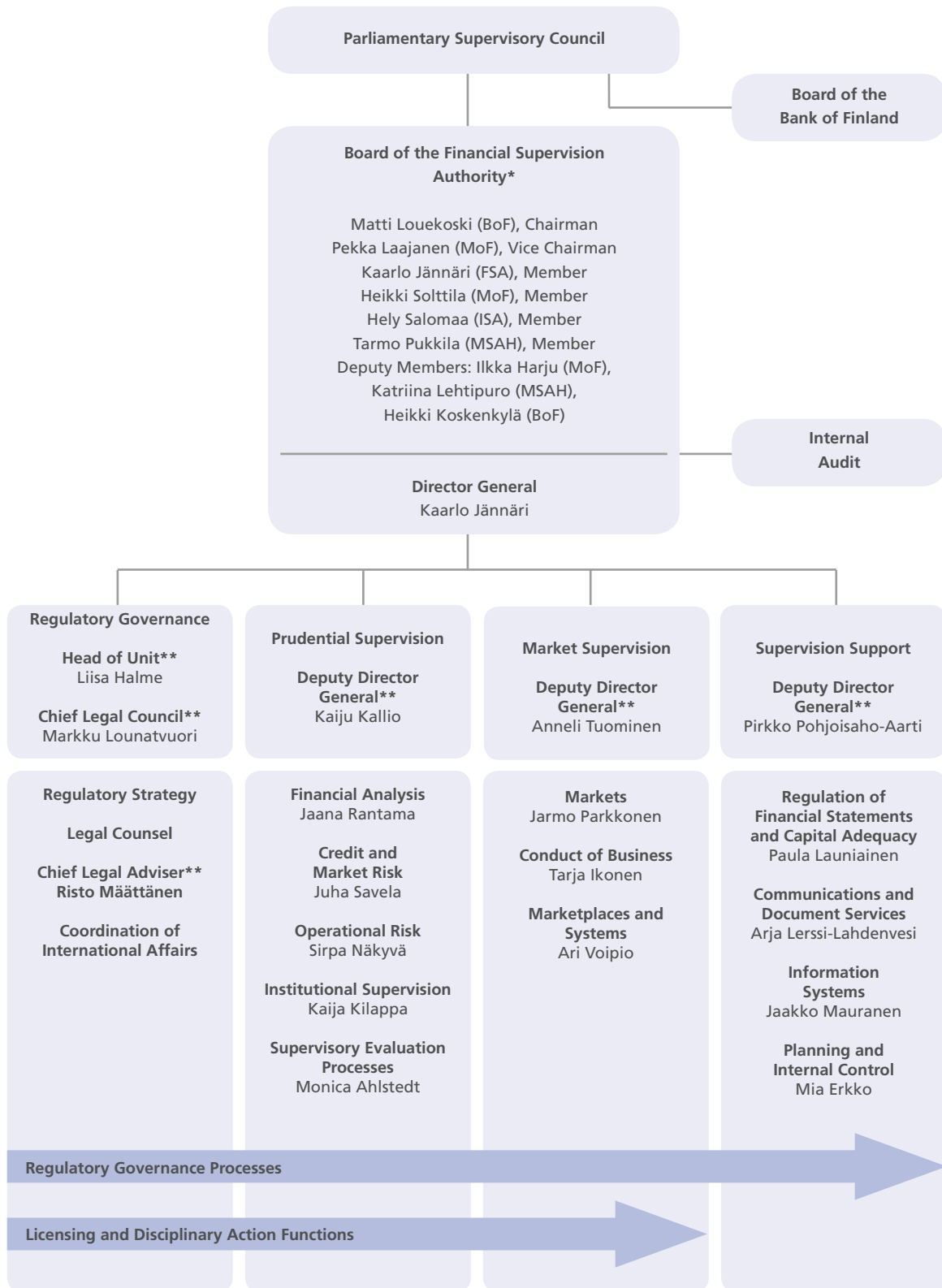
	2003	2002	2001	2000
Number of staff employed	138	136	125	123
Income and expenses, EUR million				
Operating expenses	15,0	14,2	12,4	11,5
Supervision fees				
Periodic fees	14,6	13,7	11,7	10,8
Processing fees	0,5	0,5	0,6	0,6

Source: Financial Supervision Authority.

Chart 7.

Financial Supervision Authority Organisation 31 December 2003

The FSA
in brief



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

** Member of the advisory Management Group.



Table 4.

Financial Supervision Authority; expenses and income in 2002 and 2003, EUR thousands

	Actual 2002	Actual 2003	Budgeted 2004
Expenses			
STAFF EXPENSES			
Wages			
Permanent employees	6,012	6,708	7,224
Fixed-term employees	684	584	244
Holiday substitutes	86	72	79
Other fees	81	68	92
	<u>6,864</u>	<u>7,432</u>	<u>7,639</u>
Other staff expenses			
Staff-related expenses	2,236	2,286	2,332
Other staff expenses	109	119	185
	<u>2,345</u>	<u>2,404</u>	<u>2,517</u>
Total staff expenses	9,209	9,837	10,156
OTHER EXPENSES			
Training	302	249	386
Travel	442	391	464
IT expenses	817	917	1,508
Office expenses	590	756	834
Real estate rents and maintenance costs	1,630	1,674	1,708
Other expenses	1,151	1,206	1,455
	<u>4,932</u>	<u>5,193</u>	<u>6,354</u>
DEPRECIATIONS			
Depreciation on equipment and furnishing	25	15	31
	<u>25</u>	<u>15</u>	<u>31</u>
Total expenses	14,166	15,045	16,540
Income			
SUPERVISION FEES			
Periodical fees	-13,659	-14,564	-15,911
Processing fees	-493	-472	-630
	<u>-14,152</u>	<u>-15,036</u>	<u>-16,540</u>
OTHER INCOME			
Miscellaneous income	-14	-8	0
	<u>-14</u>	<u>-8</u>	<u>0</u>
Total income	-14,166	-15,045	-16,540

The FSA
in brief

Table 5.

Fees charged to supervised entities in 2002 and 2003, EUR thousands

	2003	2002
CREDIT MARKET FEES		
Commercial banks	6,049	5,782
OKO Bank Group Central Cooperative, member banks	1,524	1,347
Local cooperative banks	176	154
Savings banks	252	221
Aktia Savings Bank	201	171
Other credit institutions	739	826
Guarantee funds	34	31
Representative offices and branches of foreign credit institutions	48	53
Credit institutions' holding	15	13
Pawnshops	7	8
Total	9,044	8,606
CAPITAL MARKET FEES		
Marketplaces	660	532
Firms offering investment services	1,787	1,987
Management companies	1,024	780
Book-entry system	507	403
Issuers	1,273	1,107
Keepers of insider registers	268	244
Total	5,520	5,053
PROCESSING FEES		
Management companies	159	158
Issuers	285	308
Others	28	27
Total	472	493
TOTAL FEES	15,036	14,152

The FSA
in brief

Source: Financial Supervision Authority.

► Appendices

▼ Journal 2003

Appendices

Main items of the Journal	2003	2002
Internal matters	60	45
Administration of supervised entities	386	375
Supervision	305	370
Risk management	68	51
Accounting, annual accounts and auditing	15	11
Customer protection and safeguarding	178	233
Inspections	41	65
Other matters concerning supervised entities	40	39
Other external matters	119	117
Total	1,212	1,306
Major categories of journal entries:	2003	2002
Listing particulars	133	151
Investigation requests concerning customer protection	100	166
Regulations related matters	90	99
Notifications	84	139
International cooperation	58	59
Domestic cooperation	52	51
Inspections by plan	41	63
Contractual terms	39	44
Prospectuses	30	42

Items recorded in the journal 2002 of the Financial Supervision Authority amounted to 1,212 matters, broken down by departments as follows: Capital Markets Department 759, Credit Institutions Department 335, Support Services Department 78 and the Regulation Strategy Unit 40.

▼
Financial Supervision Authority's key supervisory powers, 2003

Authorisation*	Number
New authorisations	
Investment firm authorisation	1
Investment firm	2
Cancellation of authorisation**	2
Other permits	
Mutual fund rules	76
Safe custody agreements for mutual funds	35
Inter-authority statement-related matters (incl. special funds rules)	94
Extension of consolidated financial statements and consolidated group	3
Exemption permit regarding depreciation of own funds	3
Permit regarding obligation to inform, the publication of public-offer prospectus or listing particulars, compilation, contents and publication of interim reports	177
Special insider register	3
Signatory rights	3
Authority report	4
insider register-related applications and permits	6
Other	10
Measures related to the investigation of market abuse and dereliction of duty	
Investigations into suspected securities market abuse and neglect	57
Request for police investigation	7
Unofficial reprimand	10
Administrative sanctions	
Public admonition or warning*	0
Withdrawal of authorisation*	0
Disclosure ban (during ongoing investigation)*	0
Conditional fine (imposed by FSA)	0
Conditional fine (imposed by financial market tribunal)	1
Customers' requests for investigation into supervised entities' practices	
Requests for further investigation	109

* From 1 July 2003

** Credit institutions and pawnshops

Appendices

▼
Supervised institutions 1999–2003

31 Dec	LP	OPR	POP	SPY	SP	LL	VR	PLL	UE	ULS	AOJ	SIPA	MP	RY	Others	Total
1999	9	246	43	1	39	17	4	13	5	18	11	45	2	25	13	491
2000	9	244	43	1	39	17	4	13	6	18	12	48	1	26	13	494
2001	9	244	42	1	39	16	4	13	7	19	12	50	1	24	13	494
2002	11	243	42	1	39	16	4	13	4	20	11	46	1	23	13	487
2003	11	242	42	3	37	14	4	11	4	18	17	46	1	27	14	491

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
Others	Deposit guarantee fund (1), Investor compensation fund (1), Holding companies of investment firms (8), Holding companies of credit institutions (3), OKO Bank Group Central Cooperative (1)

Representative offices abroad	1999	2000	2001	2002	2003
Subsidiaries	4	4	7	10	7
Representative offices	16	16	11	7	4
Branch offices	8	9	11	11	11

Appendices

PUBLICATIONS 2003

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

Standards

RA4.1

Reporting of large exposures and risk concentrations

1.5

Supervision of financial and insurance conglomerates

4.1

Establishment and maintenance of internal control and risk management

Regulations and guidelines

106.6

Appendices Regulation on the reporting of own funds and consolidated own funds

203.23

Regulation on the reporting of own funds and consolidated own funds

105.15

Mortgage banks' management of balance sheet risks

Interpretations

- FSA interpretation of credit institutions' treatment of credit derivatives in the calculation of capital adequacy and large exposures
- FSA interpretation of non market price transactions

Information releases

- New schedule of specific fees to take effect on 1 January 2004 and new grounds for supervision fees
- New schedule of specific fees to take effect on 1 October 2003
- Standard on the supervision of financial and insurance conglomerates
- FATF 40 recommendations on anti-money-laundering measures revised
- Standard on establishment and maintenance of internal control and risk management

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