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ANNUAL REPORT

RAHOITUSTARKASTUS
FINANSINSPEKTIONEN
FINANCIAL SUPERVISION

Contents

Director General's Review

Director General's Review 2006

In Finland, as in general throughout the world, economic development was extremely robust in 2006. For the financial sector, this was seen in as being a year of record high profitability. The volume of loans, fee income levels and the growth in bank service charges clearly compensated for the effects of narrowing interest margins brought on by stiffening competition. Due to the sound position of the economy (National Accounts figures), loan losses remain negligible. The outlook for 2007 is favourable.

The housing loan market in Finland continued its rapid upward movement, at close on 15% increase over the year. Fortunately narrowing of interest margins seems to be coming to a halt. Similarly, household consumer credit increased rapidly and competitive conditions caused these interest margins to narrow as well. However, an exception to this pattern was seen in the astronomically high interest rates charged on instant loans acquired using mobile phone sms messages. Although companies offering this form of lending, using mobile phones or Internet, are outside the Authority's supervisory remit, they provide relatively small loans and remain a marginal phenomenon, they are still a symptom of the frivolousness and rash-thinking that increasingly affects individuals' household expenses. Along with other authorities and political decision-makers, FIN-FSA is striving to find a means of quashing this type of activity. Complaints about this type of business activity have been on the increase and legislation is already in the process of being drafted.

More pernicious to households than instant loans, however, is still the burden caused by the servicing of housing loans that are increasingly larger and longer in maturity period, and exacerbated when interest rates rise or unemployment or some other unexpected event brings about a notable reduction in the means available for the loan servicing. On top of which, it is increasingly evident that, in the country's growth centres in particular, as soaring housing prices have taken housing loans to unbearable heights, there is a fear that the next economic slowdown Finland could cause the current housing price bubble to burst in some way or other. Fortunately, membership of the European Union and the euro area probably protects Finland from the types of problems seen in the early 1990s.

Convergence of financial markets within the European Union has brought with it a burgeoning number of cross-border financial sector restructuring arrangements. It is no longer a question of merely a Nordic phenomenon; rather banks, insurance companies, stock exchanges, clearing houses and payment systems across the entire Union area are looking for increasingly tight forms of cooperation and consolidation, regardless of national borders. Indeed, it no longer suffices to consider European consolidation; transatlantic consolidation is moving ahead at the same rate, when we see that both the New York Stock Exchange and NASDAQ are in the process of buying themselves a solid foothold in Europe's leading bourses. The International Financial Reporting Standards (IFRSs) and America's equivalent, the GAAP (generally accepted accounting principles), are likely to continue their harmonisation process over the coming years. Greater levels of harmonisation are also being sought in market supervision and regulation between Europe and North America.

The highest profile restructurings in Finland have been Nordic or domestic in nature. At the end of 2005, the OP Bank Group (Amalgamation of Cooperative Banks acquired the Pohjola insurance group. Restructuring of this new, large domestic financial group was finalised in 2006. Finland's Financial Supervision Authority (FIN-FSA) and Insurance Supervisory Authority (ISA) intensified their cooperation in order to jointly supervise the operations of this financial conglomerate. Also, late in 2006, Aktia Savings Bank bought the Veritas Life Insurance Company from the Veritas Pension Insurance Company Ltd. This move meant that Veritas Pension became a major shareholder in Aktia. This led to the Aktia Group forming a financial conglomerate, which is now supervised by the FIN-FSA, in cooperation with ISA.

The most significant restructuring seen in 2006, in Finland, was the Sampo Group's decision to sell Sampo Bank plc to the Danish Danske Bank. This led to Sampo no longer being involved in banking, meaning that its supervision, which has been undertaken by FIN-FSA in cooperation with ISA, ceases to be the responsibility of the Financial Supervision Authority. On the other hand, FIN-FSA has set up close cooperation with the Danish supervisory authority, Finanstillsynet, for supervision of Sampo Bank's activities, as Sampo Bank has become part of a large Danish financial group, operating in several countries.

A particular point of interest is how Sampo intends to use the sizeable funds acquired from the sale of Sampo Bank. Also, the new government in Sweden has announced that it intends to sell its considerable interests in Nordea, within some unspecified period. It is certain, however, that restructuring in the Nordic countries, as well as farther afield in Europe, will continue bringing added pressure to develop the European supervisory structure in order that it reflect the increasingly multinational nature of the market.

The EU legislative framework is based on the principle of home country supervision, meaning the supervisory authority in the financial company's juridical home country bears prime supervisory responsibility for the whole group. The host country, in other words the country in which a subsidiary or branch office operates, other than the home country, has merely an advisory role. The creation of momentous financial giants, with a key position in terms of financial market stability spanning many countries, is breaking down the credibility of the existing home country supervision principle. Were a crisis to occur, the means – to say nothing of the motivation – of an individual country's supervisory authority, central bank and ministry of finance to handle the issue is limited. This problem has also been identified outside the Nordic countries, and development of several crisis management projects within the EU is underway. In the short term it is impossible to amend the existing juridical structure, making the development of various cooperative solutions between the parties concerned more essential, in the meantime.

Cooperation between the supervisory authorities in the present form of supervisory committees can be broadened towards a uniform supervisory culture. However, this requires a levelling of supervisory powers, resources and competencies in all the countries concerned. There is still a long way to go before this is a reality. I still believe that, in the long term, there is no other solution available than the establishment of a European-level supervisory authority, along the lines of the European System of Central Banks, with transnational decision-making powers over the supervision of key multinational financial conglomerates central to the stability of the financial system. Representatives of national supervisory authorities would form the decision making body of such an organisation. The supervision of smaller institutions, significant to the respective domestic market, would continue to be supervised only at the individual, national level – albeit with a more harmonised framework of principles and practices than currently exists. It is to be hoped that the pending EU-level crisis exercises indicate such a course of action, to avoid having to come to such a solution as the result of an actual crisis.

The ongoing debate in Finland over the merging of the Financial Supervision Authority and the Insurance Supervisory Authority have been buoyed by the creation of bank and financial conglomerates as well as the fact that insurance, investment service and bank products are – to some degree – substitutable for each other, but their market regulations, taxation treatment and fee structure, from the consumers' perspective, differ in ways that are hard to differentiate. It could be that, in the aftermath of Finland's March parliamentary elections, the new government will take these matters up again. My personal leaning is towards support of the consolidation of the authorities, particularly bearing in mind the synergies that can thus be achieved concerning the monitoring of investment risk.

This review is my last as Director General of the Financial Supervision Authority. My eleven years as head of the FIN-FSA comes to a close with the publication of this annual report. Before arriving at the Financial Supervision Authority, I worked for 23 years at the Bank of Finland, which also included a leave of absence to work at the International Monetary Fund (IMF) 1980–1982 and another period, 1991–1993, during the Finnish banking crisis, when I headed the Skopbank, after the Bank of Finland took control of it. The banking crisis, and all it brought with it, was unequivocally the most challenging time of my career. During my first year as Director General at the Financial Supervision Authority I was still involved in the follow-up of the banking crisis. It is incredible to imagine that, in the less-than-ten last years of my career the Finnish financial market has undergone virtually complete transformation following membership of the European Union and adoption of the euro. Of the future there is little of certainty of which one can be sure, other than that things are still changing. I do worry that the changes ahead in the next few years will not be as beneficial as those experienced in the first years of this millennium,

The position of Director General is an isolated one. One has to make difficult decisions against fierce outside pressure, and criticism – both public and out of the public eye – is impossible to avoid. I wish my successor endurance and cool-headed wisdom when facing her coming endeavours. And finally, I wish to extend my thanks to the highly competent and motivated staff of the Financial Supervision Authority. Many of whom have become good friends, as too have many of my EU colleagues. Keep up your good work and cultivate a sound working environment, which can ensure the continuance of high quality and efficient supervision.

Helsinki, February 2007
Kaarlo Jännäri

Director General's Review

First I should like to thank my predecessor, Kaarlo Jännäri. I feel privileged to continue his pioneering work. Mr Jännäri's tenure as Director General reflected the tens of years' experience he has in both international and domestic financial markets. He was an assertive leader, who through his own example emphasised the importance of objectivity and independence in the work of a supervisory authority.

I believe my predecessor is correct in stating that the changes ahead in the financial markets may not, unfortunately be as favourable as they have been to date. The past five years have been marked by a highly benign operating environment in the financial sector. A reduction in unemployment levels and robust economic growth ha meant that the financial situation of households and companies alike has been good and their debt servicing capacity has remained intact. The rise in securities and housing prices has sustained collateral values for loans, in spite of the fast growth in private sector borrowing.

However, one must not get lulled into a sense of complacency by this benign period, rather we must be prepared for the economic situation not continuing to be as favourable as until now. We must also pay special attention to the fact that both borrowers and lenders have, over time, gradually become more sensitive to changes in economic development and possible disruptions in financial markets. Consequently, the effects of the disturbances have become increasingly serious – also from the banks' and other financial institutions' perspective. The sensitivity to disruptions has been increased by the growing level of indebtedness of the household sector; some of which are already at the pain barrier. Financial institutions are themselves more susceptible to disruptions in global financial markets, because an increasing share of their funding is market based. Hence, a tightening of financial markets' liquidity can end the exceptionally low pricing of risks in financial markets and have a knock-on effect on financial institutions' refinancing costs and securities' prices, for example.

There have been significant ownership changes in Finnish financial institutions in the last few years. These new structures, also elsewhere in Europe, have put pressure on reconsidering supervisory duties and responsibilities, at EU level as much as at the domestic level. Stability within the Finnish financial market must be safeguarded also when a considerable proportion of the financial institutions are under foreign ownership. This need is emphasised, when the activities in Finland are in the form of a branch office, or when the local bank's risk management relies on centralised functions in the group's headquarters abroad. Supervisors have started to cooperate closely on the supervision of banking groups and financial conglomerates operating over many countries, so as to enable the efficient supervision of the overall risks of these groups.

Close cooperation is also essential concerning the supervision of operations and markets in Finland, as today cross-border banking groups are being administered and their risks are being managed centrally to a significant extent. In addition to tightening supervisory cooperation, it is important to analyse how far this kind of agreement-based supervisory activity can go, also regarding crisis situations, where it is necessary to identify with which supervisory authority and government or even tax payer the ultimate responsibility lies. There is a clear need for legislative changes at the EU level. From the practical, operational point of view it is just as important that the Nordic countries in particular arrange crisis situation drills, which put the operability of the current supervisory and regulatory system to the test.

In recent years, the FIN-FSA has expressed its concern over the loosening of lending standards, the narrowness of housing loan margins and the over-indebtedness of customers when it comes to housing and consumer loans. We have paid particular attention to whether or not households pay adequate consideration to their ability to service their loans, taking into account the possibility of rising interest rates and other future events that could put a strain on their finances. of the risk of banks' deteriorating profitability has increased over the long term, as rapid credit growth has increased credit risk and housing loan margins alone are no longer sufficient to meet the banks' required return on capital. To a great extent banks' profitability now rests on fee income, which is also susceptible to fluctuations in the economic cycle.

The rise in household indebtedness reflects changes in society's values. Values have shifted over the last decade or so away from placing importance on saving, towards a more consumeristic lifestyle. The shift has been assisted by the ease of taking credit: families are buying a detached house, on borrowed money, as their first home, on top of which they may borrow money to increase their consumption. On the other hand, the importance of saving is not given much ground and it does not have enough appeal. This is where our society should have a clear debate on values. Reforms should be made to encourage saving in its many different forms. It would also be of great importance to the economy if households were to diversify their savings to also include more domestic shares.

It seems that the real significance and risks of higher indebtedness are not fully appreciated. Healthy financial management of households and its basic principles ought to be more thoroughly taught also in school. When it comes to consumer education, the Financial Supervision Authority has an important role to play as a provider of objective information. Our aim is to provide bank customers and savers alike with up-to-date support material on the FIN-FSA web site, concerning various financial products and their associated risks and fee structures. The importance of objective information is emphasised through the increasing variety and complexity of financial products. The FIN-FSA, for its part, tries to influence the clarity and comprehensibility of the information that is issued by listed companies and financial service providers.

Our work in promoting confidence, stability and competitiveness in the Finnish financial markets requires a competent and highly motivated staff at the Financial Supervision Authority. The appreciation of the Authority rests, to a great extent, on our expertise and objectivity. By pulling together we shall be able to do our best for the good of our financial markets, customers, savers and investors.

I am taking up my new position with humility. The challenges we are facing are significant.

Helsinki, February 2007
Anneli Tuominen

The FIN-FSA in brief

The Finnish Financial Supervision Authority (FIN-FSA) supervises financial markets and those who operate in these markets. Supervised entities include banks, investment firms, fund management companies and the stock exchange. The FIN-FSA also supervises listed companies' compliance with disclosure obligations and the quality of financial reporting.

The objective of the Authority's operations is to ensure financial stability and maintain public confidence in financial markets, as stated in the Act on the Financial Supervision Authority. Operations follow the strategy adopted by the FIN-FSA Board. Values guiding the FIN-FSA are independence, openness, result orientation and expertise.

Supervision and Regulation

The core operations of the FIN-FSA comprise supervision and regulation. Prudential supervision focuses particularly on the most important and risk-sensitive institutions and activities. Supervision assesses the financial position, risks, risk-bearing capacity and risk management systems of supervised entities.

The FIN-FSA emphasises owners' and management's responsibility for internal control and risk management. Thus the Authority aims at ensuring that supervised entities have sufficient financial and other prerequisites to carry out operations and that they do not assume so much risk as to endanger their capital adequacy. The FIN-FSA seeks to be proactive in identifying risks and pressures for change threatening financial market stability.

Securities market supervision focuses on codes of conduct applied by supervised entities and on issuers' compliance with disclosure requirements. The FIN-FSA also supervises compliance with insider information regulations and other provisions of the Securities Markets Act. In addition, the FIN-FSA seeks to promote the smooth and reliable functioning of securities trading, clearing and settlement. The FIN-FSA also supervises compliance with International Financial Reporting Standards (IFRSs).

In addition to supervisory measures, the FIN-FSA has the right to impose sanctions if it finds that the law or its own regulations have been breached. The main sanctions used by the Authority are public reprimand, public warning, prohibition to act as board member or managing director, administrative fine and penalty payments.

Regulatory activities – drafting and issuance of standards

Regulation activities cover both the issuance of standards and participation in the drafting of financial markets legislation at national as well as at EU level. The FIN-FSA monitors market conditions closely and, where necessary, submits proposals to other authorities for legislative action or other measures.

Besides supervision and regulation, the FIN-FSA is also vested with the task of promoting public knowledge and awareness of the financial markets. The FIN-FSA's website provides households and individual investors with information on issues such as financial markets, investment and savings products and services, choice of service provider and the conclusion of contract (the service is currently available in Finnish and Swedish). Information is also given on supervised entities' financial state and risks.

The FIN-FSA grants authorisation to credit institutions, investment firms, fund management companies and pawnshops. The FIN-FSA has also the right to revoke the authorisation of these supervised entities either on their application or on conditions fulfilling the requirements of revocation.

GOVERNANCE AND MANAGEMENT

The FIN-FSA is connected administratively with the Bank of Finland, but is autonomous in its decision-making.

The governance and management system of the FIN-FSA is prescribed by the Act on the Financial Supervision Authority (the FSA Act). It is complemented through an audit performed by the auditors of the Bank of Finland, independent internal audit, and internal guidance and control systems.

The FSA Act requires that the FIN-FSA demonstrates transparency in its operations and decision-making procedures and has a sound governance and management system. As for the establishment and organisation of governance and management, the FIN-FSA observes, where applicable, the same principles as its supervised entities.

Parliamentary Supervisory Council

The Parliamentary Supervisory Council, elected by the Finnish Parliament, bears responsibility for supervising the overall expediency and efficiency of the FIN-FSA's operations and decides on certain administrative issues. The Parliamentary Supervisory Council appoints those members of the FIN-FSA Board that are not directly stipulated by law.

The Board of the FIN-FSA

The FIN-FSA Board is responsible for the steering and supervision of the FIN-FSA's operations and decides the long-term strategic decisions and objectives and monitors their achievement.

The Board consists of six members. Four members are nominated by the Parliamentary Supervisory Council on the basis of a proposal of the Bank of Finland, the Ministry of Finance and the Ministry of Social Affairs and Health. The Directors General of the FIN-FSA and the Insurance Supervision Authority are ex officio members of the Board.

Director General

The FIN-FSA is headed by a Director General whose appointment and dismissal rests with the President of the Republic of Finland. The Director General is responsible for ensuring that the FIN-FSA performs all its duties efficiently and expediently in accordance with the guidelines laid down by the Board in order to achieve its statutory objectives.

The Director General takes decisions on important issues in consultation with the Management Group, consisting of the Director General, the Deputy Directors, the Chief Legal Counsel and the Senior Adviser of the Regulatory Governance Unit.

ORGANISATION OF THE FIN-FSA

The organisation of the FIN-FSA consists of the Regulatory Governance Unit, the Market Supervision Department, the Prudential Supervision Department, the Communications and Information Services Unit and the Organisational Planning and Organisational Development Unit. The organisational charts are presented in Annexes 2 and 3.

The supervisory functions have been assigned to Market Supervision and Prudential Supervision. Market Supervision is responsible for the supervision of markets, code of conduct and securities markets infrastructure as well as related regulation and its development. It is also responsible for the supervision of compliance with International Financial Reporting Standards (IFRSs) as well as with disclosure requirements by securities issuers.

Prudential Supervision focuses on the prudential supervision of all supervised entities, information systems as well as related regulation and its development. The department monitors risks, capital adequacy and profitability of credit institutions, investment firms and fund management companies. It also analyses the overall situation of the financial markets and assesses risks relating to changes in the economic environment. Furthermore, the department monitors and supports preparations of supervised entities related to the capital adequacy reform (Basel II).

The Regulatory Governance unit is in charge of steering the provision of FIN-FSA regulations, the preparation of the strategic objectives and principles for regulation, and guiding and controlling the achievement of these objectives. It is also responsible for the authorisation and sanction processes, the coordination of international activities and the supervision of compliance with insider regulation undertaken by the FIN-FSA staff.

The Communications and Information Services unit is responsible for communications and information services, whereas the Operational Planning and Organisational Development unit is in charge of operational planning and monitoring, coordination of strategic work and organisational development. Both units report to the Director General.

STAFF

The FIN-FSA is an expert organisation. 71% of the staff hold expert positions, 11% serve as managers and 18% hold other positions.

The FIN-FSA's approved operational strength is 142 employees, but the actual operational strength was, due to ongoing recruitment, 137 employees at the end of 2006. A total of 54 worked in the Market Supervision Department, 63 in the Prudential Supervision Department, 9 in the Regulatory Governance Unit, 7 in the Communications and Information Services and 2 in the Operational Planning and Organisational Development Unit. The number of man-years worked totalled 144.7. The average turnover rate was 9% for both those entering the FIN-FSA's service[1] and those leaving the FIN-FSA.[2]

The FIN-FSA's role as the authority supervising financial market sets specific ethical requirements on its employees and their activities, these being loyalty and independence. The employees are to bear in mind the objectives of the FIN-FSA and work towards their achievement. Their relationships or economic ties to supervised entities are not to become too close or otherwise such that their independence could be compromised.

FUNDING AND OPERATING COSTS

The FIN-FSA finances its operations by levying supervision and processing fees from supervised entities and securities issuers. In 2006, the combined supervision and processing fees charged by the FIN-FSA totalled EUR 17.5, in addition to which a surplus of EUR 2.3 million was transferred from the previous year.

[1] Turnover rate for those entering the FIN-FSA's service = Number of recruited employees / average operational strength of personnel x 100.

[2] Turnover rate for those leaving the FIN-FSA's service = Number of persons who left the FIN-FSA's service / average operational strength of personnel x 100.

The FIN-FSA's operating costs totalled EUR 17.2 million. The majority of this consisted of staff expenses (EUR 12.4 million), which also included an unanticipated contribution paid to the Bank of Finland pension fund (EUR 1.4 million). Other major expense items were administrative services from the Bank of Finland (EUR 2.1 million) and rental of premises (EUR 1.2 million). As supervision and processing fees exceeded costs in 2006 in the amount of approximately EUR 2.6 million, this surplus will be taken into account when determining supervision fees for 2007.

The total budget for 2007 was EUR 18.1 million. Approximately EUR 11.5 million has been earmarked for staff expenses, of which EUR 8.9 million is to be spent on salaries and EUR 2.6 million on other staff-related expenses. Staff-related expenses include statutory and voluntary social security expenses as well as occupational health service expenses.

Other expenses are due to official travel, training, security, catering and personnel services as well as services purchased from external parties. Official travel comprises mainly working group meetings of the Committee of European Banking Supervisors (CEBS) and the Committee of European Securities Regulators (CESR) as well as joint meetings of Nordic supervisors. An average sum of EUR 1,700 is budgeted for 2007 for competence development per person. The FIN-FSA purchases services relating to personnel, financial administration, information management, security and other areas of general administration, from the Bank of Finland. These expenses account for EUR 2.3 million in the budget for 2007.

Strategy 2007–2009

Our vision is to be a proactive supervisor of high repute.

Business objectives:

Financial stability and promotion of public confidence in financial markets

Competitive and well-functioning financial markets

To ensure attainment of these objectives, the FIN-FSA has made the following strategic choices with a view to the forthcoming planning period:

We allocate resources to proactive and risk-based supervision.

The FIN-FSA uses off-site analysis based on reporting to monitor supervised entities' risk taking, profitability and capital adequacy on a continuous basis. Risk exposures and the capacity to bear risks are subject to regular analysis. On-site inspections focus more closely on risks and risk management and are particularly concentrated on entities and systems crucial to financial market stability.

Increasing the number of inspections that started in 2006 will be continued, as regulatory work will take up fewer resources following the completion of the Basel II capital adequacy reform. In 2006, the inspections focused particularly on exposure to credit risks and their management. The FIN-FSA addressed risks arising from the rapid growth in lending and deficiencies in banks' procedures. Monitoring of credit risks continues to be a key area of focus along with risk management systems and the monitoring of operative risks.

The FIN-FSA's strategy 2007–2009

VISION
Pre-emptive and credible supervisor

Strategic focuses

	Strategic focuses
Society's perspective	We will allocate more resources to pre-emptive and risk-based supervisory activities. We will review the risk profile of our supervised entities and inspect the adequacy of their capital management and internal governance. We will deepen cooperation with foreign supervisory authorities and develop methods for effectively supervising financial conglomerates. We promote the comprehensibility, reliability and quality of the financial information available to investors and customers. We foster sound market practices and enforce them through appropriate supervisory action. We will promote the convergence of regulation and supervisory practices in the EU in cooperation with other regulatory and supervisory bodies. We will make sure that our own regulation and guidance is well focused and clear. We will promote co-operation with other supervisory authorities. We will support self-regulation where appropriate.
Supervised entities' and listed companies' perspective	We will make sure that our actions are predictable, legally sound and fair. We will improve our dialogue with our supervised entities and other reference groups.
Resources and budgeting	We function cost-consciously. We will adjust our resources according to the operations of our supervised entities and the challenges brought about by European integration.
Internal processes	We will reduce pass-through times in our internal processes, improve our working methods and prepare ourselves for the use of new supervisory powers.
Organisational development and job satisfaction	We will develop our expertise in anticipation of the changes in the financial industry. We foster strong motivation amongst our staff.

Objectives

Stable financial markets and confidence in their operation

- Supervised entities have solid risk-bearing capacity and have sound internal governance and risk management systems. Potential failures will not cause major disruptions in financial markets.
- High quality of investor and customer protection.
- FIN-FSA regulation is principles-based, proportionate and effective.

Competitive and well-functioning financial markets in Finland.

- The evolving European regulatory and supervisory framework is well-suited for Finnish entities.

CRITICAL SUCCESS FACTORS
Skilled and motivated staff
Sufficient and comparable supervisory powers as in other EU Member States
Prompt and clear communication

The Basel II capital adequacy reform entered into force at the beginning of 2007. Banks and investment firms must introduce new capital adequacy calculation and reporting procedures by no later than 1 January 2008. The reform not only supports supervised entities' own risk and capital adequacy management but also enhances the FIN-FSA's supervisory process. For example, the quality of the credit portfolio will be subject to closer monitoring and the escalation of risks can be detected sooner, as supervised entities develop their own internal methods and use them in their reporting to the FIN-FSA. The scope of capital adequacy monitoring has been expanded and made more systematic to cover supervised entities' all essential risk exposures, threats affecting the operating environment and cyclical fluctuations. The FIN-FSA has devoted substantial resources to ensuring reliable and smooth introduction of the Basel II reform in all supervised entities. This work continues.

We inspect the reliability of supervised entities' internal governance and capital adequacy management.

Internal governance, coupled with the reliability and eligibility of management, provides the grounds for good risk management. Internal governance procedures are supervised by the FIN-FSA. Internal governance also occupies a pronounced role in the Basel II reform, which requires that supervised entities have in place systematic procedures for capital adequacy management to ensure all risks are covered on a continuous basis as well as plans for acquiring new capital if needed. Capital adequacy management must be incorporated into business strategy and administration. If supervised entities expose themselves to greater risks, they must have sufficient capital. In the future, the FIN-FSA will assess all supervised entities' capital adequacy management procedures on an annual basis and may require, if need be, that the amount of capital be increased.

We will enhance international supervisory cooperation and supervision of financial conglomerates.

Cooperation with Nordic supervisory authorities has been necessary in respect of the supervision of financial conglomerates operating in several Nordic countries, following their increasing share of the Finnish financial market. Cooperation must continue to be enhanced. The FIN-FSA has also worked in increasingly closer cooperation with the Insurance Supervision Authority as regards supervision of domestic financial conglomerates. Cooperation with these supervisory authorities is necessary to ensure supervision of the stability of the Finnish financial market, management of potential crisis situations as well as efficient overall supervision of the conglomerates. Close cooperation has also been continued with the Savings Bank Inspectorate and the Local Cooperative Bank Association in respect of the supervision of local banking groups. This work will continue to be developed to fulfil the requirements of Basel II.

EU-level cooperation takes place through the Committee of European Banking Supervisors (CEBS) and the Banking Supervision Committee (BSC). The objective is to ensure an efficient European supervisory system and converging operating procedures as well as effective monitoring of risks in the financial market. The resources of the FIN-FSA only enable participation in projects that are essential to the Finnish financial market.

We enhance the understandability, reliability and quality of financial information given to investors and customers.

The FIN-FSA regards the high quality of financial information as one of the most important elements of investor and customer protection. High-quality investor information is essential for evaluating the financial standing of listed companies. Investors must be able to trust that the information provided by listed companies is correct and be able to compare the profit-earning capacity and risk profile of companies operating in different countries. The FIN-FSA contributes to improving the clarity of investor information.

In recent years, the FIN-FSA has conducted surveys which have assessed the quality of information given to investors and how it could be improved. The surveys have focused on a variety of topics, such as profit forecasts released in line with the securities markets legislation and compliance with the International Financial Reporting Standards (IFRSs). The surveys have been made public and the findings have been communicated to listed companies and different interest groups. The surveys show that the quality of IFRS-compliant financial statements is varied and that companies still have much to improve. In contrast, more information was given to investors about forecasts on future developments. The FIN-FSA continues to carry out these surveys. One area of focus in 2007 will be the impairment testing of listed companies' assets.

The need to ensure the understandability of information given to investors and savers is becoming pronounced as the interest in investing in private pension plans is growing and households' investments are increasingly being dominated by securities-related investing. The FIN-FSA considers it important that the information provided to investors and savers is understandable and written in plain language. The requirements on unambiguous information concern the disclosure of financial statements by listed companies, mutual funds' investment strategy, fees and the determination of yield on deposits' share-related profit. They also concern information given to bank customers about lending, investing and other services and about the impact of the combination of services on fees.

It is important for the FIN-FSA to provide, on its website, objective and up-to-date information to banks' customers and savers about different loan, saving and investment alternatives. If the FIN-FSA succeeds in this task, its customers can access useful information before making financial commitments. The need for explicit information is heightened in structured instruments and other types of new, complex products. The FIN-FSA intends to offer increasingly more information that enables customers to compare the prices of different loan alternatives, financing and investment forms and other products.

The FIN-FSA regularly makes information available publicly on the condition of supervised entities and the financial market and the risks affecting them. The number of published analyses and speeches was increased in 2006 because households' risk exposures in particular were considered to have become pronounced due to intensive loan taking. Following the Basel II reform, increasingly more information will be provided about supervised entities' own financial standing and risks.

We promote good market practices and address neglect with appropriate determination.

Healthy operations are a prerequisite for functional financial markets. This is one of the key objectives of the FIN-FSA. Comprehensive authoritative regulation is based on common operating procedures. The regulations on market abuse, eg abuse of insider information and share price manipulation, enforced in 2005, has clarified market practices throughout the EU. New regulations will be introduced at the end of 2007 concerning the provision of investment services in particular. This will serve to improve investor protection throughout Europe. The purpose of regulation is to ensure that customers are treated in as equal and fair manner as possible.

It is important for the FIN-FSA to be able to take advance action for the prevention of reproachable market operations and the promotion of good market practices. This the FIN-FSA aims to achieve by telling about regulation and its objectives and interpretations in information briefings and discussion events and by providing practical guidelines to supervised entities and listed companies. Following the completion of major regulation projects, the FIN-FSA is able to conduct increasingly more inspection visits at supervised entities and surveys on different topics.

It is essential for the sake of credibility and market confidence that in the event of neglect, the supervised authority reacts promptly and to the appropriate degree of severity. In considering its reaction the FIN-FSA takes always into account the degree of severity of the action from the point of view of markets, customers and investors.

We promote the convergence of regulatory and supervisory powers and practices in EU member states.

The challenge in supervision over the next few years is the development of division of labour between the home country and host country authorities, in order for supervision to correspond to changing market structures. The EU has acknowledged that changing market structures, particularly the increasing number of cross-border financial conglomerates, call for modifications to practical supervisory activities, even though the capacity to alter the basic legal structure of supervision does not exist. Measures to improve cooperation, converge reporting practices and delegate tasks between supervisory authorities have partly been taken and are partly being investigated.

The FIN-FSA intends to make its contribution at the EU level as well as in the Nordic countries and Finland to ensure that through regulatory and supervisory cooperation, the FIN-FSA will have enhanced operative prerequisites for looking after the stability of markets and market confidence. Close cooperation will be continued with the supervisory authorities of other EU member states to establish common interpretations and supervisory principles. The FIN-FSA will also work to ensure that the Finnish regulatory environment enables efficient and profitable conduct of business, thus promoting the attraction of the Finnish financial market.

We work to ensure that our guidelines are unambiguous and appropriately allocated.

According to the feedback received, the FIN-FSA has succeeded in improving the quality of its regulations. Critical comments have focused on the difficulty of applying the same regulation to supervised entities of different size and type. Regulation will increasingly take into account the scope and risks of supervised entities' activities. This is a challenge to the FIN-FSA and the entire EU. The objective is for the FIN-FSA standards to provide supervised entities with a clear understanding of the role and expectations of the supervisor. The FIN-FSA seeks to find practical working solutions to how the same regulation could be applied to supervised entities of different sizes. The FIN-FSA also seeks to improve its binding regulations by introducing clearer marginal headings to standards and devoting time and resources on a comprehensive hearing stage and on analysing the need and impact of regulation.

Adoption of the Markets in Financial Instruments Directive (MiFID) at the end of 2007 will have a major impact on FIN-FSA regulatory activities and future supervisory work. Since summer 2006, the FIN-FSA has concentrated on modifying its legally binding regulations to comply with the MiFID and on improving the process of handling authorisation applications.

We support development of responsible self-regulation.

One area of focus for the FIN-FSA for 2007–2009 is to support development of responsible self-regulation. To this effect, the FIN-FSA will carry out a survey on the application areas of self-regulation in the financial market. The survey will be used to determine the FIN-FSA's role relative to self-regulation.

The problem with self-regulation has been the inadequacy of oversight and sanctions. On the other hand, an action programme for better regulation published in Finland in August 2006 discusses self-regulation as an alternative and supplement to authority regulation. The action programme uses the concept of alternative regulation, which refers to the kind of social steering methods used by public or private parties in replacement of legislation in order to achieve a specific objective. Alternative regulation not only seeks to reduce public regulation but increase flexibility of the legal system.

We operate in a cost-effective manner and adapt our resources to the scope of supervised entities' business and the challenges of integration.

The FIN-FSA seeks to develop its operations in such a manner that the number of personnel and cost-efficiency correspond to developments in the operating environment and changes in supervised entities' business. In supervision and regulation our aim is to ensure that supervised entities and other interest groups feel positive about cooperation with the FIN-FSA and appreciate the added value this cooperation delivers.

Supervision of EU area financial markets is increasingly based on supervisory cooperation and convergence of supervisory practices in line with the so-called Lamfalussy process. Expanding international and EU-level supervisory cooperation, structural changes in the financial market and developments in regulation put major demands on FIN-FSA personnel.

One of the greatest challenges for the FIN-FSA is to take care of increasing supervisory duties with the current personnel levels. Owing to the good employment situation in the financial market, recruitment of experienced professionals has become increasingly difficult, which translates into clearly heightened personnel risks. The increase in workload is being balanced through the use of temporary staff, which is reflected in the growth of man years in 2007. Temporary staff is especially needed to take care of tasks related to the introduction of Basel II regulations. The use of temporary staff also reduces the need of expensive external IT consultation services.

FIN-FSA strives to keep its budget growth in line with the overall change in prices. Personnel and other operating costs will be kept moderate in the next planning period. The budget will be increased by major IT development projects stemming from EU regulation-related IT requirements.

We improve the efficiency of our operations and prepare for the use of new operating powers.

The FIN-FSA intends to improve the efficacy of its core processes. The supervision process will be revised in 2007 in line with the Basel II framework and the Directive on Markets in Financial Instruments (MiFID).

Advanced IT solutions will continue to be employed in improving the efficiency of supervision and operating practices. In 2006, the FIN-FSA launched a system project to improve the reporting of trades in financing instruments and a reporting project related to the capital adequacy requirements. In 2007, virtual workspace will be introduced gradually to the entire FIN-FSA staff.

We take a proactive approach to improving our staff competence to reflect changes in the business environment.

A proactive approach is being applied at the FIN-FSA to improve our staff competence in reflection to changes in the business environment. Major areas that pose challenges on the competence of the entire staff in 2007–2009 are the new capital adequacy requirements (Basel II), International Financial Reporting Standards (IFRS), the EU's revised securities markets regulations and corporate law.

The results of our interest group survey show that the FIN-FSA provides good support to supervised entities in improving risk and capital adequacy management and introducing the Basel II reform. Training and other investments in competence development have thus produced results. Competence enrichment is nevertheless an ongoing area of focus, as supervised entities' risk management methods and financing instruments are subject to vigorous development.

We foster good job motivation.

We pay increasing attention to personnel wellbeing. The aim is to consider ways to curb pressures on personnel. We develop personnel management in particular as regards job motivation, improve task prioritisation and aim to balance the work load. In 2007, we will again conduct an internal working atmosphere survey.

At the end of 2006, the FIN-FSA started a leadership training programme involving all the superiors. Competence development and personnel risk mitigation were consolidated through the drawing up of a FIN-FSA competence strategy for 2007–2009. Job rotation is used as a tool to improve the efficiency of operations and to enhance our staff's professional skills.

The analytical framework for management activities was revised so that the Parliamentary Supervisory Council and the FSA Board will get more concrete tools for evaluating the appropriateness of the FSA's operations. The analytical framework was also enhanced to facilitate better communication of the FIN-FSA strategy to personnel.

The economic environment in 2006

Economic developments in 2006 better than forecast

The economic developments in 2006 exceeded forecasts, and the economic outlook is also favourable. Total output growth is rapid in Finland compared with average growth in Europe. However, the rate of growth is expected decline slightly in the near future. Finnish exports and consumer demand remained strong in 2006 and the rate of inflation was one the lowest in Europe. Employment also improved, and the unemployment rate fell below 8%.

The European Central Bank raised its key interest rate

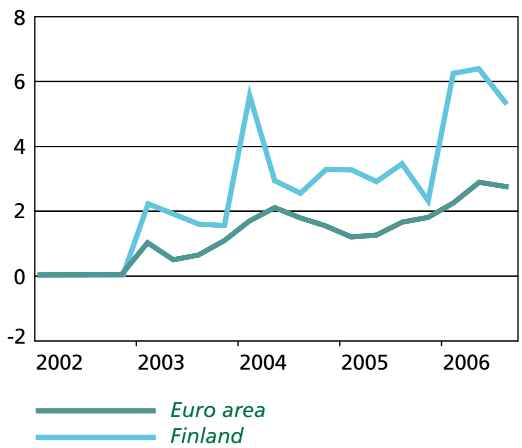
Due to inflationary pressures in the euro area, the European Central Bank raised its steering rate[3] several times in 2006. The last rate rise occurred in December. At the end of 2006, the ECB key interest rate stood at 3.50%.

In the course of 2006, the Euribor rates rose by just over one percentage point. The increase was so moderate that the higher debt servicing costs have caused no major problems. As expected, banks' net interest income has improved in line with rising interest rates.

[3] The minimum bid rate on the Eurosystem's main refinancing operations.

Total output in the Euro area and Finland

Annual change, %



Sources: Eurostat, Bank of Finland and Statistics Finland.

Uncertainty about financial market developments reflected in more volatile interest rates and asset prices

In 2006 the financial markets were surrounded by a higher degree of uncertainty about the stance of macroeconomic and monetary policies and the force of forthcoming change. Uncertainty was reflected in volatile market rates and, in spring 2006, in asset prices in the stock market. However, the decline in share prices in the spring was only short-lived, and 2006 turned out to be a better securities market year than expected. The continued favourable economic developments and strong corporate profitability boosted share prices and turnover on the stock exchange. The turnover of listed shares was about 30% higher than in 2005.

The housing loan market continued to grow

Credit demand continued strong throughout 2006, albeit somewhat weaker than in 2005. For many years, the stock of outstanding housing loans has grown a very rapid pace, since low-cost loans and longer maturity periods have spurred households to active house exchange. At the same time, however, prices have been rising. The benefits of low interest rates and longer maturity periods have been directly transmitted to house prices.

The rate of increase in the average square metre price of old flats started to decline in the latter part of 2006. Longer selling periods and fewer house purchases also bear witness of a slowdown in the housing market compared to the record rate of 2005.

Unemployment and rising interest rates pose risks to indebted households

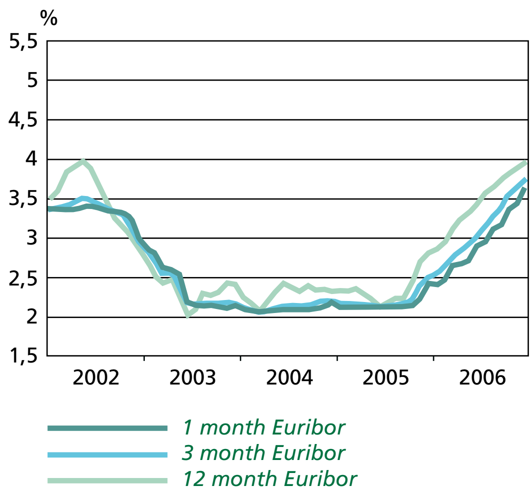
By the end of 2006, the average debt of a household had risen to 96% of annual disposable income. In addition to low lending rates and narrower lending margins, longer maturity periods have contributed to the growth of household debt. According to the Finnish Bankers' Association report *Saving and the use of credit* released in April 2006, the average maturity period of a new housing loan had risen from 11 to 17 years in two years. It is likely that a proportion of households already are overindebted, but according to Statistics Finland's consumer confidence indicator households' house purchase propensity and confidence in their own finances on the whole still remained strong in the latter part of the year.

The effects of large housing loans and rising lending rates on the solvency of households with outstanding debt will only show in the long term. For individual households, the major risk related to indebtedness is that of a decline in earnings, for example due to unemployment. Different to many other euro countries, most of the lending stock in Finland is comprised of floating-rate loans, and hence borrowers carry the risk arising from interest rate changes.

Tight competition in loan markets

The competition in loan markets became even tighter in 2006. Lending rate margins, especially those on housing loans narrowed. A survey of

Euribor rates, monthly



Source: Reuters.

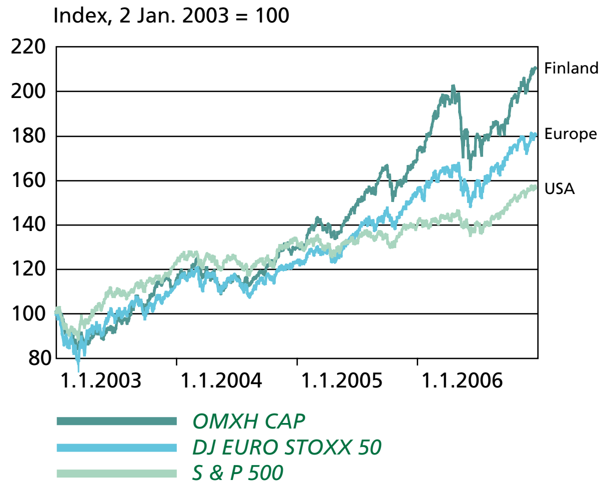
management of liquidity risk carried out by the Financial Supervision Authority (FIN-FSA) indicated not only that lending rate margins had narrowed but that the dispersion of lending rate margins between different banks had also diminished. According to the FIN-FSA's observations, banks rarely price household credit according to risk.

On the basis of the same survey, the conclusion was drawn that competition had not affected margins on consumer credit, since they had not narrowed to any marked degree. On the whole, there are larger spreads on consumer credit than on housing loans, since part of consumer credit is granted against collateral and part as card loans without collateral.

Risks in financial markets are growing

In the short term, the most likely risk that Finnish banks may become exposed to is some external shock originating from the international financial markets. Owing to the solid basis of the Finnish economy, internal shocks are less likely to occur.

Stock indices



Sources: OMXH and Bloomberg.

Due to brisk economic growth, the banks' operating environment remains favourable. The risks attached to corporate loans have been kept under control. Thanks to high employment, households continue totally speaking to be well positioned financially and capable to service their debts. Since asset prices have remained high, collateral assets have not declined in value.

For a long time, the most probable and commonly known risks in the international financial markets have remained the same, and they are for example following:

- Increase in household sector indebtedness.
  Rising interest rates will impair the debt servicing ability of household most heavily in debt. This is a typical risk in many EU countries, including Finland. The loan losses of financiers will grow in the longer term, if the debt servicing ability of the household sector deteriorates.

- Decline in the equity ratio of the corporate sector.
  Rising interest rates will impair the debt servicing ability of the most heavily indebted companies. On the whole, the equity ratio of the Finnish corporate sector has remained high, but in some companies it has deteriorated due to large distributions of profits, repurchases of own shares and corporate acquisitions The loan losses of financiers will grow in the long term, if the debt servicing ability of corporate sector deteriorates if a recession occurs.

- Increase in banks' dependency of wholesale financial markets.
  Banks are, to an increasing degree, financing their vigorous lending growth through market-oriented funding. Thus, they are becoming more susceptible to liquidity risk, ie fluctuations in the price and availability of funding.

- Exceptionally low pricing of risk.
  If risk premia went up suddenly, asset prices would fall sharply. A tightening of liquidity would also affect speculative investment, and asset prices may start to fall if the supply of securities and other assets grows.

- Global imbalances originating from financial deficits.
  An uncontrolled correction of imbalances would bring about a credit and market risk spiral in the international markets. The situation in the United States has deteriorated as a result of which disturbances in the international financial markets could increase.

Even if the risks in financial markets remained unchanged, the situation would not be stable. Both financiers' and borrowers' sensitivity to disturbances in the financial markets has gradually increased. Some of the risks mentioned above could affect banking sector profitability in the longer term, while others could, if they materialised, even weaken the capital adequacy of banks. If changes in the financial markets or the business cycle are gradual, market participants will have time to adapt. Abrupt changes, on the other hand, would cause problems.

Profitability in the EU banking sector remains good

The profitability and capital adequacy of European banks have successively improved since 2003, and this trend continued unchanged in 2006. The rise in profitability can be ascribed to three common factors in the EU. Firstly, bank lending has grown vigorously due to low lending rates. Secondly, securities-related fee income has increased due to buoyant mutual fund and share trading. Thirdly, recognition of large loan impairments has been very modest. Also otherwise, the environment has been favourable for banking and financial operations. Rapid profitability growth in the banking sector has mainly been dampened by stiffer competition that has mainly been reflected in narrow lending margins. These EU trends are also clearly discernible in the performance of banks and banking groups operating in the Finnish market.

Due to the adoption of IFRS standards, it has become more difficult to compare 2004 and 2005 financial statements with each other. A number of EU countries have not yet switched over to IFRS data collection and some banks still prepare their financial statements according to national accounting provisions. In addition, the IFRS standards have in themselves contributed to a rapid growth of banks' balance sheets, since balance sheet items recognised at fair value have grown in line with market values.

EU banking sector capital adequacy remained strong, despite some deterioration

The overall capital adequacy ratio of EU banks amounted to about 11.5% on average and the Tier 1 capital adequacy ratio, which is calculated on the basis of core capital, to about 8%. The corresponding ratios for Finnish banks are markedly higher, albeit partly for structural reasons. These key capital adequacy ratios deteriorated further in 2005 as a result of rapid lending growth. This trend continued unchanged in 2006. The reasons for the decline were higher capital requirements due to the increase in lending and a few large corporate acquisitions. Despite the decline, the capital adequacy of the European banking sector remained very high, clearly exceeding the minimum requirements set by authorities.

Favourable outlook for the EU banking sector

In general, the near-term outlook for the euro area banking sector is favourable. The banking sector's financial performance is very good and risk-bearing capacity strong on average. However, the positive outlook is clouded by a number of threats which, if they materialised, could lead to a weaker performance. The long-lasting low level of interest rates may have tempted banks to large risk-taking in order to attain higher yields. The main risks in euro area banking and financial operations continue to be those attached to global economic trends and sudden market correction of any imbalances.

One possible risk factor could involve vulnerability to new types of not readily measurable risks in financial markets, such as risks transmitted through hedge funds. Different risk-transfer instruments and potential transfer of risk from the banking sector to other sectors and vice versa may give rise to complicated and indefinable risk concentrations.

Restructuring in the Finnish banking sector follows the Europe-wide trend

Over the years, the European banking sector has been marked by a stronger integration, internationalisation, a reduction in the number of banks and expansion to areas outside core banking functions. The same trends are also discernible in Finland.

In addition to the major EU trends, the Finnish banking sector also shares many of the features typical of the other Nordic countries. In all the Nordic countries, markets are highly concentrated and dominated by a few large financial conglomerates. The largest Nordic banks operate in nearly all Nordic countries. By contrast, non-EU banks play a very modest role in the Nordic markets.

Continued restructuring in the Finnish banking sector

The Finnish financial markets have undergone major structural changes. In 2006 most of structural arrangements were made between banks and insurance companies. The OP Bank Group reorganised the companies within its financial conglomerate during 2006. This was due to the OP Bank Group's acquisition of the Pohjola Insurance Group in 2005. The Savings Bank Group and The Local Insurance Group announced that they planned to establish a jointly-owned life insurance company and join their efforts in other business areas as well. In addition, Aktia Savings Bank announced that it intended to acquire the entire shareholding in Veritas Life Insurance Company.

The Sampo Group's decision to sell Sampo Bank to Danske Bank means that one domestic financial and insurance conglomerate will leave the Finnish financial market while subsidiaries of foreign credit institutions will strengthen their position in the Finnish market. When the deal is finalised, the Nordic banking groups will have an even larger share in the Finnish market.

By means of ownership arrangements, banks have continued to extend their operations also to areas outside their core functions. Aktia Savings Bank has, for example, set up house agent business in many local areas. Opposite trends – interest in banking by non-banking firms – have also been discernible. An increase in joint retail and banking activities has also been observed. The furthest step in this direction was taken by the SOK Group (a big Finnish cooperative with retail operations) in founding a bank, the S Bank, in 2006.

As elsewhere in Europe, the number of banks has dwindled slightly also in Finland. Owing to tighter competition and market conditions, two mergers were finalised within the OP Bank Group in 2006. The cooperative banks of Eurajoki, Kankaanpää, the Rauma Region and the Pori Region merged and became Länsi-Suomen Osuuspankki (the Western Finland Cooperative Bank). In addition, the cooperative banks of Loimaa and the Loimaa Area merged.

Banks have become increasingly international and have extended their activities across the borders. In 2006 the expansion was focused on Russia. OKO Corporate Finance expanded to Russia and opened a customer service point in St. Petersburg. Sampo Bank, on the other hand, acquired the Profibank in St. Petersburg. Nordea Bank Finland disposed of its minority holding in International Bank of Moscow, and sold the holding to a UniCredit subsidiary. About the same time, the parent company Nordea Bank AB acquired a 75.01% holding in the Russian JSB Orgresbank. By virtue of this deal, which is likely to be finalised in the first quarter of 2007, the Nordea Group will continue its operations in Russia.

Intensified IT and payment systems cooperation

Banks have intensified their interbank cooperation in many different areas. Competitor cooperation deepened around a banking technology project when Aktia Savings Bank and the local savings banks sold shareholdings in Samlink, a company that develops IT systems for banks, to Handelsbanken and the local cooperative banks. Handelsbanken also decided to order Samlink's local banking service application. Sampo Bank and Nordea Bank, on their part, are setting up a joint ATM network in the Baltic region.

The banking sector's preparations for the Single European Payments Area (SEPA) are well under way. Gradually from 2008 onwards, all funds transfer, direct debit and card services will be harmonised while all national card schemes will be abandoned. Tapiola Bank and the Bank of Åland intend to establish a joint card company for the management of debit card, credit cards and card credits. The OP Group, on the other hand, has entered an agreement on payment transfer cooperation with a German service supplier. The purpose of joining their forces is to gain economies of scale.

Operations in 2006

Prudential supervision

Prudential supervision focuses on analysing supervised entities' development, risk-bearing capacity and corporate governance and the evolution of their economic and competitive environment. Adverse developments are encountered through adoption of a forward-looking approach. The aim is to ensure that institutions acting in financial markets remain sufficiently capable of providing financial services and meeting their engagements to customers under all circumstances. From the viewpoint of market efficiency, it is important for the supervisor to ensure that the consequences of bankruptcies remain under control rather than seek to prevent all bankruptcies. The main focus of supervision is on supervised entities and systems that are the most important ones from the perspective of financial stability. The Financial Supervision Authority (FIN-FSA) regularly publishes key details of supervised entities' financial standing and risks in financial markets.

In 2006 prudential supervision contributed to the pursuance of the FIN-FSA's strategic goals as follows:

The risk-bearing capacity of supervised entities must be adequate.

- Supervised entities' risk-taking, profitability and capital adequacy are monitored through continued reporting and their financial condition is analysed on a regular basis. A closer analysis of supervised entities' risk exposures and the levels of their internal controls and risk management procedures is undertaken in inspections. Inspections of credit risk exposures and risk management were increased in 2006, with an emphasis on long-term risks arising from rapid lending growth.

- Introduction of the new Basel II capital adequacy framework was fostered through organisation of information meetings for supervised entities and through publication of FIN-FSA draft standards on capital adequacy to supervised entities. Supervisory visits ensured that completion of supervised entities' internal capital adequacy assessment processes and reporting was on schedule. Approval of supervised entities' internal models and revision of reporting required a considerable resource input from the FIN-FSA.

- The risk-bearing capacity of supervised entities was generally strong in 2006. According to inspections, however, tight competition for customers has led to more relaxed lending practices and higher risks. Some deficiencies were also identified in risk management. Total risk exposures of multinational financial conglomerates did not threaten the stability of Finnish financial markets. Development of supervised entities' internal capital adequacy assessment processes progressed favourably so that Basel II requirements are likely to be mostly met well.

Supervised entities must have reliable corporate governance.

- The criteria concerning corporate governance are included in the relevant FIN-FSA standard. The aim is to enforce the standard in 2007 upon completion of discussions with representatives from the financial industry.

- The fitness and propriety of owners and management are assessed on the basis of applications for authorisation and supervised entities' notifications submitted to the FIN-FSA. The FIN-FSA's new standard on the fit and proper assessment of managers and persons in charge of key business areas is scheduled to come into force in the first part of 2007. The FIN-FSA reckons supervised entities' corporate governance procedures to be generally good, despite some shortcomings.

Timely information must be disclosed on the financial standing of supervised entities and risks related to financial products and market operations.

- During the year under review, the FIN-FSA published regular analyses of supervised entities' financial standing and risks. Information was also provided on risks related to housing loans and consumer credits and on how customers could prepare for interest rate risks. The results of a FIN-FSA survey of developments in interest rate margins and banks' liquidity risks were released in October 2006.

- Publication of information and analyses contributed to ensuring that supervised entities and their customers have access to timely and adequate information on the state of the financial sector.

- The number of published analyses grew in 2006. Participation of FIN-FSA representatives in public debate on topical issues increased, thereby supporting the effectiveness of published information. There is however a need for provision of more information on financial services and assessment of their risks that would benefit customers of supervised entities.

NEAR-TERM PRIORITIES

The main focus of inspections will be on high-risk supervised entities and operations. Upon completion in early 2007 of the capital adequacy reform, inspections will be increased. They will underscore credit and operational risks as well as risk management.

The Supervisory Review and Evaluation Process (SREP) will be applied as from 2007 to review and evaluate capital adequacy and internal capital adequacy assessment processes in respect of those supervised entities that are subject to the new Basel II capital adequacy framework. The FIN-FSA will publish its own description of these processes in the first part of 2007. The conduct of SREP assessments will require a substantial input of prudential supervision resources.

The introduction in 2007 of the, common reporting framework for the solvency ratio (COREP) under BASEL II and the finalisation of the FIN-FSA's own review processes to enable supervision under Basel II will continue to require a significant deployment of resources.

Close cooperation with other supervisory authorities is indispensable in order to ensure effective overall supervision of significant financial conglomerates and cross-border banking groups operating in Finnish markets. Such cooperative action contributes to safeguarding the stability of Finnish financial markets and the development of crisis management arrangements. In the area of prudential supervision, the FIN-FSA works together with the Bank of Finland, the Insurance Supervision Authority and Nordic and Baltic supervisory authorities. Development of Nordic-Baltic cooperation is an increasingly important area of priority now that Danske Bank acquired the ownership of Sampo Bank.

At EU level, the FIN-FSA participates in the work of the Committee of European Banking Supervisors (CEBS) and the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB). The FIN-FSA seeks to actively work towards the establishment of an effective European supervisory system for cross-border conglomerates that would also take account of the host-country supervisor's requirements for safeguarding the stability of local financial markets. Priority in the international context is given to supervisory cooperation with Nordic and Baltic supervisory authorities. Looking ahead, this work will be deepened further through the supervision of a number of banking groups. Within CEBS, the FIN-FSA participates in working groups that are the most important ones for the supervision of Finnish financial markets.

SUPERVISION AND INSPECTIONS IN 2006

The number of inspections increased over the previous year. Inspections of credit risk in particular were more frequent. Owing to the Basel II capital adequacy reform, effective since the beginning of 2007, supervision focused on analysing supervised entities' readiness to adopt the Basel II framework. The emphasis of supervisory visits and inspections was therefore on advanced models for the calculation of capital adequacy and on clarifying how supervised entities develop their own risk assessment processes and methods to determine their capital needs.

A more risk-sensitive approach to supervision

Supervised entities were assessed using the Supervisory Review and Evaluation Process (SREP) and applying Basel II requirements as extensively as possible. Comprehensive assessments were made of each of seven supervised entities (financial and insurance conglomerates and banking groups), consisting of reviews of supervised entities' financial standing, risks, internal control and risk management and evaluations of capital adequacy.

More concise assessments were undertaken in respect of investment firms, savings banks and local co-operative banks, mainly on the basis of information reported to the FIN-FSA by supervised entities themselves. The results of these assessments and requests to take the necessary action were dealt with at meetings between supervised entities at management level and the FIN-FSA.

Supervised entities were encouraged to improve their internal control and risk management arrangements

The FIN-FSA inspected the internal control and risk management systems of a number of supervised entities. The inspections revealed that some supervised entities had not adequately segregated risk control functions from business operations. Shortcomings were also identified in supervised entities' internal risk management guidelines and risk reporting to the board. Lending processes did not always foresee a clear segregation of duties between credit proposal and credit decision, which could entail a possibility of more relaxed controls on credit decisions and a deteriorating quality of the credit portfolio. Supervised entities were requested to remedy the situation, and FIN-FSA will monitor corrective action.

Supervised entities were reminded of risk management in tight competition for credit

Credit risk inspections were targeted in particular at banks' housing loans and other household credit. The inspections revealed that banks, confronted with tight competition, were inclined to bend their internal pricing rules. Credit was granted at narrower margins than recommended, customers' leeway after deduction of debt-servicing expenses from regular income remained lower than considered advisable in internal guidelines, analyses of customers' payment capacity were more relaxed and collateral requirements less stringent.

Banks were reminded of their ongoing obligation to always comply with the requirements laid down in the FIN-FSA's standard on credit risk management. At the same time, long-term risks arising from narrow margins were brought to banks' attention. Banks were urged to prepare for cyclical fluctuations in their risk controls, as also required in the Basel II capital adequacy framework. Attention was also focused on good banking practice, under which customers' excessive indebtedness should not be fostered through strong credit marketing.

Introduction of increasingly risk based approaches for capital calculation poses challenges

In accordance with the Basel II capital adequacy framework, effective from the beginning of 2007, supervised entities may apply either standardised or more advanced methods for the calculation of their Pillar 1 capital requirements. Advanced methods may be used for the calculation of capital requirements for credit risk, operational risk and market risk. Application of advanced methods is subject to decision from the FIN-FSA.

In 2006 the FIN-FSA continued inspections at two banking groups for approval of advanced methods for credit risk (Internal Ratings Based Approach, IRBA). Approval of IRBA models of banks with operations in a number of EU countries requires cooperation between the relevant supervisory authorities. In 2007 such approval inspections will also be made at other banking groups.

Banks were found to upgrade their assessment methods for credit risk in order to be able to gradually change over to more advanced and risk-sensitive approaches in their calculations of capital requirements. But the introduction of IRBA models still poses challenges. These include collection of data over a sufficiently long period, experience in using models, assessment of loan losses related to economic downturns and preparation for exceptional losses ie stress testing. The FIN-FSA has impressed on supervised entities that internal capital adequacy assessment processes based on the use of advanced models need to provide adequate safeguards in the event of a recession or crisis situation. In 2006 supervised entities were already required to develop stress testing for the assessment of effects arising from crisis situations and for crisis preparation. The FIN-FSA will issue further guidelines on the matter in the early part of 2007.

Improvements in supervised entities' own risk based capital assessments

Under the new capital adequacy framework, the minimum requirement for capital is the 'Pillar 1 requirement'. Capital adequacy under Pillar 2 is, in turn, based on supervised entities' own assessments of, and views on, their risks. Pillar 2 capital requirements cover risks other than those covered by Pillar 1 capital. According to the new capital adequacy framework, a supervised entity must have in place methods and procedures that enable it to determine the capital requirement under Pillar 2 and to assess its overall capital adequacy. This assessment is referred to as Internal Capital Adequacy Assessment Process (ICAAP).

During its supervisory visits in 2006, the FIN-FSA examined how supervised entities had developed their risk-sensitive assessments of capital requirements. The findings suggested that supervised entities' ability to assess their risks and capital needs would be largely in compliance with the Basel requirements by early 2007. Even so, a number of details in capital assessments, such as measurement of, and stress testing for, interest rate and concentration risks and sufficient preparation for cyclical fluctuations, continue to require further development. The FIN-FSA has already proposed some measures for development at its meetings with supervised entities at management level.

Management of market and liquidity risks mainly adequate

Supervision of market risks comprises control of interest rate, exchange rate, equity and real estate risks. Market risks were held well under control in 2006. Single, alarming risks identified on the basis of reporting by supervised entities were addressed during supervisory visits. Management of market risks by some supervised entities revealed shortcomings related to risk management processes and risk monitoring. The FIN-FSA required rectification of detected insufficiencies.

Banks' liquidity risk management and preparation for long-term and short-term financial risks were analysed through a survey conducted in 2006. According to the survey, organisation of liquidity risk management and mitigation of liquidity risks were mainly in order at banks. In contrast, not all banks had adequate continuity planning in place for liquidity crises. Nor had the plans been tested in all respects. The FIN-FSA requires, when reviewing supervised entities' internal capital adequacy assessment processes in 2007, that they have continuity plans in place for management of liquidity crises.

Management of operational risks more systematic

In connection with its supervisory visits in 2006, the FIN-FSA evaluated how supervised entities had developed their methods for monitoring and management of operational risks. According to observations made, supervised entities had increased their assessments of risks related to operational processes, information systems, outsourcing of operations, external threats and personnel. Based on self-assessment, supervised entities have also developed tools for mitigation of risks; however, there are no means for entirely abolishing operational risks of banks and investment firms. Financial losses arising from realisation of operational risks are registered more systematically than earlier. Supervised entities mainly have in place systematic approaches to calculate the amount of capital required to cover operational risks in line with the new regulatory framework, from the beginning of 2007.

PROFITABILITY, CAPITAL ADEQUACY AND RISKS OF SUPERVISED ENTITIES IN 2006

Bank profitability improved clearly in 2006. Income made excellent progress, and no impairment losses had been recorded on credits by the end of September. Banks' cost-efficiency and profitability thus emerged markedly better in 2006 than in 2004 and 2005.

The near-term outlook for developments in interest rates and the operational environment appears stable. In a European comparison, on average, Finnish banks are very solid, with good risk-bearing capacity. Narrow margins in housing loans and rapid loan stock growth have however increased risks. Over the longer-term, the greatest threat to bank profitability would come from rises in interest rates over extended periods and a deteriorating operational environment, leading to reduced repayment capacities of bank customers with loan commitments. A weakening in the economic environment would also erode income accrued to supervised entities from household investment.

Higher interest rates and stronger demand for consumer credit increased net interest income

Higher interest rates in the latter part of 2006 in particular increased banks' net interest income. Growth in net interest income strengthened, as average funding costs did not rise as rapidly as did lending rates. Developments were weaker in securities-related fee income and in net income from banks' own investments. Overall, interest rates had a positive impact on bank results.

The rise in interest rates increased mortgage holders' debt-servicing costs, but did not lead to significant payment difficulties that would have added to banks' loan losses. Net interest income growth was also boosted by stronger growth in the stock of consumer credit. In the latter part of the year, the stock of consumer credit expanded almost as rapidly as the housing loan stock.

Growth in fee income continued, albeit decelerating in the second half of the year

As in a couple of earlier years, fee income growth in 2006 was faster than that of net interest income. The highest growth rates continued to be recorded for securities-related fee income. Besides mutual funds' subscription, management and redemption fees, fee income from asset management and securities intermediation improved, in line with ongoing household wealth growth and the continuation of good stock market sentiment that had already been prevailing for years.

Growth in securities-related fee income accelerated so as to reach very high levels in early 2006, but started to decelerate in the second half of the year. This was due to reduced trading activity among customers and an increasing popularity of fixed-term deposits and money market funds, at the expense of investment in equity and equity funds.

Factors explaining the move towards lower-risk savings are higher interest rates and fears of a stock market downturn. On the other hand, it appeared that banks would be increasingly turning to depositors for funding and raising interest rates on fixed-term deposits more rapidly than interest rates generally rise.

More recoveries of impairment losses than entries of new loan losses

The quality of banks' credit portfolios remained good in 2006, albeit deteriorating towards the end of the year. The strong loan stock growth that had persisted for years continued. Impairment losses were recorded on a limited scale. The majority of banks registered more recoveries of impairment losses and reversals of provisions than new losses, which led to a net effect that improved results.

Non-performing assets continued to remain generally at low levels. However, banks' impairment losses and non-performing assets in gross terms started to increase in the course of the year, which possibly anticipates a turn for the worse. There was also an increase in banks' overdue assets in 2006. During its inspections, the FIN-FSA found that tight competition for housing loans had loosened credit granting criteria.

Management of structural funding risks becoming increasingly important for banks

As lending still expanded clearly more rapidly than did the stock of deposits in 2006, banks had to continue to increase the share of funding raised on market terms. Particularly funding of housing loans through mortgage-backed securities issued by mortgage banks gained widespread use.

The change from deposits to market-based funding exposed banks increasingly to structural financial risks. Banks are more sensitive to fluctuations in the cost of funds and access to funding sources. In the near future, only moderate changes are expected to occur in the cost and availability of funding.

For the majority of banks, ongoing increases in market rates would have an upward impact on net interest income, while simultaneously causing losses in the trading book. Taken as a whole, however, moderately rising interest rates would boost bank results.

Banks reduced their own equity holdings

During the year under review, banks reduced their exposure to equity risk by scaling down their equity holdings. Financial conglomerates with insurance operations and banks specialised in asset management have the largest equity holdings relative to own funds. Other banks do not have significant equity holdings.

Exchange rate risk relative to banks' own funds is small on the whole. Open positions are held for the most part in Nordic currencies. A possible depreciation of the US dollar would not entail substantial problems to the banking sector.

Of banks' direct real estate holdings, one half is held for own use and the other half for investment purposes. Real estate held for investment purposes relative to banks' own funds is very small.

Banks' loss buffers resilient to even major shocks in the economy

The Finnish banking sector's capital adequacy continued to be strong at the end of 2006. Overall, the quality of own funds was good, with the bulk of own funds classifiable as original own funds (Tier 1 capital). Continued credit risk growth and ongoing deterioration in credit portfolio quality would, however, amplify the effects of economic shocks. Towards the end of 2006, there were some signs of a weakening in the quality of credit portfolios.

According to stress tests conducted in concert by the FIN-FSA, the Bank of Finland, and the Insurance Supervision Authority for 2006–2008, banking groups' profitability would decline, but capital adequacy would not be jeopardised if the stress scenario materialised. In the scenario, household confidence would weaken, leading to lower consumption. Export demand would also collapse. The implications of these shocks would be reflected in lower GDP levels and sharply falling share and real estate prices. Increasing loan losses and weakening asset valuations would have an impact on banks' profitability and capital adequacy.

Banks' risk-bearing capacity in 2006 was fairly good in relation to risks taken by banks. It was strengthened by good profit performance and the small amount of loan losses. Banks also continued to upgrade their risk assessment methods and capital management processes. Evaluations undertaken by the FIN-FSA identified a need for banks – in order to ensure their long-term risk-bearing capacity – to proceed with sufficient prudence in assessing their own capital adequacy and setting objectives for their capital levels when they start to operate in compliance with the Basel II requirements.

Investment firms enjoyed a good year

Investment firms' good earnings performance continued in 2006. Share trading was brisk, and turnover grew over the previous year. Demand for asset management services also remained buoyant, even if growth contracted slightly from the previous year.

Demand for investment services was strong throughout the year. Assets managed also increased, although growth lagged behind the previous year's level. Growth continued to rest on increased investment in mutual fund units. Almost half of assets managed under asset management agreements were mutual fund assets.

Investment firms' fees from securities intermediation increased, while accounting for only about half of asset management income. Competition among securities intermediaries for market share was still tight, with remote brokers representing more than 60% of trading volumes. Investment firms' profitability and capital adequacy remained strong in 2006.

Good profitability for fund management companies

Fund management companies continued to reflect good profitability in 2006. Fund assets grew rapidly. Equity funds' asset position strengthened, reaching in September the level prevailing prior to the stock market correction in May. Bond funds registered the strongest increases in assets towards the end of the year.

COOPERATION WITH OTHER AUTHORITIES

Close cooperation with other supervisory authorities is indispensable to ensure effective supervision of financial and insurance conglomerates and supranational banking groups. In the area of prudential supervision, the FIN-FSA cooperates with the Bank of Finland, the Insurance Supervision Authority and Nordic and Baltic authorities.

At EU level, the FIN-FSA participates in the work of the Committee of European Banking Supervisors (CEBS) and the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB). Priority in the international context is given to supervisory cooperation with Nordic and Baltic supervisory authorities. Within CEBS, the FIN-FSA participates in working groups that are the most important ones for the supervision of Finnish financial markets.

Supervision of financial and insurance conglomerates requires close cooperation

The FIN-FSA supervises credit institution activities and securities market operations conducted by financial and insurance conglomerates and their financial reporting, whereas the Insurance Supervision Authority supervises insurance sector activity. In addition, supervisory authorities issue a joint overall assessment of each financial and insurance conglomerate, analysing the functioning of the organisation, the adequacy of internal controls and the transparency of the conglomerate's structures from a supervisory point of view. Assessments are also undertaken in respect of the size and management of the conglomerate's main risks, its profitability and capital adequacy. The capital adequacy of financial and insurance conglomerates was reckoned to be strong and their risk management at adequate levels in 2006. Risk concentrations or internal business transactions did not pose threats to conglomerates' profitability or capital adequacy.

In addition to the Insurance Supervision Authority, Swedish, Norwegian and Baltic supervisors took part in supervisory cooperation coordinated by the FIN-FSA for the supervision of the Sampo Group. The FIN-FSA and the Insurance Supervision Authority have also worked together in the supervision of the OP Bank Group after the Pohjola insurance company passed into the ownership of OKO Bank.

Towards the end of 2006, Aktia Savings Bank announced its acquisition of Veritas, a life insurance company. Following the purchase, the Aktia Savings Bank Group will become a financial and insurance conglomerate primarily engaged in financial activities, for which additional supervision will be coordinated by the FIN-FSA.

Nordic and Baltic cooperation focused on supervision of Nordea and Sampo Bank

Supervision groups established individually for each supervised entity and convening 3–5 times a year constitute the hub of cooperation between Nordic and Baltic supervisors. The FIN-FSA supervises the Nordea Bank Finland Group and participates in the Nordea Group's overall supervision, which is coordinated by the Swedish supervisor. Supervision is planned in a joint Nordic supervision group. Supervisors jointly prepare an overall assessment of the Nordea Group, annually.

Supervision of the Sampo Group was coordinated by the FIN-FSA in 2006. The supervision group also included the Insurance Supervision Authority and the Swedish and Norwegian supervisors. At the end of 2006, the Sampo Group announced the sale of Sampo Bank to the Danish Danske Bank. The FIN-FSA's responsibility for supervisory coordination will end following materialisation of the deal. However, the FIN-FSA continues to supervise Sampo Bank. Discussions on cooperation in the supervision of the Danske Bank Group were started with the Danish supervisor. Nordic supervisors also cooperate in the supervision of other banking groups operating in several Nordic countries. Regular exchange of information on changes and development trends in Nordic financial markets provides the basis for supervisory planning.

Financial markets analysed together with the Bank of Finland

The FIN-FSA cooperates with the Bank of Finland in assessing the status, future trends and risks of the financial sector. In 2006 cooperation was also exercised in the oversight of payment systems. Another area of cooperative action is the development of capabilities for the management of financial market crises. The Bank of Finland and the FIN-FSA signed a Memorandum of Understanding (MoU) for financial crisis situations in March 2006.

The FIN-FSA and the Bank of Finland are together mandated to represent Finland in the Committee of European Banking Supervisors (CEBS) and the Banking Supervision Committee (BSC) of the European System of Central Banks. The views that Finland will take up are also prepared in concert with the Bank of Finland. Revision of the Eurosystem's monetary policy instruments from the beginning of 2007 will increase information exchange between supervisory authorities and central banks, as bank loans for the corporate sector that meet certain criteria become eligible collateral for central bank financing.

Representatives from the FIN-FSA and the Ministry of Finance meet regularly to consider together topical issues related to financial market regulation and supervision and ongoing EU-level projects. Such cooperation promotes the coordination of views taken by Finland at EU-level and the preparation of national regulation.

Work by the Committee of European Banking Supervisors focuses on convergence of supervisory practices

The Committee of European Banking Supervisors (CEBS) works towards harmonising EU-wide banking supervision, and for that purpose it monitors the implementation of directives across countries, publishes guidelines for supervisors and develops supervisory practices, cooperation and information exchange. Owing to its scarce resources, in 2006, the FIN-FSA attended only such CEBS working groups and projects that were perceived as being the most important ones for Finland. The most significant permanent working group is Groupe de Contact, which promotes especially the application of guidelines on supervisory review under Pillar 2 and cross-border cooperation between supervisors.

In 2006 CEBS published guidelines on the supervisory review process related to the Basel II capital adequacy framework for application by supervisors and supervised entities. The FIN-FSA made a contribution to the development of supervisory cooperation by introducing the Nordic supervisory college model for consideration within CEBS. The FIN-FSA also contributed to guidance on the Supervisory Review and Evaluation Process (SREP) by submitting its own proposal for the content of the process to the preparatory working group for perusal.

In July 2006 CEBS published a report on the impact of the Basel II framework. The FIN-FSA was responsible for Finland's contribution to the impact study, based on 2005 data. A FIN-FSA representative took part in the steering group of the impact study, jointly set up by CEBS and the Basel Committee on Banking Supervision, which directed the issuance of an EU-level final report and recommendations for measures to be taken. On the basis of the study, analyses of the procyclicality of the Basel II capital reform and long-term capital adequacy will be started in 2007.

CEBS issued guidelines on a common framework for supervisory disclosure to supervisors concerning requirements for the content of published information and information systems used in supervisory review. The FIN-FSA participated in the elaboration of the framework. The common EU-wide framework ensures better comparability of information and provision of information to supervised entities on the implementation of prudential supervision. The bulk of the information to be disclosed under the common framework is already public in Finland. Information on prudential supervision and regulation in Finland has been available on the FIN-FSA website since the beginning of 2007.

Financial market stability as the focus of attention of Banking Supervision Committee

The Banking Supervision Committee (BSC) of the European System of Central Banks dealt with issues concerning the stability of the European financial system. The FIN-FSA participated in the work of the BSC and its working groups together with the Bank of Finland. One of the working groups examined structural developments, eg the effects of demographic ageing on banking and banks' procedures in liquidity risk management. Another working group, the Working Group on Macroprudential Analysis, prepared a stability report on the EU banking sector and contributed to the ECB's biannual Financial Stability Review with commentaries on the banking sector. The FIN-FSA delivers the necessary statistical data for the reports to the ECB and prepares country-specific overviews together with the Bank of Finland. The FIN-FSA makes use of the analyses undertaken by the Banking Supervision Committee when assessing the status of the Finnish financial sector.

DISCLOSURE OF FINANCIAL MARKET INFORMATION

The FIN-FSA seeks to increase public awareness of financial markets, supervised entities' financial standing and risks. Published information and analyses increased in 2006 from the previous year. Analyses of supervised entities' financial standing and risks were released twice in 2006.

FIN-FSA representatives took active part in public debate on lending growth and risks taken by households. In support of households' borrowing decisions, the FIN-FSA's website provided information on comparisons concerning interest-rate risks related to various types of loans and on how to hedge against rises in interest rates. On the basis of feedback received, the FIN-FSA considers it necessary to publish still more information that customers may use as a basis for their own decisions when discussing with providers of financial services.

The results of a survey of developments in banks' interest rate margins and liquidity risks were published in October 2006. The implications of the Basel II capital framework for banks and their customers were reported in the FIN-FSA's online publication, The FSA Newsline. The articles covered issues such as the impact of the reform on credit pricing and interest rate margins.

Market participants were also provided with overall information on new approaches to financial market supervision and supervisory cooperation within the EU. The FSA Newsline included commentaries on the effects of the Basel II capital framework on banks' risks and risk management procedures. Information on cooperation between the FIN-FSA and other Nordic and EU banking supervisors was also provided in the FSA Newsline.

DEVELOPMENT OF PRUDENTIAL SUPERVISION

Prudential supervision was developed with the aim of ensuring that supervisory processes, information systems, organisation of functions and supervisory tools enable supervision in compliance with the Basel II framework. Another important development project was the supervision of financial and insurance conglomerates in concert with the Insurance Supervision Authority. The need for special expertise was emphasised in both recruitment of new employees and training for prudential supervision.

Supervisory Review and Evaluation Process developed further

Under the Basel II requirements, supervised entities must have in place methods for assessing their own capital adequacy. The FIN-FSA examines supervised entities' internal capital adequacy assessment processes using the Supervisory Review and Evaluation Process (SREP). The FIN-FSA developed its KAR risk assessment system into a tool qualified for use in the SREP by adding SREP elements to the KAR system. Development of the system continues on the basis of experience gained.

The functioning of the FIN-FSA's prudential supervision organisation was tested in the implementation of the new SREP framework. The SREP was more closely integrated into the annual planning of inspections. In order to ensure the reliability of individual assessments of supervised entities, prudential supervision was supplemented with internal quality assurance and the elaboration of peer group analyses was started.

In the course of 2006 the Savings Bank Inspectorate, operating under the guidance of the FIN-FSA, developed and tested internal capital adequacy assessment processes of banks it supervises. The FIN-FSA also elaborated a capital assessment process that is based on self-assessment by supervised entities and applicable to investment firms, for example.

Enhanced supervision of financial and insurance conglomerates

The FIN-FSA and the Insurance Supervision Authority implemented in 2006 a joint project examining the development of not only supervision but also regulation and reporting of financial and insurance conglomerates. There is a need to harmonise guidance on the calculation of capital requirements for conglomerates. The aim is to clarify whether current reporting includes dead spaces jeopardising supervision. The project is expected to generate proposals in early 2007 that will enable improvements in supervision at conglomerate level.

Special supervisory expertise was strengthened

Supervisory reform requires that staff possess in-depth knowledge of core prudential principles of the revised capital adequacy framework. These include the Supervisory Review and Evaluation Process, Internal Ratings Based Approaches for the calculation of capital requirements and economic capital models used by supervised entities to determine their Pillar 2 capital levels. In 2006 prudential supervision experts upgraded their skills in advanced risk management methods by attending relevant training sessions and making use of exchange of information and experience within the Committee of European Banking Supervisors.

Market supervision

Market supervision encompasses supervision of conduct of business, marketplaces and systems, and monitoring of compliance with financial reporting requirements. Supervision focuses eg on market practices, issuers' disclosure requirements and securities market infrastructure. In addition, investigation concerns suspected abuse of insider information and other securities market offences. The monitoring of compliance with financial reporting standards focuses on financial reports published by issuers, such as financial statements and interim reports.

Market supervision was steered in 2006 by the following strategic objectives.

Published information supports the healthy development of markets.

- A large proportion of extensive regulation initiatives concerning listed companies were completed both in the EU and domestically. Regulation in relation to the disclosure obligation of listed companies is harmonised to quite a large extent.

- The Financial Supervision Authority made surveys in 2006 regarding investor information published by domestic listed companies. The surveys concerned the provision of profit forecasts referred to in the Securities Markets Act and the level of quality of the first IFRS financial statements. According to the IFRS survey, listed companies' IFRS financial statements still have room for improvement. The level of quality of financial statements for 2005 showed variation: there were appropriate reports but also many weak financial statements. According to the survey on profit forecasts, companies' profit forecasts had improved.

- The FIN-FSA provided households with information on the operation of the financial markets and the different characteristics of products and services offered in the markets for example on its website and the FSA Newsline web publication.

Market practices are appropriate.

- Market practices were mainly appropriate in 2006, although there were individual irregularities.

- Supervisors in the EU countries engaged in cooperation to ensure that regulation is interpreted, followed and supervised as uniformly as possible.

- Functional financial markets also require that market practices are sound. Comprehensive regulation paves way for harmonised practices. Regulation on market abuse, such as abuse of insider information and price manipulation that entered into force in 2005 has indeed clarified market practices in the EU area.

- The FIN-FSA informed supervised entities on the meaning of regulatory changes in information events and by providing practical guidance.

OPERATIVE FOCUS AREAS IN THE FUTURE

Market supervision focuses on supervising that investor and customer information is, to the highest degree possible, of high quality, sufficient, timely and clear in the developing market environment. The FIN-FSA also publishes surveys in the quality of investor information.

The aim is also to ensure that the financial market infrastructure works in a reliable manner. The FIN-FSA, among other things, supervises that the administration of participants is reliable and their data security is sufficient. This is highlighted particularly in cross-border activities.

The supervision of investment services concentrates on the protection of customer funds and implementation of the Directive on Markets in Financial Instruments (MiFID).

COOPERATION WITH OTHER AUTHORITIES IN THE FIELD OF SUPERVISION

Progress with respect to the EU's internal market has increased the need for cooperation between authorities. In order for the internal market to function properly, interpretation of regulation should be as uniform as possible and benefit both service providers and users.

Cooperation with supervisor colleagues concentrates on the Committee of European Securities Regulators (CESR). Its work was previously focused on regulation – particularly the drafting of proposals to the European Commission – and currently more and more on practical supervision. This is shown in the investigation of the application if IFRS financial statements norms and market abuse but also in the supervision of securities prospectuses and mutual funds.

The investigation of market abuse includes cooperation, in addition to other supervisors, with the police and prosecutors. Another goal is that national borders would not pose an obstacle to effective inspection of market abuse.

SUPERVISION OF MARKET PRACTICES

Supervision of investment services

The FIN-FSA aims to ensure that provisions on the organisation or supervised entities and on practices are followed upon issuing authorizations and also in continuous supervision. Due to the structural reorganisation typical to the industry and the establishment of new agents, the FIN-FSA received many new applications for authorizations in 2006. These were made amid changes in corporate structures related to eg improvement of operative efficiency or ensuring the commitment of key personnel. New agents were mostly established in asset management and corporate finance services.

In the supervision of brokerage and asset management, the FIN-FSA has paid attention eg on the management of conflicts of interests, equal treatment of customers and activities that are in the customers' best interests. Securities brokerage has been largely concentrated on certain brokers seeking transaction volumes by offering online services or brokers specialising in more tailored and higher-margin brokerage service offering individual added value to the customer. In asset management, customer funds are increasingly invested in mutual funds.

FIN-FSA surveyed operational risk management by investment firms

The FIN-FSA standard on management of operational risks entered into force on 1 January 2005. Requirements set by the standard are important for investment firms whose primary risks are, due to the nature of their business, operational. Credit or market risks are generally insignificant. Supervised entities can apply the FIN-FSA Standard in the appropriate manner relative to their size and operations.

The FIN-FSA studied the primary operational risks of investment firms and the management of these risks with the survey and inspection visits in 2006. The survey comprised 44 questions and covered almost all 38 investment firms.

According to the survey, the primary operational risks are the following:

- information systems, their backup systems, information management and related resources
- sufficiency and expertise of personnel
- factors related to the organisation, such as the arrangement of operations, appropriateness and functionality of organisational structure
- susceptibility of processes to errors and the sufficiency of controls
- compliance with regulations on the provision investment services
- ensuring the continuity of operations
- reputation risks

Based on the responses and inspection observations, operational risk management by investment firms is satisfactory. There are variations across companies, but any generally significant problem areas were not detected.

The identification of significant risks was not comprehensive in the case of all respondents. There were shortcomings in the identification of risks related to eg payment traffic, observance of agreements and implementation of transactions. Contingency planning was not comprehensive enough in all respects.

Risk management related to investment operations inspected at mutual funds

An inspection of risk management concerning the investment operations of management companies was begun in autumn 2005 and continued in 2006. The inspections concentrated on how management companies identify, measure and assess risks related to their investment operations, and how the day-to-day management of risks in investment activities is organised.

The inspection revealed that the management company's individual role in risk management is sometimes minor particularly in cases were portfolio management is outsourced to an external money manager. There are shortcomings in the reporting between the management company and the money manager, as well as in the division of labour in risk management. According to the inspection, the use of derivatives in the investment operations of management companies is not as common and extensive as implied by the established rules of mutual funds. Management companies focusing on absolute return mutual funds and who use derivatives in a central role in their operations also use more advanced methods in the management of risk in investment operations. In some of the management companies, the management of risks in investment operations is automatic to a large extent.

Email and Internet surveys as tools of mutual fund supervision

The FIN-FSA has established email and Internet surveys as tools of supervision. In 2006, several surveys on topical issue were made posed to management companies. Management companies were surveyed on, for example, the amount of redemptions in emerging market funds, companies' preparedness for redemptions and the amount of cash assets maintained at the companies as well as their fee and reporting practices.

Some redemption peaks were observed in emerging market funds. In some cases, unit holders had been forced to wait for their money from redemption for a longer period than usual. Keeping in mind the special characteristics of these mutual fund target markets, management companies had generally prepared fairly well for redemptions. These funds have, for example, maintained higher cash assets than usual.

Mutual fund trends and supervisors' cooperation

In 2006, there were relatively many mergers of mutual funds. In connection with the merger of Pohjola Fund Management Company and OP Fund Management Company, 18 mutual funds merged. In addition, 10 other mutual fund mergers were made (10 in 2005).

Many new mutual funds were still founded. In 2006, the rules of 58 new mutual funds were approved (77 in 2005) and 227 changes to mutual fund rules (71 in 2005).

The number of capital-protected mutual funds and hedge funds continued to increase. In capital-protected mutual funds, the investor has been promised that the whole capital invested or a minimum percentage thereof is paid back entirely either on a specified data or during the whole investment period. The new hedge funds were increasingly funds of funds whose target funds were foreign hedge funds.

The FIN-FSA has increased cooperation particularly with the supervisors in other EU countries to handle the new mutual fund products. Cooperation has been helpful in assessing market practices and allowed investments. Together with supervisors from other countries, a common stance on interpretations has been sought, which would enable the development of the operation of the mutual fund markets.

Some changes in pricing of basic banking services

Surveys on the availability and pricing of basic banking services were made on 1 January 2006 and 3 July 2006. Although some changes had been made to the prices of the services, the FIN-FSA is under the impression that basic banking services are still available at reasonable prices, and there have been no problems in the availability of services. The prices for individual services may be considered high but there are more affordable alternative operating modes in these cases, too.

Special attention paid to pawnbroking

The FIN-FSA made inspection visits in autumn 2006 to almost all pawnshops. The purpose of the visits was to get an overall picture of the operations of the companies and the process of pawnbroking from the identification of the customer until the end of the pawn auction. On the whole, deficiencies detected were isolated, and the operation of pawnshops meets the requirements of the Pawnshops Act.

The FIN-FSA revoked the authorization of one pawnshop, Satapantti Oy, on 16 June 2006. According to the view of the FIN-FSA, the company had materially breached the law and does not meet the requirements of the authorization. The company has filed for a reversal of the revoking decision. The case is pending at the Helsinki Administrative Court.

Contacts made to the Financial Supervision Authority increased

The number of contacts made to the FIN-FSA on practices of banks, investment firms and management companies increased in 2006. The number is boosted by the fact that contact is made increasingly through the Internet or via email. At the same time, the number of written requests for investigation decreased.

A majority of contacts concerning banks were related to loans, their collateral and collection. The number of questions concerning cards and different account facilities as well as bank secrecy increased. Often the enquirer was the beneficiary of an estate. Questions related to investment firms concerned the allocation of securities trades and covered warrant trade. Among cases concerning management companies, the most salient ones were related to the practices followed on redemption of mutual fund units and issues concerning mutual fund mergers.

The problems that emerged were mainly individual cases instead of problems related to a general market practice. The Financial Supervision Authority has taken measures when irregularities have been observed.

Disputes between a service provider and an individual customer were also handled at the Advisory Office for Bank Customers and the Securities Complaint Board. The Advisory Office received 1,478 contacts and the Securities Complaint Board 274. A majority of issues handled by the Advisory Office concerned banks' cards, account usage, payments and loans. The Securities Complaint Board received questions that most often concerned securities broking, mutual fund operations and investment advice.

More reports on suspected money laundering

Reports by entities supervised by the FIN-FSA on suspected money laundering have increased and in 2006 there were 621 reports. The reports mainly come from credit institutions. The increase is partly due to the fact that the Money Laundering Clearing House has adopted an electronic reporting sheet. In addition, the number got a boost from the legislative change in 2003 that extended the characteristics of criminal money laundering to include also negligent money laundering ie one that results from carelessness.

Of the reports, more than 100 have gone on to preliminary investigation by the police. The most common crime designations in preliminary investigation are debtor's dishonesty, debtor's fraud, drug-related offences and extortion.

MORE INFORMATION ON FINANCIAL MARKETS

Integration of the financial markets, technological advances and increasing variety of products and services offered in the markets has increased the choice available to the customer. At the same time, risks related to the selection of service provider and products have increased.

The FIN-FSA seeks to increase the customers' knowledge about products and services. A major channel is the section for savers and investors on the FIN-FSA's website (Säästäjälle ja sijoittajalle), currently available only in Finnish and Swedish. The site opened in 2005 was developed further in 2006. The objective is that customers could, with the help of the site, assess financial services and products and related risks.

The FSA Newsline publication also focused in 2006 on topical articles aimed at savers and investors. There were articles on eg mutual fund investing, taking of loans and so-called instant loans. In addition, the FIN-FSA had its own section and experts giving presentations on topical issues at the Sijoitus – Invest 2006 fair.

Warning lists of unauthorised service providers published on website

Investment fraud or unauthorised provision of service usually comes to the attention of the Financial Supervision Authority through contacts made by the public. In prevention of fraud, warning of investors has been proven internationally to be the most effective manner of protecting investors. The FIN-FSA publishes at its website warnings about the provision of securities without a proper prospectus along with observations concerning the obligation to have an authorization and submit a prospectus as well as warnings issued by foreign supervisors.

SUPERVISION OF DISCLOSURE OBLIGATION AND TRADING

The aim of the Financial Supervision Authority in the monitoring of the disclosure obligation is that the offerors of securities as well as listed companies fulfil their obligations and that the information given is consistent, timely and understandable. Listed companies were given guidance and training about changes in securities market legislation on the field. There were still significant differences across companies in the disclosure of information, but significant irregularities were not detected.

Improvements in justifications for profit forecasts

The FIN-FSA launched a survey in late 2005 on how well listed companies described their operating environment and its impact on future outlook in their 2004 financial statements and 2005 interim reports. At the same time, it was explored how the companies justified their outlook and how detailed forecasts they gave. The results of the survey were published in March 2006.

The survey included 75 randomly selected listed companies. The companies described trends in their operating environment fairly well, albeit at a general level. Only a few companies reported uncertainty factors relating to their forecasts and only 43% of the companies commented on their development relative to the general outlook.

Differences across companies in presenting profit forecasts were large. Many forecasts were partly unclear or prone to interpretation. Among the companies included in the survey, 9 failed to give any profit forecast. Among the remaining 66 companies, a majority gave a forecast for the whole financial year. Some companies' reports did not indicate clearly, which period or income statement item the forecast concerned. As the basis of profit forecast 25 companies used operating profit/ operating result while the other companies used some other key figure, such as earnings per share (EPS) or profit, for the period.

As follow-up to the survey in the spring, the profit forecasts given in the second-quarter interim reports were reviewed in autumn 2006. The survey included 74 of the abovementioned 75 companies. Among these, 63 companies gave a profit forecast. A few companies that had previously given a forecast now failed to give any forecasts, and some companies, contrarily to the past, gave a forecast. Justification for the forecasts as a whole was more extensive than in the comparative period in 2005. One highly positive trend was that companies had assessed the impact of their internal measures more than before instead of merely relying on the prospects of the market. Some companies had also presented the uncertainty factors relating to the forecasts well.

The FIN-FSA will continue to monitor the profit forecasts of listed companies. Supervision will pay more attention to companies whose forecasts were clearly insufficient or unclear with respect to content or justifications. Information on the future outlook of listed companies has a crucial role on the investors' informed assessment. Hence, FIN-FSA recommends that companies would present their estimates on future outlook in a clear and consistent manner.

Profit warning releases mainly clear

Profit forecasts play a significant role in the supervision of the continuous disclosure obligation. In 2006, the clarity of over 30 profit warnings issued earlier during the year was studied from the market's point of view and on the basis of recommendations given in the related FIN-FSA standard.

A majority of the profit warnings or stock exchange releases containing preliminary information for the reporting period were clear and consistent with respect to their content. In some cases, however, the profit warning was difficult to detect, since it had been included in a misleading manner in reporting on another issue, such as shareholders' meeting or a contract made. The FIN-FSA recommends that the headline of the stock exchange release on a profit warning includes a clear indication to a change in outlook.

Reporting on M&A was surveyed

In supervision of the continuous disclosure obligation, the FIN-FSA pays attention, in addition to everyday supervision, to how significant events for investors are reported. It is important to investors that estimates given in the markets in connection with acquisitions are justified and that their materialisation is reported consistently for as long as is feasible and necessary.

The survey made by the FIN-FSA in autumn 2006 on 20 corporate acquisitions and arrangements in 2004–2006 showed that the strategic justifications are presented well upon the publication of corporate acquisitions. There is room for improvement in the information given on the impact of the transaction on the business and profitability of the acquiring company.

Every other company had estimated in the context of the publication of the transaction, the synergy benefits to be achieved. An interesting observation was that although the impact of the transaction on the sales or profitability of the acquiring company had not been described clearly, a certain level of synergy benefits per year had been forecasted. In only 5 of the 20 cases studied, had the acquiring company assessed both the synergies to be achieved and published clear information on the impact of the transaction on sales and profitability. Out of these five, four cases were such that a prospectus had been made in accordance with the Securities Markets Act.

Market making for covered warrants

In 2006, the FIN-FSA paid attention to the descriptions on market making in prospectuses on covered warrants. Market making for warrants may be temporarily suspended eg due to the hedging of the issuer's own position or due to technical problems. Based on the descriptions in the prospectuses, some investors may have had the justified impression that market making was continuous under any market conditions.

Together with the Helsinki Stock Exchange and the issuers, the FIN-FSA seeks to find a more specific and uniform content for the description of market making for covered warrants, so that investors would get as accurate a picture as possible of the liquidity of covered warrants.

Surveys on insider management

In spring, FIN-FSA enquired from 30 listed companies, selected by random sampling, how they had taken the amendments made to the Securities Markets Act due to the Directive on the prevention of market abuse into account. According to the survey, most companies had drafted their own insider and trading guidelines that the company's insider had to follow along with the insider guidelines of the Helsinki Stock Exchange.

Companies had issued guidelines on the use of NDAs, the disclosure of insider information and the prevention of its use, authorization policy for insider trading and the establishment of project registers. Many companies had adopted more stringent rules than the guideline of the Helsinki Stock Exchange on the allowed trading period before the company's regular profit disclosures. Almost all companies reported that they monitored insider trading either regularly or randomly. Many companies also reminded insiders of trading restrictions and the disclosure obligation and arranged training about proper compliance with these obligations. The results of the survey and related FIN-FSA comments were sent to all listed companies during the summer.

In November, the FIN-FSA began a survey on insider notices and registers concerning all listed companies and investment firms. The results were completed in early 2007.

Markkinat bulletin

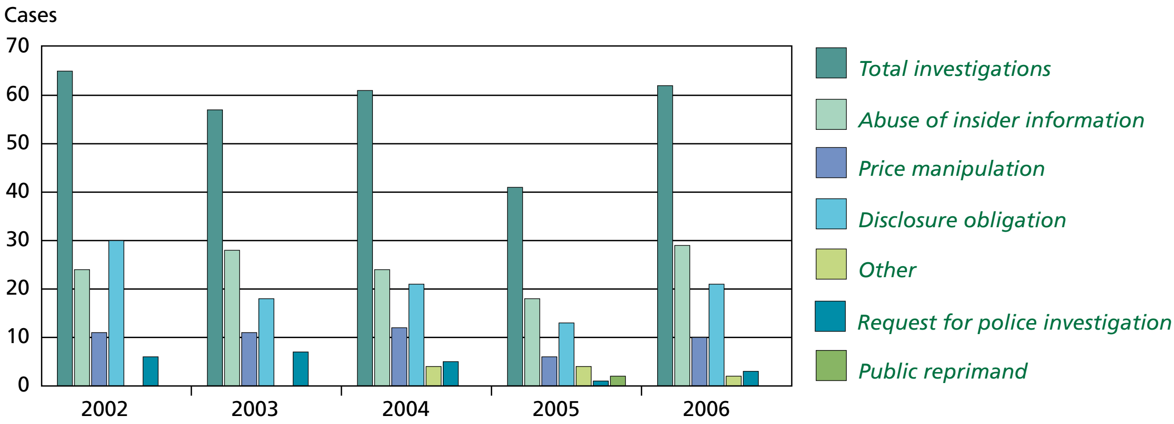
FIN-FSA's market supervision began in 2006 to publish a Markkinat (Markets) bulletin sent to subscribers via email. It addresses topical issues relating to regulation and market supervision from the viewpoint of the supervisor, listed companies and other market participants. In 2006, the Markkinat bulletin was published three times.

NUMBER OF INVESTIGATED CASES INCREASED FROM PREVIOUS YEAR

As in previous years, the FIN-FSA has collaborated with the police and prosecutors. In 2006, the FIN-FSA made 3 (1 in 2005) investigation requests to the police. One request concerned neglect of disclosure obligation and two concerned the abuse of insider information.

The number of investigated cases increased significantly in 2006 from the previous year. During the year, 62 supervision cases were

Cases of suspected securities market abuse investigated by FIN-FSA in 2002–2006



Source: Financial Supervision Authority.

investigated (41 cases in 2005). Out of this number 29 (18) concerned suspected abuse of insider information, 10 (6) market manipulation and 21 (13) neglect of the disclosure obligation. There were 2 (4) other cases under investigation, concerning among other things market practices. The main reason for the increased number of cases was that after the completion of many regulation reforms, the FIN-FSA could devote more resources on supervision and increase its regular investigation. The number of reports from market participants has also contributed to the number of cases investigated.

In 2006, the FIN-FSA has increased and developed cooperation with foreign authorities. The FIN-FSA has received more requests for judicial assistance for foreign authorities than before. The requests have mainly been related to suspected abuse of insider information. Nordic cooperation has been fruitful. Its importance will also increase in the future eg due to the expansion of the OMX Group.

Cooperation between the FIN-FSA and the market supervision unit of the Helsinki Stock Exchange has become closer and clearer. The importance of cooperation is particularly highlighted in investigation suspected price manipulation. Investigations in 2006 have concerned particularly cases where the principal has been a private investor and trading orders have been made through online trading services. In 2006, the FIN-FSA received 11 reports from securities brokers of suspicious securities trades or other transactions and 15 reports from the Helsinki Stock Exchange relating to trading practices.

SUPERVISION OF FINANCIAL STATEMENT INFORMATION OF LISTED COMPANIES

The objective of financial statement supervision is to promote the provision of open, sufficient, timely and understandable information to support decision making by investors. In addition, it aims to support the uniform application of the IFRS standards. 2006 was the second year of operation for supervision of financial statements of listed companies.

IFRS financial statements of listed companies still have room for improvement

The FIN-FSA reviewed the financial statements of 125 listed companies for 2005 to gain a general picture of the quality of and development needs in IFSR financial statements. This is important because a majority of listed companies used the new standards for the first time in 2005, and the transition had a significant impact on financial reporting by the companies.

As part of this survey, the FIN-FSA made a more detailed analysis on certain areas in financial statements selected as the focus areas. The focus areas were acquisitions, goodwill impairment testing, segment reporting, share-based incentive schemes and fair values of investments. These were considered important since the Finnish financial statement practice had clearly differed in these respects from the IFRS standards. The areas selected are an important part of investor information and thus significant information for the users of financial statements.

Sufficient and understandable notes are a major part of good and open financial statement information. According to the survey by the FIN-FSA, the notes presented by the companies in their financial statements were scant in comparison to the extensive and detailed requirements of the IFRSs. The recognition and measurement principles of the IFRSs are more complex than the previous principles. Therefore they must be clarified in the notes. In application of the standards, there are more situations than before that require judgment by management. This is the case for example in assessing the cash flows used in determining fair values. The financial statement should provide sufficient information on the methods and assumptions used in the determination of fair value and uncertainties related to measurement.

The objective of the survey was to support the development of IFRS reporting. The FIN-FSA considers important that companies make use of the observations of the survey in developing their financial statement information. After the survey, the FIN-FSA continued to explore the issues that emerged in relation to application and contacted some of the listed companies. The FIN-FSA sent a request for clarification to over 30 companies asking for further information among other things on the calculation principles applied by them and the content of notes. In their responses, most of the companies declared that they would take measures suggested by the FIN-FSA into account in preparation of their next financial statements.

More companies fell into the scope of consolidated IFRS financial statement

According to the IAS regulation, listed companies that have issued bonds on regulated markets must prepare consolidated financial statements in accordance with the IFRSs at the lasted on 1 January 2007 or for the period beginning on that date. The FIN-FSA began monitoring in autumn 2006 capabilities of the new IFRS adopters to apply the IFRS financial statement provisions. The objective of the monitoring is to ensure that the transition of these companies into the standards is appropriate.

SUPERVISION OF FINANCIAL MARKETS INFRASTRUCTURE

The financial markets infrastructure has functioned reliably and with no significant disruptions.

Monitoring of the financial markets infrastructure is conducted in close cooperation with the general oversight unit of the Financial markets and statistics department of the Bank of Finland. Cooperation is based on the cooperation agreements between EU financial supervisors and central banks, which have been made on supervision of payment systems and crisis management. Practical forms of cooperation include the exchange of information, common supervision meetings, inspection collaboration and the organisation of common seminars.

In 2006, the operating principles in supervision of the financial markets infrastructure were clarified to avoid overlapping measures and to improve the effectiveness of cooperation. The main targets of cooperation comprised EU-level initiatives on securities clearing, initiatives concerning integration of European payment traffic (Single Euro Payments Area, SEPA) and an impact assessment of central bank's new settlement system for large payments, TARGET2.

Nordic cooperation in the supervision of financial markets infrastructures has increased among other things due to the integration of marketplaces. Cooperation is based on Memoranda of Understanding providing for the division of work between supervisors, exchange of information and other forms of cooperation. The aim of cooperation is to harmonise the supervision of the various companies in the OMX and NCSD Groups in Nordic countries and to improve its efficiency.

The FIN-FSA has also supervised future changes in payment systems and securities clearing and settlement systems. There are many initiatives ongoing in the euro area in relation to payment system and payment traffic services as well as securities clearing and settlement systems.

Cooperation in supervision of OMX Group intensified further

The cooperation group established by the Swedish, Finnish and Danish supervisors for the supervision of the OMX Group convened regularly in 2006. The focus areas in the ongoing supervision of the OMX Group comprised the changes in the list structure and listing criteria carried out in the beginning October and the changes in the market model commented by the FIN-FSA before the projects were implemented.

Finnish APK became part of the NSCG Group

The Finnish central securities depositary, APK, became a wholly owned subsidiary of the Swedish Central Securities Depositary, VPC, when the Finnish and Swedish central securities depositaries merged in November 2004 and formed the NCSD Group.

In 2006, the NCSD Group's internal initiative of harmonization of operating procedures, the Nordic

Single project, was supervised. The aim of the project is to create uniform operating procedures for securities clearing and settlement in Finland and Sweden. At a later stage, the aim will be to extend the operating procedures to other Nordic countries. The objective of the project is also a common securities clearing and settlement system.

Memorandum signed on supervision of the NSCD Group

The FIN-FSA and the Swedish supervision authority, Finansinspektionen, began cooperation in the supervision of the NCSD Group in 2005. A Memorandum of Understanding on supervision was signed in the latter half of 2006. The Memorandum provides for the division of work between the supervisors, on the exchange of information and other forms of cooperation. Practical supervision is conducted by a group consisting of representatives from the supervision authorities of both countries. The supervision group is responsible for the planning and implementation of inspections and other common supervision measures.

Banks fairly well in control of risks related to IT outsourcing

A survey made by the FIN-FSA in spring 2006 explored how well banks are in control of their outsourcing process. The survey covering a majority of Finnish banks showed that banks are fairly well in control of the risks related to the outsourcing of IT services. The assessment methodologies of risks related to outsourced services are extensive and the monitoring of services is appropriate. The survey also showed that banks had set tight requirements to the continuity of outsourced IT services. During 2006, certain supervised entities began initiatives to outsource systems service outside the Nordic countries and Europe. The view of the FIN-FSA is that the monitoring and operational reliability of the services must not weaken as a result of outsourcing.

Initiatives concerning the centralisation of the back office and IT services of supervised entities continued. The FIN-FSA supervised the most significant centralisation projects in cooperation with other Nordic supervision authorities. The aim of the FIN-FSA is to ensure that the quality and continuity of the services can be ensured in change situations.

Phishing of identification data in the web increased

The phishing of identification data became more common also in Finland. The first fraud attempts in Finnish – although awkward – revealed themselves. Damage caused by the fraud attempts has so far been minor, among other things because banks have informed about them actively on their websites and the media. However, the challenge is that the quality of phishing may improve and it may be directed at certain customer groups. In addition, new phenomena related to network fraud are also on their way to Finland. These include fake invoices sent to mobile phones.

The FIN-FSA has reported on phishing at its website. Supervision has emphasised the need for a 24-hour closure service for banking IDs common for all banks. In addition, the FIN-FSA has considered it important that banks have clear and harmonised operating procedures when inquiring banking IDs from customers. The need for clear operating procedures is highlighted among other things because the identification service provided by banks is used in an increasing number of services.

Securities transaction payment systems inspected

The securities systems inspections began in 2005 were continued and focused on Finnish banks operating as clearing parties. The inspections did not reveal any significant risks. However, in individual cases risks were observed in relation to eg aging of the systems used, manual phases of the payment transmission process, volume growth and ongoing systems initiatives.

In the banks inspected, internal control in the business units, preparedness for disruptions and special situations and contingency planning were mainly appropriate. Individual deficiencies were observed in the description of the payment transmission processes, mapping of risks and contingency planning. The FIN-FSA supervises the rectification of deficiencies within specified periods.

Initiative concerning the Single Euro Payments Area

The Single Euro Payments Area (SEPA) is a common initiative by European banks, the European Central Bank and the European Commission to create a single payment transmission area. Finnish banks have together drafted a national SEPA transition plan. According to the plan, SEPA services (bank transfers, cards and direct debiting) will be adopted gradually from the beginning of 2008. Adoption will continue until the end of 2010. The present domestic payment transmission service will be used until further notice but are likely to be removed from use by the end of the transition period. Banks have promised to launch additional services when needed to maintain the current service level.

In the wake of the SEPA, domestic bank and ATM cards will be removed from use by the end of 2010 and will be replaced by international cards. The initiative also includes the equipment of cards with an EMV chip. The adoption of the chips will increase the security of the cards, since under present knowledge, it is not possible to copy the information contained in the chip. On the other hand, the fact that no signature will be used and identity will not be checked upon payment in the future, but a PIN code will be used instead, is not entirely problem-free.

A Payment System Directive is related to the SEPA. Its objective is the harmonisation of payment transmission legislation in the EU. Preparation of the directive proceeded during the Finnish EU presidency, but it will continue in the German presidency in 2007.

The FIN-FSA supervises preparations by banks for the SEPA by surveys and inspection visits. The aim of supervision is that banks maintain efficient and secure payment systems and their availability remains high. Some supervised entities have outsourced their functions outside Finland in connection with the Single Euro Payments Area. Outsourcing poses new challenges to supervision by the FIN-FSA.

Regulation

The regulatory activities of the Financial Supervision Authority (FIN-FSA) comprise both issuance of its own regulations and participation in legislative preparation in Finland and at the EU level. The FIN-FSA contributes to the preparation of EU regulations especially by participating in the work of level three supervisory committees. At the national level, representatives of FIN-FSA take part in the law drafting groups headed by the Ministry of Finance, the Ministry of Trade and Industry and the Ministry of Justice.

The 2006 strategy of the FIN-FSA focused on principles-based and high quality regulations as well as the foreseeability and credibility of the application of the law. Practical regulatory activities were guided by the following key objectives:

Regulations and the supervisory framework take account of changes in market structures

The structural changes in the financial markets continued both in Finland and elsewhere in the EU area. A considerable part of the Finnish financial market had, by the end of 2006, shifted into Nordic ownership, which also affects the practical activities of the supervisor. Regulatory and supervisory cooperation is necessary in the supervision of cross-border financial conglomerates and in the identification of crucial risks for market stability.

Both at the EU level and in other cooperation, the FIN-FSA actively contributed to ensuring that the prerequisites for ensuring the stability of domestic financial markets are in place also under changing market structures. Although the EU has recognised one aspect of importance to Finland, ie the role of the host country in the supervision of the stability of its own markets, the current EU supervisory model does not focus adequate attention on structural changes in supervised entities. However, there are no plans, at least in the short term, to interfere with the basic responsibilities of home and host country regulators. Rather, the aim is to improve supervision by introducing more forms of practical cooperation, such as delegation of tasks and harmonisation of supervisory methods and powers.

The FIN-FSA cooperated with other supervisory authorities to achieve regulatory and supervisory convergence in the EU and the Nordic countries. A common interpretation with the other Nordic supervisors has been sought for instance to the application of the capital adequacy regulations. Harmonisation of regulation and supervisory practices between the Nordic countries has advanced more than within the EU at large. For example, validations of Basel II models have been undertaken in close cooperation. In some interpretation issues the views of the Nordic countries have differed. To these issues a common interpretation will be sought.

The FIN-FSA has also endeavoured to ensure that competition neutrality be one of the key objectives of the EU over the next few years.

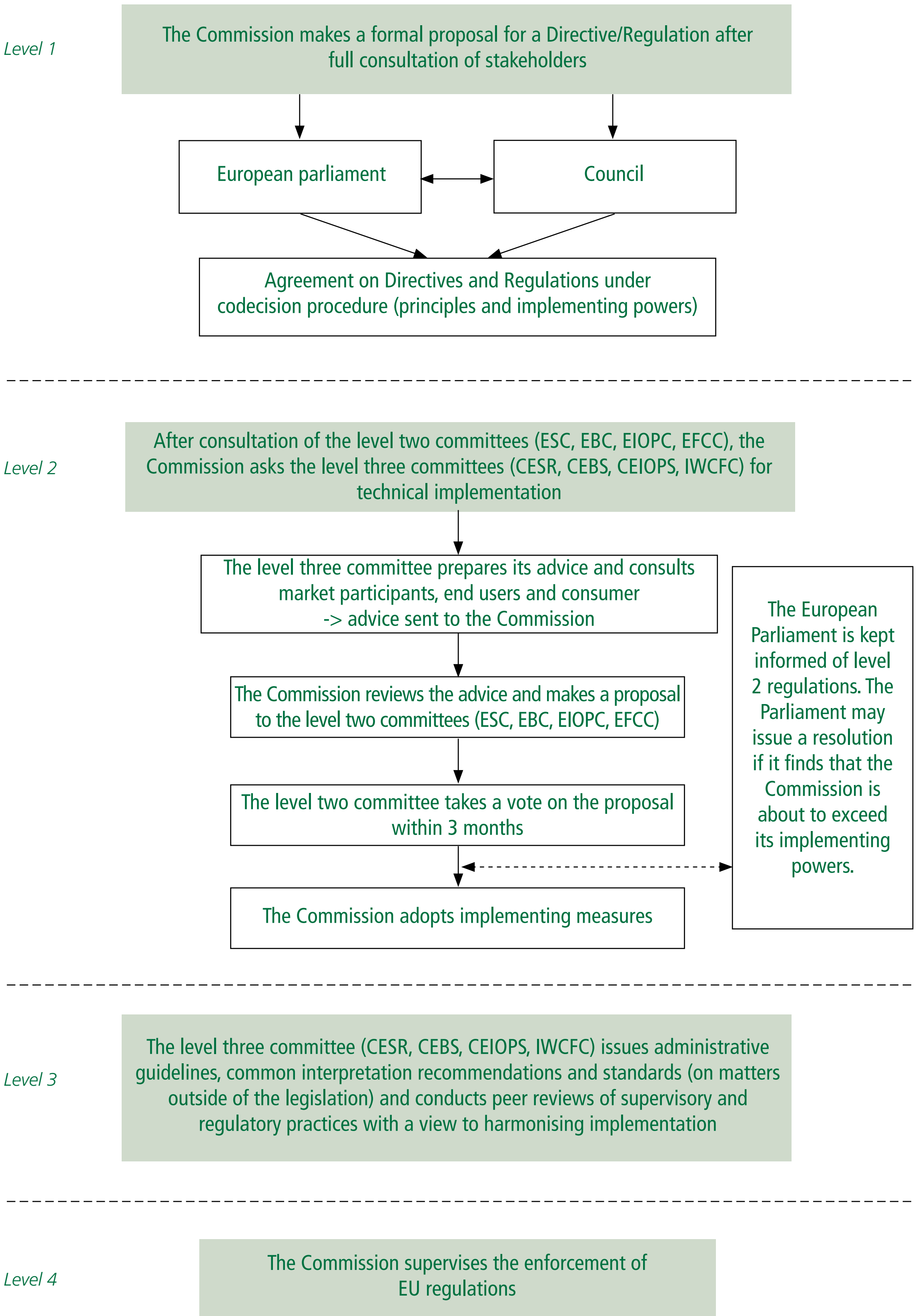
The FIN-FSA's regulatory activities produce high quality and necessary provisions and steer the activities of supervised entities and markets.

The FIN-FSA has endeavoured to ensure that the main principles entailed in the directives are reflected in lower level EU regulations (levels two and three). The aim of domestic law drafting has been effective implementation of EU directives. The FIN-FSA has also seen to it that its own standards are in line with EU regulations and principles.

The reform of the FIN-FSA's set of regulations has clarified the FIN-FSA's supervisory role and expectations in respect of the activities of supervised entities. Measures have been devoted to the consultation of interested parties in the preparatory stage of regulations and to ensuring the clarity and relevance of regulations.

The response to the FIN-FSA's regulatory issuance has been largely positive. Any criticism has concerned the extent of regulatory issuance and the poor applicability of the same regulations to supervised entities of different size and type.

The Lamfalussy model in the preparation of EU legislation



Source: Financial Supervision Authority.

EU REGULATORY ENVIRONMENT AND REGULATORY ACTIVITIES, 2006

EU regulatory activities entered a new phase

The development of the financial services and financial regulation and supervision within the EU entered a new phase with the Commission's issue of the White Paper on Financial Services Policy 2005–2010 in December 2005. The guidelines of both the Commission and the Economic and Financial Committee setting out measures to enhance supervision also received strong support at the political level, ie from the ECOFIN Council.

The main guidelines of the Commission's Financial Services Strategy for the next few years were:

- Sound implementation and enforcement of existing EU legislation.
- Application of better regulation principles in the preparation and means testing of new regulations.
- Enhancement of supervisory convergence.
- Creation of more competition especially in the retail market.
- Strengthening EU's influence globally.

In the White Paper, the Commission highlighted the following supervisory challenges over the next few years:

- Clarification of home-host responsibilities.
- Exploration of the delegation of tasks and responsibilities.
- Improvement of the efficiency of supervision by avoiding duplicative reporting and information requirements.
- More consistent and timely supervisory cooperation. Furthermore, there is a need to create an EU-wide supervisory model to support a European supervisory culture and effective supervisory cooperation. The aim is, however, not to establish a separate EU level supervisory authority.

At the beginning of 2006 it became obvious that there are no plans to interfere with the basic supervisory structures – the home-host responsibilities – over the next few years. According to the Commission, the legal limits to the reorganisation of supervisory responsibility for cross-border financial conglomerates have now been reached. Any further major changes in the division of responsibilities should be thoroughly evaluated to ensure that the changes do not conflict with for example crisis management responsibilities and the responsibilities for deposit guarantees.

The position of the European Parliament in the enforcement of level two regulations strengthened

The year 2006 was the first year in which the Lamfalussy approach was applied to all regulatory and supervisory development of EU financial markets. The Lamfalussy approach is based on a four-level model designed by the so-called Committee of Wise Men headed by Baron Lamfalussy and laying the basis for the preparation and enforcement of EU legislation.

In the course of 2006, the first interim report on the preparation of EU regulations and the effectiveness of the related Lamfalussy model was published. According to the report, the target of principles-based regulations has not been achieved in the case of level one regulations, ie in the directives. There is also otherwise a risk that EU regulations are too rich in detail and overdimensioned. Hence, there is a real need for Commission guidelines for practical approaches and for the implementation of better regulation principles.

The Inter-Institutional Monitoring Group (IIMG) will issue its final proposal for improving the effectiveness of the model in the course of 2007.

In the context of the Lamfalussy model, the aim has been to safeguard the right of the European Parliament to enforce regulations of a level lower than the directives, ie level two regulations. These regulations are adopted under a special comitology procedure, in contrast to the directives which are adopted under the codecision procedure. The position of the Parliament was strengthened with the passing of a decision by the Council in July amending the comitology decision of 1999. The existing advisory, administrative and regulatory procedures were complemented by a regulatory procedure encompassing supervision and explicitly applicable to Lamfalussy provisions. Not one of the level two regulations issued by the Commission will hereafter be adopted without endorsement by the Council and Parliament.

The aim of the decision is also to give the European Parliament better access to information on the various preparatory stages of level two regulations, although the Parliament continues to be largely dependent on the written material submitted to it by the Commission.

In the near future, Lamfalussy directives which are about to expire will be submitted to the European Parliament for processing. First to expire are the level two regulations of the Market Abuse Directive. The Parliament requires that each directive is separately submitted to it for extension of the validity of the level two provisions.

CEBS priorities in 2006

In 2006, the Committee of European Banking Supervisors (CEBS) issued guidelines on the application of the Capital Requirements Directive for supervisory authorities and supervised entities. Herewith, the Committee moved to monitor the application of the guidelines and to develop harmonised supervisory practices. The application and consequences of the CEBS guidelines were evaluated by a survey addressed, among others, to supervisory authorities and the financial sector. Work started on the harmonisation of supervisory practices in the supervision of cross-border banking groups. The responsibilities of CEBS also include rendering advice to the European Commission. In 2006, the Committee advised the Commission on the redefinition of the concept of own funds (regulatory capital) and the provisions on large exposures.

In February 2006, the Economic and Financial Committee (EFC) issued six recommendations on the improvement of supervision over the next few years ('Report on Financial Supervision' by the Financial Services Committee subordinate to the EFC). The following recommendations apply to CEBS in particular, and the Committee also reports on their implementation to the EFC:

- fostering a European supervisory culture and own assessment of the development of supervisory convergence; first assessment to be published in 2007
- design of a mediation mechanism to address disputes between supervisory authorities; the mechanism will be tested in 2008
- cross-border supervision: exploration of the possibilities for delegation of tasks and responsibilities
- harmonised reporting: a common reporting framework to be in place by 2007 and evaluation of the possibilities of using a common knowledge database by 2008.

The FIN-FSA was represented on the CEBS working group set up to ensure common procedures at the practical level, especially in the supervision of cross-border banking groups. In the interest of supervisory convergence, CEBS appointed a working group in December 2006 as reinforcement to CEBS in the implementation and enforcement of recommendations adopted by the EFC and ECOFIN. The working group started work on the design of a mediation mechanism to address disputes between supervisory authorities, and on a peer review mechanism. The working group also started to explore the possibilities for delegation of tasks and responsibilities between home and host country supervisors.

CESR's priorities in 2006

In 2006, the focus of the activities of the Committee of European Securities Regulators (CESR) shifted from harmonisation of level two regulations to development of supervisory cooperation.

A key observation made by CESR is that the importance of level three work has increased considerably. A separate working group was set up to prepare the necessary changes in the operating practices of the Committee. The working group designed evaluation criteria for identification of the level of problems to be addressed by the Committee. According to the new criteria, CESR will address problems that are serious for the market, that concern several EU countries and that the Committee can influence through available means.

In response to the views of the Economic and Financial Committee and ECOFIN on the development of supervisory cooperation, CESR submitted a report in May on planned measures to the Financial Services Committee (FSC) subordinate to the EFC. In the issues raised by ECOFIN, CESR has made very good progress, introducing, for example, a mediation method for the settlement of disputes between members. Rules for the settlement of disputes have been drawn up and will lay the basis for the handling of possible cases. No concrete cases have as yet emerged.

The implementation of transaction reporting under the Markets in Financial Instruments Directive (MiFID) represented the first concrete step towards facilitating information exchange between supervisory authorities and reporting from supervised entities. CESR set up a group concentrating on the development of information systems designed to implement the transaction reporting framework but also to promote the efficient use of information systems and enhance cooperation between them.

The monitoring of the economy and markets has been improved by stepping up cooperation between economists. In addition to the analysis of market phenomena, the ECONET of CESR also focuses on the generation of a method for the Committee's use, allowing for cost-benefit analysis of suggested measures, together with impact surveys.

Supervisory cooperation was also enhanced by reorganisation and revision of the practices of CESR-Fin, the CESR permanent group of experts in the field of financial reporting. In the year under review, preparations were also undertaken of the contents of a public data base with application decisions concerning IFRS financial statements. The database will be made available to the public in the course of 2007.

Part of the development of supervisory cooperation takes the form of greater awareness of the markets and practices of other supervisory authorities. CESR has put in place a scheme designed to increase the exchange of staff between members. Due to legislative and cultural differences, the implementation of the scheme will remain the responsibility of individual members, but CESR will distribute information on work and secondment prospects on a concentrated basis. In the course of 2007, the possibilities for organising tailor-made training to CESR members will be explored.

The Review Panel of CESR operated actively in 2006, monitoring supervisory convergence of securities market regulators. In capacity as vice president of CESR, the FIN-FSA's director general Kaarlo Jännäri acted as chairman of the Review Panel in 2003–2007. The role of the Review Panel was especially pronounced in 2006 when the focus of the operations of CESR shifted from regulatory preparation to ensuring practical supervisory convergence.

Hence, a key prerequisite for the successful operation of CESR is to ensure that its members, ie the securities market regulators of the EU countries, observe agreed recommendations and harmonised practices. It is also important to make sure that members have sufficiently identical powers for the observation of recommendations and practices. In order to ensure this, the Review Panel conducts regular evaluations and surveys.

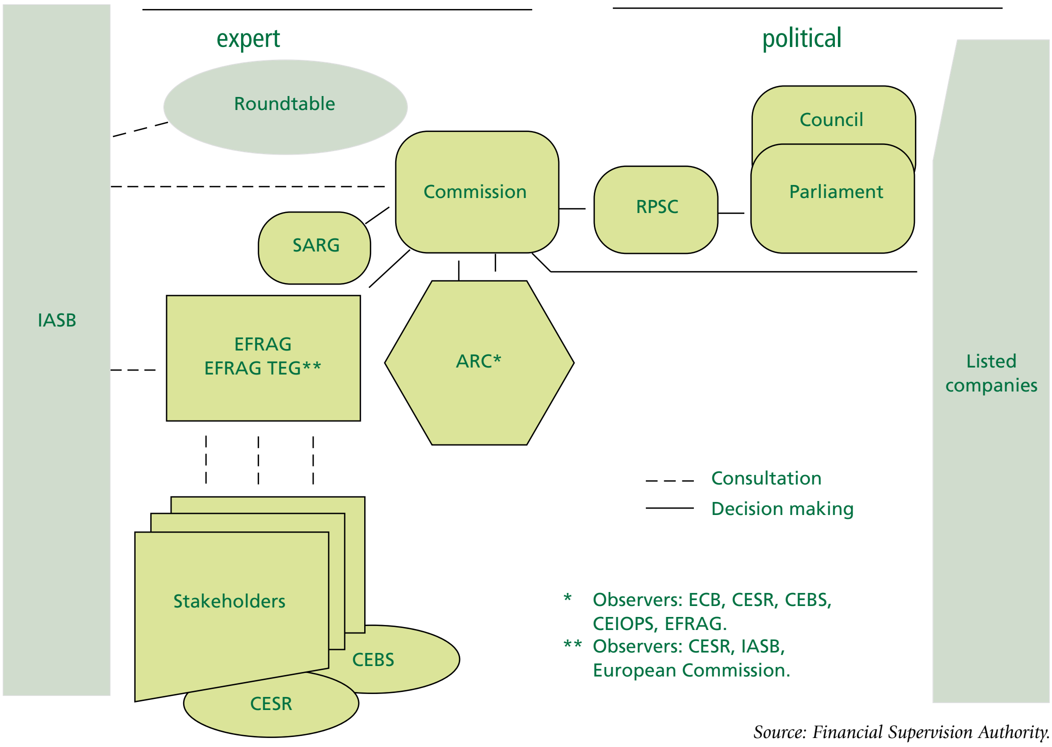
An evaluation of the implementation of the CESR Standard No 1 on Financial Information and the transitory provisions of the UCITS Directive was completed in 2006. In the early part of 2007, a survey of the powers assigned to the members of CESR by the Prospectus and Market Abuse directives will be published.

The operating principles of the Review Panel were also developed further and the review instructions updated. In principle, the results of the evaluations and surveys conducted will be posted on the CESR's website, except for confidential information and certain other exceptional cases.

IFRS regulations to be revised and harmonised with US GAAP in 2006–2008

In February 2006, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) of the United States signed a Memorandum of Understanding (MoU) strengthening the cooperation for the

IFRS approval process within the EU



Source: Financial Supervision Authority.

harmonisation of EU and US financial reporting regulations that had commenced in 2002. This work is likely to mean that the US Securities Exchange Commission (SEC) will no longer require that companies applying IFRS regulations disclose reconciliations with US GAAP.

In connection with the signing of the MoU, the IASB and FASB published a road map outlining the progress of cooperation. The regulatory work was divided into short-term convergence projects and other cooperation projects. The aim is to achieve short-term convergence by 2008. As for the other cooperation projects, the aim is to make considerable progress over the same timespan. As responsibility for the convergence projects rests with the IASB, it shall see to the convergence of its own regulations with current US regulations, while the projects for which FASB is responsible will develop regulations in line with the IFRSs.

Cooperation with SEC

In 2006, CESR and the Securities Exchange Commission (SEC) decided to step up cooperation. The cooperation is, among other things, designed to promote high-quality development and harmonised application of financial reporting regulations. The aim is that the organisations responsible for the enforcement of financial reporting regulations in EU member states together with SEC, in 2007, sign a Memorandum of Understanding (MoU) on the exchange of information and cooperation in the enforcement of financial reporting from listed companies.

European cooperation in the harmonisation of financial reporting practices

Financial reporting standards of a high quality are an important element of the deepening of European capital markets. The mechanism for approval of IASB standards and interpretations as

EU legislation is fairly effective according to the first estimates but needs to be developed further. In 2006, the Commission set up a Standards Advisory Review Group to assist the Commission in the IFRS approval process by evaluating whether the opinions of the European Financial Reporting Advisory Group (EFRAG) on the approval of IFRS regulations are of a good quality. Furthermore, the IFRS approval process was so changed that the proposal is reviewed by the expert committee of the European Parliament before a regulation on the approval of the standards is issued.

As inconsistencies in the application of the standards are to be expected in the beginning, the European authorities have wanted to influence the contents of regulations and step up communications between different organisations both within the EU and between the EU and the US. The Commission has set up an unofficial round table to promote the consistent application of IFRSs and identify interpretation issues that should be submitted to the International Financial Reporting Interpretations Committee (IFRIC) for review. The representatives of the round table include the Commission, the IASB, the EU committees of supervisors, the big four auditing firms, national regulatory issuers and preparers of financial statements.

The supervisory authorities play a key role in the promotion of the harmonised application of the IFRSs. This has called for closer supervisory cooperation. The cooperation is coordinated by the CESR permanent working group CESR-Fin and the European Enforcers Coordination Sessions (EECS) subordinate to it. The aim is to promote the harmonised application of the standards through discussion of supervision cases and the contents of IFRS regulations. A database with supervisory decisions will be made public in 2007. In the course of 2006, EECS prepared and made available to supervisory authorities a check list of information to be disclosed in financial statements. Furthermore, CESR-Fin launched a survey on the experiences of supervisory authorities of the enforcement of the first financial statements prepared in line with the IFRSs.

NATIONAL LEGISLATIVE PROJECTS

National regulatory projects carried out in 2006

The national legislation allowing for the establishment and registration of European cooperative societies (SCE) in Finland, the Act on European Cooperative Societies, took effect at the beginning of 2006. Provisions on European cooperative societies are included in the Council Regulation on the Statute for a European Cooperative Society (SCE), as well as in national legislation.

The national legislation relating to the implementation of the Directive on Takeover Bids took effect at the beginning of July 2006. The legislation is especially directed towards ensuring equal treatment of holders of securities in a company and comprehensive disclosure requirements.

The new Companies Act took effect on 1 September 2006. The Act, among other things, introduced less strict provisions on the administration of companies, allowed for more rapid merger and demerger of companies and made distribution of assets conditional upon solvency.

New capital adequacy framework

The new legislation on the supervision of the financial position of credit institutions, investment firms and fund management companies engaging in asset management (implementation of the Capital Requirements Directive) took effect on 15 February 2007.

Implementation of the Markets in Financial Instruments Directive

The Directive of the European Parliament and of the Council of 2004 on markets in financial instruments (MiFID), together with its level two implementing directives and regulations, are among the most significant EU projects for regulatory harmonisation in the financial services sector. The Directive is expected to have a considerable impact on the structure of EU securities markets.

Transposition of the Directive into Finnish law calls for profound amendments to national legislation. A new Investment Firms Act will be passed and the Securities Markets Act will be extensively revised. Amendments will also be made to the Mutual Funds Act, the Credit Institutions Act, the Act on Trading in Standardised Options and Futures and the Act on the Financial Supervision Authority. The aim is to have the final Government bill ready for adoption by the beginning of April 2007 and the legislative amendments approved and published in the Statute Book of Finland on 1 July 2007, effective from the beginning of November 2007.

Implementation of the Transparency Directive

The Transparency Directive governing issuers' regular reporting requirements, shareholders' obligations to disclose holdings and the distribution and availability of information was implemented through an amendment of securities market legislation on 15 February 2007.

New Anti-Money Laundering Act under preparation

The amendments to national legislation ensuing from the EU Third Money Laundering Directive will be carried out by 15 December 2007. The Directive requires that supervised entities improve their Know-Your-Customer processes (due diligence) and risk management. Supervised entities must undertake critical evaluations of existing customer relationships and classify their customers according to inherent risks. Customer information must be updated and additional information possibly obtained. In addition, supervised entities must introduce continuous risk-based monitoring of customer relationships and transactions. The Directive also requires that supervised entities put in place a customer approval mechanism for high-risk customer relationships.

Other national projects in progress

Similarly as in the EU, Finland has also introduced an action plan for better regulation. The national guidelines are largely consistent with the EU guidelines.

A report on the inclusion of provisions on cross-border mergers and demergers in the Companies Act, the Co-operatives Act, the Credit Institutions Act and other acts on financial operations was completed in December 2006.The Government bill is scheduled for introduction in the course of summer 2007.

Government introduced a bill for a new Auditing Act on 13 October 2006. Parliament passed the bill, as amended, on 6 February 2007. The strictest auditing requirements apply to organisations of importance to the public good, including publicly traded companies, credit institutions and insurance companies.

The reform of the emergency powers legislation was postponed and was not taken up by the Parliament in office. Government introduced a bill for the amendment of the Real Estate Funds Act and the Mutual Funds Act. The amendments to these acts are designed to promote collective investments in real estate. The Government bills for a Class Action Act and general legislation on credit references were passed by Parliament in February 2007.

Review of the need for regulation and supervision of instant loans

In spring 2006, the FIN-FSA received several inquiries about instant loans. Instant loans are unsecured loans of a maturity of less than three months, acquired over the Internet or using mobile phone sms messages and being instantly available on the customer's account. The companies providing instant loans are not supervised by the FIN-FSA as they have not, at least so far, financed their activities through repayable means from the public, ie deposits or bonds. The operations mainly fall within the scope of the consumer protection legislation and the procedures should therefore be supervised and regulated by the National Consumer Administration.

The survey undertaken by the FIN-FSA in summer 2006 indicated that a majority of the persons resorting to instant loans are between the ages of 20 and 30 and that the annual interest rates on the loans amount to several hundred per cent. The FIN-FSA also sent the survey to the financial supervisors of other EU countries in order to explore the extent of the instant loan business and legislation and supervision in the field. The survey showed that instant loans are mainly a Nordic phenomenon.

The FIN-FSA has introduced a column with questions and answers on instant loans on its website. Here, those contemplating instant loans are advised to rethink their need for a loan, find out the actual costs of the loan and compare different sources of finance.

The FIN-FSA has actively advocated a joint approach by the authorities to the solution of the problems having arisen in connection with instant loans. It is important to assess the need for amending legislation for instance as regards the obligation to report annual interest rates, as well as registration of operations.

THE FIN-FSA'S OWN REGULATORY ISSUANCE

In terms of the FIN-FSA's own regulatory issuance, 2006 was an active year and the reform of the set of regulations advanced considerably in the year. Twenty new standards were issued and several existing standards were updated. The major part of the new standards (11) were related to the Basel II reform. The new capital adequacy framework introduced at the beginning of 2007 constitutes one of the most significant regulatory projects in the history of the FIN-FSA.

Another reform of relevance to the FIN-FSA's regulatory issuance in 2006 was the transposition of the Markets in Financial Instruments Directive (MiFID) into Finnish law. The implementation of the Directive will influence the FIN-FSA's regulatory issuance, the authorisation process and supervisory practices. In summer 2006, a project was launched with the aim of issuing FIN-FSA standards implementing the Implementing Directive that is not integrated with national legislation. In need of amendment in this context are particularly standards in the corporate governance and code of conduct sections of the regulation set. The aim is to issue the amended standards in the summer of 2007.

In the course of 2006, the FIN-FSA continued its work to clarify the key principles of the reform of the regulation set, ie improvement of the quality of regulatory issuance and better transparency of the preparatory stage of regulations. As regards ensuring the quality of the regulatory issuance, the focus in 2006 was on the clarification of the standards' sections on legal basis and scope of application.

In the interest of better transparency, increasing measures were devoted to consultation of target groups and stakeholders in the preparatory stage. The idea behind this is to give target groups an opportunity to present their views on the needs of regulation and the mode of implementation even before drafting of the regulation starts. The European Commission has also emphasised transparency as one of the principles of better regulation.

In ensuring clarity of regulatory issuance, the application of regulations of the same subject field to supervised entities of different type and size has presented a challenge. Attention has been paid to the relevance of the size of the supervised entity and the nature of the business in the application of the standards by including various application guidelines in the standards. This work continues in 2007.

AUTHORISATION PROCESS

The FIN-FSA awarded seven new authorisations in 2006; four of which were issued to investment firms and three to credit institutions. Two of the authorisations for credit institutions were awarded to credit institutions established through merger of two supervised entities. Four applications for adjustment of the authorisation for expansion of operations were approved.

Three authorisations were revoked upon the application of the companies concerned and one at the FIN-FSA's initiative.

At the end of 2006, the FIN-FSA was handling six applications for authorisation.

Supervision IT systems

The information systems used in supervision were developed and renewed at a rapid pace in 2006. The development project is largely related to the ongoing initiatives aimed at the harmonisation of reporting within the EU. The FIN-FSA's current monitoring systems were also renewed.

Basel II reporting system in the pipeline

A common reporting system will be taken into use in 2007 for reporting under the Basel II framework. The system will harmonise capital adequacy reporting in the EU. Data specifications and presentation of data will be standardised. An information system initiative related to the implementation of the system was kicked off in April 2006. The FIN-FSA arranged many events for supervised entities, addressing issues related to the roll-out of the system and the reporting language used in it. Data will be collected for the first time in accordance with the system in June 2007.

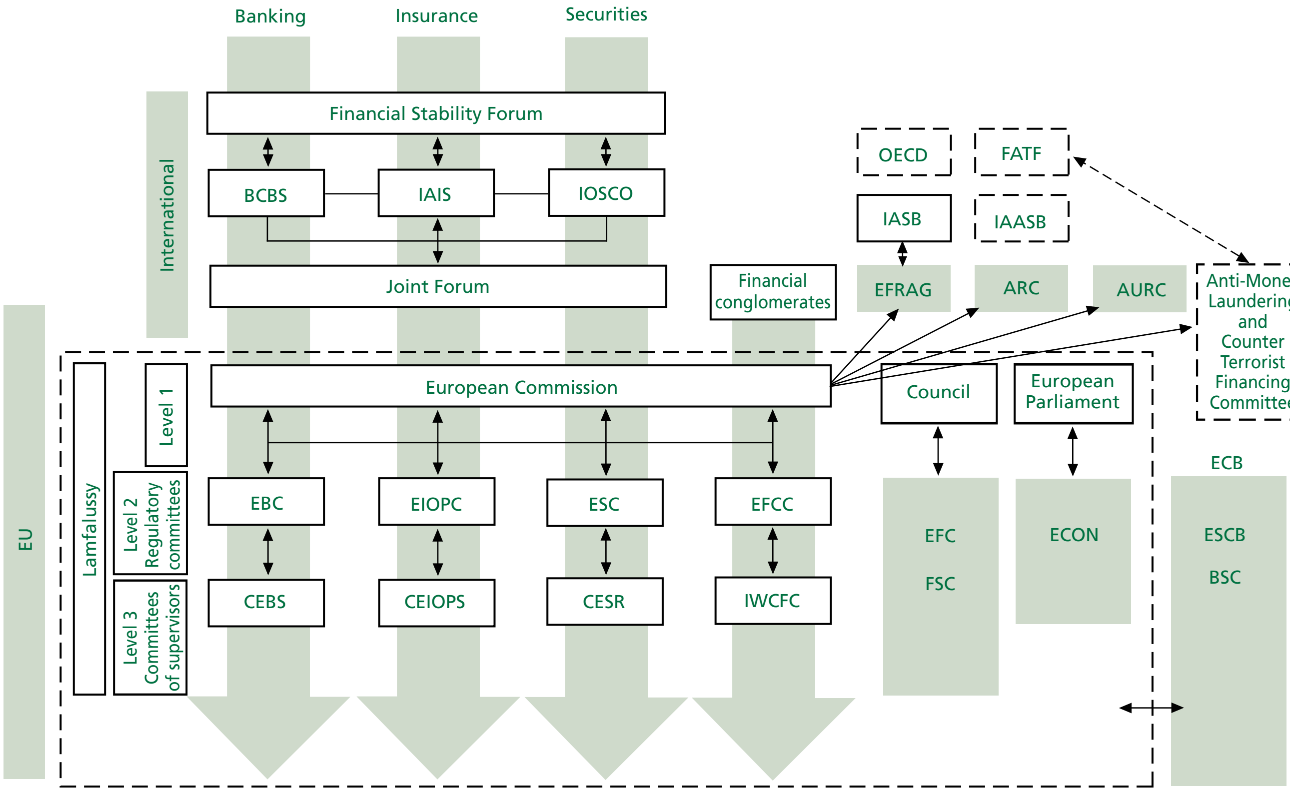
Nordic co-operation got a boost in renewing the securities transactions reporting system

Reporting of securities transactions is going to change when the Directive on Markets in Financial Instruments (MiFID) is implemented nationally. Transaction reporting under the Directive must be in place on 11 November 2007. Brokers must report all transactions made in financial instruments traded publicly in EEA countries. The FIN-FSA is developing data specifications of the securities transaction reporting system in together with Nordic and Baltic supervisors. Co-operation is aimed at standardising the specifications and increasing the efficiency of the system.

Supervision is based on timely and reliable reporting

Reliability of the supervisory information reported to the FIN-FSA was improved by reviewing the controls of individual risk monitoring systems and by making improvements to them. In addition, information technology was used to develop new concise and timely internal risk reports for the FIN-FSA and in developing inspection activities and monitoring of inspections. System overhauls that make supervision more efficient were based on improved utilisation of the present systems and the data collected.

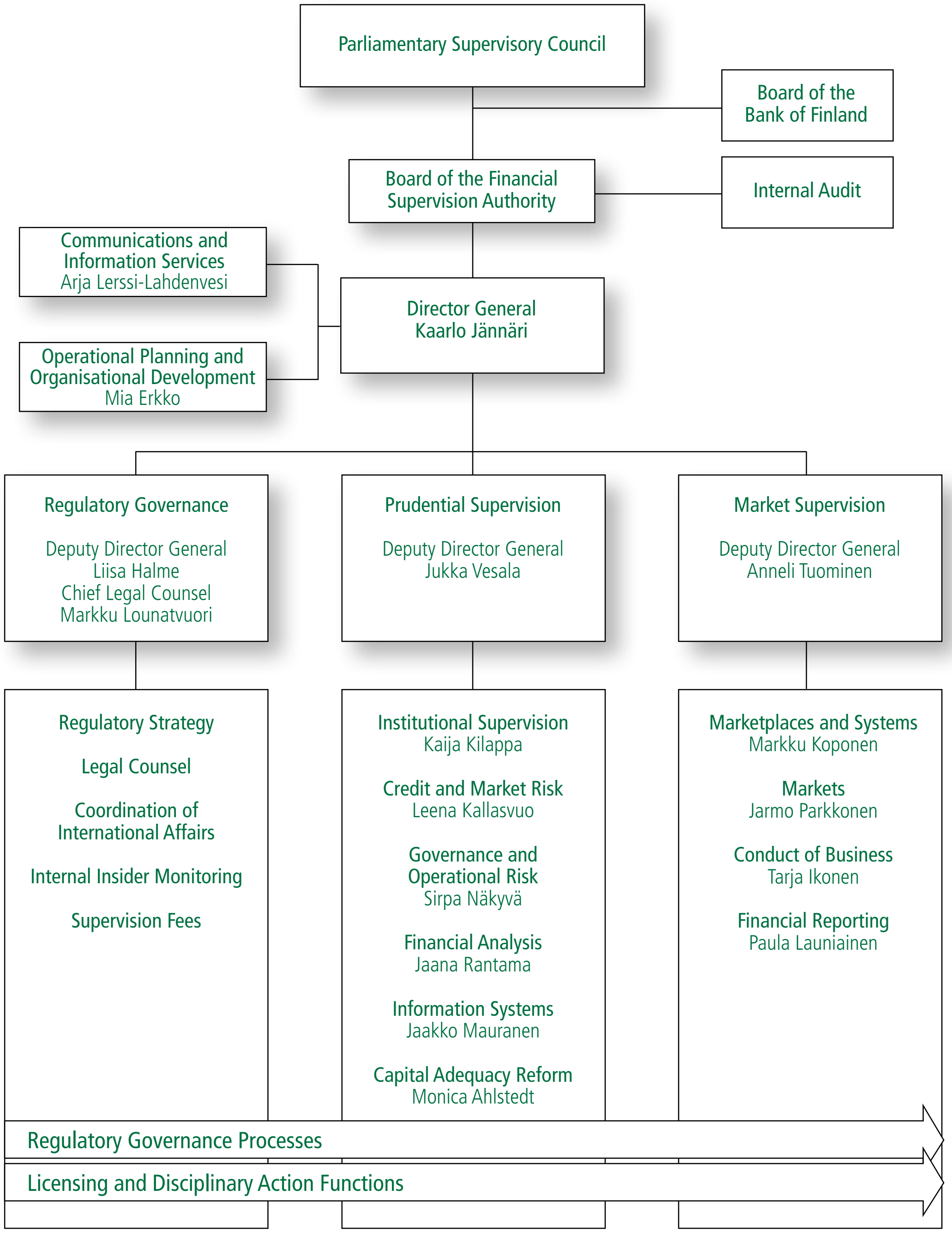
EU and international committees



ARC	Accounting Regulatory Committee
AURC	Audit Regulatory Committee
BCBS	Basel Committee on Banking Supervision
BSC	Banking Supervision Committee
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pension Supervisors
CESR	Committee of European Securities Regulators
EBC	European Banking Committee
ECB	European Central Bank
ECON	Committee on Economic and Monetary Affairs
EFC	Economic and Financial Committee
EFCC	European Financial Conglomerates Committee
EFRAG	European Financial Reporting Advisory Group
EIOPC	European Insurance and Occupational Pension Committee
ESC	European Securities Committee
ESCB	European System of Central Banks
FATF	Financial Action Task Force of Money Laundering
FSC	Financial Services Committee
IAASB	International Auditing and Assurance Standards Board
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IOSCO	International Organization of Securities Commission
IWCFC	Interim Working Committee on Financial Conglomerates
OECD	Organisation for Economic Co-operation and Development

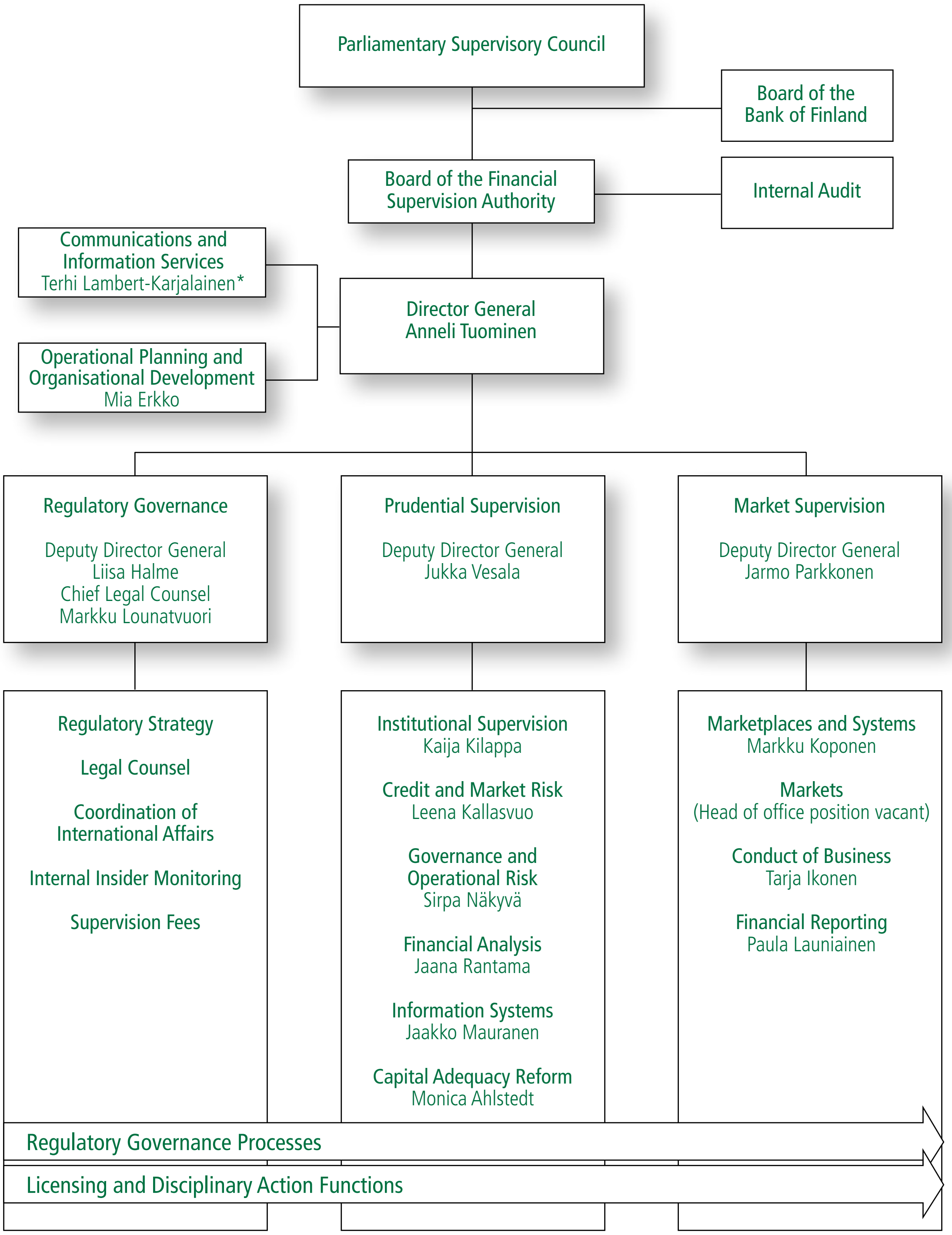
Source: Financial Supervision Authority.

The Finnish Financial Supervision Authority
31 December 2006



The Management Group members for the Finnish Financial Supervision Authority are Director General Kaarlo Jännäri, Deputy Directors General Liisa Halme, Jukka Vesala and Anneli Tuominen as well as Markku Lounatvuori (Chief Legal Counsel) and Risto Määttänen (Senior Adviser).

The Finnish Financial Supervision Authority 1 February 2007



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* As of 10 April 2007.

The FIN-FSA staffing by task, 2005 and 2006

	2006		2005	
	Number of persons	Number relative to total staff, %	Number of persons	Number relative to total staff, %
Licensing and authorisation function	5,5	4	5,5	4
Regulatory function	19,8	14	20,5	15
Monitoring and financial reporting	10	7	10	7
Financial reporting and analysis	13	9	13	9
Market supervision	12,5	9	12	9
• Public offer and listing prospectuses	4	3	4	3
• Reporting and disclosure obligations	3,5	3	3	2
• Stock exchange trading supervision and market abuse investigation	4	3	4,5	3
• Insider register	1	1	0,5	0
Inspection and supervision function	44,4	32	43,75	32
• Prudential supervision	23	17	22	16
• Monitoring codes of practice	11,2	8	13	9
• Financial market infrastructure (payment and IT systems, trading, clearing, payment and deposit systems, operators and counterparties)	10	7	8	6
• Information	0,2	0	0,75	1
International activities	4,8	4	6	4
Communications and document services	7	5	7	5
Information systems	8	6	8,25	6
Accounting, operations planning	3	2	2	1
Senior management, secretaries	9	7	10	7
Total	*137*	*100*	*138*	*100*

Source: Financial Supervision Authority.

The FIN-FSA staff, expenses and income 2002-2006

	2006	2005	2004	2003	2002
Number of personnel, at year end	137	138	138,5	138	136
Expenses and income, EUR million					
Operating expenses	17,2	15,8	15,6	15,0	14,2
Supervision fees	16,9	17,4	14,9	14,6	13,7
Processing fees	0,6	0,7	0,8	0,5	0,5

Source: Financial Supervision Authority.

Journal 2006

Main items of the Journal	2006	2005
Governance	46	47
Regulation	114	103
Market supervision	546	551
Prudential supervision	84	72
Other supervisory activity	630	569
Other	155	139
Total	*1 575*	*1 481*
Major categories of Journal entries		
Prospectuses	225	211
Notifications	188	178
Regulations related matters	139	124
Requests for further investigation	94	128
Fit and Proper reports; senior management	58	73
International cooperation	61	53
Supervision certificates	59	60
Contractual terms	44	64
Inspections and supervisory visits	44	46

In 2006, 1,575 entries were made in the FIN-FSA Journal, broken down by department, as follows: Market Supervision 1,170; Prudential Supervision 340; Regulatory Governance 65.

Source: Financial Supervision Authority.

Supervision and specific fees 2002–2006

Supervision fees, EUR thousands

Previous data is not comparable with figures for 2006 and 2005 because the Act on Supervision Fees that entered into force at the beginning of 2005 changed the criteria for supervision fees.

Fee-paying entities	2006	2005	2004	2003	2002
Credit institutions	11 016	11 482			
Investment firms	1 015	1 262			
Fund management companies	2 216	1 792			
Stock exchange	536	591			
Finnish Central Securities Depository (APK)	215	252			
Issuers	1 773	1 845			
Others	130	211			
TOTAL	*16 901*	*17 435*	*14 857*	*14 564*	*13 659*

Specific fees, EUR thousands

Fee-paying entities	2006	2005	2004	2003	2002
Fund management companies	216	220	283	159	158
Issuers	207	373	420	285	308
Others	169	76	62	28	27
TOTAL	*592*	*670*	*764*	*472*	*493*

Total fees, EUR thousands

Fees	2006	2005	2004	2003	2002
Supervision fees	16 901	17 435	14 857	14 564	13 659
Specific fees	592	670	764	472	493
TOTAL	*17 493*	*18 105*	*15 621*	*15 036*	*14 152*

Source: Financial Supervision Authority.

The FIN-FSA budget 2007 expenses and income 2005–2006, EUR thousands

	Actual 2005	Actual 2006	Budget 2007
Expenses			
Staff expenses			
Wages	8 254	8 500	8 928
Other staff expenses	2 629	2 456	2 570
Contribution to the Bank of Finland pension fund[1]		1 400	
Total staff expenses	*10 883*	*12 356*	*11 498*
Other expenses			
Training	191	183	242
Travel	451	385	471
IT expenses	1 000	1 002	2 110
Language services	320	282	350
Real estate rents and maintenance costs	1 288	1 262	1 267
Security	348	376	360
Other expenses	1 298	1 341	1 665
Total other expenses	*4 896*	*4 831*	*6 465*
Depreciation			
Equipment and furniture	28	24	61
Software	12	17	34
Total depreciation	*40*	*41*	*96*
TOTAL EXPENSES	**15 820**	**17 228**	**18 059**
Income			
Supervision fees	17 435	16 901	15 541
Processing fees	670	592	800
Other income	6	1	0
Surplus of the previous year[2]		*2 292*	*2 559*
TOTAL INCOME	**18 112**	**19 787**	**18 900**

Source: Financial Supervision Authority.

[1] The Bank of Finland's pension fund was created with the purpose to prepare for covering pension liability and finance employees' pensions. The aim is to cover pension liabilities to a level of 110% by 2012 through regular accruals to the fund. To attain the targeted level the Bank of Finland pays a contribution to the pension fund amounting to EUR 10 million in 2006. The FIN-FSA's share of the pension fund contribution is 14%, ie EUR 1.4 million.

[2] The Act on Supervision Fees (1249/2004) outlines the practice in such cases where the income from the combined supervision fees and processing fees exceed expences in the FIN-FSA's annual budget. In the case that there is a surplus for the previous year greater than 5% of the annual budget total, the fees charged to the supervised entities are reduced accordingly, taking the previous calendar year's surplus/deficit into account. Equal treatment of the supervised entities requires that an equivalent relative reduction is made to all of the supervision fees payable.

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