

2005

ANNUAL REPORT



RAHOITUSTARKASTUS
FINANSINSPEKTIONEN
FINANCIAL SUPERVISION

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In economic terms and from the financial markets' point of view, 2005 was a good year internationally and for Finland, alike. The signs are that 2006 will continue along this constructive route. Integration of the world's economy – globalisation – has proved to be a positive force. Then again, global dependence on others' success creates an atmosphere of uncertainty, which can put this development at risk.

In fact, there are many threats shadowing the stability of the world economy. The current account and public sector deficits that presently face the United States, along with their level of private sector indebtedness cannot be borne indefinitely. China, together with other Asian Tigers' export-driven rapid growth could similarly face deceleration, unless the countries are able to put more into developing their domestic demand.

Structural rigidity in Europe is still in need of being scaled down, which is not easy, and continues to cause protectionist reactions. The Japanese economy, on the other hand, is finally showing signs of its long-desired recovery.

The risks related to the price and availability of energy and raw materials are widely acknowledged. These are not exclusively economic problems but relate to broader political problems, which cannot be controlled through market forces but rather require sound political management. Sound economic policies are also essential

in order for the imbalances of the world economy to be righted, without damaging advances in prosperity.

As long as no unexpected political problems arise and no natural disasters occur, all the prerequisites for continuing favourable development already exist.

The key – the motor, in fact – of global integration is the convergence of financial markets, the opening up of capital movements. Meanwhile, the markets have developed new practices and financial instruments, whose complexity pose challenges to risk management and financial supervision, alike. The lessening in importance of national markets and the partial blending of these markets into international, global or – at the very least – regional or multi-national financial markets has continued.

Finland is a member of the European Union and part of the Union's common euro-currency area. It is therefore natural that our economy, including our financial markets, is ever more clearly an integral part of the broader European entity.

Low euro interest rates and the relatively strong growth of the Finnish economy have continued to support the rapid increase in lending that has been seen in Finland lately. The same low interest rates, growth in earnings and strong confidence

in the future have boosted the rate of indebtedness of Finnish households. Lending to households increased substantially over year, by over 15%, while loans to non-financial corporations increased by approximately 9%.

The corporate debt ratio has remained, on average, at reasonable levels. Meanwhile, the rapid growth in household lending has led to a clear risk of excessive indebtedness for some households. The Financial Supervisory Authority has repeatedly published its concerns regarding the over-heating of the housing market, in particular. The narrow lending margins, long loan periods and slips over collateral requirements are cause for concern in terms of banks' risk management and their risk-bearing capacity in the long run, were an economic downturn or crisis to hit our economy.

Having said that, Finnish banks' economic outlook at present is excellent. Despite which it behoves us to question whether the current narrow interest margins are sufficient to cover future loan losses, when the inevitable downturn occurs. Of the households likely to experience difficulties brought about by a downturn in the economy, young families with children would be most severely affected. Recently, the International Monetary Fund (IMF) has drawn attention to the hazards incurred by overheating in Finland's housing and housing loan markets. If we do find ourselves in difficulties, there is little comfort in knowing that there has been an even faster rate of growth in housing prices and lending in some other industrialised country than Finland.

Another feature identified on the lending market, although less publicly aired, has been related to the worryingly explosive growth in private equity financing'. Private equity investors and funds specialising in such investment are increasingly taking advantage of the low interest rates by raising large loans to finance acquisitions and restructuring. Thus, leveraging can be used to make a relatively small investment bring in colossal capital returns, as long as the expecta-

tions behind the restructuring are realised and interest rates remain low. Banks have been fairly open-handed in financing this type of activity; imposing interest rates of such narrowness that, when linked to loans of the size in question, forebode of undervaluation of the risks. Also, in this Finland has been following international trends and the matter can, in no way, be considered a purely Finnish phenomenon.

The positive tone experienced by the Finnish securities market continued. The OMX Helsinki All-Share Index rose over the year by close on 30%. Investment in mutual funds increased rapidly, while bank deposits grew more moderately which resulted in the largest growth in financial wealth being directed towards the securities markets or unit-linked insurance products. There is still reason to aim for harmonisation of the various investment products' taxation and marketing-related requirements in order to better encourage household investment. In practice these days, almost identical products are sold as deposits, mutual fund investments or as insurance-related savings products.

The narrowing of differences between the sectors also continued to be seen in companies' restructuring. The OKOBank Group bought out the Pohjola insurance group. The entity that came out of the take-over became a significant Finnish financial conglomerate. As the Sampo Group and the pan-Nordic Nordea Group take the form of financial and insurance 'supermarkets' it can be said that, along with the OKOBank Group, these three conglomerates form the backbone of the Finnish financial system and that, from the point of view of stability, effective supervision of the three is an essential issue. For this reason increasingly tight cooperation between the Financial Supervision Authority and the Insurance Supervision Authority is of the essence. Domestic cooperation alone, however, is not enough and closer collaboration with the supervisory authorities in the other Nordic countries and the Baltic States must be maintained. Supervision of the OMX group also requires close cooperation between the authorities. In addition to the stock exchanges in Helsinki, Stockholm and

Copenhagen, OMX owns exchanges in the Baltic countries.

Restructuring of the financial sector is probably going to continue and is unlikely to be restricted to merging or corporate reorganisation within the Nordic and Baltic region alone. Cross-border mergers and acquisitions have been initiated throughout the entire European Union area and fighting ones corner out of a sense of local patriotism is unlikely to have any significant effect on the trend, even if it has been seen in the case of some countries. This is a development that has implications on tighter supervisory cooperation both at the European Union and, partially, at the global level.

The political prerequisites for a Europe-wide supervisory system, along the lines of the European System of Central Banks (ESCB), will not exist for some time to come and it will therefore be necessary to put effort into further developing the network of national supervisory authorities in the coming years. Central to this is the so-called level three committees of the Lamfalussy process, consisting of the Committee of European Securities Regulators (CESR), the Committee of the European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). As financial conglomerates become more widely spread cooperation between these committees becomes more essential. Pressures on them to succeed and the need for them to do so are considerable. Despite a high degree of mutual trust amongst the supervisors and their aspirations regarding an increase in cooperation and harmonisation of practices, the diversity of member countries' traditions and constitutional arrangements do not make this situation any easier or even necessarily possible. Political decision-makers would be wise to ensure that all the EU countries' supervisors – including the Finnish authorities – be granted the powers and resources which would enable them to bring about the desired harmonisation and cross-border cooperation. This is one of the challenges facing Finland's Presidency of the European Union in

the second half of 2006. Nor is this merely a question of supervision, rather it also encompasses deposit guarantee cover, crisis management and central banks' liquidity arrangements, if or when some form of crisis affects the pan-European financial system.

The coming into affect of the International Financial Reporting Standards (IFRS) in the EU in 2005, pose a supervisory challenge with global connotations. The United States' supervisory authority, the Securities and Exchange Commission, has committed itself to accepting the application of IFRSs by European companies listed in the States within the period 2007–2009, as long as the European Union can assure SEC of its ability to supervise compliance with IFRS requirements. In the long run, the aim is that United States', Canadian, Japanese and many other nations' financial reporting will all converge with the IFRS, gradually leading to a truly global standard.

In Finland it is the job of the FIN-FSA to monitor IFRS compliance and the authority has been operating in close connection with other EU countries under the auspices of the Committee of European Securities Regulators (CESR) in this matter. Supervision of IFRS compliance has begun well, although we in Finland have not been able to avoid some even very difficult interpretation issues. The near future will show whether the supervision of the IFRSs, dispersed as it is throughout Europe, can operate objectively and effectively over the entire EU area.

Central also to the work of the FIN-FSA remains the challenge of supervising the new, so-called Basel II capital adequacy requirements, in Finland. The new requirements are due to enter into force by the beginning of 2007. A massive amount of preparatory work has been done relating to Basel II, not only at the Financial Supervision Authority but also within the banks and investment firms supervised by the FIN-FSA as well as by the Ministry of Finance, which has been busy drafting national legislation necessitated by the capital adequacy reform.

In addition to the Basel II directive, the many new directives concerning securities markets practices – some of which have already come into force, others are still at the preparatory stage – pose a challenge to the entire financial sector. Most demanding of them all probably being the MiFID, the directive on markets in financial instruments, due to come into force throughout the EU, on 1 November 2007. The MiFID will have a notable impact on market practices and competition.

In addition to the challenges that the regulations impose is the importance of maintaining normal, on-going supervision and inspections. When all of this is calculated together in terms of means and competence requirements, it is not far-fetched to understand that resources are put to the test. If, meanwhile Nordea or some other sizable supervised entity relocates, in juridical terms, outside the country's borders, causing a substantial gap in the Financial Supervision Authority's supervision fee revenue, we would be left facing some

fundamental questions. What level of supervision must Finland, as an EU country, maintain and how can this be funded? Outside the Nordic countries, the central bank or the state are generally the providers of at least some of the funding required to undertake supervision. This is the direction I also see Finland having to take if it wishes to uphold the level of credibility in supervision and the skill-levels that credibility requires, without adding considerably to the supervisory fee burden of the financial sector operators that remain domiciled in Finland.

These challenges add to the high level of involvement and enthusiasm in this work. I am delighted to acknowledge that enthusiasm, competence and capability are found in ample measure in the Financial Supervision Authority's staff. For which, I extend my thanks.

Helsinki, February 2006
Kaarlo Jännäri

► Strategy 2006–2008

The statutory objective of the Financial Supervision Authority (FIN-FSA) is to promote financial stability and public confidence in the operation of financial markets. The strategy for 2006–2008 includes the additional objective of competitive and effective financial markets. The vision of the FIN-FSA is to be a proactive and respected authority.

THE FIN-FSA'S STRATEGY FOR 2006–2008 COMPRISES THE FOLLOWING OBJECTIVES:

I Adequate risk-bearing capacity and sound governance within supervised entities.

II Disclosure of information fosters sound market development and due codes of conduct.

III FIN-FSA regulations are principles-based, of high quality and application of the law is foreseeable and credible.

IV FIN-FSA operations are reliable, effective and efficient.

Adequate risk-bearing capacity and sound governance

I ADEQUATE RISK-BEARING CAPACITY AND SOUND GOVERNANCE WITHIN SUPERVISED ENTITIES

Strategic focus:

- We review and assess supervised entities' risk management and Internal Capital Adequacy Assessment Processes (ICAAP) – exposures and risk management, capital adequacy and internal governance.

The statutory objective of the FIN-FSA is to promote financial stability. This means that institutions operating in the financial markets should maintain sufficient capability, in all circumstances, to provide financial services and to fulfil their commitments towards customers. From the viewpoint of efficient markets it is important that the supervisor does not seek to prevent every failure but rather that the impact of any failure would be controlled and not place financial stability at risk.

The first strategic objective 'adequate risk-bearing capacity and sound governance within supervised entities' transforms the statutory stability objective into an operative objective for the

FIN-FSA, since adequate risk-bearing capacity and sound corporate governance safeguard the continuity of the operations of supervised entities. In order to meet the objective, the focus of the FIN-FSA's prudential supervision includes the supervised entities' risk-bearing capacity, risk management, profitability and capital adequacy.

RISKS MUST BE RELATIVE TO RISK-BEARING CAPACITY

The FIN-FSA monitors the financial situation and risk-bearing capacity of supervised entities in the context of ongoing supervision and inspections. In addition, in its annual comprehensive risk assessment, the FIN-FSA analyses the risks of at least the most significant supervised entities. The FIN-FSA draws up the risk assessment according to published methodology. It also, to a significant extent, directs supervisory resources on the basis of this assessment.

In 2006, the FIN-FSA will develop its risk assessment framework in accordance with the requirements of the capital adequacy reform (Basel II) that will enter into force in 2007. This reform means that the supervisor will be responsible for assessing systematically the sufficiency of supervised entities' own funds relative to all material risks. The reform will also broaden the supervisor's powers, enabling the supervisor, on the basis of its risk assessment, to require the supervised entity to increase its own funds above the minimum required level.

The capital adequacy and risk-bearing capacity of supervised entities remained fairly good in 2005 in Finland. However, the FIN-FSA paid attention to the fact that the rapid growth in lending volumes and the slackening of collateral requirements increase banks' credit risk, particularly as far as lending to household is concerned. The FIN-FSA urged banks to ensure the adequacy of their risk management. In future, more resources will be directed at the supervision of credit risks.

The operations and risk-bearing capacity of entities responsible for maintaining the Finnish finan-

cial market infrastructure were also considered fairly sound. However, the internationalisation of these participants poses certain supervisory challenges.

INSTITUTIONS MUST MAINTAIN EFFECTIVE RISK MANAGEMENT

Supervised entities' own risk management and internal control should be effective at all times. The FIN-FSA standards on risk management reflect best practises in the sector and the supervisor's expectations on the organisation and contents of risk management. The standards do not usually specify detailed models of operation. Rather, supervised entities can choose the way best suited for them to organise their own risk management and internal control.

The FIN-FSA has made fairly good progress in the issuance of standards on risk management and internal control. The aim is that the standards on the management of market and liquidity risks as well as the standard on sound governance, which are still pending, could be issued and implemented in 2006.

All in all, supervised entities' internal control and risk management are satisfactory. In addition to the management of credit risk, the FIN-FSA has only intervened in a few individual cases where shortcomings have been identified. Adaptation of corporate governance to match international recommendations can require further measures on the part of supervised entities.

STABILITY REQUIRES SUFFICIENT PROFITABILITY AND CAPITAL ADEQUACY IN THE LONG TERM

Supervision should be as preventive as possible and aim at maintaining sustainable stability. For this reason, the FIN-FSA also assesses how supervised entities' decisions on business activities affect their future profitability and its changes, and hence their capital adequacy (strategic risks). The aim is not to intervene in business decisions,

since they are the explicit responsibility of supervised entities' top management.

In 2005, the FIN-FSA expressed its concern over the very tight competition in housing loan markets, which has led to narrow interest margins, large-sized credits and the slackening of credit criteria (eg collateral requirements). Should economic conditions become less favourable, banks could be faced with profitability problems in the future. Other income would also decrease and loan losses would correspondingly increase. These risks have heightened as credit repayment periods have continued to lengthen. The FIN-FSA has urged banks to consider customers' solvency risks and ensure the sufficiency of their own risk management.

CAPITAL ADEQUACY REFORM IMPOSES REQUIREMENTS ON SUPERVISED ENTITIES

In order for the expectations of supervised entities and markets to be fulfilled, it is essential that supervised entities comply with the new capital adequacy rules, as of the beginning of 2007. The general objective of the capital adequacy reform is to further increase the use of more sophisticated risk management methods. This is supported by providing credit institutions and supervised entities with the opportunity to use their own calculation models in determining the required minimum level of own funds.

The FIN-FSA has supported the supervised entities' preparation for Basel II regulations and the transition to the use of internal models by actively informing about the reform and the related preparatory work of the Committee of European Banking Supervisors (CEBS). This work is still under way. The scope and nature of supervised entities' activities are taken into consideration in the application of capital adequacy requirements. In the case of multi-national banking groups, the FIN-FSA works in close cooperation with other Nordic and Baltic supervisors.

Supervised entities have generally made good progress in preparing for the capital adequacy reform, even though the changeover schedule remains tight. The rapid introduction of internal models in particular requires significant system improvements by supervised entities. The appropriate organisation of Internal Capital Adequacy Assessment Process (ICAAP) also requires further development.

SUPERVISION MUST REMAIN EFFICIENT AMID STRUCTURAL CHANGE

Large financial conglomerates are still a fairly new phenomenon in Finnish financial markets, and their overall supervision still needs further development. The FIN-FSA supervises domestic banking and insurance conglomerates in cooperation with the Insurance Supervision Authority and foreign supervisory authorities. In 2006, particular focus will be directed towards the development of practical supervision, methodology for preparing risk assessments and the reporting of risks at conglomerate level.

In addition, the internationalisation of supervised entities' activities and increased activities by foreign institutions also calls for closer cooperation between supervisory authorities of Nordic, Baltic and other EU countries in particular.

Cooperation between the Nordic countries in particular is already widespread. The FIN-FSA aims at ensuring that its possibilities to contribute to the stability of Finnish financial markets remain good and that it continues to make an active contribution to the supervision of multinational conglomerates. Furthermore, it is also essential to ensure that competitive neutrality in regulation and supervision is sustained, to the extent possible, particularly in respect of the Nordic region where financial markets are already highly integrated.

Disclosure of information and codes of conduct

II DISCLOSURE OF INFORMATION FOSTERS SOUND MARKET DEVELOPMENT AND DUE CODES OF CONDUCT

Strategic focus:

- We deliver added value through our supervisory work, enhancing the reliability and quality of investor information to markets.
- We encourage service providers to adopt internal processes that comply with sound conduct of business rules (COB) in customer relationships and provide customers adequate access to quality information to use as a basis for decision.

The statutory objective of the FIN-FSA is to promote public confidence in the operation of financial markets. In practice, confidence in the markets requires for instance that information published by supervised entities and listed companies is reliable, timely and adequate. Another prerequisite is that service providers treat customers fairly and appropriately.

INSTRUCTIONS AND TRAINING FOR LISTED COMPANIES ON REGULATORY REFORMS

The reporting year was challenging for the FIN-FSA, supervised entities and listed companies alike as there were many regulatory reforms to take into account and implementation of the EU Financial Services Action Plan (FSAP) was at its peak. Several regulatory changes enhancing financial market integration were decided on, some were under negotiation of and a few had already been implemented and transposed into national law. The most important regulatory ongoing reforms in 2005 comprised the International Financial Regulation Standards (IFRSs), the Markets in Financial Instruments Directive, the Transparency Directive, the Market Abuse

Directive and the Prospectus Directive.

In addition to making an active contribution to regulatory work, the FIN-FSA also wants to guarantee that new regulations are adopted as quickly and fully as possible. The FIN-FSA believes that it can best help in the adoption of new regulations by training listed companies and supervised entities and providing them with relevant instructions.

For instance, in 2005 listed companies were instructed on changes caused by the Prospectus Directive and the Market Abuse Directive to the Securities Markets Act. These instructions concerned listed companies' disclosure obligation and insider registers. However, in its supervision the FIN-FSA is prepared for the fact that, despite ample instructions, not all new regulations have been fully adopted yet.

MAJOR DIFFERENCES IN INFORMATION DISCLOSURE BETWEEN COMPANIES

The FIN-FSA feels that, confidence in the quality of financial information remained fairly high, although there were isolated irregularities in the disclosure of information which aroused a lot of publicity. The main concern was that, even though no major problems were detected concerning disclosure by listed companies, there are still considerable differences between companies in the quality of information disclosed.

The FIN-FSA aims at ensuring that listed companies and supervised entities give as comparable information as possible of their financial situation to investors and depositors.

IFRS COMPLIANCE MONITORING LAUNCHED

The application of International Financial Reporting Standards (IFRSs) became mandatory in the consolidated financial statements of EU countries' listed companies as of 1 January 2005. In Finland, the majority of listed companies applied IFRSs for the first time in their financial statements for 2005.

As a new activity, the FIN-FSA began to monitor compliance with the IFRSs according to a series of set objectives. It concentrates on Finnish companies that have issued shares admitted to public trading or which have applied for admission of their shares to public trading. The purpose of IFRS monitoring is to maintain confidence in the operations of the markets and promote the provision of high-quality and transparent financial information to support investors in their decision making.

In 2005 the FIN-FSA surveyed the quality and effects of listed companies' communication on the transition to IFRSs. According to the FIN-FSA's findings, it is expected that there will be differences in the quality of financial statements reported according to IFRSs in 2005.

The FIN-FSA participates actively in the cooperation and coordination between EU supervisors responsible for monitoring compliance with the financial reporting requirements. This way it aims at ensuring for example that national supervision-related decisions on the application of IFRSs are as uniform as possible with decisions taken by other authorities responsible for IFRS compliance monitoring. Cooperation and coordination between supervisors is essential in the situation where regulation is on a universal scale and supervision is at national level.

ONLY ISOLATED PROBLEMS WITH CODES OF CONDUCT, UNAUTHORISED SERVICES PROVIDERS CAUSE FOR CONCERN

Through its supervisory activities the FIN-FSA seeks to ensure that supervised entities comply with legislation, international requirements and sound practices in their customer relations. This is supervised by the FIN-FSA's inspections, supervisory visits and written requests for clarification.

In spite of problems, the FIN-FSA considers that supervised entities' codes of conduct are mostly appropriate. For instance, the rapid increase in

the number of investment funds and the simultaneous strengthening of operational efficiency has resulted in a considerable increase in errors in the calculation of the value of fund shares by some mutual funds. The FIN-FSA has intervened and required that the situation be remedied.

Over the coming years, investment service providers in particular will need to change their practices due to the regulatory reforms. The FIN-FSA plays an active role as trainer and instructor also in respect of these reforms. Special attention will be paid in the supervision of service providers' internal processes. They need to conform, as far as possible, with sound conformity with good codes of conduct in their customer relations.

The FIN-FSA is alarmed by the notable increase in suspected cases of unauthorised provision of services, or even of scams and scam attempts indicating criminal activity. The FIN-FSA has raised public awareness of the situation through interviews and articles in newspaper and magazines as well as through warnings issued on the authority's website.

USEFUL INFORMATION FOR INVESTORS AND BANKING CUSTOMERS ON THE FIN-FSA WEBSITE

At the beginning of 2005 the FIN-FSA published a new directory for savers, investors and banking customers on its website. The directory provides useful information on financial products and services and the related risks. The goal is to enable the users of the FIN-FSA's website to compare financial products and services and related risks on the basis of the information given in the directory and become more active as financial services users and investors.

The FIN-FSA aims to provide website users with as real-time information as possible. These webpages provide a means for the FIN-FSA

to perform some of its statutory obligations regarding promoting the availability of information on the operation of financial markets. The FIN-FSA also publishes information on its website on conditions in the financial system and the operation of financial markets. In addition, the authority provides educational information in its online publication FSA Newsline. The FIN-FSA also participates in training directed at investors and investment seminars.

High quality regulations and credible application of the law

III FIN-FSA REGULATIONS ARE PRINCIPLES-BASED, OF HIGH QUALITY AND APPLICATION OF THE LAW IS FORESEEABLE AND CREDIBLE

Strategic focus:

- We promote the convergence of regulatory and supervisory powers and practices in EU member states.
- We foster sound market practices and appropriate internal control and risk management processes in supervised entities, through the issuance of regulations and guidelines.

The regulatory activities of the FIN-FSA are guided by the statutory objective of financial stability and public confidence in the operation of financial markets. Regulatory activities' priority areas are also affected by the additional objective included in the FIN-FSA strategy for 2006: maintenance of competitiveness of Finnish financial markets.

REGULATORY AND SUPERVISORY FRAMEWORK SHOULD ALLOW REASSESSMENT FOLLOWING MARKET STRUCTURE CHANGES

Financial market structures have continued to undergo changes and sectoral restructuring has taken place both domestically and across borders.

With its own regulation the European Union has clearly supported the creation of an integrated European market area.

In its Financial Services Action Plan (FSAP) the European Commission emphasises the importance of cross-sectoral regulatory cooperation. The Commission also stresses that securities as well as bank and insurance sectors should aim at better regulation. This means, above all, impact assessments of the need and effectiveness of regulation.

The FIN-FSA has actively contributed at EU level as well as in other regulatory and supervision cooperation contexts towards sustaining the supervisors' prerequisites for ensuring financial stability, also in times of changing market conditions. In particular, the FIN-FSA has stressed the importance of strengthening the coordinative role of home country supervisor and coordination between supervisors in different countries. This would help to ensure reliable supervision and reduce the supervisory burden related to cross-border banking groups.

The FIN-FSA has also emphasised that the host country supervisor should be given an adequate role in the supervision of systemically important branches in particular. This could require changes in EU legislation. The current regime of home country and host country supervision was established for markets of a different kind and could, to some extent, even restrict adequate cooperation between supervisors.

FIN-FSA REGULATORY ACTIVITIES SHOULD RESULT IN HIGH-QUALITY REGULATIONS

The work for the reform of the FIN-FSA's regulatory framework made significant strides in 2005. The priority of this work was on the transfer of regulatory powers relating to the capital adequacy reform (Basel II), affecting credit institutions and investment firms, to the FIN-FSA. In addition, financial reporting regulations in accordance with IFRSs' valuation principles became mandatory to all credit institutions and investment firms, in respect of financial instruments.

As regards securities markets, the FIN-FSA reformed its regulation on regular reporting requirements and declarations on insider holdings. The reforms were made to reflect amendments to the Securities Markets Act. In respect of code of conduct regulations, the FIN-FSA concentrated on combining regulations concerning banks and investment firms and cutting down details in the provisions.

The reform of the FIN-FSA's regulatory framework has clarified the authority's role as a supervisor and its expectations in respect of the operations of supervised entities. In addition to ongoing discussions on regulatory reform with supervised entities and listed companies, for each draft standard issued, the FIN-FSA requests statements on the draft standard from a broad group of stakeholders.

Although an attempt has been made to whittle down all unnecessary regulation in the context of the reform, financial market participants are still subject to a great deal of regulation. The EU has not achieved its stated objective of principles-based regulation. The level II regulation in particular is still rather detailed, which in turn affects the FIN-FSA's regulation.

FIN-FSA EXERCISES SUPERVISORY AND SANCTIONARY POWERS IN A TIMELY AND CONSISTENT MANNER

The FIN-FSA considers it important that its own operational practices are foreseeable, legally certain and equal. The FIN-FSA has continued with the policy of openness regarding the publication of supervisory measures and sanctions imposed as well as the justification of decisions given. It has also provided more information on its website on the criteria for the granting of authorisation and the use of sanctions.

According to the FIN-FSA's own assessment, supervised entities and other market participants rely on the authority's fairness and consider that it operates openly enough. On the other hand, some criticism has been voiced because of the strictness with which the FIN-FSA is seen as applying the law.

Reliable, effective and efficient FSA operations

IV FIN-FSA OPERATIONS ARE RELIABLE, EFFECTIVE AND EFFICIENT

Strategic focus:

- We ensure that the FIN-FSA has in place the appropriate skills and resources, considering the range of activities of supervised entities and the challenges of integration.

The fourth strategic objective sets the requirements of reliability, effectiveness and efficiency for the FIN-FSA's activities. The aim is also to ensure that the supervisor has adequate expertise and resources in all situations to perform the increasingly challenging tasks vested upon the authority. Attention is also given to the staff size. It should be proportionate to the scope of supervised entities' activities and the demands of financial market integration.

The effectiveness of the FIN-FSA is ultimately determined through the statutory objective of ensuring the stability and confidence in financial markets. Financial stability and the maintenance of confidence in the operation of financial markets are affected by the functioning of the market itself as well as the activities of various authorities. On the other hand, a supervisor's activities are also assessed on the basis of how well the supervisor has met the strategic and other goals set for it.

The FIN-FSA aims to undertake its supervisory and regulatory activities economically and effectively, so as to allow the supervised entities and stakeholders to experience the advantages of cooperation and of the value added, brought by the supervisory authority. It is also important that the authority is perceived as reliable and fair. High-quality supervision and regulation call for professional competence and continuing skills development.

STRATEGIC OBJECTIVES WERE ACHIEVED

The FIN-FSA's activities were carried out as planned in 2005, and the central strategic objectives set for supervision and regulation were achieved. IT system projects were also mainly carried out according to schedule.

In the years ahead, the target and strategy orientation of FIN-FSA operations will be enhanced by extending the strategy period to cover the three forthcoming years, reviewed on a yearly basis. Operating performance evaluation will be broadened and developed.

CONTINUOUS DEVELOPMENT OF OPERATIONAL PRACTICES AND SKILLS

The efficiency of the FIN-FSA's core processes was enhanced in 2005 in order to improve, for example, customer orientation and cooperation between individual organisational units. Job rotation continued to be implemented to bring about enhanced operational efficiency and to broaden professional skills among the staff.

The FIN-FSA continues to further improve processes and operational practices eg through advanced IT (for example through the introduction of the electronic workdesk).

In 2005, the focus of competence development was on the proficiency required for supervisory activities relating to the new capital adequacy framework (Basel II), the EU Financial Services Action Plan (FSAP) and the new International Financial Reporting Standards (IFRS).

The results of the survey on working atmosphere, carried out in October 2005, showed that the

working atmosphere is good and encouraging and that the staff respect the FIN-FSA as an employer. However, attention should be paid to operational practices, prioritisation of tasks and the division of work loads.

COSTS REMAINED UNCHANGED

In 2005, the operating expenses of the FIN-FSA remained at 2004 levels. Operating expenses totalled EUR 15.8, which was about 9% less than budgeted. The FIN-FSA acquired administrative services from the Bank of Finland to the value of EUR 2.2 million. In addition, the rent for the FIN-FSA premises was EUR 1.2 million.

The FIN-FSA aims at keeping the growth in the total amount of budget and operating costs in accordance with changes in general price levels. Growth in staff-related and other expenses is moderate in the forthcoming planning period. However, the budget is being increased by IT development projects resulting from requirements on IT systems imposed by EU legislation. Some of projects undertaken in 2005 were directly connected with EU-level legislative amendments and the resulting IT system requirements. The benefits of these improvements will only be visible in some years' time.

In 2005, the FIN-FSA had an operational strength of 138 persons (approved maximal operational strength 142 persons). No additional resources have been proposed for 2006–2008. The aim is to adjust the staff size according to the number of supervised entities. Administrative and economic grounds for this arise if one of the central supervised entities becomes a branch, thus leading to a fall in supervision fees.

► Operating environment in 2005

World economic growth was fairly strong throughout 2005. According to preliminary estimates, the annual growth rate reached more than 4%. US economic growth remained strong despite the damage caused by the hurricanes hitting the Gulf of Mexico and the stoppages in oil production.

Other key regions also contributed to world economic growth. In Asia, China continued to perform very strongly, whereas growth in Japan remained slower than the world average.

Euro area economic growth also fell short of the performances seen elsewhere, with the growth rate being dampened by structural problems, rising crude oil prices and the strength of the euro, particularly at the beginning of the year.

Among the positive news in 2005 were improvements in the economic prospects of the EU's large member states, Germany and France. Signs of economic recovery and inflation picking up were also seen elsewhere in the euro area. In December, the ECB raised its key interest rates by 0.25 percentage points to 2.25%. This was the first time in two and a half years that the ECB raised interest rates.

Global economic risks unchanged

Favourable world economic growth continues to be associated with a number of risks, including imbalances in US foreign trade and public finances, oil price developments, natural catastrophes and epidemics. Should these risks materialise, they would disturb the stability of the financial markets. From the point of view of the financial sector, a key phenomenon for several years has been a global abundance of liquidity, which has contributed to an increase in asset prices, growth in private sector indebtedness and low long-term interest rates.

The greatest threat in the euro area is related to the uncontrollable unravelling of global economic imbalances. Knock-on effects would be seen in both the real economy and financial markets. The debt ratio of euro area households has risen in recent years, but remains lower than in the United States and Japan.

Finland's operating environment remained favourable

The operating environment in Finland was fairly good in 2005, even though preliminary estimates indicate that GDP growth remained below 2%. Favourable developments were seen in employment, private consumption grew clearly and companies' willingness to invest remained unchanged.

Finland's economic growth was adversely affected by a paper industry labour dispute, which brought paper production to a standstill for months in spring 2005. The effects of the dispute will continue to be manifested even in the growth figures for 2006 in terms of higher production growth figures, following the restoration of previous production levels. It is estimated that, had the paper industry disagreement not occurred, Finland's GDP growth for 2005 would have been around 3%.

The operating environment was favourable for the financial sector. The number of bankruptcies and payment irregularities did not increase. The low interest rate level, growth in real income and strong confidence in future economic growth kept households' credit demand buoyant. Lending to households grew by some 15% over the year. Non-financial corporations were also active on the loan market, with corporate lending increasing by approximately 9%. Corporate indebtedness was nevertheless clearly lower than in the early 1990s, and very low by international standards. In contrast, household indebtedness has increased rapidly and unevenly. In fact, some households run the risk of excessive indebtedness.

Short market rates on the increase

In the United States, the Federal Reserve increased its key interest rates 8 times during 2005, with the reference rate being 4.25% at the end of the year. The series of interest rate rises

began in June 2004, and according to the latest market surveys, is expected to be nearing an end.

In the euro area, the European Central Bank (ECB) raised its key interest rates in December 2005 for the first time in more than two years. Short-term market rates, which are the key rates for housing loans, began to increase earlier in the autumn, as expectations about the ECB's interest rate hike began to intensify. At the turn of the year, euro area short-term market rates were approximately 0.5 percentage points higher than a year earlier. In contrast, long-term interest rates remained low, thus reflecting market expectations of future inflation and growth prospects. Both long and short-term interest rates remain historically low, however.

Euro weakened against the US dollar

The euro appreciated against the US dollar during 2002–2004. Reaching 1.34, the EUR/USD exchange rate peaked at the end of 2004, after which the euro began a steady depreciation, and by the end of 2005 it had become considerably weaker (EUR/USD 1.18). The appreciation of the dollar against the euro heightened right after the French referendum over the EU's constitution. Higher interest rates in the United States also contributed to the strengthening of the dollar at the time.

The depreciation of the euro was a contributing factor to euro area economic growth. Particularly the major exporting countries of Germany and France were supported by the weaker euro. It goes without saying that Finland's export industry also benefited from the depreciation of the euro. In contrast, euro area households' real purchasing power declined.

Upward trend in the securities markets continued

During 2005, trading on the Helsinki Stock Exchange was exceptionally active, reaching the turnover of the year 2000, although market capitalisation, EUR 203 million, was only half of that in 2000.

Share prices continued to rise in 2005. The OMX-All-Share Index increased by almost 30% during the year. Measured by the performance of the OMXH index, the Helsinki Stock Exchange does not quite reach the average growth rates of other European stock exchanges observed over the past three years. In contrast, faster growth has been recorded for indices where the weight of individual shares has been restricted, such as OMXH25 and OMXH CAP.

Share price performances vary a great deal from sector to sector. The strong upswing of the energy, metal and banking sectors in particular

continued in 2005. Sectoral indices for IT and electronics as well as forestry did not change to any noticeable effect.

The upward swing was also seen in mutual funds. At the end of 2005, the assets managed in such funds totalled EUR 45 billion (EUR 32 billion at the end of 2004). Total capital grew by 41% during the year (36% in 2004). The growth of mutual funds thus accelerated from the previous year. Furthermore, the majority of this growth was accounted for by new subscriptions, not by an increase in the value of the funds.

Slightly more new loans were issued on the Finnish bond market than before. Financial institutions in particular, along with non-financial corporations, increasingly raised capital from the domestic bond market. The majority of bond financing was nevertheless raised from abroad.

► Operations in 2005

The capital adequacy and risk-bearing capacity of the entities supervised by the Financial Supervision Authority (FIN-FSA) remained sound, despite a slight weakening in the capital adequacy ratios shown by banks in 2005. Stress tests reveal that banks' risk-bearing is capable of withstanding a sizeable drop in asset prices as well as an increase in interest rates.

Risk for banks is expected to rise in the future, however, with the rapid growth in lending stock. The FIN-FSA encouraged banks to pay particular attention to their risk management. Credit risk inspections and the extensive household credit survey conducted in the autumn outlined the chance that some households are possibly already over indebted and that banks' credit risk has edged up in line with the loosening of lending criteria.

BASEL II REFORM STILL REQUIRES NOTABLE INPUT OF RESOURCES

The Financial Supervision Authority supported the supervised entities in their preparations to meet the Basel II capital adequacy requirements. To date, preparations are close to schedule in almost all the supervised entities. Adoption of the supervised entities' own internal capital adequacy calculation models at the beginning of 2007 still

requires considerable input of resources by the entities themselves and the FIN-FSA alike. As Basel II also has an impact on the FIN-FSA's supervision of capital adequacy, the Authority undertook a restructuring of its supervisory procedures and risk analysis systems.

COMPANY-SPECIFIC DISCREPANCIES IN MEETING DISCLOSURE REQUIREMENTS

Confidence in the quality of financial information remained sound, despite a few highly-publicised incidences involving the release of inadequate information. Notable differences have been found between companies in the compliance with disclosure requirements. Over the year, the FIN-FSA issued guidelines to listed companies and provided training on the changes in disclosure requirements.

In 2005, the Financial Supervision Authority began its supervision of listed companies' financial statements – in other words IFRS supervision. The quality of information in the changeover to the IFRS was surveyed, as was the impact on company results and balance sheet in adopting these standards. The survey showed the information issued by companies was obscure and spotty in quality. The grade of the forthcoming financial statement is expected to vary.

WEB PAGES TO INFORM SAVERS AND INVESTORS

The FIN-FSA opened a set of web pages, as part of its Internet site, designed to inform and guide savers and investors. At the same time, a black list of questionable service providers was issued. The scale of suspect financial service providers seriously widened in 2005. The public was warned about the fraudulent activity in the attempt to pre-empt and identify any such scamming.

THE STATUS OF BASIC BANKING SERVICES REMAINED UNCHANGED

Accessibility to banking services and their pricing remained largely unchanged as before, according to the FIN-FSA survey. No cases have come to the FIN-FSA's attention in which the provision of basic banking services was refused without grounds.

NUMBER OF CASES REFERRED TO THE POLICE INVESTIGATION DROPPED

In 2005, the police worked through the backlog of securities market cases for investigation. At the same time, the number of new cases referred to the police by the FIN-FSA dropped, as did cases of suspected securities market abuse under investigation by the FIN-FSA.

INCREASED MARKET INTEGRATION RAISES THE IMPORTANCE OF EU SUPERVISORY COLLABORATION

With the integration of financial markets, the EU has acknowledged the need for close cooperation between home country and host country supervisors.¹ The problems facing the current supervisory and crisis management systems have been recognised as financial markets integrate.

The FIN-FSA has worked to influence the development of the regulatory and supervisory functions within the financial markets. The FSA aims to establish the prerequisites for sustainable stability of the markets, even in times of structural change. The home country's coordinating

role ought to be strengthened along with the coordination between national supervisors. The host country is also to play a strong enough role in the supervision of systemically important branch offices.

The shared work in the Committee of European Securities Regulators (CESR) and the Committee of European Banking Supervisors (CEBS) is significant and is growing increasingly close. An example of this within the CESR is the long term cooperation in issues involved in case investigation of securities markets abuse. Another is the uniform application of the international financial reporting standards (IFRS).

EU regulation has not attained all objectives relating to principle-based legislation. In particular, the so-called level two regulation is both detailed and voluminous, adding to the workload and costs of the both the FIN-FSA and the supervised entities. In renewing its regulatory framework, the FIN-FSA has sought to clarify its role as supervisor and its expectations in terms of the supervised entities' operations.

CHALLENGE OF ADEQUATE RESOURCES IN THE FACE OF INCREASING WORK LOAD

Financial Supervision Authority was staffed by 138 persons in 2005, although the approved operating strength was 142. Operating expenses totalled EUR 15.8 million, remaining at the previous year's level. Over a fifth of the operating expenses, or EUR 3.4 million, comprised rent and other administrative expenses billed by the Bank of Finland.

The new Act on Supervision Fees specified the fees payable to the FIN-FSA. During 2005, supervision and specific fees came to a surplus of EUR 2.3 million, which will be credited in return in fees due in 2006.

¹⁾ 'Home country supervisor' means the supervisory authority of the country in which the company's head office is domiciled. 'Host country supervisor' refers to the supervisory authority in the country in which the branch office is situated as well as referring to the domestic supervisor of financial conglomerates' subsidiaries.

Prudential supervision

Prudential supervision encompasses supervising the adequacy of the risk-bearing capacity of credit institutions, investment firms and fund management companies providing asset management services as well as their corporate governance procedures.

Prudential supervision assesses the supervised entities' profitability and capital adequacy as well as the credit, market and operational risks involved in their operations. The focus is on internal governance and the level and control of risks. In addition to risks relating to individual supervised entities, the FIN-FSA also analyses the overall situation of the financial markets and publishes the results of such studies.

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.

- The FIN-FSA assesses supervised entities' financial standing, capital adequacy and risk exposure via regular reporting and inspections. A comprehensive risk evaluation is prepared annually of the most significant supervised entities and selected smaller ones. In 2005, this type of evaluation was carried out concerning 8 banks or bank groups and 2 other supervised entities (an investment firm and another credit institution).
- Owing to the rapid growth of lending in Finland, exposure to credit risk was a particular focus of the inspections in 2005. The FIN-FSA drew attention publicly to the rapid growth of housing loans. The FIN-FSA believes that this growth will increase banks' risks in the future and will subject households to interest rate risk and the risk of excessive indebtedness.
- During its inspection visits, the FIN-FSA also examined the extent to which banks had prepared for the changeover to compliance

with the new international financial reporting standards (Basel II). A special area of interest was supervised entities' internal capital adequacy assessment process (ICAAP).

- The risk-bearing capacity of supervised entities remained solid in 2005. Preparations towards Basel II progressed generally according to the timetable.

Supervised entities must have reliable corporate governance procedures.

- Regulation and supervision contribute to ensuring that supervised entities are managed in a professional manner and according to sound and prudent business principles.
- In 2005, the FIN-FSA inspected the reliability and adequacy of internal control and risk management within supervised entities.
- Internal control and risk management had been arranged reasonably well, but management of credit risk and operational risk needs to be enhanced.

Correct and reliable information must be disclosed on the state of the financial market and of the profitability, risks and risk-bearing capacity of supervised entities.

- The function of disclosing information and analyses is to provide supervised entities and investors with useful information for risk management purposes.
- In 2005, analyses concerning the financial standing and risks of supervised entities as well as the overall situation of the financial market were made more thorough and the amount of information disclosed was increased. A separate analysis was published of risks concerning lending to households.

SUPERVISORY COOPERATION WITH OTHER AUTHORITIES

In prudential supervision, the FIN-FSA cooperates with the Bank of Finland, the Finnish Insurance Supervision Authority and the supervisory authorities of the Nordic countries and the Baltic states. EU-level cooperation takes place through the Committee of European Banking Supervisors (CEBS), the European System of Central Banks (ESCB) and the Banking Supervision Committee (BSC).

Owing to increased international cooperation among supervisors, the FIN-FSA's priorities in international activities were areas that are crucial to the supervision of the Finnish financial market. For example, the FIN-FSA worked on having a say in the supervision of multinational conglomerates.

FUTURE AREAS OF PRIORITY

In the near future, prudential supervision resources will be focused on finalising the capital adequacy reform (Basel II), increasing inspections in different risk areas, improving supervision of financial conglomerates and efficient cooperation among supervisors in the Nordic countries and Baltic states.

Tasks related to the Basel II reform include publication of capital adequacy standards, development of supervisory processes and assessments of supervised entities' own, so-called advanced risk management methods. Inspections will increasingly be focused on credit risk. Supervision of financial conglomerates will be improved in cooperation with other authorities (especially the Insurance Supervision Authority) and by upgrading the content of supervision in respect of financial conglomerates.

The supervision and reporting systems relating to prudential supervision must be in compliance with the requirements of the capital adequacy reform. That is why supervisory processes have been organised in line with the new capital

adequacy framework. Supervisory tools (such as risk assessment systems) are still being enhanced, in order for all the inspection and assessment methods as per the new capital adequacy framework to be complete by the beginning of 2007.

PROFITABILITY, CAPITAL ADEQUACY AND RISKS OF SUPERVISED ENTITIES IN 2005

The FIN-FSA analyses the profitability, capital adequacy and risks of supervised entities and publishes results of such analyses. In 2005, reports on the results appeared in two special analysis issues of the online publication FSA Newsline. In December, the results of a survey on lending to households were published online.

The results outlined in the following sections are based on developments in the first three quarters of 2005.

Profitability of the banking sector improved

Banks' profitability² in Finland improved as a result of the favourable operating environment in 2005. Intense competition for loan customers tightened margins, making them clearly narrower than elsewhere in the euro area. However, rapid growth in lending compensated for the narrower margins, and the combined net interest income of the banking sector continued to increase.

The demand for investment services has been solid for more than two years and remained robust during the review period. Indeed, banks are offering an increasingly wider selection of other financial services that are risk-free to them. This is reflected in a rise in fee income. In fact, already more than a third of the fee income earned in 2005 was linked to securities. Net fee income increased slightly more than net interest income.

²⁾ Due to the changes arising from IFRS, data for 2005 is not comparable to data for the previous year. The figures for Nordea Bank Finland are not included in the calculations.

Although banks continued to exercise tight control over costs, personnel expenses rose slightly from the previous year. This was partly the result of increases in wages and partly due to the need to employ more personnel in selling savings products. Overall, expenses grew very little. Because the ratio of expenses to income declined somewhat, banks' effectiveness continued to improve.

Banks' risk-bearing capacity still solid

Despite a slight deterioration in capital adequacy ratios, banks' capital adequacy continued to be good throughout 2005. Capital adequacy was burdened by the rapid growth in the stock of lending, but positive performances and equity instruments raised from the monetary markets have increased banks' own funds and kept capital adequacy ratios good.

The adequacy of supervised entities' risk-bearing capacity is also assessed using so-called stress tests. In these tests, it is assumed that such factors as asset prices, interest rate levels and credit write-downs do vary to an exceptional degree. The calculations show that in these potential stress situations, banks' capital adequacy was not endangered.

The quality of banks' own funds continues to be good, even though the proportion of capital loans from original own funds has increased in recent years. Original own funds (Tier 1) constitute more than 4/5 of banks' total own funds and they are mainly made up of equity and accrued profits.

Competition over housing loan customers increased banks' credit risks

The significance of households as banks' credit customers has increased in the last five years. More than 60% of banks' total stock of lending of EUR 107.8 billion was made up of loans to households, in comparison to 54% in early 2000. The stock of housing loans has almost doubled in the same period.

According to a survey conducted by the FIN-FSA in autumn 2005, banks' margins on housing loans have become exceptionally narrow. This is due to, for example, banks' competition over housing loan customers and the Basel II capital adequacy reform, which will reduce capital adequacy requirements imposed on banks in connection with housing loans. Although the reform will not be introduced until the beginning of 2007, some banks have already incorporated its impact into the pricing of their loans.

Housing loan margins are also affected by banks' drive towards product packaging, ie banks are increasingly offering their customers comprehensive product packages, the result being that housing loan margins depend on what other services or products offered by the bank the customer uses.

The FIN-FSA has found that in addition to loan margins, banks compete for housing loan customers by offering relaxed collateral requirements and longer loan periods and accepting higher loan-to-value (LTV) rates. A housing loan can be granted even if the applicant's own funding share is nil or if they have no other collateral or guarantees than the prospective property or the state guarantee. The deposit required for the state guarantee can in these instances be arranged through a collateral-free additional housing loan facility (offering so-called HAL loans).

The proportion of large housing loans has increased

The increasing share of large housing loans of banks' total stock of lending, coupled with longer loan periods, contribute to increased risks to banks. A housing loan is typically taken out for 21–30 years. Approximately 37% of new housing loans taken out in early 2005 fell into this category, as opposed to only 22% in 2002. According to a survey conducted by the FIN-FSA, 57% of new housing loans totalled less than EUR 100,000, with 34% of the loans being between EUR 100,000 and EUR 200,000 and 9% consisting of loans in excess of EUR 200,000.

Indebtedness is highest in the age category of 25 to 50 year-olds. In proportion to the size of the age group, those aged between 25 and 35 have the largest housing loans. This age group also takes out new lending the most. Large consumer credits obtained in connection with large housing loans further increase indebtedness. Indeed, excessive indebtedness may already be a threat to some households.

In the wake of growing indebtedness, households have become increasingly exposed to changes in market interest rates. Some 95% of new housing loans are tied to short-term reference rates, which are also often used as reference rates for consumer credit.

Fixed-rate housing loans have typically accounted for a very small share of the stock of Finnish housing loans, due to structural factors in the financial market, among other reasons. For example, only less than 5% of new loans are tied to fixed rates. The demand for housing loans with fixed interest has been feeble in recent years due to customers favouring loans with variable interest rates in an environment of low market rates. In many other euro-area countries, a substantial part of housing loans is tied to long-term interest rates. In France, for example, half of new housing loans are tied to fixed-term rates of even exceeding 10 years.

Owing to the popularity of short-term reference rates, changes in market rates are more rapidly reflected in loan servicing expenses in Finland than they are elsewhere in euro-area countries. The extension of housing loans' original repayment periods, instalment-free years and increases in the size of loans all serve to increase loan customers' exposure to interest rate risk. Indeed, indebted households bear the greatest risk associated with the rapid growth of the stock of housing loans.

Quality of the loan portfolio is still good

Overall, the quality of banks' loan portfolios has remained good so far, even though the stock of lending has expanded strongly for several years.

There have been very few write-downs of loans and other receivables. Most banks' loan loss recoveries and reversals of provisions exceeded new impairment losses, thereby boosting these banks' results.

Overall, non-performing assets and loan losses accounted for a small part of the stock of lending. However, in some sectors the share of non-performing assets of the stock of lending was larger than average. Even though this was reflected in the quality of banks' loan portfolios, no significant losses arose from loans granted to these sectors.

The structure of the profit and loss account will change in the wake of the introduction of the new practice for recording impairment losses as per the IFRS standards. In the future, the size of impairment losses entered will exceed the size of previously entered loan losses. On the other hand, according to the IFRS standards, all loans will accrue interest income (including zero-rate loans and non-performing loans). This will compensate for the impact on performance of impairment losses.

The role of risk management will become more pronounced as the strong growth of housing loans and flexibility in collateral practices will increase banks' exposure to credit risks. Economic forecasts show that customers' loan servicing capacity is not expected to undergo any major changes in the near future. This notwithstanding, hidden uncertainties in the economy, should they materialise, may contribute to making the situation gloomier.

Banks' dependency on market-based funding has increased

Banks are increasingly dependent on market-based funding, as it covers an average of 75% of all lending. Structural liquidity risks have therefore increased, because deposit funding is generally more sustainable than market-based funding. This notwithstanding, large banks have not actively sought to increase deposits, as they have noticed it is more lucrative to sell households

other forms of saving, such as units in mutual funds and insurance investments. The share of deposits increased considerably among savings banks and local cooperative banks that operate in the traditional area of banking, with the amount of deposits exceeding that of credit.

Banks prepared in advance for risks related to funding price and availability by diversifying their fund-raising programmes and stepping up the operations of their mortgage banks. Housing loans were transferred from savings banks to mortgage banks, and funds were raised via mortgage bonds from international markets. The coupon rate of bonds issued during the summer and autumn of 2005 was 2.4–2.5%. The maturities of the bonds were several years, with 5 years and beyond being a very typical maturity of a mortgage bond. The demand for these bonds was buoyant, and they were excessively oversubscribed.

Banks' combined short-term funding fluctuated from a surplus to a deficit over the course of 2005. This was due to the maturing of large bonds and the issuance of certificates of deposit. Nevertheless, most banks' funding deficits changed only little and overall, banks' liquidity can be considered to be good. Deposits amounted to nearly EUR 75 billion, up 4% on the previous year.

Banks' exposure to market risk was minimal

Banks' foreign exchange trading picked up in 2005. Despite an increase in the value of foreign exchange trades and the size of open positions, banks kept their exposure to exchange rate risk at a very reasonable level.

Overall, the banking sector had interest rate risk well under control.³ The combined interest rate risk was clearly below 10% of net profit. Expectations about an interest rate hike were felt in September 2005 in that according to calculations, banks' combined trading stock would have

generated capital gains along with rising interest rates.

3) The impact is based on an interest rate rise of 1/2 of a percentage point.

The profitability and capital adequacy of the EU banking sector remained strong

According to the European Central Bank (ECB), the profitability of the EU banking sector continued its recovery over the first half of 2005, continuing the trend started in 2003. Banks have benefited from the strong demand for loans and the ample liquidity situation. Key contributors to banks' profitability were reductions in loan loss provisions, an increase in lending to households (especially housing loans) and resurgence in the demand for corporate loans.

There are, however, significant national differences in efficiency between banks. Finnish banks are among the most profitable in the EU, with the ratio of expenses to income amounting to 57% as opposed to an average of 59% in the EU banking sector.

Banks' income structures also vary from country to country. The income structure of Finnish banks in particular differs clearly from the average income structure of the EU banking sector in that the significance of net interest income in banks' income formation is greater in Finland than in the other EU countries. For example, in 2005 net interest income accounted for 67% of banks' income in Finland as opposed to 57% in the EU banking sector as a whole.

While the overall outlook for the EU banking sector is positive, the future holds some risks. They include uncertainty of the macro economy (particularly oil price developments), an imbalance in international financial markets and the rising indebtedness of households. Although it is unlikely that major loan losses will arise from loans to households over the short term, long-term risks are becoming more evident. This is due to the fact that in new housing loans, the ratio of

the loan amount to the collateral has increased. In most countries, however, the ratio of the loan amount to the collateral in housing loans is still very reasonable. Households' financial position has also been stable in many countries.

If there were to be a sudden release of imbalances in the financial markets, direct impacts on the EU banking sector would also most likely be limited. This is because EU banks' exposure to exchange rate risk is moderate and banks' overall direct exposure to interest rate risk is minimal. This notwithstanding, the banking sector would incur indirect damage if the financial position of their customers were to deteriorate due to an increase in oil prices or changes in exchange rates.

Improvements in banks' risk management systems have been a positive development. However, the transfer of credit risk from bank to bank and from banks to other financial institutions, which has become common recently, has not yet been subjected to stress tests. Banks' strong results for 2004 and the early part of 2005 have nevertheless given opportunities for boosting profitability and capital adequacy buffers. Profitability indicators, which have been calculated for the 15 central banks of the old EU member states, have improved steadily from 2003 onwards. Thus confidence in the positive outlook regarding the banking sector's profitability and operating environment in the near future has remained strong. This can also be interpreted in such a way that the majority of the large EU banks have their risk exposures under control.

Demand for investment services

The operating environment for investment firms remained good during 2005. Share trading was buoyant and turnover increased from the previous year. Demand for asset management services was also seen to increase. Investment firms' fee income increased as a result of a cyclical upturn, even though the growth rate slowed down over the course of the year.

Nonetheless, in 2005 fee income rose to levels last seen in 2000.

Investment services are popular in the current market situation. The amount of managed funds has continued to increase substantially. The majority of this growth is due to the popularity of mutual funds as a form of saving. This is reflected in asset management in two ways: the majority of funds in asset management are funds that have been invested in mutual funds, and the funds of asset management customers are being invested in mutual funds. Nearly half of the assets managed at investment firms are assets of Finnish mutual funds. Fee income arising from asset management increased but not in equal proportion to the volume of funds in asset management. Tightening competition will reduce fee income.

Investment firms' fee income from securities intermediation is approximately half of the fee income obtained from asset management. As in asset management, the growth of fee income in securities intermediation is slower than the activity of the investment market would suggest. Competition among securities intermediaries over market shares is intense. Remote brokers accounted for about 60% of total share trading in 2005, an increase of 4.2 percentage points from the previous year.

Investment service providers have performed well during the last two years. Good profitability has also boosted investment firms' capital adequacy. Their combined own funds have more than doubled in comparison with the statutory requirements.

ONGOING SUPERVISION AND INSPECTIONS

Owing to the rapid growth of lending, exposure to credit risk was a particularly strong focus of the FIN-FSA's inspections in 2005. Banks were urged to pay attention to risk management, as a survey on housing loans conducted in the

autumn showed that banks' risks had increased, especially in housing loans.

Preparation of national legislation and the FIN-FSA's own standards as well as work carried out at the Committee of European Banking Supervisors (CEBS) required a substantial amount of prudential supervision resources.

Supervision enhanced on the basis of risk assessments

The FIN-FSA assesses the financial position, capital adequacy and risk exposure of supervised entities on the basis of regular reporting procedures. Inspections are mostly focused on entities that are of great significance to financial market stability. With regard to smaller entities, risk analyses are prepared on the basis of the information submitted by them, and they are used to select individual inspection targets.

During the year, extensive and systematic risk assessments (using the FIN-FSA's KAR system) were prepared of the supervised entities having the greatest significance for financial market stability. These assessments focused on profitability, capital adequacy, risk exposure, strategy, reliability of management, internal governance and the level of risk management for specific risk areas. The key risk areas are credit risk, market risk, liquidity risk, operational risk and strategic risk.

General assessments of domestic and international bank groups were prepared in cooperation with supervisory authorities at home and abroad. The risk assessments and any resulting necessary supervisory actions were discussed by the FIN-FSA management and at meetings with the representatives of the supervised entities' executive management.

Credit risk inspections were enhanced

Credit risk inspections were increased in 2005. Inspections focused on collateral procedures, the pricing of credit, the credit granting and deci-

sion-making process, large exposures and the adequacy of banks' internal risk control. Special attention was paid to loan marketing.

Inspections revealed that branch offices had not always complied with the internal guidelines issued by their headquarters in respect of collateral. Likewise, customers' loan servicing ability had not been properly investigated in all cases. Aggressive marketing of consumer credit in connection with housing loans was very common.

The FSA urged the banks to remedy the shortcomings identified in the management of credit risk. In future inspections, the focus will be on checking whether banks comply with sound lending principles and contribute to ensuring, in line with good banking practice, that their customers do not run excessive debts, even though the customer's own responsibility also needs to be emphasised.

Household lending survey also showed risks had increased

In autumn 2005, the FIN-FSA investigated the state of competition in lending to households as well as banks' risks by conducting a survey targeted at Finnish banks, covering 93% of the housing loan market. Banks were asked to explain how risks associated with housing loans have been taken into account in their lending and risk management activities.

The survey showed that in some branch offices, tighter competition has led to a relaxation of collateral requirements, higher loan-to-value (LTV) rates, longer loan maturities and exceptionally narrow margins.

The FIN-FSA urged the banks to address the shortcomings identified in risk management. In addition, banks need to incorporate into their lending approach procedures that take into account the customer's financial capacity. To ensure adequate risk management, the FIN-FSA requires that banks comply with the provisions of

its standard on credit risk management as regards the criteria on granting loans to households, their prices and collateral and the related internal guidelines issued by the bank as well as supervision of compliance with these guidelines. In future, the FIN-FSA will pay increasing attention to ensuring that the provisions of the standard are complied with.

Approval process of internal ratings-based approaches (IRBA)

One of the aims of the new capital adequacy framework (Basel II) is to increase the use of advanced risk management methods. When calculating minimum capital adequacy in credit risk, supervised entities can replace standardised methods and apply so-called advanced methods, which are based on supervised entities' own internal risk classifications (Internal Ratings Based Approach, IRBA). These methods can be applied with effect from the beginning of 2007.

Because the application of the IRBA model requires acceptance by the authorities, the FIN-FSA has created the necessary application and approval procedures. Introduction of the IRBA methods continues to pose great challenges to both banks and the FIN-FSA.

The capital adequacy directive regulates the approval of IRBA models in such groups of supervised entities, where the entities have subsidiaries in other EU member states. The Committee of European Banking Supervisors (CEBS) has also issued detailed guidelines especially on the introduction of international approval processes. The approval process is coordinated by the home country supervisor of the parent company of the supervised entity, with contributions from supervisors from all those countries where the supervised entity has subsidiaries.

In 2005, Nordic and Baltic supervision authorities agreed on joint procedures in respect of the approval of IRBA models in cases where supervised entities have cross-border operations. The FIN-FSA acts as the consolidating supervisor in one approval process and began an off-site

review of the application of one international banking group. As a host country supervisor, the FIN-FSA also participated in a joint approval process with the other Nordic supervisors. In future, the FIN-FSA will participate in other approval processes.

The FIN-FSA will charge a service fee for the handling of applications regarding the IRBA method. The size of the fee is based on the scope of operations included in the IRBA model and on the amount of work entailed in the assessment of the models.

Preparations towards Basel II progressed according to timetable

Supervised entities must have their Basel II compliant internal capital adequacy assessment process (ICAAP) in place with effect from the beginning of 2007. They also need to have established appropriate operating processes and IT systems for the calculation of the minimum capital requirement and the reporting and disclosure of information.

The aim of the FIN-FSA's inspections was to ensure that supervised entities succeed in establishing the necessary internal capital adequacy assessment processes within schedule. All in all, projects related to capital adequacy management processes progressed so well in 2005 that most supervised entities can be estimated to have the required Basel II-compliant systems in place with effect from the beginning of 2007. However, some supervised entities were still lagging behind and communication about the Basel II reform was targeted at these entities.

In October 2005, the Basel Committee on Banking Supervision started the fifth test calculation (QIS5) on the impact of the capital adequacy reform. The Committee of European Banking Supervisors (CEBS) coordinates the collection of information at the EU level on the size and distribution of solvency capital for the impact assessment. The FIN-FSA prepared the guidelines and carried out the collection of information

in Finland. The results of the assessment will become available in spring 2006 and they will be used in the finalisation of Basel II requirements.

Supervised entities progressed in the management of operational risk

Management of operational risk continued to be assessed in several supervised entities over the course of 2005. The aim was to find out what methods are employed by supervised entities to investigate and monitor operational risk and what measures they have taken to reduce these risks.

Basel II capital adequacy requirements include a new feature: a capital requirement must be calculated on operational risk. That is why another aim of the inspections was to ensure that supervised entities develop their assessment and monitoring systems in respect of operational risk and incorporate in their own development work the requirements laid down in the FIN-FSA standard on the management of operational risk.

Exposure to operational risk was also inspected as part of internal control and in connection with inspections of credit risk and market risk. Some shortcomings that contribute to operational risk were detected in the division of responsibilities, monitoring and reporting systems as well as in internal guidelines. The FIN-FSA demanded that the banks remedy the shortcomings identified.

In 2005, supervised entities developed their monitoring, reporting and IT systems so that by the beginning of 2007 they would have the necessary systems in place required by the capital adequacy reform in respect of capital adequacy calculation and reporting. Several supervised entities also improved their internal systems for the collection of data on losses in line with the relevant FIN-FSA standard.

COOPERATION IN THE FIELD OF SUPERVISION

Cooperation among supervisors has intensified due to the increasingly international nature of

operations carried out by supervised entities and the emergence of financial conglomerates. Domestic financial conglomerates are supervised in cooperation with the Insurance Supervision Authority and foreign supervision authorities. The FIN-FSA has increasingly closer cooperation particularly with the Nordic and Baltic supervision authorities.

Extensive cooperation in the supervision of Nordea and Sampo continued

Financial conglomerates were supervised in cooperation with the Insurance Supervision Authority based on an established practice. Cooperation with the Swedish supervisor (Finansinspektionen) in respect of the Sampo group was enhanced via contributions by other Nordic authorities. In autumn 2005, cooperation in supervision was extended to the amalgamation of cooperative banks, when OKO Bank acquired a majority holding in the insurance company Pohjola.

The regulatory capital, economic capital, risk position and risk management of financial conglomerates were assessed on a regular basis. Development work began on supervisory practices and related reporting systems in order for supervision authorities to get a more reliable picture of financial conglomerates' risk areas and the risks related to internal transactions within the conglomerates. This work is continuing in 2006.

Joint investigations were also begun to establish the impact of the capital adequacy reforms (Basel II and the so-called solvency II) currently under preparation on the operations and supervision of financial conglomerates.

Cooperation among Nordic supervision authorities focused on the supervision of the Nordea Group. The FIN-FSA supervises Nordea Bank Finland and, together with other Nordic supervisors, contributes to the supervision of the entire Nordea Group, as coordinated by the Swedish supervision authority. Nordic supervision authorities have established a cooperation group, which

coordinates the supervision of Nordea on a regular basis by confirming joint inspection plans and supervising their fulfilment.

Close Nordic cooperation was also seen in matters concerning regulation. In 2005, two expert groups consisting of representatives from Nordic supervision authorities focused on the Basel II reform with the aim of harmonising regulations in the Nordic countries.

Cooperation with the Baltic supervision authorities was increased. Meeting regularly, the authorities discussed thoroughly various issues relating to the supervision of Finnish banks' subsidiaries and branch offices operating in the Baltic states. Baltic supervisors contributed to the annual Supervisory Review and Evaluation Process (SREP) concerning the Nordea Group and the Sampo Group. They are also involved in the acceptance inspection of the Internal Ratings Based Foundation Approach (IRBA) being adopted by the Sampo Group, which started in 2005 and is coordinated by the FIN-FSA.

Committee of European Banking Supervisors harmonises supervision practices

Cooperation among European banking supervisors increased considerably in the wake of active work by the Committee of European Banking Supervisors (CEBS). The committee prepared two draft guidelines in 2005, which were concerned with cooperation between home and host country authorities and the acceptance of IRBA methods in capital adequacy calculation. The committee also accepted a new framework for capital adequacy reporting.

The FIN-FSA was involved in the preparation of the draft guideline on cooperation between the home country and host country supervisors. The guideline sets out the general principles applicable to cooperation among supervisors in the supervision of multinational banking conglomerates. The FIN-FSA considers the guideline to be beneficial for all countries responsible for supervision. It also considers it important that the

cooperation principles detailed in the guideline are applied to the supervision of a multinational conglomerate operating through both subsidiaries and branch offices. The streamlining of cooperation among supervisors also benefits multinational banking conglomerates, because they are being managed through an increasingly centralised business structure rather than legal units.

The CEBS draft guideline on the approval and implementation of advanced approaches (IRBA, AMA) in capital adequacy calculation concentrates especially on cooperation among supervisors in the acceptance of methods used by multinational banking conglomerates. The FIN-FSA took part in the preparation of this guideline and began to apply the principles to the acceptance of those methods. The CEBS also worked on guidelines for the Supervisory Review Process (SREP). The FIN-FSA has made a contribution to the preparation of these guidelines.

The new capital adequacy framework (COREP) approved by CEBS corresponds to the FIN-FSA's requirements on capital adequacy reporting. The framework will become applicable as of the beginning of 2007.

The work of a committee preparing common European standards for the reporting of IFRS financial statements to the authorities was completed in autumn 2005. The FIN-FSA has begun preparations for the introduction of this harmonised reporting framework (FINREP).

The Banking Supervision Committee of the ESCB promoted prudential supervision

Together the FIN-FSA and the Bank of Finland take part in the work of the Banking Supervision Committee (BSC) of the ESCB. The committee promotes cooperation between central banks and supervision authorities on the supervision of the financial conditions and risks of the EU banking sector and on crisis management. This cooperation focuses on such issues as structural changes in the European banking sector and the operation

of multinational banking conglomerates from the point of view of financial market stability.

In 2005, the FIN-FSA participated in the activities of two working groups under the Banking Supervision Committee. The working groups investigated and prepared reports on the stability of the European banking sector, banks' strategies and risks as well as major EU banks' large exposures. Jointly collected data and analyses are useful as they provide national supervisors a good basis of comparison.

DEVELOPMENT OF PRUDENTIAL SUPERVISION

Development of prudential supervision is guided by the new capital adequacy framework (Basel II), which will be introduced with effect from the beginning of 2007. Supervisory processes in the FIN-FSA have already been organised in line with the reforms adopted in prudential supervision. Development of supervisory methods continues to ensure achievement of the necessary supervision readiness.

Capital adequacy reform introduces new supervisory tools

Key to the new capital adequacy framework is the overall assessment of capital adequacy (Pillar 2). It will introduce obligations that apply to both supervised entities and supervisors alike.

Supervised entities are required to establish a comprehensive internal capital adequacy assessment process (ICAAP), whereby they evaluate their capital needs and risk management procedures on the basis of all material risks. Capital adequacy management is an integral part of reliable corporate governance in supervised entities.

Supervision authorities in turn regularly assess supervised entities' capital adequacy management and their level of capital adequacy relative to the overall risk. The new framework broadens supervision powers in that supervision authorities can set a requirement on capital adequacy,

which exceeds the minimum capital adequacy requirement.

Supervisory processes and the risk assessment system are being upgraded

Work on preparing the FIN-FSA for the changes arising from the capital adequacy reform progressed according to plan in 2005. The FIN-FSA developed its own operations and its current risk assessment system to make them compliant with the requirements of the reform.

In order to ensure effective assessments, the Prudential Supervision Department was reorganised to reflect the new tasks and reforms in supervision. To ensure the quality of the assessment process, the necessary tools for analysis are being developed further. This applies particularly to advanced risk management methods and the assessment of supervised entities' risk-based capital. Staff competence in the new capital adequacy reform was enhanced through training and international cooperation.

In spring 2005, the FIN-FSA published online a description of its current risk assessment system. This system will continue to be a key tool in capital adequacy monitoring in the future. The risk assessment system and the related methodology will continue to be developed on the basis of the supervisor's assessment process in line with the Basel II reform and the needs of supervision.

The FIN-FSA defined its internal procedures and described its approval process for the advanced methods of capital adequacy calculation. Supervised entities were notified of the acceptance process in summer 2005.

As part of the capital adequacy reform carried out during the year, the FIN-FSA started to define an acceptance procedure for credit rating institutions' credit ratings. In addition, a project related to the capital adequacy reform was started on the fulfilment of the disclosure requirements by supervision authorities. In November 2005, the Committee of European Banking Supervisors

(CEBS) issued its recommendations on the disclosure requirements. The FIN-FSA will continue to comply with the recommendations of the CEBS in announcing principles and methods in the general assessment of capital adequacy and disclosing national decisions and statistical data relating to the implementation of the reform.

The capital adequacy reform will also change the contents and technical presentation of capital adequacy data to be reported to the FIN-FSA. Capital adequacy reporting will serve as one source of information along with other types of risk reporting in assessing capital adequacy management within supervised entities. Preliminary investigations on IT modifications relating to the assessment process and reporting by supervisors were started towards the end of 2005.

Market supervision

Market supervision encompasses oversight of conduct of business, marketplaces and systems and monitoring of compliance with financial reporting requirements.

Supervisory authorities focus on eg market practices, issuers' disclosure requirements and securities market infrastructure. In addition, inspection 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 guided in 2005 by the following strategic objectives.

Disclosed information supports healthy development of markets.

- Listed companies were given guidelines and training on amended disclosure requirements in 2005.
- The monitoring of compliance with financial

reporting by listed companies was begun and an assessment was made on their transition to IFRS. Listed companies were informed of the new supervision task of the Financial Supervision Authority. Inspections of opening IFRS balance sheets were conducted at banks adopting the IFRSs.

- No significant irregularities were found in the disclosures by listed companies but there are still considerable differences between companies.
- The quality of the IFRS financial statements of listed companies is expected to vary. Problematic issues include the accounting treatment of corporate restructuring, impairment testing, segment reporting, hedge accounting and the use of fair value reporting.

Market practices are appropriate.

- Supervision of market practices in 2005 focused eg on the processes and practices related to trading orders and the allocation of executed transactions, the division of responsibilities between the main broker and sub-broker and compliance with the Act on the prevention of money laundering.
- Practices followed by supervised entities were mainly found to be appropriate in 2005, although there were individual irregularities. Awareness of the issues regarding the prevention of money laundering is relatively good. There has been a considerable increase in the provision of suspicious or even potentially criminal provision of investment services.
- Basic information on products and service providers on the financial markets was gathered at the FIN-FSA website for savers and investors. Feedback received about the site has been positive.
- Warnings about unauthorised service providers were issued so that attempts of investment fraud could be recognised already in advance.

SUPERVISORY COOPERATION WITH OTHER AUTHORITIES

Progress with respect to the EU's internal market has increased the need for cooperation between authorities considerably. The Financial Supervision Authority focuses on cooperation in the scope of the Committee of European Securities Regulators, CESR. In many areas, this work has focused on preparation of the so-called level-two recommendations for the European Commission. In the future, the focus will shift more towards deepening supervisory cooperation in practice.

At the moment, supervisory cooperation in the CERS is most advanced in issues related to the inspection of market abuse and the application of the IFRSs. In the future, cooperation concerning the supervision of investment services and securities prospectuses will also be highlighted. To ensure the smooth functioning of the internal market, supervisors are aiming their cooperation at the uniform interpretation of regulations across the EU. Another goal is effective inspection of market abuse across country borders.

FUTURE AREAS OF OPERATIVE FOCUS

In the near future, market supervision will focus on the supervision of the amended disclosure requirements for listed companies and compliance with financial reporting requirements. Listed companies will receive guidance on changes in regulations relating to the disclosure obligation.

Another important focus area in supervision is to ensure that the functionality and reliability of the infrastructure of the securities markets is maintained while the integration of stock exchanges and settlement systems continues.

The Financial Supervision Authority participates in the implementation of the Directive on markets in financial instruments (MiFID). Further development will be put into increasing awareness of the web service site for savers and investors and its topicality will be enhanced.

SUPERVISION OF MARKET PRACTICES

Market practices were mainly appropriate in 2005, although there were some individual irregularities.

A website opened for savers and investors

At the beginning of 2005, the Financial Supervision Authority opened the website "Säästäjälle ja sijoittajalle" aimed at investors and banking customers. The objective is to provide customers with information to enable them to better assess financial services and related risks.

Since the site was opened, its content has been broadened, including adding topical material relating to IT security and investment products, such as index loans.

During the year, experts from the Financial Supervision Authority gave presentations on topical issues in various training events and seminars. The FSA Newsline publication focused in 2005 on articles aimed at savers and investors.

Website warning lists concerning unauthorised service providers

Unauthorised provision of service and investment fraud usually comes to the attention of the Financial Supervision Authority through contacts made by the public. In 2005, the FIN-FSA made a particular effort to warn the public about such service providers so that fraud attempts could be recognised before they are realised.

The FIN-FSA started to publish a warning list on its website about companies potentially related to investment fraud. Methods typically used in investment fraud were also discussed in the "Säästäjälle ja sijoittajalle" directory, in the FSA Newsline web publication and the SijoitusInvest event in November.

Number of contacts with the FIN-FSA remained unchanged

Contact made in 2005 by private persons and companies to the Financial Supervision Authority remained at previous levels (122 contacts in total). Contact was increasingly made through the Internet.

A majority of incidences concerned the practices of banks, investment firms, management companies and pawnbrokers. The largest subject area of contacts concerning banks were questions related to loans and their collateral, but there was also an increase in the number of questions related to cards and various account facilities. Often the enquirer was the trustee of a deceased person's estate or the beneficiary of an estate. The problems that emerged were mainly individual cases rather than problems related to a general market practice. The FIN-FSA has taken measures when irregularities have been suspected.

Inspections of banks' customer feedback systems that were begun in the previous year were continued in 2005. The inspections did not reveal any major deficiencies in the handling of customer feedback.

Disputes between service providers and individual customers were also handled at the Advisory Office for Bank Customers and the Securities Complaint Board. The Advisory Office received 1,428 contacts and the Securities Complaint Board 288 contacts. A majority of issues handled by the Advisory Office concerned the use of accounts, payments and loans. The Securities Complaint Board received questions that most often concerned securities broking, mutual fund operations and investment advice.

No significant changes in pricing of basic banking services

In July 2005, a review was made of the availability and pricing of basic banking services. There were no significant changes in the pricing or availability of services from similar reviews previously conducted by the Financial Supervision Authority.

The Financial Supervision Authority has not become aware of any cases where a bank had declined the provision of basic banking services without justification. The most expensive service continued to be the payment of an invoice at a bank branch, but usually a more affordable alternative is also available, such as payment service and direct debiting.

Management companies need to continue paying attention to internal controls

Inspections concerning the calculation of the net asset value (NAV) of mutual funds and mutual fund unit registers focused on the functionality and reliability of processes related to the management of mutual fund unit registers and NAV calculation. Both inspections covered all management companies and were conducted partly as inspection visits and partly as surveys.

Inspection of mutual fund unit registers revealed that the name of the unitholder had not always been recorded in the register. Instead of the unitholder, the register contained the name of the asset manager, which was typically a foreign credit institution or investment firm. In accordance with the Mutual Funds Act, however, nominee registration is not allowed, rather the name of the unitholder must always be recorded in the mutual fund unit register.

A further inspection on the calculation of the net asset value of mutual funds indicated that management companies had mainly taken recommendations by the FIN-FSA into account in their NAV calculation. However, in some management companies, the number of mistakes in NAV calculation had increased considerably. The mistakes had been caused by a rapid growth in the number of mutual funds and concurrent improvement of operational efficiency. The FIN-FSA has taken measures when irregularities have been observed. The functionality of the internal controls of management companies will be highlighted in the future as the number of unitholders increases, the size of mutual funds grows and products become increasingly complex.

Inspection of risk management concerning the investment operations of management companies was begun in autumn 2005 and continues in 2006. The inspection aims to find out how management companies identify, measure and assess risks resulting from their investment operations. The objective is also to find out how they intend to limit these risks and how the internal control of management companies works with regard to risk management. The inspections are based on an amendment made to the Mutual Funds Act in 2004. At that time, general provisions on the risk management of a management company were included in the Act, and an opportunity was given to use derivatives in investment operations.

Applications for permission to merge mutual funds increased

In 2005, the FIN-FSA received many applications for permission concerning the implementation of a merger between mutual funds. About ten mutual funds were merged during the year with other mutual funds.

Management companies have considered the merger of a mutual fund with another mutual fund a better solution for the unitholder than the dismantling of the fund. Mutual funds have been forced to resort to these measures for example when mutual fund assets or the number of unitholders have decreased below the minimum levels provided in the Mutual Funds Act. Measures have also been taken in circumstances where a management company has ended up managing several largely similar mutual funds. This may have been the case for example in the context of corporate restructuring in the financial sector.

Mutual fund mergers can be expected also in 2006. In considering the prerequisites for a merger, the Financial Supervision Authority assesses how well the requirements of the law, such as the interests of the unitholders are fulfilled.

Handling of trading orders and practices in allocation of transactions are appropriate

In spring 2005, the FIN-FSA reviewed securities intermediaries' and asset managers' processes and practices in relation to transactions and the allocation of transactions exercised. The review focused particularly on whether the equal treatment of customers was endangered or hindered due to proprietary trading by the supervised entity. The review looked into 9 market participants. A survey conducted prior to the review covered 43 securities brokers and asset managers.

The inspections and the review did not reveal significant problems in relation to the customers' interests, equal treatment or conflict of interests. Securities intermediaries and asset managers have acknowledged the importance of the equal treatment of customers and the management of conflicts of interests in the procedures relating to trading orders and the allocation of transactions. Many processes relating to trading have been automated to a fairly large extent.

In contrast, equal treatment and management of conflicts of interests had not been analysed in all respects concerning different services, customer groups and products. There were not always principles agreed on in advance for partially exercised orders and incorrect transaction allocation.

The Financial Supervision Authority has issued specific guidelines on the equal treatment in the customers best interests in providing investment services.

Ambiguities in the division of responsibility between the main and sub-broker

The use of agents in the transmission of securities trading orders were inspected in spring 2005. The objective was to find out how and through what kind of agents trading orders concerning investments were transferred to those executing them. In addition, assessment was made as to

whether the customers' agents were engaging in operations requiring an authorisation. A survey related to the inspection was sent to 62 securities intermediaries. The inspection visits were made to 5 securities intermediaries, chosen on the basis of the survey responses.

The inspection revealed that the division of responsibility between the main and sub-broker was often unclear and that it had been interpreted in many different ways. The agreement structure used had caused uncertainty and different interpretations on whose agent the sub-intermediary was. The FIN-FSA underscored to the securities brokers that full responsibility for the trading order belonged to the main intermediary. In addition, the importance of clarification of the agreement structure was emphasised.

The inspection also revealed that customers' agents often acted as agents for many customers. Their authorisations were of continuous nature. In addition, the extent and flexibility of the authorisations pointed towards asset management. As regards these market participants, the FIN-FSA will conduct a separate assessment on their need to change their operations or apply for authorisation.

Obligations provided by Act on prevention of money laundering followed fairly well

Awareness of the obligations provided by the Act on the identification, due diligence and money laundering were assessed in 2005 with a review. In the same context, it was also assessed how the EU's new, third directive on the prevention of money laundering would affect the procedures of supervised entities. Responses were received from 130 credit institutions, investment firms, management companies and branches of foreign credit institutions and investment firms.

A majority of the respondents of the survey met the requirements of current legislation on the identification of the customer. The respondents had, almost without exception, organised their operations and risk management so that they

had the prerequisites in place to prevent money laundering and other abuse that might put their operations at risk. Almost all of them had assigned a contact person responsible for internal coordination and communication with the authorities in issues relating to the prevention of money laundering. Similarly, almost all of them had set internal guidelines and trained their personnel. However, there was room for improvement in due diligence. In addition to identification, the customer's financial situation, operation and use of services must be monitored on a regular basis. The new EU directive on the prevention of money laundering will provide clearer requirements for knowing the customer's operations and the development of methods for monitoring customer relationships.

During the year, the FIN-FSA made inspection visits and inspections related to the prevention of money laundering and provided training events on a regular basis.

450 money laundering notices from supervised entities

The Money Laundering Clearing House received a total of 3,661 notices of suspicious transactions in 2005. Entities supervised by the Financial Supervision Authority gave 482 notices to the Clearing House, and 143, ie 34%, of these were referred to the police for preliminary investigation. The notices concerned most often the use of accounts, cash payments and domestic and foreign payments. The cases referred to preliminary investigation related to suspicions of tax or other fraud, debtor's dishonesty, payment method fraud and drug offences.

MONITORING OF DISCLOSURE OBLIGATION

The objective of the Financial Supervision Authority in the monitoring of the disclosure obligation is to ensure that the offerers of securities as well as listed companies fulfil their obligations and that the information given is consistent,

timely and understandable.

Listed companies were provided with guidelines and training on changes in the disclosure obligation. There were still significant differences across companies in the disclosure of information, but no significant irregularities were not detected.

Final terms of index loans have often corresponded to preliminary terms

In 2005, the Financial Supervision Authority reviewed to what extent the confirmed final terms of index loans have corresponded to the indicative eg preliminary terms presented in marketing. The review concerned index loans offered to the public between 1 January 2002 and 30 April 2005, which totalled 157. Indicative terms were used by 9 issuers.

Indicative terms may be related to the return coefficient or minimum interest of the loan. By using these terms, issuers want to ensure that if market conditions change, they still have the opportunity to have an influence on the loan terms at the time of issue. The issue price of the loan may also be variable, in which case the issuer may react to market changes by adjusting the issue price. In assessing the price of an index loan and in comparing these loans, investors should take the issue price into account and the fact that the actual terms may not be the same as those indicated.

The review by the FIN-FSA showed that in most cases the final value of an indicated variable corresponded to the estimate given. In addition, in cases where there was a deviation from the indicated value, the confirmed final term was typically more favourable than the indicated term.

Significant differences were not detected among issuers as to how the final terms of index loans compared to the indicated terms. In contrast, there were differences as to how frequently the final term corresponded exactly to the indicated value.

Quality variations in commentary sections of listed companies' interim reports

The FIN-FSA conducted a survey in 2005 on the quality of interim reports by listed companies. A corresponding review was also made in 2004. The aim was to get a general picture of how well the contents of the commentary sections of companies' interim reports for the second quarter of 2005 correspond to current regulatory provisions and investors' information requirements. The selected sample consisted of 78 companies quoted on the main, I and NM lists, and ranking differently in the corresponding survey in the previous year.

According to the review, the quality of interim reports had not changed much as a whole from the previous year. There continued to be large differences across companies. However, reporting on many issues previously described unsatisfactorily had developed for the better. For instance, an increasingly large number of companies gave investors at least some sort of information on the status of their inventories. Reporting on financing-related issues had improved further from an already quite good level.

Better information than in the comparative period was given eg on the geographical breakdown of turnover and profits, raw material prices, exchange rates and costs and factors with an impact on profits. On the other hand, a large proportion of the companies failed to report the geographical breakdown of the operating profit. Large differences across companies were also found in cost reporting.

The area in greatest need of improvement be the reporting of mergers and acquisitions, risks and external market factors. Justifications of future prospects could also be improved further.

Looking ahead, the FIN-FSA will continue to monitor the quality of listed companies' interim reports. Companies' reporting of their business

outlook and provision of information on corporate restructuring will be among the key supervisory areas.

Number of investigation requests decreased

In 2005, the FIN-FSA made one investigation request to the police (5 in 2004) and gave 2 public reprimands (0). The investigation request was made on a company offering a bond for subscription to the public without a prospectus approved by the authorities. Public reprimands were given on neglect of the disclosure obligation and conduct in violation of good practices in securities markets.

The number of cases under investigation also decreased from the previous year. During the year, about 41 suspected cases of securities market abuse or neglect were investigated (61 cases in 2004). Out of this number, 18 (24) concerned suspected abuse of insider information, 6 (12) market manipulation and 13 (21) neglect of the disclosure obligation. There were 4 (4) other cases under investigation, concerning, among other things, market practices.

Increase in foreign-based trading at the Helsinki Stock Exchange has hindered the investigation of suspected abuse. Inspection is delayed for example by the fact that the FIN-FSA has increasingly to consult foreign authorities in order to obtain information on market participants, for which the FIN-FSA has taken an active role in developing cooperation between authorities. In 2005, already 70% of the total trading volume of the stock exchange consisted of trading by remote brokers or intermediaries under foreign ownership. This development has been partially supported by the fact that domestic market participants have increased their trading through foreign service providers.

The investigative and sanctioning powers of the FIN-FSA concerning market abuse cases and the inspection of prospectuses were extended in June 2005 when the reform of the Securities Market Act entered into force.

The bureau of investigation's investigation backlog has been cleared, and the police have had the opportunity to take cases under investigation immediately. The Financial Supervision Authority has also given a significant amount of expert assistance both to the police and the prosecutor in the investigation of cases.

SUPERVISION OF FINANCIAL REPORTING BY LISTED COMPANIES

The supervision of financial information published by listed companies, in other words monitoring compliance with the IFRSs became a task for the Financial Supervision Authority at the beginning of 2005. The supervision focuses on financial reports published by issuers, such as financial statements and interim reports.

Listed companies issued impenetrable but timely information on IFRS transition

A majority of listed companies disseminated information in spring 2005 on the impact of the transition to the IFRSs. The adoption of the standards has a significant impact on financial reporting by the companies, and understanding the changes poses a challenge to the readers of financial statements.

Over the year, the Financial Supervision Authority reviewed the quality of the transition information published by listed companies. According to the review, large companies provided more and often also better quality information than small companies. The quality of information varied not only according to the size of the company but also across stock exchange lists. A majority (2/3) of the companies on the main list managed the dissemination of information well, but only a few of them excellent, as assessed by the FIN-FSA. Dissemination by companies on the NM list was primarily good or moderately good. Dissemination by I-list companies was weakest. The quality of information varied, and the transition information were also obscure.

The review by the FIN-FSA also looked into the quantitative impacts of the IFRS transition on the

financial information of listed companies. The impact of the transition on the amount of equity on the transition date was small, in relation to the whole, but in individual companies there were also large equity changes.

Adoption of the IFRSs decreased the amount of equity on the balance sheet on 1 January 2004 in almost every third company. Adjustments with a positive impact on equity were reported at about EUR 1.6 million and adjustments with a negative impact at EUR 1.3 million. The net increase in the companies' balance sheets on 1 January 2004 due to the adoption of the IFRSs was therefore EUR 300 million.

The adoption of the IFRSs increased the profit for 2004 at about 60% of listed companies. However, profit changes varied significantly across companies. Overall, profits increased due to the IFRSs by over EUR 0.8 million. The biggest factor increasing profits for 2004 was the abandoning of goodwill depreciations upon adoption of the IFRSs.

The quality of the first IFRS financial statements is expected to vary. Problematic issues include the accounting treatment of corporate restructuring, impairment testing, segment reporting, hedge accounting and use of fair values.

Banks' opening IFRS balance sheets prepared correctly in material respects

The Financial Supervision Authority conducted an inspection of the opening IFRS balance sheets in those listed banks that made IFRS financial statements for 2005. According to observations made by the FIN-FSA, IFRS balance sheets had been prepared correctly by the banks that were inspected.

However, based on the inspections, the FIN-FSA gave recommendations to banks on the development of systems for financial reporting and on improving internal guidelines and documentation. Banks' attention was also drawn to the acquisition cost calculations concerning company acquisitions and goodwill impairment testing.

The Financial Supervision Authority set out its views on questions concerning application of IFRSs

The presentation of industrial carbon dioxide emission rights in financial statements in accordance with the IFRSs posed difficulties to listed companies during the year. For many companies their first interim report for 2005 was where they applied the interpretation on the accounting treatment of emission rights given at the end of 2004 by the International Financial Reporting Interpretations Committee (IFRIC) under the International Accounting Standards Board (IASB) and cancelled by the Board later in June 2005.

The cancellation of the interpretation created a difficult situation for the companies. Which regulations should the companies apply in the accounting of emission rights in future interim reports and financial statements the FIN-FSA recommended that listed companies ensure that the financial statements contain sufficient information on the impacts of the emission rights. In addition, the companies should include a description of the situation concerning the emission rights and emissions and the accounting practices applied in the notes to the financial statements.

The FIN-FSA also set out its views during the year on the financial statements treatment of a restructuring arrangement by a listed company.

Cooperation between supervisors important in IFRS application

The FIN-FSA participated in cooperation and coordination between the EU's financial statements supervisors in 2005. Cooperation is aimed at promoting harmonised application of the IFRSs.

Regular European Enforcers Coordination Sessions were begun at the Committee of European Securities Regulators (CESR). Towards the end of the year, a supervision database was taken into use, where key decisions on financial statements supervision in all member states are to be filed. It is also intended that the supervi-

sion decisions in the database be published in the future. Publication is aimed at increasing the transparency and predictability of supervision.

SUPERVISION OF FINANCIAL MARKETS INFRASTRUCTURE

Nordic cooperation in the supervision of financial markets infrastructures has increased, partly 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 FIN-FSA has focused its supervision also on future changes in payment systems. There are many ongoing initiatives in the euro area relating to payment systems and payment traffic services.

Danish authority to participate in supervision of OMX Group

Swedish, Finnish and Danish supervision authorities are cooperating in the supervision of the OMX Group. The Danish supervision authority (Finanstilsynet) joined the cooperation between the Financial Supervision Authority and the Swedish supervision authority (Finansinspektionen) in the Memorandum of Understanding on the supervision of the OMX Group in November 2005 when the Copenhagen Stock Exchange joined the OMX Group.

The objective of cooperation between the authorities is to harmonise the supervision of the various companies in the OMX group in Finland, Sweden and Denmark and make it more efficient. Practical supervision cooperation is conducted by a supervision group comprising representatives of the supervision authorities. The task of the group is to make a uniform view of issues relevant for supervision.

The focus areas in the continuous supervision of the OMX Group in 2005 were the reform initiative of the market supervision at the stock exchange (establishment of a market supervision

committee), exchange list reform and changes made in the market model. The FIN-FSA set out its views on these issues before the implementation of the initiatives.

Finnish Central Securities Depository separated from OMX Group

In early 2005, the FIN-FSA supervised the separation of the Finnish Central Securities Depository (APK) from the OMX Group. The Finnish APK became a wholly-owned subsidiary of the Swedish Central Securities Depository, VPC, when the Finnish and Swedish central securities depositaries merged in November 2004 and formed the NCSD Group.

The separation proceeded in control and without difficulties in spite of the related significant organisational and IT arrangements.

Cooperation began in supervision of NCSD Group

The FIN-FSA and the Swedish supervision authority (Finansinspektionen) began cooperation in the supervision of the NCSD Group in 2005. The objective is to combine, and improve the efficiency of supervision of the companies in the group in Finland and Sweden. The Memorandum of Understanding on the supervision is at the final stages.

The Memorandum of Understanding provides for the division of work between the supervisors, the exchange of information and other forms of cooperation. Practical supervision is conducted by a supervision group consisting of representatives from the supervision authorities of both countries. The supervision group is responsible among other things for the planning and implementation of common supervision measures, such as inspections.

Finland also victim of ID data phishing

The phishing of identification data required in the use of electronic services has been a significant security threat in many countries already for some years. The first phishing (scams used to gain

confidential information by use of IT systems) attempts in Finland were made in autumn 2005. Although they resulted in a lot of additional work for the banks targeted, the damages remained limited. The media had a key role in minimising the damages, since banks disseminated information actively on the attacks, and the issue broke the news recurrently.

In its supervision aimed at preventing phishing, the Financial Supervision Authority paid particular attention to nullification of network IDs. From the customer's viewpoint it is important that network IDs can be cancelled quickly and easily when necessary, particularly since banks have actively promoted the use of their user IDs in services outside the banking sector.

The Financial Supervision Authority underscored that the instructions for handling identification data should be as simple and consistent as possible. The clearest point of departure for the customer is that neither the bank, the police or anyone else has the right to inquire ID data via email, telephone or any other means.

Back office and IT services of supervised entities transferred away from Finland

Many supervised entities sought economies of scale by centralising various back office and IT services outside the Finnish borders. The most significant centralisation projects in cooperation with the Nordic supervision authorities were supervised by the FIN-FSA. The objective of the supervision was to ensure that the quality and continuity of the services can be ensured also in change situations and thereafter.

Payment traffic related to investment services as new area of inspection

In 2005, payment traffic related to investment services was adopted as a new focus area in the inspection of payment systems. The aim of the inspections was to receive an overall picture of

the arrangements and systems used in paying for securities transactions, related risks and risk management. In addition, the responsibilities between participants and risks related to agreements between the participants were reviewed. Inspections will be continued in 2006.

Generally speaking, supervised entities inspected in 2005 had arranged the payment traffic related to investment services well. Room for improvement was found primarily in the identification of risk, their systematic management and the ensuring of business continuity.

Many payment systems change and development initiatives ongoing in euro area

In addition to existing payment systems, supervision focused on future payment systems changes and on how supervised entities had prepared for them. It can be expected that retail payments in particular will change significantly in the coming years as the payment systems in the euro area integrate.

There are many initiatives going on in the euro area. The European Commission published its proposal for a Payment Services Directive in December 2005. If adopted, the Directive will liberate the provision of payment traffic services across country borders and open the area more and more to agents outside the banking sector.

In the so-called Single Euro Payment Area initiative (SEPA), key European banking sector agents are aiming at creating harmonised basic paying services for the whole euro area by 2008. The objective is to replace national solutions with these services at a later stage. Part of the SEPA initiative consists of card systems. In the worldwide EMV initiative, the magnetic strips of cards are being replaced by chips. The main attention in supervision of these initiatives is on how supervised entities are managing risks related to change.

Management of data security at banks appropriate, data security threats increased

In its spring 2005 inspection visits, the Financial Supervision Authority reviewed how main Finnish banks had prepared for different data security breaches, such as virus attack, IT system break-in and data seepage. In particular, it was explored how these were supervised, how they were reacted to and reported on. In addition, it was explored what kind of procedures banks had in place for patching data security loopholes.

According to the view of the FIN-FSA, the management of data security breaches at banks was mainly appropriate. However, a challenge was to shorten the time from the publication of a data security vulnerability to the moment when it has been patched, the patch has been tested and installed in production environment. This time should be shortened further as much as possible.

Regulation

The regulatory activities of the Financial Supervision Authority (FIN-FSA) comprise both issuance of its own regulations and participation in legislative preparation, both in Finland and at European Union level. The regulatory strategy focuses on principles and quality as well as the predictability and credibility of the application of the law.

In 2005, the regulatory strategy was based on the following key objectives:

The FIN-FSA contributes to the drafting of EU legislation, development of harmonised EU supervision and improvement of Nordic supervisory cooperation.

- The FIN-FSA played an active role in the development of regulation and supervision at the EU level in 2005. The FIN-FSA sought to promote the development of financial market

regulation and supervision to ensure that it will retain its potential to assume responsibility for the stability of national financial markets also under changing market structures.

- The FIN-FSA repeatedly drew attention to the need to strengthen the coordinating role of the home country supervisor and step up cooperation between national supervisors to ensure the credibility of supervision and reduce the burden of supervision, also in the case of cross-border banking groups. The host country supervisor should be accorded an adequate role in the supervision of systemically important branches. This may also call for amendments to EU legislation. The current home and host country regime has been designed for totally different markets and may, in certain respects, even impose limitations on adequate supervisory cooperation.

The FIN-FSA promotes principles-based regulations and complements them with codes of conduct and application guidelines.

- The FIN-FSA's own regulatory issuance is designed to produce high quality and relevant provisions. The FIN-FSA's own regulatory reform made significant strides in 2005. The focus lay on the transposition of the rules of the Basel II Framework into the FIN-FSA's regulations. The financial reporting regulations based on the principles for measurement of financial instruments set out in the International Financial Reporting Standards (IFRS) were extended to cover all credit institutions and investment firms.
- The FIN-FSA's regulations on the ongoing disclosure requirements applicable to securities markets and declaration of insider holdings were revised in line with the amendments to the Securities Markets Act. The code of conduct regulations combined the regulatory issuance for banks and investment firms and cut down on overall regulatory detail.

- The regulatory reform has clarified the FIN-FSA's supervisory role and expectations in respect of the activities of supervised entities. In addition to launching consultations on each draft standard under preparation among a wide group of stakeholders, the FIN-FSA engages in an ongoing dialogue on the regulatory reform with supervised entities and listed companies.
- Financial market participants continue to be governed by a lot of regulations, although the FIN-FSA has taken measures to eliminate any unnecessary issuance of regulations.
- The EU has not yet been capable of attaining its goal of principle-based and target-oriented provisions. In particular, level two regulations continue to be highly detailed, which is also reflected in the FIN-FSA's regulatory activities.

The FIN-FSA exercises investigatory and sanction powers in a proactive manner.

- The FIN-FSA considers it important to adopt an operating policy based on predictability, legal safety and impartiality. The FIN-FSA has continued its open approach to the publication of supervisory measures and sanctions and statements of the justification behind its decisions. The information content of the authority's website has been enhanced as regards the criteria for both the granting of authorisations and the exercise of sanctions.
- According to the FIN-FSA's own assessment, supervised entities and other market participants have confidence in the impartiality of the supervisor and find its operations to be highly transparent. However, some criticism has been voiced regarding the FIN-FSA's strict approach to the application of the law.
- The FIN-FSA has exercised supervisory and sanctionary power in a timely and consistent manner.

EU REGULATORY ENVIRONMENT AND REGULATORY ACTIVITIES, 2005

In May 2005, the European Commission published its Green Paper on Financial Services Policy 2005–2010 known as the Post-FSAP upon which it then based a White Paper: Financial Services Policy 2005–2010, issued in December.

The Commission announces the following regulatory development objectives:

- Implementation of existing legislation
- Principles of better regulation
- Convergence of supervision
- Strengthening competition in particular in retail markets
- External influence of the EU.

The guiding principle of the Commission's strategy (known as the Post-FSAP) is to concentrate in the first stage on the harmonised implementation of EU legislation across member states in accordance with agreed timetables. New regulatory initiatives are taken for well-founded reasons only. The list of regulatory initiatives is so extensive that both the authorities and the market participants need time for the implementation of the body of EU legislation already adopted. The European Commission intends to closely supervise the transposition of EU legislation into national law and will intervene if national implementation is found wanting.

The Commission also emphasises the objective of better regulation. According to the principles adopted over three years ago, all new proposals must first be subjected to broad consultations with the Internet being one of the means used for the consultation procedure every time. All proposals must also undergo a careful impact assessment study, especially a cost-benefit analysis, before a decision on the necessity of a new legislative initiative is taken.

The Commission will also undertake a review of financial services regulations and remove conflicting provisions both within and between

regulatory areas. The review will first address securities market regulations, with the assistance of an expert group in the field.

REGULATORY PROCESS STILL BASED ON THE LAMFALUSSY APPROACH

Since 2002, the regulation and supervision of European securities markets has been developed in line with the four-level regulatory approach known as the Lamfalussy framework. This framework also provides the basis for the harmonisation of legislation and supervision. First applied to the regulation and supervision of securities markets, it was extended to cover banking and insurance in spring 2005.

The aim of the Lamfalussy model is to develop the regulation and supervision of EU financial markets towards true integration. The framework is also designed to enhance the drafting and application of EU financial market regulations, promote the convergence of supervision and regulation within the European Union and increase the transparency and openness of supervision and regulatory drafting.

The initial assessments of the effectiveness of the Lamfalussy framework in the securities markets have been largely positive, although some necessary improvements have been highlighted. The European Parliament wishes to exercise sufficient supervision over level two regulations especially now considering the delay in the implementation of the EU Constitution.

THE FIN-FSA REPRESENTATION ON CEBS AND CESR

In keeping with the Lamfalussy approach, both a regulatory committee (level 2) as well as a supervisory committee (level 3) operate in each of the securities, banking and insurance sectors. The FIN-FSA takes part in the work of the supervisory committees (level three), ie the Committee of European Banking Supervisors (CEBS) and the Committee of European Securities Regulators

(CESR). Insurance supervisors have set up their own Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

A framework for the regulation and supervision of financial conglomerates in line with the Lamfalussy approach is still not in place. The European Commission has set up a level-two Financial Conglomerates Committee, while the level-three committee structure and operating principles are still only at the planning stage. The Committee members will come mainly from prudential and insurance supervisors. Supervisors have expressed their preferences for an unofficial committee as opposed to an independent committee. The Committee would report to CEBS and CESR. An Interim Working Committee has been set up to address urgent supervisory and regulatory issues related to conglomerates.

So far, the level three committees of banking and securities regulators (CEBS and CESR) have adopted different operating practices, which is largely due to the various preparatory stages of EU regulations in both sectors and the differences in securities market and capital adequacy regulations. CEBS has mostly concentrated on level-three regulations as the revision of the Capital Requirements Directive was fairly far ahead at the establishment of the Committee. In other words, the Committee has focused on the formulation of guidelines with practical explanations of levels one and two of the Directive.

By contrast, CESR has, thus far, been mostly concerned with the drafting of level-two regulations. The Committee has issued advice to the Commission on the Market Abuse, Prospectus and Transparency Directives and on the Markets in Financial Instruments Directive.

FIRST FULL YEAR OF OPERATIONS FOR CEBS

In 2005, CEBS concentrated largely on the implementation of the regulations and supervisory measures of the Basel II Framework.

Over the year, the Committee drafted guidelines for the Basel II Framework to be introduced by supervisors at national level. It also issued guidelines for the approval assessment of the Internal Rating Based Approach (IRBA) and the Advanced Measurement Approach (AMA) and for the approval of the ratings of credit rating agencies (Basel II, pillar 1). A general guideline on home-host country cooperation was completed, as was an impact assessment study of the consequences of the IFRS transition on banks' balance sheets and own funds.

In 2005, CEBS reviewed the application of the Supervisory Review and Evaluation Process (SREP) and prepared related guidelines (Basel II, pillar 2). The Committee also addressed the development of the deposit guarantee scheme, issued advice to the Commission on the drafting and implementation of the Capital Requirements Directive (CRD) and reviewed the assessment of the suitability of qualifying shareholders in connection with mergers and acquisitions.

Home-host country supervisory cooperation to be improved

In 2005, CEBS drafted level-three guidelines on home-host cooperation. The guidelines are based on the new Capital Requirements Directive, which calls for closer supervisory cooperation. The general principles of the guidelines should, however, always be applied to cross-border supervisory cooperation. Nordic cooperation has served as an example in the preparation of the guidelines. The principles of the guideline are applied to cross-border cooperation, for example in the approval process of IRBA, AMA and in the SREP.

The guidelines do not propose changes to the legal responsibilities of supervisors. However, supervisory cooperation is designed to improve supervision both in terms of maintenance of stability and reduction in the costs to supervised entities.

Uniform principles for Supervisory Review Process

In January 2006 CEBS issued its guidelines on the Supervisory Review Process. The guidelines include requirements for the Internal Capital Adequacy Assessment Process (ICAAP) and other requirements to be met by the supervisor in assessing the capital adequacy of supervised entities. The Supervisory Review Process is an integral element of the Basel II Framework.

Guideline for approval of the Advanced Measurement Approach available to supervisors

Level three guidelines regarding approval of the Advanced Measurement Approach (AMA) and Internal Ratings Based Approach (IRBA) were drawn up (so-called model validation guidelines). The guidelines cover operating principles for supervisors and the key criteria for multinational banking conglomerates' approval processes for the models. Supervisors may comply with the guidelines when making assessments other than for multinational banks, where applicable.

Responsibility for organisation of the cross-border approval process and coordination has to be through consolidating supervision, ie the home country supervisory authority of the banking conglomerate's parent or holding company. This means that the subsidiary's supervisor participates in the assessment process in the manner agreed on by the supervisors. In particular, the subsidiary's supervisor can assess the acceptability of localised models and the application within the subsidiaries of models developed at the conglomerate level.

Branch offices are specifically mentioned in the guidelines in that the consolidating supervisor must be in contact with the supervisors of the systemically important branch offices and agree on informing them adequately and possibly including them in the assessment process.

CEBS sees no need to change the deposit guarantee scheme

In autumn 2005, CEBS issued advice to the Commission on the possible need to change the deposit guarantee scheme.

CEBS found that there is currently no need to change the present deposit guarantee scheme to any significant degree. Market changes may, however, give rise to rapid changes. This may also happen when deposit guarantee cover becomes a clear obstacle to market entry.

In terms of the division of labour between home and host country supervisors, CEBS has taken the stance that should a branch office's deposit guarantee cover be changed to suit the host country approach, the host country supervisor should also be given supervisory responsibility. CEBS therefore accepted the opinion also supported by the FIN-FSA that supervisory and crisis management responsibility (including deposit guarantees) must be aligned.

Explicit criteria for assessing the stability of qualifying shareholders

In May 2005, CEBS advised the Commission concerning the need to amend provisions of the Consolidated Banking Directive related to acquisition of holdings, reporting of qualifying holdings and the right of competent authorities to oppose qualifying holdings.

The project for amending the Consolidated Banking Directive is based on the desire of the Ecofin Council to review the reasons why mergers and acquisitions within the EU seem to be less frequent in the banking sector than in other corporate sectors. The Commission wants to introduce binding and uniform criteria for the assessment of the suitability of qualifying shareholders. The FIN-FSA has supported the position of the majority of CEBS members in the mutual recognition of supervisor reviews and clear common main principles.

Impact assessment of transition to IFRSs

In 2005, CEBS conducted an impact assessment of the consequences of the transition to IFRS financial statements on banks' balance sheets and own funds. This assessment study was based on a survey by each member state directed at a representative number of banks preparing IFRS financial statements. The survey indicated that the guidelines for banks on the calculation of own funds had a neutralising effect on the changes brought about by the changeover to IFRSs.

CESR CONCENTRATED ON ADVISORY ROLE REGARDING LEVEL TWO REGULATIONS

In 2005, CESR concentrated on the drafting of level-two regulations related to the Directives included in the Financial Services Action Plan (FSAP), ie the Markets in Financial Instruments Directive, the Transparency Directive, the Mutual Funds Directive and the Prospectus Directive.

When the Financial Services Action Plan is complete, the work of the Committee will be directed towards the deepening of supervisory cooperation and harmonised supervisory practices instead of the provision of advice to the Commission on level two regulations.

An important element of the work of CEBS is the Review Panel, which monitors and evaluates how member countries comply with the provisions and practical obligations of cooperation. In 2005, the Review Panel's work included preparing a comparison of the powers of the CESR member countries. The importance of the work of the Review Panel is highlighted as it is necessary for the success of the network of supervisors that members comply with agreed rules and that cooperation is seamless.

INCORPORATION OF FINANCIAL REPORTING REGULATIONS WITH EU LEGISLATION

Integration of International Financial Reporting Standards issued by IASB integrated with EU legislation

The International Accounting Standards Board (IASB) is currently one of the key players in the development of financial reporting regulations. IASB is an organisation under private law the regulations of which are incorporated with EU legislation through a separate procedure.

In 2005, IASB adopted the Fair Value Option, which also allowed for the fair value measurement of financial liabilities under certain terms. Furthermore, it adopted IFRS 7 on Financial Instruments: Disclosures. Some standards were also revised by IASB. The international Financial Reporting Interpretations Committee (IFRIC) also issued a number of interpretations.

In June 2005 the IASB withdrew its Interpretation on Emission Rights. This was the first time that a final regulation on financial statements was revoked.

NATIONAL REGULATORY ACTIVITIES 2005

Several legislative initiatives related to the implementation of EU legislation in Finnish law were underway in 2005.

The aim of the legislative amendments has been to promote financial market integration, improve financial sector operations and strengthen financial stability. At the same time, these amendments will, however, impose considerable costs on both the FIN-FSA and market participants and force them to change operating practices. Major concurrent system and policy changes may also pose a challenge to the stability of the sector in the transitory stage.

For the FIN-FSA, one implication of the amendments to legislation is that the supervisory authority will assume responsibility for the supervision of the financial statements of listed companies.

Amendments to Accounting Directive implemented by amendments to Accounting Act

International Financial Reporting Standards (IFRS) were adopted by the EU at the beginning of 2005 and were transposed into Finnish law by amendments to the Accounting Act. The IFRSs apply at least to all listed companies required to prepare consolidated financial statements.

IAS 39 'Financial Instruments: Recognition and Measurement', which is key to the banking and financial sector, was partially adopted, with some of the provisions on hedge accounting not endorsed by the EU.

Preparations of capital adequacy regulations moved ahead

The Capital Requirements Directive related to the Basel II Framework for credit institutions and investment firms will mainly take effect on 1 January 2007. In Finland, the related national implementation has been prepared by a Ministry of Finance working group in the work in which the FIN-FSA takes an active part. The draft Government bill with a proposal for amending the relevant legislation and for the issuance of decrees was launched for consultations in November 2005. The final Government bill is scheduled for introduction into Parliament in spring 2006.

The capital adequacy reform will introduce new minimum capital requirements for individual participants. Although the legislative amendments impose considerable system costs on market participants, the amendments, nevertheless, encourage banks and investment firms to improve their own risk management systems and internal practices.

Regulations governing investment firms and stock exchanges are revised

In 2005, the FIN-FSA contributed to the national implementation of both the Markets in Financial Instruments Directive and the Directives governing information disclosure, including the Directive on Takeover Bids, the Transparency Directive and the Prospectus Directive.

The major ongoing legislative project in the securities markets is the national implementation of the Markets in Financial Instruments Directive (MiFID). At the same time, the regulations governing investment firms and stock exchanges in particular are being revised. Furthermore, the Commission will issue a considerable amount of level two regulations along with the Directive.

The new regulations will enhance competition between marketplaces in particular. The costs incurred by marketplaces and investment firms are also expected to grow in the short term. Some of the costs are non-recurrent, while some will increase running expenses.

The relevant Finnish provisions are being drafted by a Ministry of Finance working group, the mandate of which is due to expire at the end of May 2006. The national provisions must be introduced by 31 January 2007 and their implementation will commence on 1 November 2007.

National implementation of directives on Information Disclosure underway

In integrating the directives on Information Disclosure into Finnish law, the objective of the FIN-FSA has been to address the shortcomings and problems identified in current legislation. Another aim has been to keep to well-proven practices.

The shortcomings identified relate either to the investor protection scheme in general or to obsolete information disclosure requirements. The powers invested in the authorities have also been found wanting. On the other hand,

many regulations are issued through European regulations, which are not, as such, applicable to the distinctive characteristics of Finnish market participants or market structures. These regulations will, as far as possible, be adapted to the Finnish environment (for example minimum harmonisation/options). Another aim is also to promote the competitiveness and attraction of the Finnish market.

The Directive on Takeover Bids will take effect in May 2006. The national implementation of the Directive is being prepared by a Ministry of Finance working group which also includes representatives of the FIN-FSA. The aim of the FIN-FSA is to improve investor protection, clarify the public bid process and promote the proactivity of the process. These issues have been highlighted in connection with the equivalent treatment of securities holders, pricing of the bid and competing bids in particular. The new regulations will largely address these issues.

In the national implementation of the Transparency Directive, the FIN-FSA aims to ensure that investors continue to receive an adequate level of information, while taking in account the costs incurred by issuers. The single most important issues raised in connection with the preparations are related to the number of interim reports and content requirements. However, the requirements of the Directive make it necessary to also address the distribution and storage of stock exchange releases. The Directive will take effect on 20 January 2007, with the national working group continuing its work throughout 2006.

In the year under review, the FIN-FSA also participated in the work of the Ministry of Finance working group preparing the national implementation of the Prospectus Directive. The Act took effect on 1 July 2005. In its follow-up work, the working group also addressed issues of prospectus liability and launched consultations on a separate report on prospectus liability. Any regulatory needs are assessed on the basis of statements.

Needs for amendment of Auditing Act clarified

The FIN-FSA participated in the work of the Ministry of Trade and Insurance working group reviewing the amendment of the Auditing Act. Preparations of the working group continued. In autumn 2005, the Ministry arranged discussion meetings on the working group report of November 2005 on the needs for amending the Auditing Act and the areas of development of statutory auditing. Discussion meetings will continue in 2006.

The Government bill proposing an amendment to the Auditing Act is scheduled for introduction to Parliament in spring 2006. The amendments required by the revised Auditing Directive will also be enforced in connection with the legislative amendment. These amendments impose additional requirements on the public supervision of audits.

The FIN-FSA has been involved in contributing to the development of national regulations in the auditing business for example by participating in the work of the Ministry of Trade and Industry working group reviewing the amendment of the Auditing Act.

THE FIN-FSA'S OWN REGULATORY ISSUANCE

The reform of the FIN-FSA's own regulatory issuance advanced considerably in the year. Eight new standards were issued, more than ten draft standards were circulated for comment and four existing standards were revised.

Overall, the reform has clarified the FIN-FSA's supervisory role and expectations in respect of the activities of supervised entities. Although the aim of the reform has been to cut down on all less necessary regulations, financial market participants are still governed by a vast amount of regulations, including the introduction of IFRSs and the Basel II Framework.

Implementation of the Basel II Framework moved ahead

The FIN-FSA's issuance of rules related to the Basel II Framework moved ahead. In spring 2005 six draft standards were released on the calculation of minimum capital charges for credit risk, operational risk and market risk as well as on the capital charges for credit risk mitigating techniques and credit risk and securitisation (Basel II, pillar 1). It also issued proposals for the covering of expenses regarding the approval of the Internal Ratings Based Approach (IRBA) and proposals regarding supervisory fees for the joint undertaking of the approval processes.

In November the first draft standard on the Internal Capital Adequacy Assessment Process (ICAAP) of supervised entities was issued (pillar 2). In early 2006, consultations will be launched on a draft standard on the information disclosure requirements applicable to supervised entities (pillar 3). The FIN-FSA will arrange a second round of consultations on most drafts and will issue the final standards in autumn 2006.

Nearly all risk management standards have now taken effect, save for the standards on market risk and liquidity risk management. The risk management standards cover various risk areas more extensively than before.

Preparation of corporate governance and market entry standards moved ahead

The standard governing the authorisation process and regulating market entry to improve the application process was circulated for comment in autumn 2005. The standard sets out the provisions on the authorisation criteria. Information is also provided on the details which the FIN-FSA considers in the granting of authorisations and what reports the application for authorisation should include. The standard will take effect in the course of spring 2006.

The draft standard on the fitness and propriety of management was completed and circulated

for comment in 2005. The standard highlights the supervised entity's own responsibility for supervising the fitness, propriety and expertise of management and the supervised entity's own responsibility to act in circumstances where credibility is or may be in jeopardy.

A draft standard on internal governance in supervised entities was issued. Consultations on the draft standard were launched in spring 2006. The standard is an integral part of the corporate governance regulations applicable to supervised entities and addressing the relations between the company's board and senior management as well as between owners and stakeholders. The objective of the standard is to ensure that the supervised entity is managed in a professional way and in accordance with sound and prudent business principles.

The FIN-FSA is also in the process of drafting a standard laying down the scope of permissible business allowed to supervised entities engaging in business subject to authorisation. This is a matter of ongoing concern as supervised entities expand their business into new areas. Before the standard is released guidelines are issued on these issues case by case and subsequently transposed into the standard. The standard will take effect in 2006.

Standards on information disclosure were updated in response to legislative amendments

At the beginning of July 2005, an Act on the Prevention of Market Abuse was introduced and in response the FIN-FSA revised three of its standards, ie disclosure requirements for issuers and shareholders, declaration of insider holdings and insider registers, certificates of deposit and acceptable market practices. On the one hand, the standards brought about the implementation of the Market Abuse Directive and, on the other hand, clarified the obligations ensuing from the legislative amendment to various participants.

The revision of the standard on securities offer-

ings and listings was commenced in line with the Prospectus Directive. The standard will be released in spring 2006. In addition to being revised, the standard will also be supplemented with new interpretations where appropriate.

New financial reporting regulations for credit institutions and investment firms

The standard on financial statements and annual reports and the related reporting standard took effect at the end of November 2005. In principle, the standard applies to those credit institutions and investment firms that do not prepare their financial statements or consolidated financial statements in accordance with IFRSs. The first time the standard will be applied is to the financial statements prepared in 2005.

The standards on risk reporting and balance sheet reporting were updated in line with the IFRSs (amendments to IFRSs). Equivalent amendments were also made to the reporting standards governing credit risk and market risk supervision.

Rules of conduct for banks and investment firms to be combined

The FIN-FSA's code of conduct combined the regulatory issuance for banks and investment firms and cut down on regulatory detail. The amendments following from the Markets in Financial Instruments Directive (MiFID) will be considered in the national implementation of the Directive.

The standard on customer identification, due diligence and prevention of money laundering and the standard on notification of suspicious securities transactions and other suspect transactions took effect in June. The standards are designed to promote prudent and harmonised market practices, the risk management related to supervised entities' customer relations and prevention and exposure of market abuse.

Draft standards on contracts and marketing were circulated for comment in 2005 and are scheduled for introduction in early 2007.

New reporting framework for securities transactions

The transposition of MiFID into Finnish law will change and expand reporting on securities transactions. In the future, brokers or brokers' representatives must report all transactions within the European Economic Area in publicly traded instruments, regardless of whether the transaction has taken place in or outside the marketplace. The national provisions must be implemented by 1 January 2007. They will become applicable from 1 November 2007.

The transactions are reported to the broker's home country authorities. In other words, each securities broker must also report all transactions they undertake in other EEA countries to their home country authorities. Branches are required to report transactions to the authorities of the country of residence of the branch. Reporting must follow without delay and by the end of the day following the transaction day at the latest.

The new European reporting framework for securities transactions will be multilateral, with each national supervisor having their own individual reception and delivery of reports as well as an actual monitoring system. For the reporting of securities transactions, the FIN-FSA will introduce a new monitoring system for securities transactions (the so-called AKVA system).

AUTHORISATION PROCESS

Numerous applications for authorisation were reviewed in 2005.

The FIN-FSA awarded seven new authorisations; four of which were issued to investment firms, two to fund management companies and one to a credit institution. Three applications for adjustment of the authorisation for expansion of operations were approved. Furthermore, the first branch of a European company commenced operations during the year in Finland.

Nine authorisations were revoked upon the appli-

cation of the companies concerned. These were mostly related to sales of business to another authorisation holder.

NEW SUPERVISION FEE CRITERIA

The fee criteria applied to the supervision fees levied by the FIN-FSA were revised in response to the new Supervision Fees Act introduced at the beginning of 2005. The objective of the legislative amendment was to meet the constitutional requirements on fiscal fees and to secure the financing of the FIN-FSA's operations.

The FIN-FSA's operations will continue to be financed by supervision fees and processing fees charged to supervised entities and other liable entities on an annual basis. The new Act on the supervision fees collected by the Financial Supervision Authority (1294/2004) sets out detailed provisions on the supervision fee criteria. These criteria make it possible for liable entities to calculate or estimate their supervision fees in advance.

Supervision fee criteria clarified

The supervision fee criteria have been so set as to maintain the previous level of fees and their respective breakdown between different groups. The aim has been to keep the changes in the fees imposed on individual liable entities to moderate levels.

The supervision fee payable by credit institutions, investment firms and fund management companies comprises a basic fee and a proportional fee based on the balance sheet. Branches of foreign credit institutions, investment firms and fund management companies are also liable to pay a basic fee and a proportional fee. With the reform, provision has been made for an increase in credit institution services run in branches and an increase in related supervisory work.

The supervision fee payable by securities exchanges, options corporations and clearing corporations comprises a proportional fee calcu-

lated on the turnover of the liable entity. A certain minimum fee has been laid down.

The supervision fee payable by the Finnish Central Securities Depository APK, issuers of publicly traded securities and other liable entities is based on the basic fee alone. The supervision fee payable by issuers takes the additional costs arising from the enforcement of financial statements prepared in line with International Financial Reporting Standards (IFRSs) into account.

Supervision support activities

The information systems used for supervisory purposes by the FIN-FSA were developed and updated at a rapid rate in 2005. Some of the FIN-FSA's information technology projects were directly linked to ongoing EU development projects.

TECHNICAL SPECIFICATIONS FOR SECURITIES TRANSACTION REPORTING FINALISED

Securities transaction reporting will change and expand as a result of the implementation of the directive on markets in financial instruments (MiFID). Under the MiFID, every national supervisory authority within the EU must have systems in place for receiving, forwarding and monitoring transaction reports.

For this purpose, the FIN-FSA is developing a new system called AKVA for collecting information on and monitoring securities transactions. The technical specifications were finalised in April 2005. The AKVA system will be used to monitor securities transactions and investigate possible market abuse.

Finnish authorities deemed it necessary to set up a new securities transactions reporting system at this early stage, since the functioning of the SIRE system currently used in conjunction with the

book-entry system has been under threat. New procedures for securities clearing and settlement may lead to a situation where the SIRE system can no longer be used as a back-up system for securities transactions reporting.

When the AKVA system is up and running, it will be by far the largest operating system used by the FIN-FSA. The system must meet the criteria laid down in the MiFID.

THE EU FRAMEWORK FOR COMMON REPORTING OF THE NEW SOLVENCY RATIO

A common pan-European framework for solvency ratio reporting (COREP) under Basel II will be introduced in 2007. It will provide a basis for uniform reporting using standard definitions, formats and technical specifications. National differences are no importance since key prudential information is defined in a common language directly linked to the relevant solvency directives. Beyond a core set of information, supervisory authorities retain some national flexibility in that they are free to choose, among the common COREP elements, those that are most appropriate to their supervisory practices.

In 2005, the FIN-FSA decided to permit supervised entities to report in the XBRL format (eXtensible Business Reporting Language) recommended by the Committee of European Banking Supervisors (CEBS). Permitting supervised entities to use XML-based XBRL reporting involves major changes to the FIN-FSA's data collection, storage and monitoring systems. On balance, however, the exchange of key prudential information with other supervisory authorities will be enhanced as a result of the reform.

Data will be collected in the new format for the first time as for the situation on 31 March 2007. In addition, the FIN-FSA will introduce COREP tables for parallel running of solvency ratios in 2006. The implementation of the new reporting system will start in spring 2006.

The common vocabulary and definitions of COREP are well suited to the FIN-FSA's prudential supervision requirements and will facilitate reporting by multinational banks. In fact, the FIN-FSA has been supporting the CEBS' objective to set up a uniform reporting framework for the new solvency ratio. The FIN-FSA's new standards on solvency ratio reporting currently under preparation are being drawn up in compliance with COREP.

Consistency in reporting will facilitate data collection by supervisory authorities and increase the comparability of data in supervising international banking groups. In the long term, supervised entities will also benefit from lower costs of reporting.

A STANDARDISED FRAMEWORK FOR FINANCIAL REPORTING (FINREP)

The FIN-FSA will start using the standardised framework for financial reporting (FINREP), adopted by the CEBS, in 2008. The new framework covers reporting of income statement and balance sheet data, but not data on risks.

Since not all the EU countries will start using the voluntary FINREP framework, full harmonisation of financial reporting will not be achieved. Hence, there will still be situations where national authorities may apply differing income statement and balance sheet reporting rules to enterprises of international banking groups operating in several countries.

The FIN-FSA is seeking to incorporate the necessary changes into the Finnish authorities' joint reporting framework VIRATI, in which the FIN-FSA, the Bank of Finland and Statistics Finland cooperate.

REVISED SYSTEM FOR REPORTING OF BALANCE SHEET, INCOME STATEMENT AND RISK DATA

As supervised entities started to apply IFRS standards, their reporting of balance sheet, income statement and risk data also changed. The FIN-FSA's information systems were upgraded to comply with the revised reporting system. The compilation of data is still based on Excel applications that can be downloaded from the FIN-FSA's Internet site.

► The FSA in brief

The Finnish Financial Supervision Authority (FIN-FSA) supervises the financial markets and those who participate in these markets. Supervision covers operations of banks, investment firms, management companies and the stock exchange.

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.

The values guiding the Financial Supervision Authority's operations are independence, openness, productivity and expertise.

SUPERVISION AND REGULATION

The core operations of the FIN-FSA comprise supervision and regulation.

Supervision focuses on the most important and risk-sensitive institutions and systems. Supervision assesses the financial state, risk-bearing capacity and risk management systems of supervised entities, as well as emphasises owners' and management's responsibility for internal control and risk management. Thus the FIN-FSA 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 solvency. 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 the markets and on issuers' compliance with disclosure requirements. In addition, suspected cases of abuse of insider information and other securities market crimes are investigated. 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).

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.

PROMOTION OF FINANCIAL MARKETS AWARENESS

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 new 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.

Governance and management

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

The governance and management system 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 the FIN-FSA's internal guidance and control systems.

The FSA Act requires the FIN-FSA to demonstrate transparency in its operations and decision-making procedures and to have a good corporate governance and management system. As for organising governance and management, the FIN-FSA observes, where applicable, the same international standards as its supervised entities.

PARLIAMENTARY SUPERVISORY COUNCIL

The Parliamentary Supervisory Council 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 the members of the FIN-FSA Board.

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

The organisation of the FIN-FSA consists of the Regulatory Governance Unit and two departments: Market Supervision and Prudential Supervision. In addition, two units report directly to the Director General: Communications and Information Services and Operational Planning and Organisational Development.

The supervisory functions have been assigned to Market Supervision and Prudential Supervision. The Prudential Supervision Department focuses on the prudential supervision of all supervised entities as well as for setting up and developing

the regulatory framework in this area of supervision. The department monitors the risks, capital adequacy and profitability of credit institutions, investment firms and management companies providing asset management services. It also analyses the overall situation of the financial markets and assesses risks related to changes in the economic environment. The department monitors and supports preparations of supervised entities related to the capital adequacy reform (Basel II). In addition, Prudential Supervision Department provides IT services to the FIN-FSA organisation.

The Market Supervision Department 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).

The Regulatory Governance Unit is in charge of the preparation of the strategic objectives and principles for regulation, and guiding and controlling the achievement of these objectives. In addition, it is responsible for the authorisation and sanction processes.

The Communications and Information Services Unit is responsible for communications and document services, whereas the Operational Planning and Organisational Development Unit is in charge of operational planning and organisational development.

70% OF THE STAFF IN EXPERT POSITIONS

The FIN-FSA employed 138 persons at the end of 2005 (138.5 persons in 2004). A total of 64.5 employees worked in the Prudential Supervision Department, 54.5 in the Market Supervision Department, 9 in the Regulatory Governance Unit and 9 in the staff functions directly subordinated to the Director General. The average turnover rate was 6.5% (9%) for those entering the FIN-FSA's service⁴ and 9% (5%) for those leaving the FIN-FSA⁵.

70% of the FIN-FSA's employees served as experts and 10% as managers while 20% held other positions.

The FIN-FSA's role as the authority supervising financial market sets specific ethical requirements to 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.

⁴⁾ Turnover rate for those entering the FIN-FSA's service = Number of recruited employees / average operational strength of personnel x 100.

⁵⁾ Turnover rate for those leaving the FIN-FSA's service = Number of employees who left the FIN-FSA's service / average operational strength of personnel x 100.

Funding and operating costs

The FIN-FSA finances its operations by levying supervision fees and processing fees.

In 2005, the total fees charged by the FIN-FSA amounted to EUR 18.1 million. Costs arising from the operations of the FIN-FSA amounted to EUR 15.8 million, of which over one fifth, or EUR 3.4 million, represented payments for the use of the Bank of Finland administrative services (EUR 2.2 million) and the rental of premises (EUR 1.2 million). As supervision and processing fees exceeded costs in 2005 in the amount of EUR 2.3 million, supervision fees will be reduced accordingly in 2006.

The total budget figure for 2006 is EUR 18.5 million. The major part of the costs arising from operations comprises staff expenses and other staff-related expenses. About EUR 11.5 million has been earmarked for staff expenses: EUR 8.6 million is to be spent on salaries and EUR 2.9 million on staff-related expenses. Staff-related

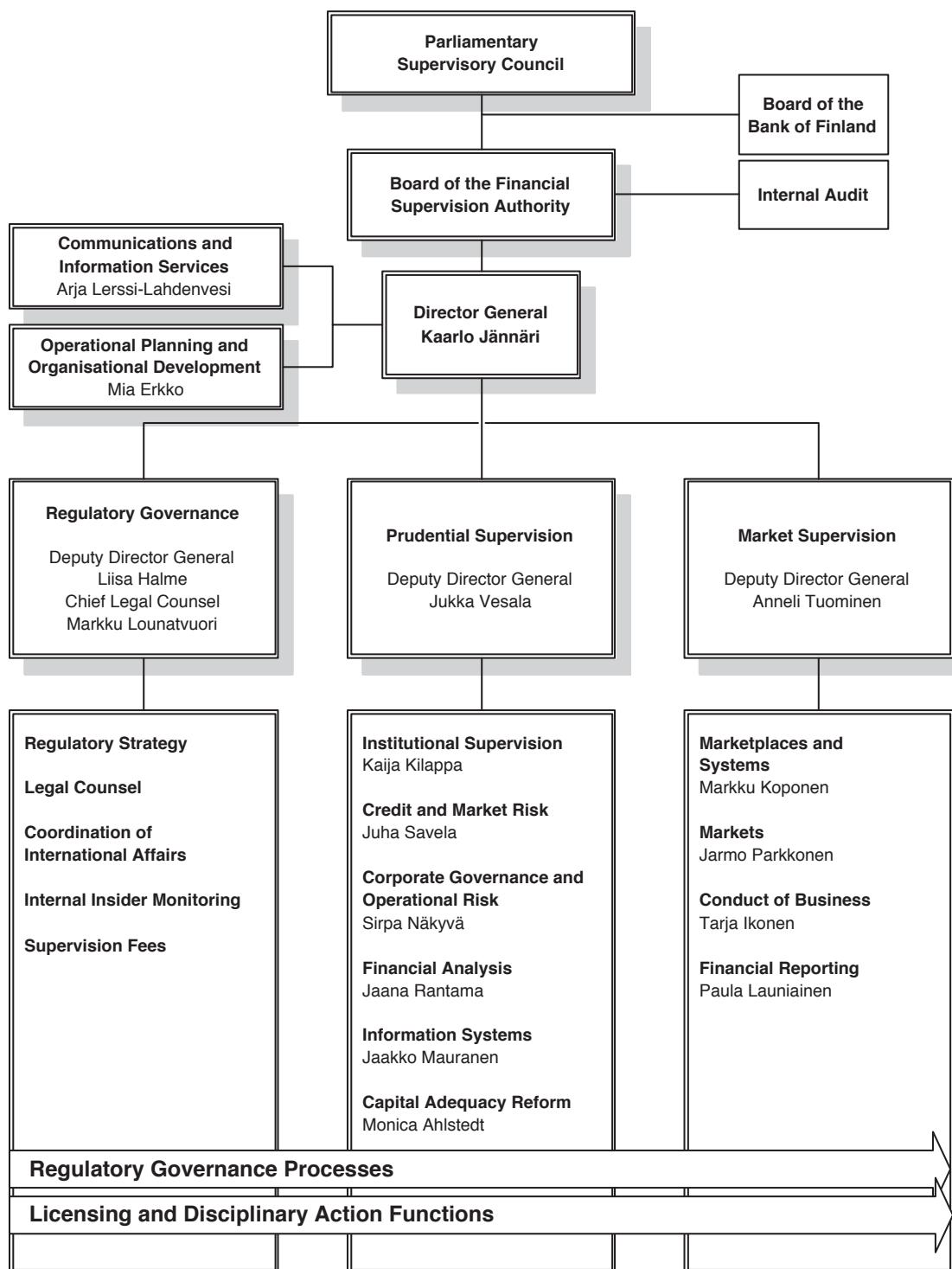
expenses include statutory and voluntary social security expenses, occupational health service expenses and recruitment expenses.

Other expenses are due to official travel, training, security, catering and personnel services as well

as services purchased from external parties. The FIN-FSA purchases services from the Bank of Finland, including services relating to personnel and financial administration, information management, security and other areas of general administration.

The Finnish Financial Supervision Authority

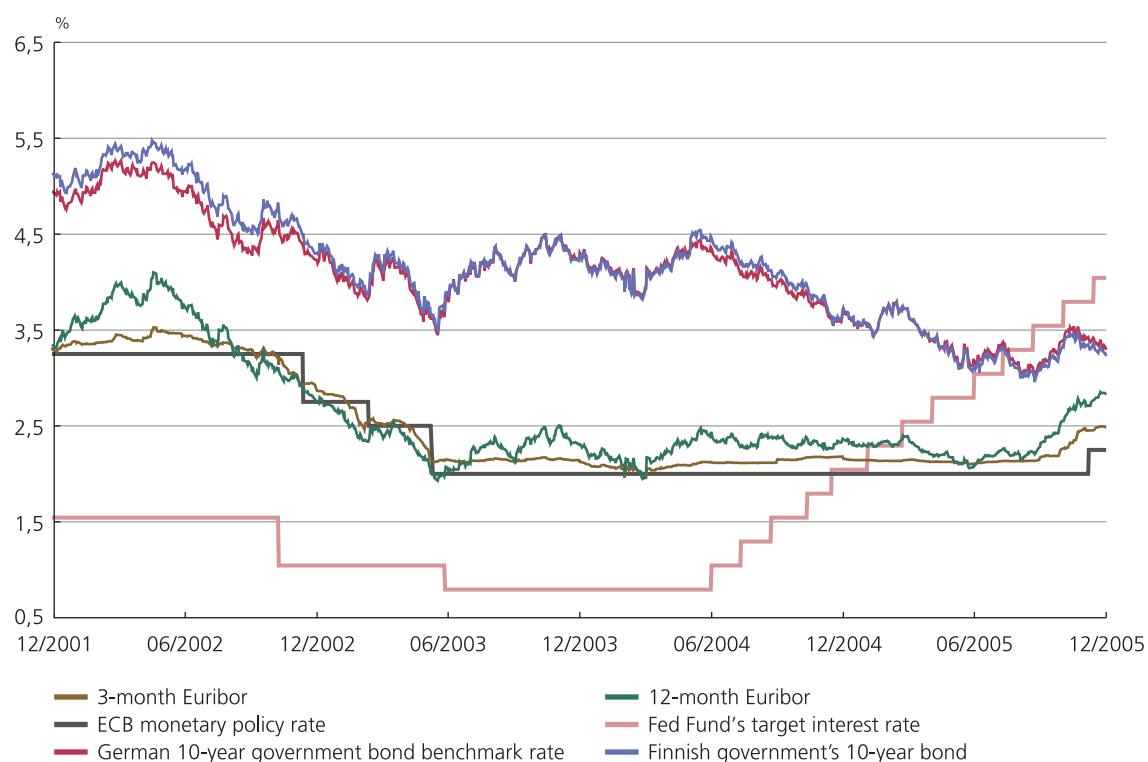
31 December 2005



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

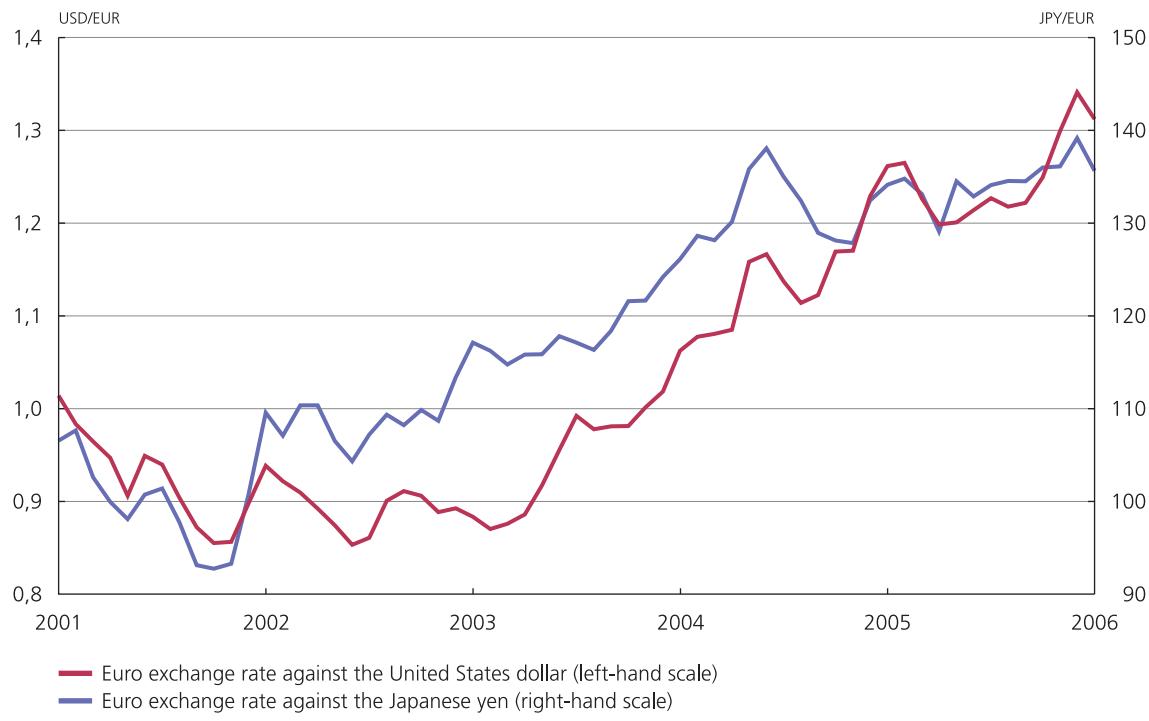
► Tables and charts

Financial markets' interest rates 29 Dec 2001–31 Dec 2005



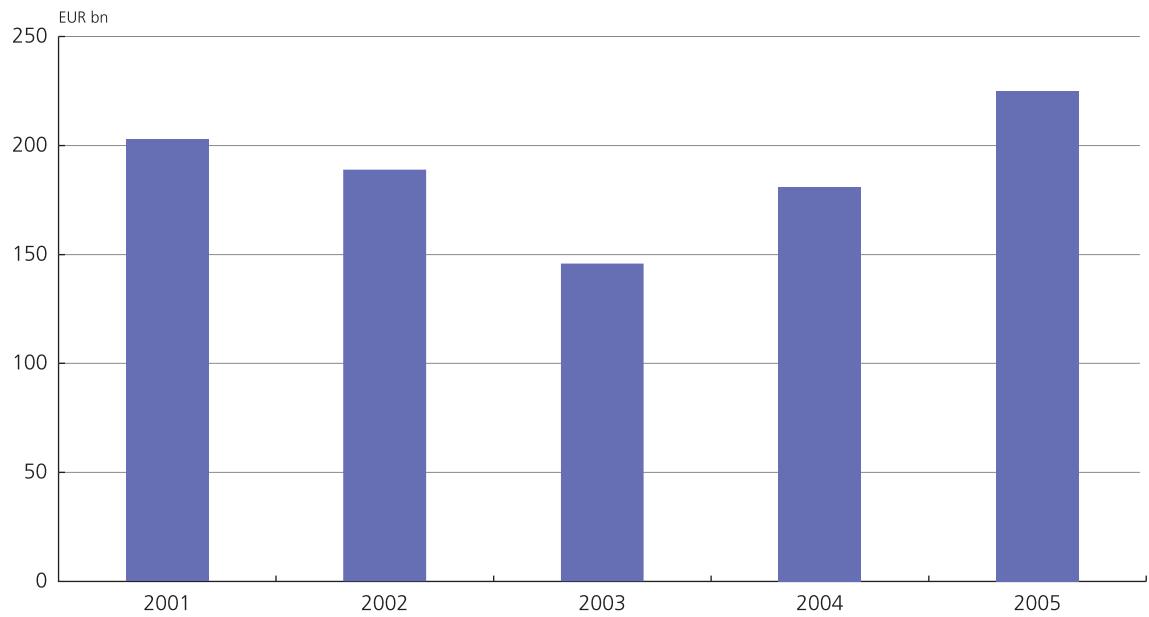
Euro exchange rate against dollar and yen, monthly

As the euro strengthens, the curve rises



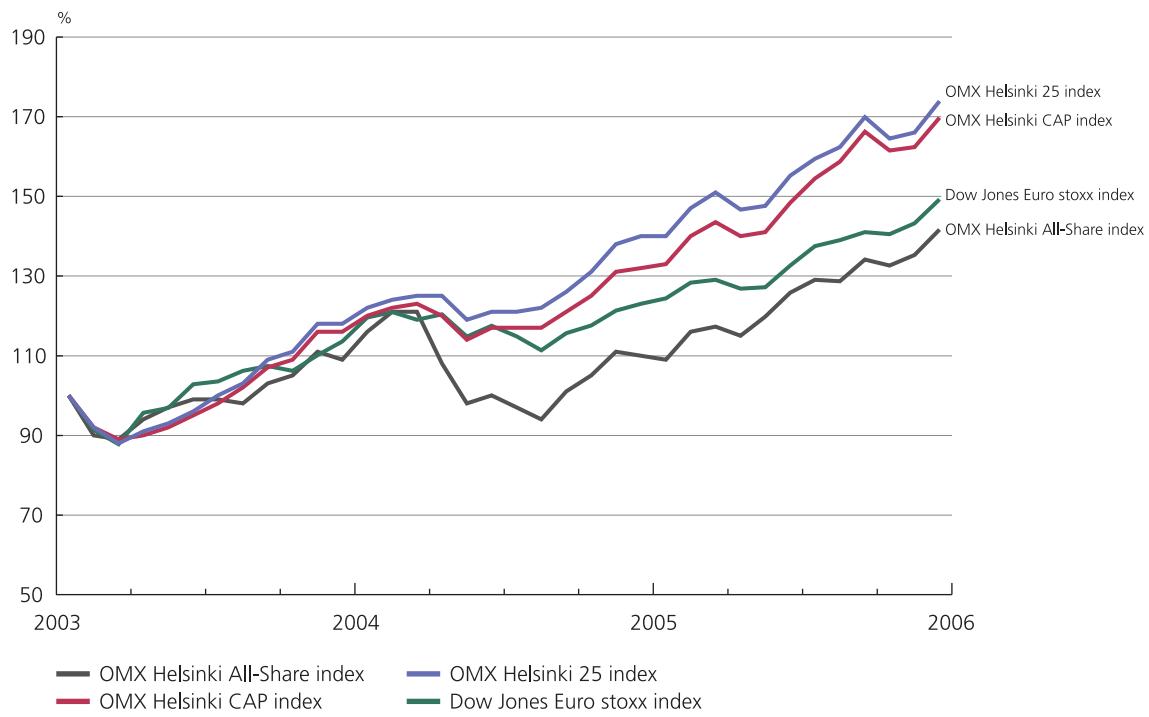
Source: ECB and Reuters.

Shares traded on the Helsinki Stock Exchange 2001–2005



Source: OMX.

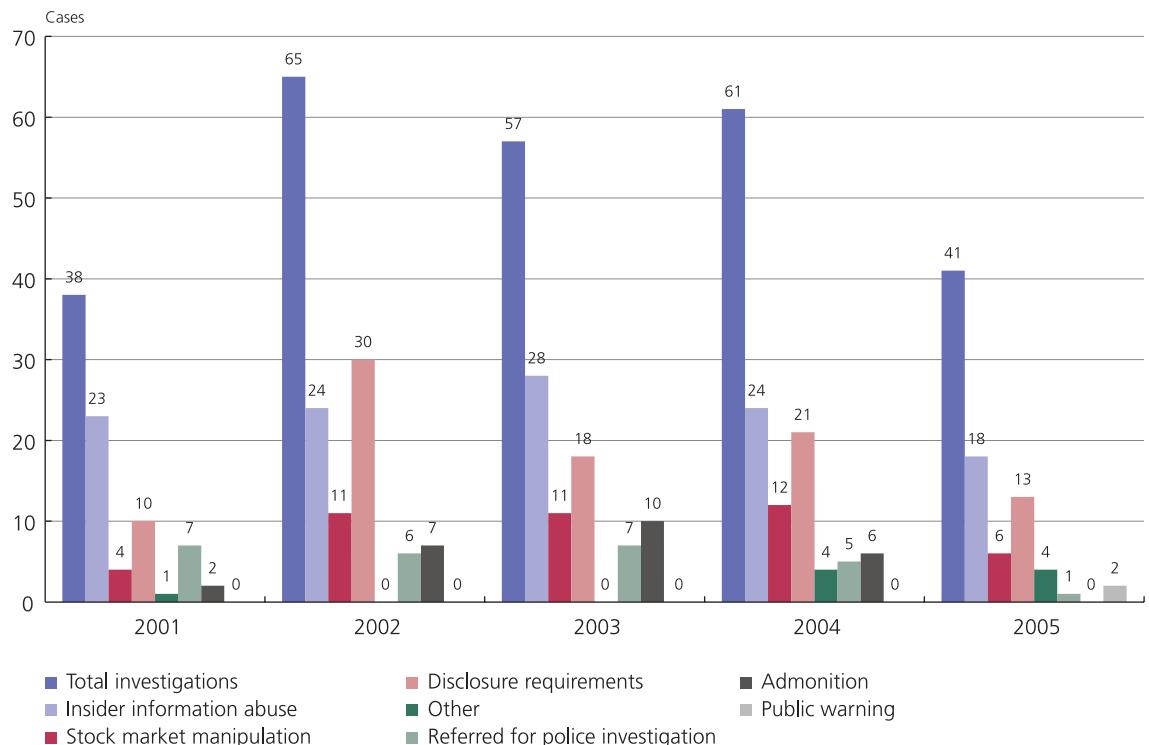
Helsinki Stock Exchange share index development 2003–2005



Percentage change calculated from price index. Monthly figures are average of daily figures.

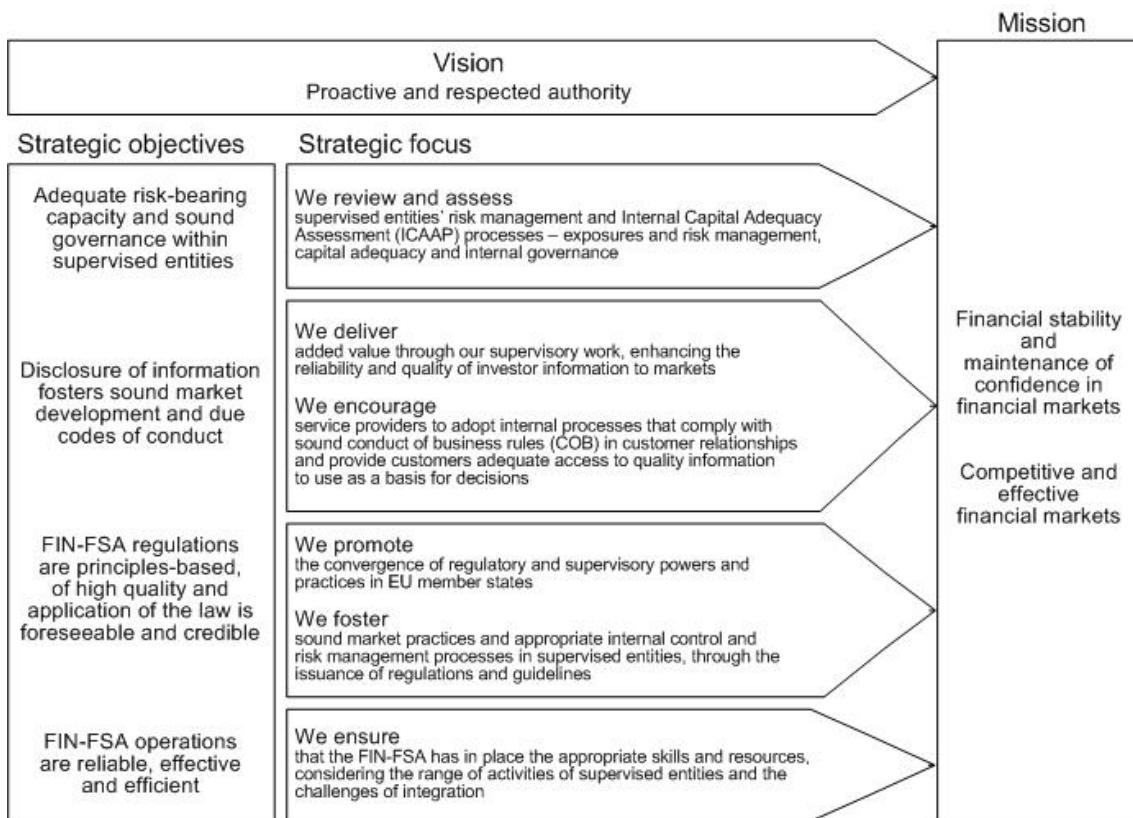
Source: OMX.

Cases of suspected securities market abuse investigated by FIN-FSA 2001–2005

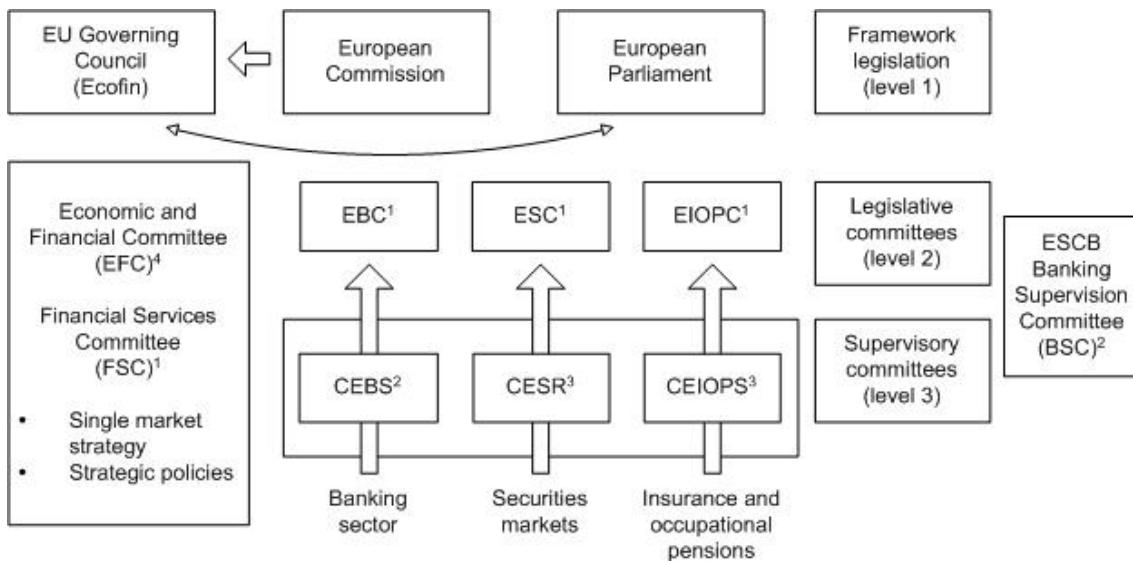


Source: Financial Supervision Authority.

THE FIN-FSA STRATEGY 2006–2008



EU-LEVEL SUPERVISORY AND REGULATORY COOPERATION



1) Comprises ministerial representatives

2) Comprises representatives from banking supervisory authorities and central banks

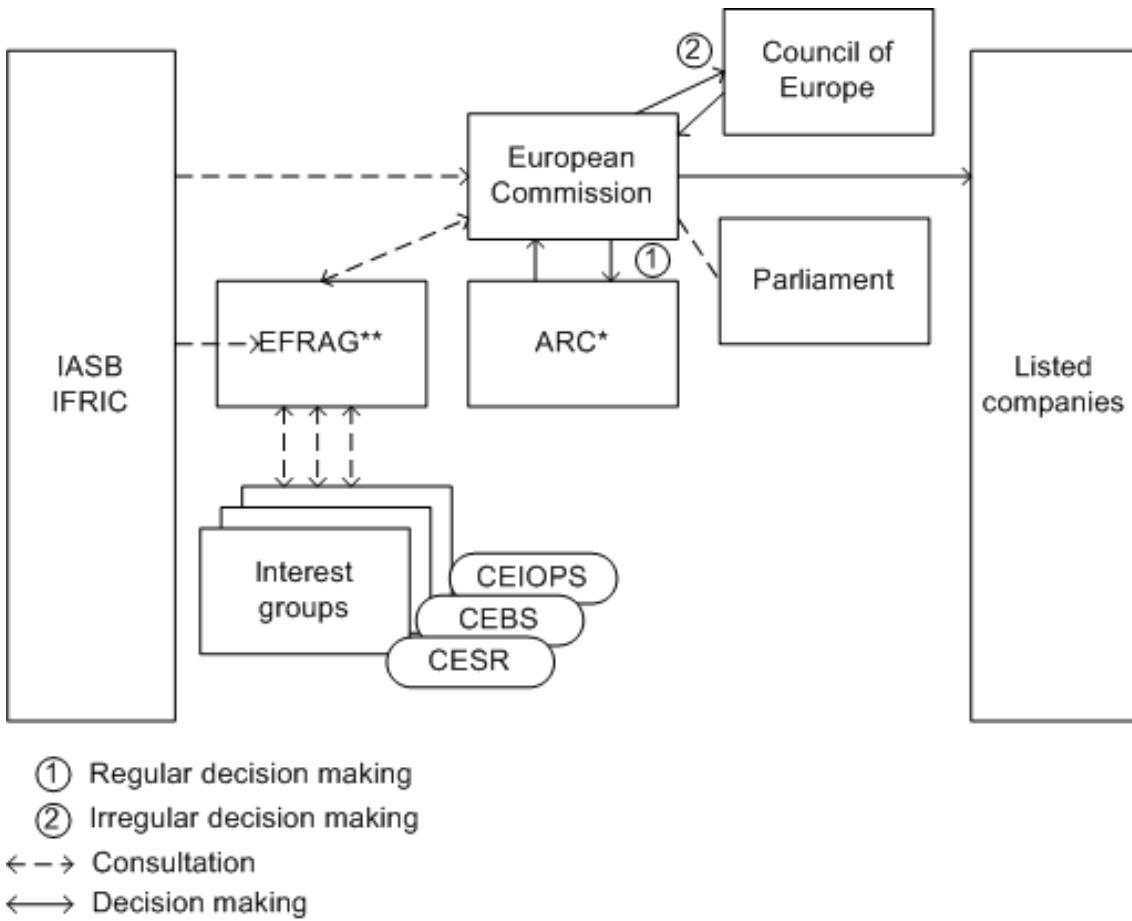
3) Comprises representatives from supervisory authorities

4) Comprises ministerial and central bank representatives

Abbreviations:

FSC	Financial Services Committee
EBC	European Banking Committee
ESC	European Securities Committee
EIOPC	European Insurance and Occupational Pensions Committee
CEBS	Committee of European Banking Supervisors
CESR	Committee of European Securities Regulators
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors.

IFRS APPROVAL PROCESS WITHIN THE EU



The key players in the approval of the IFRSs are the European Financial Reporting Advisory Group (EFRAG) and the Accounting Regulatory Committee (ARC). The latter is composed of representatives of various ministries of member countries.

EFRAG supports the Commission in the decision whether a final standard issued by the International Accounting Standards Board (IASB) or an interpretation issued by the International Financial Reporting Interpretations Committee (IFRIC) can be adopted as EU legislation. After this, EFRAG makes a proposal to the Commission on the approval of the standard or interpretation.

The Committee of European Securities Regulators (CESR) has observer status both within EFRAG and within the Accounting Regulatory Committee (ARC), whereas CEBS has observer status only in the latter. Both the committees (CERS and CEBS) endeavour to contribute to financial reporting regulations and interpretations especially when IASB or IFRIC issues a proposal for a new standard or interpretation or suggests amendments to them.

So far, CESR has influenced the activities of EFRAG by issuing opinions on its comment letters to IASB. CEBS has sent letters of comment directly to the Board.

THE FIN-FSA STAFFING, BY TASK 2004-2005

	2005		2004	
	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 functions	20,5	15 %	24,5	18 %
Monitoring of financial reporting	10	7 %	9	6 %
Financial reporting and analysis	13	9 %	10	7 %
Market Supervision	12	9 %	12,5	9 %
• Public-offer and listing prospectuses	4	3 %	4,5	3 %
• Reporting and disclosure obligations	3	2 %	3,5	3 %
• Stock exchange trading supervision and market abuse investigation	4,5	3 %	4	3 %
• Insider registers	0,5	0 %	0,5	0 %
Inspection and supervision functions	43,75	32 %	42	30 %
• Prudential supervision	22	16 %	24	17 %
• Monitoring codes of practice	13	9 %	10	7 %
• Financial market infrastructure (payment and IT systems, trading, clearing, payment and deposit systems, operators and counterparties)	8	6 %	6,5	5 %
• Information	0,75	1 %	1,5	1 %
International activities	6	4 %	6	4 %
Communication and document services	7	5 %	7	5 %
Information systems	8,25	6 %	8	6 %
Accounting, operations planning	2	1 %	2	1 %
Senior management, secretaries	10	7 %	12	9 %
Total	138	100 %	138,5	100 %

Source: Financial Supervision Authority.

THE FIN-FSA STAFF, EXPENSES AND INCOME 2001–2005

	2005	2004	2003	2002	2001
Number of staff employed	138	138,5	138	136	125
Income and expenses, EUR million					
Operating expenses	15,8	15,6	15,0	14,2	12,4
Supervision fees	17,4	14,9	14,6	13,7	11,8
Specific fees	0,7	0,8	0,5	0,5	0,6

Source: Financial Supervision Authority.

JOURNAL 2005

Main items of the journal	2005	2004
Governance	47	46
Regulation	103	106
Market Supervision	551	508
Prudential Supervision	72	84
Other supervisory activity	569	489
Other	139	121
Total	1481	1354

Major categories of journal entries	2005	2004
Listing particulars	180	185
Notifications	178	145
Request for further investigation	128	122
Regulations related matters	124	115
Fit and proper notifications; senior management	73	62
Contractual terms	64	50
International cooperation	53	61
Inspections and supervisory visits	46	31

In 2005, 1,482 entries were made in the FIN-FSA journal, broken down by department, as follows:
 Market Supervision 1,154; Prudential Supervision 261; Regulatory Governance 66.

SUPERVISION AND SPECIFIC FEES 2001–2005

Table 1. Supervision fees, EUR thousands

Fee-paying entities	2005	2004	2003	2002	2001
Credit institutions	11 482				
Investment firms	1 262				
Fund management companies	1 792				
Stock exchange	591				
Finnish Central Securities Depository (APK)	252				
Issuers	1 845				
Other	211				
TOTAL	17 435	14 857	14 564	13 659	11 720

From the beginning of 2005 the criteria for supervision fees changed in line with new legislation.

Table 2. Specific fees, EUR thousands

Fee-paying entities	2005	2004	2003	2002	2001
Fund management Companies	220	283	159	158	238
Issuers	373	420	285	308	343
Other	76	62	28	27	56
TOTAL	670	764	472	493	637

Table 3. Total fees, EUR thousands

Fees	2005	2004	2003	2002	2001
Supervision fees	17 435	14 857	14 564	13 659	11 720
Specific fees	670	764	472	493	637
TOTAL	18 105	15 621	15 036	14 152	12 357

Source: Financial Supervision Authority.

THE FIN-FSA BUDGET 2006, EXPENSES AND INCOME 2004–2005, EUR THOUSANDS

	Actual 2004	Actual 2005	Budgeted 2006
Expenses			
Staff expenses			
Wages			
Permanent employees	7 235	7 681	8 093
Fixed-term employees	457	363	344
Holiday substitutes	68	90	108
Other fees	131	121	101
	7 891	8 254	8 646
Other staff expenses			
Staff-related expenses	2 405	2 522	2 658
Other staff expenses	140	107	208
	2 544	2 629	2 866
Total staff expenses	10 436	10 883	11 512
Other expenses			
Training	256	191	279
Travel	413	451	477
IT expenses	888	1 000	1 993
Office expenses	745	666	844
Real estate rents and maintenance	1 681	1 288	1 306
Other expenses	1 188	1 299	1 964
Total other expenses	5 171	4 896	6 862
Depreciation			
Depreciation on equipment and furnishing	14	28	74
Software	0	12	24
Total depreciation	14	40	98
Total expenses	15 621	15 820	18 472
Supervision fees	14 857	17 435	16 725
Spesific fees	764	670	0
Other income	0	6	0
Total Income	15 621	18 112	16 725
Surplus (+) / deficit (-)	0	+ 2 292	- 1 747

The criteria for supervision fees changed from 1 January 2005, with the coming into force of the new Act on Supervision Fees. The new Act outlines the practice in such cases where the income from the combined supervision fees and specific fees exceed expenses in the FIN-FSA's annual budget. In the case that there is a surplus greater than 5% budgeted expenses on the previous year, 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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