2007

ANNUAL REPORT

RAHOITUSTARKASTUS
FINANSINSPEKTIONEN
FINANCIAL SUPERVISION

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Director general's review

When taking the helm of the Financial Supervision Authority, last February, I was aware that financial supervision was in a state of flux, both in terms of substance and organisation. At FIN-FSA we view such changes as challenges to be faced head on through hard work and commitment.

I firmly believe that, in today's society, the route to permanent results is through efforts springing from a common set of values. For that very reason the spring of 2007 was a time when we examined in depth the FIN-FSA's – in fact FIN-FSA staff's – values and any need that might exist for reformulating them. Everybody in the organisation was involved in the discussion, and plenty of comments were aired. As a result of this process we drafted a set of values which expressed the supervisors' independence and accountability, the intention of the staff of FIN-FSA to learn on a continuous basis and to aim for the highest standard of professional skills, their service-mindedness and efficiency and, not least, the need to promote well-being in their working community. These values are intended to emphasise both the high level of professionalism and a positive working atmosphere. I am confident that each point will, in its own way, help us achieve our objectives.

According to the Government's spring programme 2007, supervision of the financial and insurance sectors is to be merged in Finland, at the beginning of 2009. The Ministries of Finance and Social Affairs and Health jointly established a working group to plan this merge. Minister Antti Tanskanen was appointed to lead the working group, which was also made up of representatives from the abovementioned ministries, as well as the Ministry of Justice, the Bank of Finland, the Insurance Supervisory Authority (ISA) and the Financial Supervision Authority. The group dealt both with operational and organisational issues in a constructive atmosphere. The group's proposal will be signed in early February. In my opinion, the proposal clearly represents the various interest groups' expectations and provides a sound basis for the new supervisory authority's operations.

FIN-FSA had taken a neutrally positive stance regarding the question of a merge of the two supervisory authorities. FIN-FSA has been of the opinion that a merge would bring about supervisory synergies, the benefits of which would be directly felt by the financial market. As a member of the working group, I endeavoured to define the objectives of financial supervision clearly and thoroughly, and I emphasised the need for adequate supervisory powers, sound governance structure and operational independence for the new authority. While the new supervisory authority will have to operate on a cost-effective basis, it will also have to be able to compete within the financial sector in order to recruit and

keep the best personnel. The new authority needs to be able to supervise – in association with the respective home competent authorities – significant branch offices that operate in Finland. The funding of the new authority also needs to be on a sound footing.

Finland is one of the first EU countries in which foreign owned banks will change their significant subsidiary operations into branch offices. During 2008, Sampo-Danske will become a branch, and later this seems likely to happen to Nordea, too. From the point of view of the Finnish financial market, both of these branch offices would be systemically significant. It is essential that the supervision of these banks be arranged effectively and comprehensively, in cooperation with the home country supervisory authorities. Supervisory cooperation such as this should cover ongoing supervision in normal times as well as any potential crisis situation. Also at EU level, FIN-FSA has been active in promoting the role of the host country supervisors in the conduct of supervision regarding branch offices. It is essential that this role be accurately defined in EU legislation, in the current revision of the Capital Requirements Directive.

From time to time, supervisory authorities arrange crisis exercises in order to test readiness to manage crises. At the beginning of autumn 2007, FIN-FSA participated in a Nordic Financial Crisis Exercise along with fellow Nordic Ministries of Finance, central banks and financial supervisory authorities. The purpose of the exercise included evaluating the various authorities' preparedness regarding the exchange of information and the coordination of the crisis management activities between authorities.

The exercise turned out to be extremely useful in helping the Nordic authorities develop effective cooperation for crisis situations. The exercise pointed to several areas for further development in the cooperation between authorities. These were, in particular, in the areas of the information exchange, application of agreed coordination mechanisms in decision making, and common analysis of the implications of the crisis situation. It is vital that we take heed of the lessons learnt from the exercise, particularly in this time when cross-border supervisory cooperation is being deepened and legal supervisory responsibilities are being reviewed.

The crisis springing from the United States' subprime loan market overshadowed the second half of the year, although the direct effects on the Finnish financial markets have been very few. The direct risks related to subprime investments held by Finnish banks' are relatively small and the deterioration in the valuation of debt securities caused by the market turmoil has remained relatively small despite bringing about a reduction in the profitability of some banks in the second half of the year.

Despite the market disturbances, the financial position of Finland's banks remained stable. From the banks' perspective, short money markets have been performing without any difficulty, despite a rise in the cost of funds. The cost of long-term financing has shown a marked increase, as the risk premia required from banks has also gone up. They may remain somewhat above their pre-crisis level for a while. In addition to increasingly expensive market financing, banks' profitability is likely to weaken due to tightening interest rate competition over deposits as well as the continuing low margin levels from mortgage lending.

Liquidity risks have become particularly pronounced during the market turmoil. The crisis has shown, for example, the hazards of a one-sided funding structure. Supervisors are currently in the process of drawing up a set of principles to apply to effective liquidity risk management in banks. In practice, this means adequate risk diversification and stress testing, amongst other things. At the same time they are paying attention to the measurement of complex financial instruments.

The crisis has clearly underlined the importance of making accurate and adequate information available to the market. The financial markets have felt there could have been greater transparency and continue to place great value on it. A lack of confidence and disturbances arose in financial markets when nobody seemed to be aware of the size of the losses and ultimately which institutions' profitability will be affected.

The effect of the crisis on the real economy is still being evaluated. The Finnish financial markets have also found themselves having to adjust to a lower-than-anticipated level of economic growth.

This is then reflected as much in lending as in the level of fee income. Banks' capital buffers, that have grown as a result of the high profitability levels of the last few years, are anyway so high that only major disturbances in the operating environment could shake the foundations of the banks' capital adequacy,

FIN-FSA has taken care of its task of informing the public and has already long warned householders of the dangers of over-indebtedness. Although, in international comparisons, the Finnish level of indebtedness is not in itself very high, the concentration of overindebtedness in young adults is a particular cause for concern. In some cases housing and consumer loans have risen rather high in proportion to the family's income level and wealth. Banks are competing increasingly intensely for customers and there are fewer constraints on increased borrowing than before, emphasising the customers' need to judge their own risk-bearing capacity and preparedness for various risk factors.

The European Union's Financial Services Action Plan (FSAP) has finally been implemented at national level. In practice, FSAP has brought about a surge of rules and plenty of detailed regulations. Adopting the new regulations has posed a major challenge to supervised entities. Over the passing year, the coming into force of the Markets in Financial Instruments Directive (MiFID) and Basel II capital adequacy requirements have posed both a considerable human and financial pressure on supervised entities' resources. The volume of regulatory work has also consumed a lot of supervisors' resources. Over the coming year we will be able to concentrate considerably more of our energies on the actual job of supervision and inspection.

It is to be hoped that the Better Regulation Programme of the European Union will help in reducing the regulatory burden and that the practical implementation of the principles-based regulation can be realised. Thus, we could better adapt the regulatory principles to the various supervised entities of different size and type and cut back on details in regulation.

The role of self regulation in the financial markets, and particularly the securities markets, has been discussed more than before during the year under review. FIN-FSA's approach to self regulation is pragmatic: within some sectors it allows a clearly more flexible solution and one that adapts to changes in business operations, within other sectors pure self regulation is not efficient or credible. Where self regulation is appropriate and undertaken in a responsible manner, FIN-FSA is ready to actively support it through its own activities.

Exclusively national solutions in supervision as much as in regulation have moved into the history books; service provision has become global, financial crises no longer remain within the borders of any one country. As the complexity of the risks and regulations governing global financial markets become greater, the professional demands placed on the competencies of supervisors are amplified. At the same time, supervisors are expected to work in an evermore cost-effective manner. Well-functioning financial markets require a more vigilant grasp of its supervisors in customer and investor protection-related matters as well as the readiness to produce timely and useful information to support customers in their decision making.

As structural changes continue to take place in the financial markets, the supervisory challenges are many and, to some extent, conflicting. However, as I also was happy to be able to state at the beginning of last year, the personnel of the FIN-FSA have been ready for their part to do the hard work required to meet these challenges, supported by their high levels of motivation and professional skill.

Helsinki, 15 January 2008
Anneli Tuominen

The FIN-FSA in brief

FIN-FSA tasks and organisation

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

The objective of FIN-FSA 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 FIN-FSA Board.

Core operations: supervision and regulation

FIN-FSA's core operations comprise supervision and regulation, of which the former separates between prudential and market supervision. Prudential supervision focuses particularly on the most important and risk-sensitive institutions and activities and assesses supervised entities' financial position, risks, risk-bearing capacity and risk management systems.

FIN-FSA emphasises owners' and management's responsibility for internal control and risk management as to ensure that supervised entities have sufficient financial and other prerequisites to operate and that they do not assume so much risk as to endanger their capital adequacy. FIN-FSA seeks to be proactive in identifying risks and pressures for change threatening financial market stability. However, supervision is not regarded as the means of preventing financial market corporations' bankruptcies at all times, nor could it be so. The objective is to ensure that the related consequences affecting customers and financial market stability are contained.

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

FIN-FSA grants authorisation to credit institutions, investment firms, fund management companies and pawnshops. It has also the right to revoke the authorisation of these supervised entities either on their application or on conditions fulfilling revocation requirements. Authorisation decisions made can be found in Table 'Journal 2007' on page 9.

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

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. FIN-FSA monitors market conditions closely and, where necessary, submits proposals to other authorities for legislative action or other measures.

Besides supervision and regulation, FIN-FSA is also vested with the task of promoting public knowledge and awareness of the financial markets as to give members of the public the opportunity to take and bear responsibility for their own finances.

GOVERNANCE AND MANAGEMENT

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

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

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

Parliamentary Supervisory Council

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

The Board of the FIN-FSA

The FIN-FSA board is responsible for the steering and supervision of 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, one on the basis of a proposal of the Bank of Finland, two based on the Ministry of Finance proposal and one based on the proposal of the Ministry of Social Affairs and Health. The Director Generals of FIN-FSA and the Insurance Supervision Authority are ex officio members of the Board.

Director General

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 FIN-FSA performs all its duties efficiently and expediently in accordance with 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, Deputy Directors and the Chief Legal Counsel.

ORGANISATION

The organisation of the FIN-FSA consists of three departments: the Market Supervision and the Prudential Supervision departments as well as the Regulatory Governance unit. In addition, the Communications unit operates directly under the Director General. FIN-FSA's organisation chart is shown in Annex 1.

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

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

The Regulatory Governance unit is in charge of steering the provision of FIN-FSA regulations and the preparation of the strategic objectives for regulation. It is also responsible for the authorisation and sanction processes, the legality of FIN-FSA activities, uniform interpretation of the law and the supervision of compliance with insider regulation undertaken by FIN-FSA staff. In addition, the Regulatory Governance unit is responsible for

organisational development, financial issues and document management.

The Communication unit is responsible for communication and consumer information.

STAFF

FIN-FSA is an expert organisation; 73% of the staff hold expert positions, 10% serve as managers and 17% hold other positions.

FIN-FSA's approved operational strength is 142 employees, but at the end of 2007 the actual numbers stood at 141 employees. A total of 53 worked in the Market Supervision, 65 in the Prudential Supervision, 17 in the Regulatory Governance unit and 3 in Communications. The number of man-years worked totalled 145. The average turnover rate was 13.5% for those entering FIN-FSA's service[1] and 10% for those leaving FIN-FSA.[2]

FIN-FSA's role as the authority supervising financial market sets specific ethical requirements on its employees and their activities, these being loyalty and independence. The employees are to bear in mind FIN-FSA's objectives 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.

In May 2007, FIN-FSA staff members captured their values jointly as follows:

We are financial market professional who

- earn trust, every day
- communicate actively and are service-minded
- work efficiently and effectively
- pull together

The employee attitude survey conducted in autumn 2007 did not show any major changes compared with previous surveys. The survey revealed that cooperation between units had improved, whereas remuneration practices for good performance had weakened. The staff felt that the workload should also be more balanced. Supervisory work received good feedback, and the internal communication system was considered to function well. The response rate was 86% (88% in 2005).

FUNDING AND OPERATING COSTS

FIN-FSA finances its operations by levying supervision and processing fees from supervised entities and securities issuers. In 2007, the combined supervision and processing fees charged by FIN-FSA totalled EUR 16.4 million, in addition to which a surplus of EUR 2.6 million was transferred from the previous year.

FIN-FSA's operating costs totalled EUR 16.2 million. The majority of this consisted of staff expenses (EUR 10.9 million). Other major expense items were administrative services from the Bank of Finland (EUR 2.2 million) and rental of premises (EUR 1.2 million). In addition, FIN-FSA will pay its contribution to the Bank of Finland pension fund, the amount of which is to be confirmed later in spring. The resulting deficit will be taken into account when determining supervision fees for 2008.

The total budget for 2008 is EUR 17.2 million. Approximately EUR 11.4 million has been earmarked for staff expenses, of which EUR 8.8 million is to be spent on salaries and EUR 2.7 million on other staff-related expenses. Staff-related expenses include statutory and voluntary social security expenses as well as occupational health service expenses.

Other expenses are due to official travel, training, security, catering and personnel services as well as services purchased from external parties. Official travel comprises mainly working group meetings of the Committee of European Banking Supervisors (CEBS) and the Committee of European Securities Regulators (CESR) as well as joint meetings of Nordic supervisors. An average sum of EUR 1,700 is budgeted for 2008 for competence development per person. FIN-FSA purchases services relating to personnel, financial administration, information management, security and other areas of general administration, from the Bank of Finland. These expenses account for EUR 2.3 million in the budget for 2008.

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

The year's events

1 January Standard *RA4.10 Reporting of Lending to Related Parties and Related Parties' Investments* came into effect
15 January **Jukka Vesala**, Deputy Director General, appointed to the board of the Committee of European Banking Supervisors *(CEBS)*
24.–25 January FIN-FSA participates in *Vero 2007* (Taxation 2007) happening, arranged by the Taxpayers Association of Finland
31 January **Kaarlo Jännäri**, Director General, retires
1 February **Anneli Tuominen** takes up post of Director General and **Jarmo Parkkonen** takes over post of Head of Market Supervision
1 February FIN-FSA discontinues making prior comments on marketing material of prospectuses
15 February EU Directives on Transparency and Capital Requirements implemented into Finnish legislation
15 February Powers to regulate on regular disclosure of information granted to FIN-FSA
1 March FIN-FSA clarifies the binding nature of its regulatory framework by adopting new margin classification in its standards
1 March 10 Standards under the set of regulations on Capital adequacy and risk management come into effect
2 March FIN-FSA Board hands in its Annual Report for the previous year to the Parliamentary Supervisory Council
30 March Standard *RA4.8 Reporting of regulatory capital adequacy and minimum capital requirements related to credit-, counterparty-, market- and operative risk* comes into effect
15 April Finnish Government's includes the merging of the Financial Supervision Authority and the Insurance Supervisory Authority in its spring programme with the objective of the new supervisory body commencing operations from the beginning of 2009.
16.–27 April The Financial Task Force on Money Laundering FATF, visited Finland in order to undertake its mutual evaluation
25 April FIN-FSA signs a Memorandum of Understanding with the Russian central bank, on banking supervision
28 May The FIN-FSA personnel adopts their new set of values and ethical principles
29 May FIN-FSA participates in the IMF country inspection of Finland
18 June FIN-FSA publishes its *10 Trading guidelines for traders*
20 June The Ministries of Finance and Social Affairs and Health jointly establish a working group to bring about the merge of the Financial Supervision Authority and the Insurance Supervisory Authority
30 June Standard *4.3a Own funds and minimum level of own funds* comes into effect
1 July Standard *1.4 Assessment of fitness and Propriety (fit & proper)* and the related Reporting Standard comment into effect
7 September FIN-FSA publishes the results of a survey showing that Finnish banks' subprime responsibilities are few
20–24 September FIN-FSA participates in the Nordic Financial Crisis Exercise, along with other Nordic supervisory authorities, central banks and Ministries of Finance as well as Baltic central banks
21 September FIN-FSA issues a public reprimand to *Elektrobit* for its breach of a disclosure obligation
27 September FIN-FSA announces that it does not object to Nasdaq holding all OMX shares
19 October FIN-FSA publishes a survey on the financial reporting for 2006 of listed companies
25 October The Financial Task Force on Money Laundering FATF, publishes its mutual evaluation of Finland
1 November FIN-FSA Standards related to the coming into effect of the Directive on Markets in Financial Instruments (MiFID) *1.3 Standard on Corporate Governance and organisational requirements, 1.6 Standard on the outsourcing of operations, 2.1 Standard on the code of conduct for the provision of financial services, 2.2 Standard on the marketing of*

Journal 2007

Main items of the Journal	2007	2006
Governance	86	46
Regulation	164	114
Market supervision	554	546
Prudential supervision	82	84
Other supervisory activity	927	630
Other	130	155
Total	*1943*	*1575*

Major categories of Journal entries		
Notifications	380	188
Prospectuses	282	225
Regulations related matters	151	139
Requests for further investigation	100	94
Fit and Proper reports; senior management	88	58
Administrative sanctions and supervisory powers	80	–
Authorisation decisions, incl. new authorisations granted, changed authorisations and revocations	20	14
Inspections and supervisory visits	53	44
Contractual terms	52	44
International cooperation	49	61
Publications; communication releases	43	34
Supervision certificates	42	59

In 2007, 1,943 entries were made in the FIN-FSA Journal, broken down by department, as follows: Market Supervision 1,445; Prudential Supervision 378; Regulatory Governance 120.

Source: Financial Supervision Authority.

financial services and financial instruments and RA5.1 Reporting on trading Standard all came into force

1 November the Directive on Markets in Financial Instruments (MiFID) comes into effect

12 November FIN-FSA publishes its reply to the notification by Borse Dubai on the acquisition of shares in OMX

14–**15 November** FIN-FSA participates in *Sijoitus-Invest 2007* (an investment fair), arranged by Helsinki Fair Ltd

10 December FIN-FSA announces that it has entered into a Memorandum of Understanding with the International Organization of Securities Commissions (IOSCO)

What is MiFID?

MiFID – the Markets in Financial Instrument Directive – is a major part of the European Union's Financial Services Action Plan (FSAP) and is designed to create a European single market in financial instruments. MiFID came into effect on 1 November 2007, replacing the former Investment Services Directive.

Main objectives:

- to improve investor protection
- to increase market transparency and efficiency
- to promote competition for financial services in Europe

One of the directive's key aspects is the improvement of the operation of the EU 'passport' that allows investment firms in the EU to provide services across borders on the basis of a single authorisation valid throughout the Community. MiFID also harmonises conduct of business rules for providers of investment services, which contributes to easier provision of services in EU countries.

As of the entry into force of MiFID, the provision of investment advice is subject to authorisation. Under the EU passport, investment advice can also be provided on a cross-border basis.

What is Basel II?

Basel II is a framework revising capital adequacy regulations and supervision pertaining to deposit banks, investment firms and fund management companies. The purpose of the new framework is to ensure that supervised entities' own capital adequacy assessment process and own funds are adequate in relation to their

- risk exposures
- risk management system and
- internal control

Basel II comprises three pillars:

- Pillar 1: calculation of minimum capital requirements for credit, market and operational risk
- Pillar 2: adequacy of capital for risks not covered by Pillar 1, banks' own Internal Capital Adequacy Assessment Process (ICAAP) and Supervisory Review and Evaluation Process (SREP)
- Pillar 3: disclosure of information on capital adequacy

Basel II aligns regulatory capital requirements more closely to firms' actual risks. At the same time, it provides incentives for firms to improve their risk management practices. Proactive capital planning must be based on a company's whole risk profile.

Most aspects of Basel II came into effect on 1 January 2007. The most sophisticated approaches for the calculation of capital requirements for credit and operational risks are subject to FIN-FSA's permission and were applicable from 1 January 2008. In 2007, credit institutions and investment firms could still apply Basel I requirements.

What does subprime mean?

Subprime loans are mortgage-backed housing loans that US creditors have granted to customers who are already known to have poor debt servicing records. The term 'subprime' refers to the credit status of the borrower: best borrowers are called 'prime' borrowers and those below their standards 'subprime' borrowers. Those categorised as subprime borrowers usually have payment defaults or income that provides little leeway for debt servicing.

A typical feature of a subprime loan is that the initial interest rate is low and fixed for 2 years, for instance. The rate is then reset to equal the level of an agreed reference rate, and added with a margin including a risk premium. This margin has increased subprime lenders' interest expenses significantly and caused payment defaults. The borrower's situation may be aggravated further if the value of the house used as collateral falls markedly.

The majority of subprime loans has been securitised and sold from original lenders' balance sheets. As there was ample liquidity in the markets, investors also bought riskier instruments yielding high payoffs. Consequently, subprime risk spread to European banks. It was also difficult to get a clear picture of the pattern of risk-spreading, which added to the general lack of confidence in the financial markets. This in turn tightened banks' liquidity situation and raised costs for market-based financing.

The year in brief

OBJECTIVES OF FINANCIAL MARKET STABILITY AND CONFIDENCE

In all its operations, the Financial Supervision Authority (FIN-FSA) aims at ensuring financial stability and maintaining confidence in financial markets. It also seeks to promote competitiveness in Finnish financial markets. The EU-level objectives relate to the achievement of single financial markets and common supervisory practices.

FIN-FSA has been a pioneer in the supervision of cross border financial conglomerates. Developments in Finnish financial markets have highlighted the importance of a strong and clear role of the host country supervisor.

PRUDENTIAL SUPERVISION

The Basel II framework on capital adequacy came into effect at the beginning of 2007, and the majority of supervised entities started to apply the new regulations straight away. FIN-FSA's standards on capital adequacy took effect in February and were directly applicable in supervision. Consequently, FIN-FSA's operations shifted increasingly from regulatory to supervisory work. The assessment and approval of supervised entities' internal ratings based approaches for calculating regulatory capital requirements continued to require a substantial input of resources. Supervised entities developed their Internal Capital Adequacy Assessment Processes (ICAAP) further. FIN-FSA's prudential supervision was increasingly conducted through comprehensive evaluations of supervised entities' ICAAPs and the adequacy of regulatory capital.

The US subprime crisis was also reflected in Europe, although the direct impact on the Finnish financial sector proved to remain relatively small. However, indirect effects were also felt in Finland. FIN-FSA carried out an impact assessment of the subprime crisis in banks' funding costs, liquidity and possible impairment losses. The implications of the crisis were also analysed in cooperation with other supervisors in the Committee of European Banking Supervisors (CEBS). FIN-FSA continues to monitor the effects of the subprime crisis.

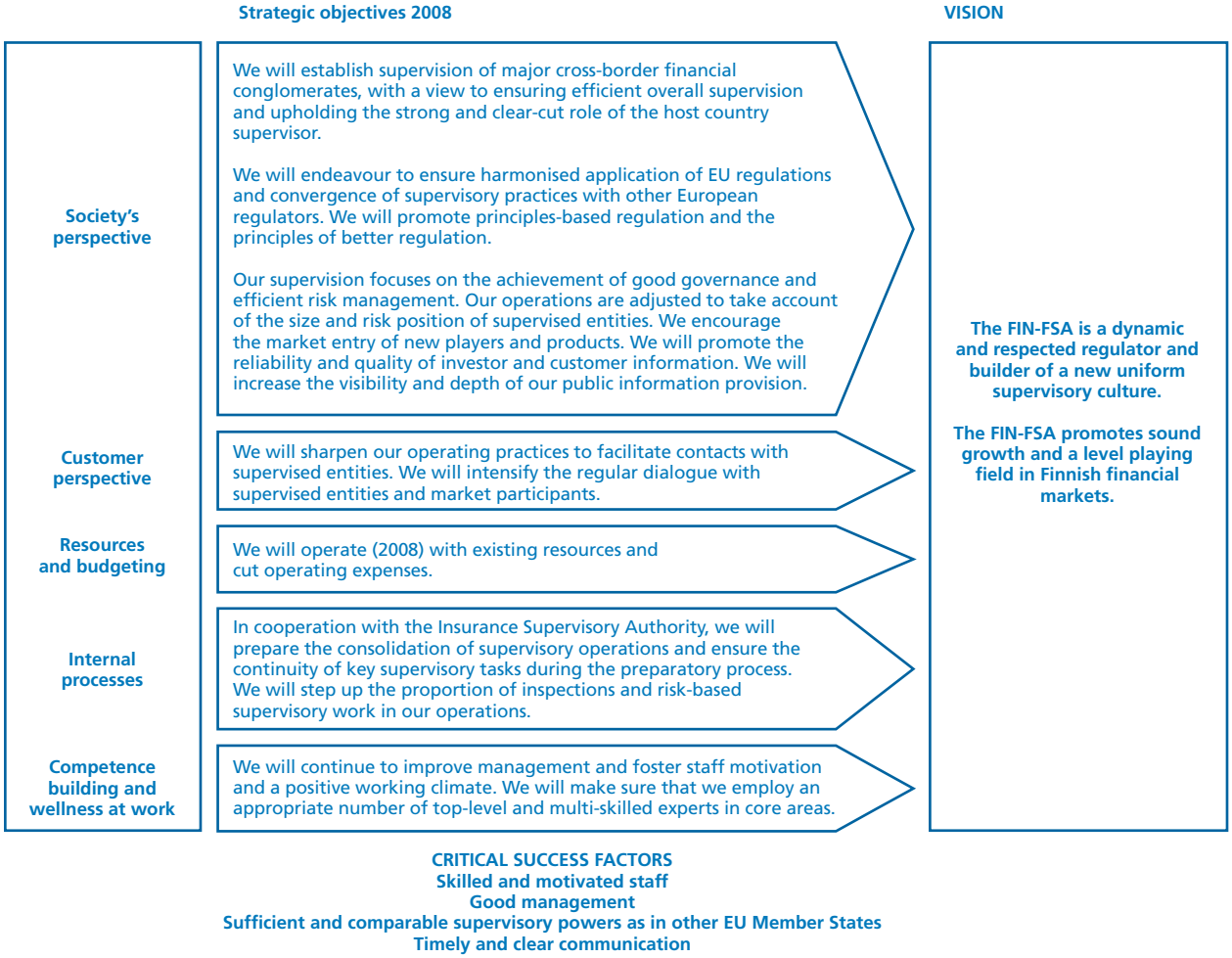
FIN-FSA's inspections of prudential supervision increased. Supervisors focused particularly on supervised entities' risk management systems. The majority of inspections concentrated on large supervised entities, but the operations of small banks were also reviewed. Key themes of inspections were credit, market and liquidity risk.

The Finnish, Swedish, Norwegian and Danish supervisory authorities continued their close cooperation in the supervision of Nordea Group. FIN-FSA deepened its cooperation with the Danish Finanstilsynet in the supervision of Danske Group. Likewise, cooperation with the Icelandic

FINANCIAL SUPERVISION AUTHORITY

OBJECTIVES

STABLE AND COMPETITIVE FINANCIAL MARKETS AND MAINTENANCE OF CONFIDENCE IN THEIR OPERATIONS



FME increased, as Icelandic banks expanded their activities in Finland.

Banks' competition for deposits intensified towards the end of 2007, raising discussions about deposit guarantee. FIN-FSA informed the public of minimum protection provided in the EEA and the related country-specific differences.

MARKET SUPERVISION

As regards market supervision, the year was above all marked by the national implementation of the MiFID directive. MiFID required substantial preparatory work by FIN-FSA. For instance, FIN-FSA examined supervised entities' preparedness for MiFID implementation. It reviewed the organisation, methods and systems relating to the supervision of investment services. Investment firms authorisation processes were updated for efficient handling of new applications and application instructions. Seminars were organised for existing and new market participants. FIN-FSA also updated its own standards to comply with the new directive.

Interest in structured products grew further, and therefore FIN-FSA continued its efforts to enhance the transparency of structured products' rules

and pricing. Considerable progress was made when the Finnish Structured Products Association recommended its members to disclose in public the structuring costs of structured products.

With regard to IFRS compliance, FIN-FSA carried out a survey to assess whether firms had improved their financial reporting from the previous year. The survey revealed that listed companies had upgraded their financial statements of 2006, although there was still need for improvement in the presentation of information. FIN-FSA also assessed the application of the main requirements of IAS 36 'Impairment of Assets'. The survey results indicate that the practical application of IAS 36 is challenging and varies between companies. The chosen practices may affect the results of impairment testing and therefore also the balance sheet value of asset items.

REGULATION

MiFID was an essential element in terms of the year's regulations. The directive brought about new regulation on investment services activity and had a significant effect on FIN-FSA's own set of regulations. For instance, it made provisions for investment advice and the organisation of multilateral trading subject to authorisation. The directive also affected credit institution regulation. FIN-FSA updated its regulation on internal governance and defined principles that supervised entities should observe to foster efficient internal control and risk management. Criteria for the granting of authorisations were also revised to comply with MiFID.

At EU level, supervisory authorities continued their efforts to remove barriers to integration. The most important step was the implementation of the Cross-Border Mergers Directive promoting the creation of a real single market. In practice the directive facilitates cross-border mergers and increases the number of branches. In Finland, authorities revised provisions on the guaranteeing of deposits, which contributes to easier practical execution of cross-border restructuring. According to the new regulation on deposit guarantees, contributions paid to the deposit guarantee fund are linked to banks' capital adequacy: the higher the capital adequacy ratio, the lower the contribution.

New practices were sought to enable principle-based and better regulation. The key challenge is to ensure that common regulation principles apply to supervised entities of different sizes and types. FIN-FSA outlined its view on the role of self-regulation in financial markets. The objectives of better regulation require that markets should also seek alternative instruments for authorities' regulations.

CONSUMER INFORMATION

Informing the public is one of FIN-FSA's statutory responsibilities. The need for information has increased continuously as the economic operating environment has become ever more complex.

Members of the public must take and bear responsibility for their personal finances themselves. To support members of the public in this, FIN-FSA has continued its consumer information efforts by publishing and maintaining information, on its website, designed to assist when comparing financial services and products. In addition, the online publication *FSA Newsline* examines topical issues such as risks related to large mortgage loans. The media has also continued to discuss these topics. In the latter part of 2007, issues relating to deposit guarantee were brought up on several occasions in FIN-FSA's own publications and expert opinions.

In November, FIN-FSA again participated in the *Sijoitus-Invest* event in Helsinki. FIN-FSA's 14 seminars on 6 different topics drew full audiences on both event days. As in the previous year, index loans again proved to be the topic that generated the most interest. Structured investment products have also otherwise been discussed in FIN-FSA's consumer information releases. The event saw the introduction of the FIN-FSA online game *Financial Wizard* directed particularly at the adolescents and young adults. In the first week of its operation, the game was played over 3,000 times. In future, the game will also be part of an online study package directed at students and developed jointly with the Bank of Finland.

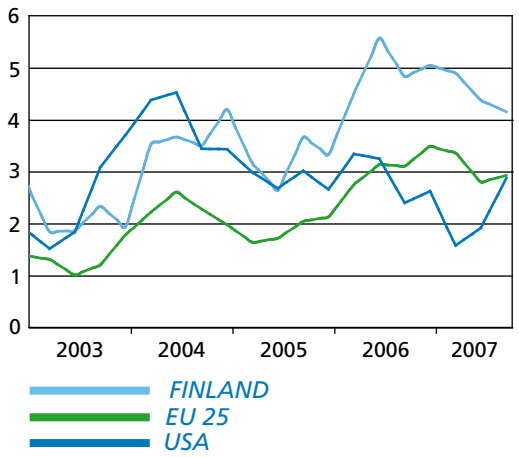
Economic operating environment

Economic growth continued strong

The Finnish operating environment for supervised entities was good in the period under review, although the year was characterised by the so-called subprime crisis that spread from the US mortgage market to the global financial markets. The world economy continued its strong growth, thereby facilitating euro area growth. The Finnish economy also sustained rapid growth throughout the review period, with performance exceeding both the euro area average and the growth seen in the USA.

Finnish wage earners' earnings rose by an average of more than 5%, but inflation hovered below the euro area average at around 3%. The number of employed increased and some sectors are even voicing concerns over lack of labour force. The unemployment rate fell below 7%. Thanks to higher real income and positive employment developments, consumers' ability to service their debts remained good. Instead, higher interest rates and inflation undermined consumers' purchasing power. Looking at the corporate sector, the situation was good even though a slight increase in the number of bankruptcies was noticed towards the end of the year.

Gross National Product

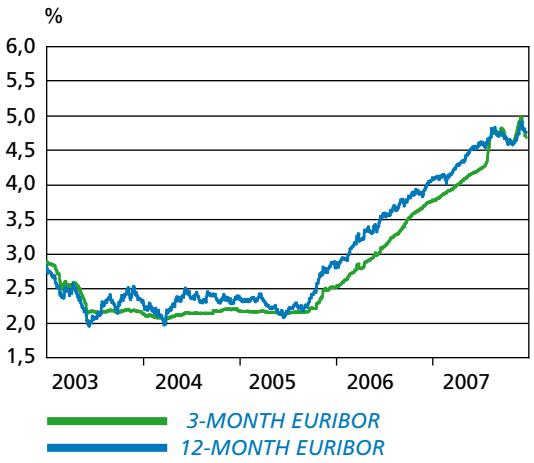


Sources: Statistics Finland, Eurostat and BEA.

Particularly strong phenomena in the financial markets

Banks' loan customers, with almost no exception, have had to pay higher interest on their loans since the previous rate review date. The rise in short-term market rates that started in 2005 continued in the

Euribor



Source: Reuters.

review period. It has been very rapid and has closely followed the trend seen in 2003–2005.

In August, turbulence spread into the monetary and financial markets and was particularly strongly reflected in the interest rate and share markets. Within a couple of days, the three-month Euribor rose half a percentage point and remained high relative to the key interest rates. This phenomenon was caused by alarming news from the US mortgage markets and the ensuing heightened uncertainty in the markets.

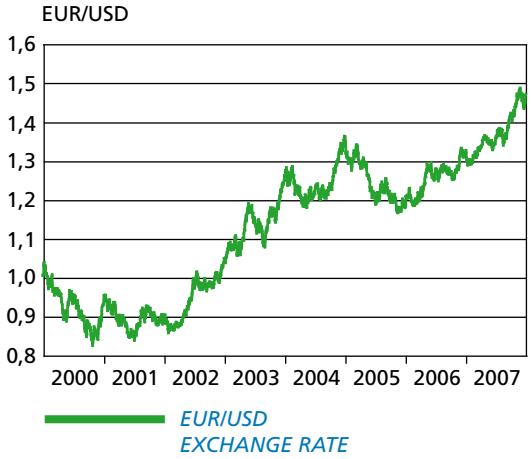
US mortgage problems result in market turmoil

In August, in the middle of the European summer holiday period, worrying news began to spread from the financial markets concerning lack of confidence, subprime loans and liquidity problems affecting certain banks. Rates on unsecured inter-bank lending rose exceptionally strongly, which was reflected in the rapid growth of the price difference in secured (repo agreements) and unsecured inter-bank money. Finnish loan customers experienced the unrest in the financial markets as volatility in the Euribor rates and as higher than normal level of central bank key interest rates.

The FIN-FSA immediately conducted a survey on Finnish banks' situation and released a press release of the findings. The survey showed that Finnish banks were not directly vulnerable to the problems and did not give rise to feelings of distrust in the Finnish financial markets. Finnish banks had no problem in raising short-term funding, but were compelled to do it at a higher market interest rate than before the crisis. The cost of long-term funding for Finnish banks also increased clearly.

EUR/USD exchange rate

Upward sloping curve denotes appreciation of the euro

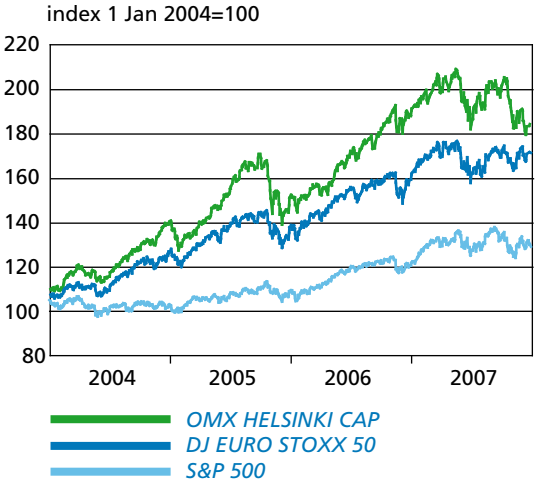


Source: Reuters.

Foreign currency, equity and commodity markets were also characterised by strong volatility. The exchange rate of the euro relative to the US dollar is currently at an all-time high. In the short term, a strong euro increases the purchasing power of those consumers who earn their wages in euro, but in the longer term companies risk jeopardising their competitiveness, which results in weakening growth expectations.

The bad news made equity markets nervous, with the result that share prices dipped towards the end of the summer after a long period of sustained growth. Strong increases in the price of oil added to the uncertainty related to economic growth and inflation expectations. Uncertainty in developments in the economic operating environment intensified due to rapid and strong changes. The most pessimistic evaluators were already seeing signs of a global credit depression.

Exchange rates in Finland, Europe and USA



Sources: OMX and Bloomberg.

Moderate slow-down expected in the Finnish economy

According to the Bank of Finland's forecast published in October 2007, Finland's economic growth will slow down gradually in the coming years in that growth for 2008 is expected to be 3.1% and only 2.5% for 2009. Looking at households' solvency and banks' credit risks, the outlook remains favourable since unemployment is forecast to improve, despite slower economic growth, and wage earners' real earnings will increase. For the corporate sector, the forecast is bleaker due to the expected cyclical turn in the economy, although the latest survey by the Confederation of Finnish Industry shows that output expectations by industry have remained virtually unchanged.

The FIN-FSA called for banks to produce various sensitivity and scenario calculations, which were used to evaluate developments in banks' performance and risk exposure in the much poorer economic situation. These so-called stress tests demonstrated that banks profitability would weaken significantly, but that their capital adequacy would not be jeopardised. The results of these calculations are discussed in more detail on page 23.

Tentative signs of calming in the mortgage market

The rise in interest rates affected loan takers' loan servicing costs and loan periods. In average terms, consumers' ability to service their debts has nevertheless remained good and no significant changes have been detected in payment defaults and write-downs. Demand for loans in the financial year continued stronger than in the previous year. The stock of housing loans grew record high, although households' views on the affordability of borrowing have become weaker towards the end of the year, as evaluated by Statistics Finland. The interest rate upward creep that started towards the end of 2005 has slowed down demand for housing loans only marginally. Persistently low interest rates and long mortgages have boosted households' activity in the mortgage market, thus contributing to constant rises in interest rates.

However, the growth rate of house prices began to slow down after the first half of the year. Longer sales times and a reduction in the number of home purchases are also an indication of a possible turnaround in the housing market. Price increases were nevertheless supported by households' continued favourable income and employment developments.

Households' debt risks increasingly concentrated in the hands of young families

Households' debt ratio continued its rapid rise in the period under review. Although Finnish households' average debt burden amounted to nearly their available annual income, it was still lower than in Sweden and Denmark. About a third of Finns have a mortgage. Housing loans and other borrowing is concentrated in the hands of families with children, with the average loan size increasing rapidly. Owing to large mortgages and rising interest rates some households are exposed to increasingly higher debt risks. Rising interest rates have burdened indebted households, which has been reflected in growing payment defaults in consumer credits.

According to a consumer survey by Statistics Finland, households' intentions regarding house purchase and consumers' confidence in their own economy, savings potential and employment were nevertheless stronger at the end of the year than in the previous year.

Significant growth in corporate borrowing

Corporate borrowing increased at a much faster annual rate than in the previous year. According to a corporate funding survey[3], major companies had hardly any problems with funding, whereas smaller companies have had difficulty in raising new funding. Small companies' loan margins have widened since the previous year and the conditions of loans have become tighter.

Competition over loan margins easing out

Banks' competition over loan margins eased out. Margins became very narrow, but eventually the shrinking came to an end. Banks are still actively marketing housing loans and consumer credits. In the wake of increased product development, competition is now moving from traditional mortgages to other types of credit.

Inter-bank competition has spread to fixed-term deposits and investment deposits

The higher interest rates from the point of view of investors and depositors have heightened the attraction of deposits especially since inter-bank competition grew more intense in the savings and deposits market towards the end of the year. The Icelandic banks operating in Finland launched extravagant interest rate offers. Markets also continue to provide increasingly complicated investment products. Combined investment packages consisting of, eg, a deposit + a unit fund are advertised as earning higher interest rates, but in practice it is difficult for customers to compare real prices and conditions. From the point of view of investors, share markets' volatility coupled with higher interest rates boosted the attraction of lower-risk investment alternatives.

Restructuring in the Nordic financial sector continued

The number of Icelandic banks in the Finnish financial market increased when Glitnir and Straumur entered the Finnish market following the acquisition of FIM and eQ, respectively. Kaupthing Bank, which started operations in Finland in 2006, transferred its banking operations to the Finnish branch office at the end of the year.

The sale of Sampo Bank to Danske Bank was completed at the end of January. The new owner has announced that the integration of Sampo Bank into the Danske Bank Group will be completed by Easter 2008, when Sampo Bank becomes a branch office of Danske Bank. In terms of foreign banks, Handelsbanken from Sweden currently has by far the largest presence in Finland with its network of 44 branch offices throughout the country.

A new actor in the banking sector

Operations of S-Pankki cooperative bank started up in October with the transfer of customers' funds in the savings association of the S-retail cooperative as deposits into the new bank. The bank operates in retail outlets, restaurants and hotels of the S-chain.

[3] A survey conducted by the Confederation of Finnish Industries, Ministry of Trade and Industry and Bank of Finland.

Despite its wide customer base, initially S-Pankki does not intend to enter into competition on the loan markets. Instead, S-Pankki offered members of the cooperative a combined retail group loyal customer card and credit card. Competing retail groups and banks subsequently brought into the market similar combination cards.

Structural changes in cooperatives and savings banks groups

The former OP Group changed its name into OP-Pohjola Group, which better describes the group's operations. Likewise, following the acquisition of the entire share capital of the Pohjola Group in 2005, OKO Bank will change its name into Pohjola Bank. Within the OKO Bank Group, mergers of local cooperative banks continued as follows (with the receiving bank mentioned in brackets): Pyhäntä (Oulu), Miettilä (Simpele), Ruhtinaansalmi (Suomussalmi) and Kylmäkoski (in the community of Toijala, which has subsequently changed its name into Akaa).

Padasjoen Säästöpankki savings bank, which had expanded to a number of neighbouring municipalities in south-eastern Finland, signed away its operations to the newly established Helmi Säästöpankki savings bank.

SEPA preparations continued

Local cooperative banks, savings banks and Aktia commenced preparations for the setting up of a joint payment centre. Their aim is to safeguard the banks' competitive edge in the introductory phase of the Single Euro Payment Area (SEPA).

Profitability and capital adequacy of the EU banking sector remained strong on average

According to statistics provided by the European Central Bank (ECB), profitability of the banking sector in the euro area continued strong early in the review period. Average return on equity improved somewhat from the previous year, particularly due to good performances posted by large banks. Measured by the income-to-expense ratio, banks' operations showed a slight improvement. There are, however, significant differences in efficiency between banks. As in previous years, efficiency of the Finnish banking sector slightly exceeded the EU average.

However, the turbulence in the financial market did have an adverse impact on the fourth-quarter results of some European banks. European banks' risk-bearing capacity is nevertheless strong, thanks to the excellent performances posted in recent years. According to an ECB report on the stability of the banking sector[4], published in November 2007, banks' good stability is not endangered. In the wake of the financial market turbulence and the collapse of US subprime investments, some European banks had to make significant value write-downs on their investment, with some banks running into major liquidity problems.

[4] ECB: EU Banking Sector Stability Report. November 2007.

Operations in 2007

Prudential supervision

Prudential supervision seeks to identify financial market risks and pre-emptively ward off the emergence of serious crises. However, even if supervision does not aim at, or is not capable of, preventing failures of supervised entities under all circumstances, it strives to limit adverse effects and the overall costs of potential crises.

Supervision promotes financial stability and public confidence in financial markets, focusing on the assessment of supervised entities' financial performance, risk exposure, corporate governance, risk management and risk-bearing capacity as a whole. Hence, the main emphasis of supervision is on the systemically most important supervised entities and systems entailing the largest risks. As well as the FIN-FSA's own monitoring, prompt information exchange between European supervisors is increasingly needed.

Key events in 2007

- *Revised capital adequacy framework Basel II was introduced*
- *Immediate effects of the subprime crisis remained small in Finland*
- *Credit risks and risk management emerged as main inspection areas*
- *Nordic cooperation deepened in supervision of banking groups*
- *Banks' structural arrangements and deposit rate offering brought the question of deposit protection up for discussion*
- *CEBS made progress in the promotion of supervisory cooperation; the results were positive also from the FIN-FSA's point of view*

Outlook for 2008

- *Number of inspections will increase, with emphasis on market and liquidity risks, integrity of capital adequacy reporting and capital planning*
- *Basel II implementation will be supported and monitored on an ongoing basis*
- *Practical work in branch supervision will commence*
- *Banks' SEPA migration will be followed up*

Revised capital adequacy framework Basel II was introduced

The Basel II capital adequacy framework entered into force from the beginning of the year under review, with corresponding standards and amendments to the Credit Institutions Act becoming effective on 15 February. A number of the supervised entities change over to Basel II regulations from the beginning of 2008, by which time, at the latest, all deposit banks, other credit institutions and investment firms are required to comply with the new framework.

The FIN-FSA reviews and evaluates its supervised entities' Internal Capital Adequacy Assessment Processes (ICAAPs) annually, issuing its own supervisory reviews thereof (Supervisory Review and Evaluation Process, SREP). During the year under review, supervised entities' ICAAPs improved and their capital adequacy assessments were mainly reliable. Differences between supervised entities exist, however, and systems continue to require further development.

Immediate effects of the subprime crisis were small

The crisis originating from the subprime segment of the US mortgage market started to show significant signs in financial markets in August. One risk arose from banks' direct investments in funds that had reinvested their assets in securitised subprime loans. Another risk took the form of banks' potential commitments to foreign banks that had important subprime risks. A third source of risk was related to bank liquidity, which was seen to tighten in international markets especially for banks dependent on short-term funding.

Finnish banks' direct and indirect risk exposures on securitised assets were limited. Nor were Finnish banks perceived as having encountered significant immediate risks through interbank financial markets. Owing to the considerable tightening of market liquidity that had started in the autumn, the FIN-FSA examined banks' contingency arrangements for funding and liquidity positions, including their preparedness for ongoing tight market situation. According to the analysis, banks' liquidity risk management was in order and their liquidity positions in the autumn were good, despite market volatility. Banks were also prepared to face continued tight market conditions eg by building up liquidity buffers. From the viewpoint of Finnish banks, short-term money markets functioned smoothly. Higher costs for long-term funding reduced debt securities issuance by banks. The crisis may also lead to banks booking writedowns on interest-bearing securities included in their liquid portfolios. The effects of the crisis stemming from subprime lending cannot be seen as having dissipated; rather, its indirect implications for bank profitability and capital adequacy need to be monitored on an ongoing basis.

Credit risks and their management emerged as main inspection areas

The number of inspections was increased, with a particular focus on supervised entities' credit risk management systems. While inspections were primarily concentrated on large supervised entities, small banks' operations were also under scrutiny. Credit demand was robust, and competition for customers was reflected in strong credit marketing. The FIN-FSA emphasised the importance of customer repayment capacity and sufficient collateral coverage in connection with credit granting. The FIN-FSA also inspected banks' market and liquidity risks, partly in cooperation with the Insurance Supervisory Authority (ISA). Management of market risks was mainly at adequate levels. Attention was devoted to sufficient internal controls.

Nordic cooperation deepened in supervision of cross-border banking groups

Supervision of the Nordea Group continued to be exercised jointly by the Finnish, Swedish, Norwegian and Danish authorities. Supervisory coordination was ensured by the Swedish authority, Finansinspektionen. At the core of this work is the Nordic supervision group, which convenes on a regular basis. This cooperation model has proved efficient in information sharing and coordination and in taking account of the various supervisors' actions and views. The Nordea Group was given permission to use the Internal Ratings Based Approach (IRBA) from the beginning of July.

Cooperation in supervising the Sampo Group was broadened with the Danish supervisor, Finanstilsynet.

Contacts with the Icelandic authority FME were also stepped up in response to the increased presence of Icelandic banks' in Finnish financial markets. Nordic banks' risks and financial positions were discussed in joint Nordic supervision groups and at supervisors' management meetings. The risks of multinational Nordic banking groups did not threaten the stability of Finnish financial markets in the year under review.

With increasing cross-border banking activity, the implications of financial market crises also spread more easily from one country to another. EU supervisory authorities, central banks and ministries of finance are developing their capabilities for managing cross-border crises. The preparedness of Nordic authorities (central banks, supervisors, ministries of finance) and Baltic central banks for information exchange and crisis management coordination was tested in a Nordic financial crisis exercise in September. The results of the exercise will be used for improvement of crisis preparation.

Banks' structural arrangements and deposit rate offering caused discussion of deposit protection

A project foreseeing the merger of Kaupthing Bank plc with its Icelandic parent bank, and initiation of Sampo Bank plc's merger arrangements with its parent institution Danske Bank, combined with banks' deposit rate competition, raised questions among the public as to how depositor and investor protection was organised in the respective home countries of the deposit-taking banks.

EU directives on deposit guarantee schemes provide a minimum protection of EUR 20,000 per depositor or investor across EU and EEA countries. Even so, there may be differences in the levels of protection afforded in various countries. Such differences may be mitigated through arrangements of additional coverage, which is applied from the deposit guarantee fund of the country in which a foreign branch operates. Both Kaupthing Bank hf. and Danske Bank applied for additional coverage from the Finnish Deposit Guarantee Fund. Such additional coverage was granted to Kaupthing Bank in the year under review, while decision on Danske Bank's application is still pending.

Finnish legislation on deposit protection was revised in December so that contributions paid by banks as members of the Deposit Guarantee Fund are exclusively determined by the bank's capital adequacy removing the targeted quantitative limits on contributions that had been in the old Act. However, no changes were made to the maximum amounts of Finnish protection, which remain at EUR 25,000 for depositors and EUR 20,000 for investors.

Supervisory cooperation developed within CEBS

CEBS developed a template for supervisory cooperation concerning cross-border banking groups, which was published at the end of the year. The FIN-FSA actively took part in the development of supervisory cooperation, lending support to a supervisory college model based on Nordic experience where all supervisors of a banking group's important subsidiaries and branches participate in the group's overall supervision. In the autumn, CEBS gave its approval for applying such a supervisory college approach when cooperation is being developed for the supervision of a group that operates under a branch structure.

SUPERVISED ENTITIES' PROFITABILITY, CAPITAL ADEQUACY AND RISKS

Financial market disturbances had no significant impact on bank profitability

Bank profitability continued to improve. Even so, the growth rate of profitability declined towards the end of the year. Despite the market turbulence caused by the subprime crisis, banks' financial results were at record-high levels.

Underlying the banking sector's stronger profitability were continuously growing lending volumes, improved net interest income and rising fee income. Income in the early part of the year was also spurred by non-recurring capital gains related to structural arrangements in the banking sector. Strong income generation sufficed to cover higher expenses.

Excellent income developments boosted profitability

The rise in interest rates that started at the end of 2005 continued to improve banks' net interest income. On the other hand, the higher level of interest rates along with the subprime crisis increased funding costs, bringing growth to levels slightly lower than in the previous year. However, interest income expanded faster than interest expenses. Banks' net interest income was also boosted by lending growth.

Fee income also grew in net terms compared with the same periods in the previous year. Towards the end of the year, however, fee income declined slightly. The decrease in fee income was affected by portfolio shifts, when a proportion of investors transferred their financial assets from mutual funds and shares to other instruments with lower risk, such as fixed-term deposits. This is partly explained by banks' willingness to increase the share of deposits in their funding, which has caused rates on fixed-term deposits to rise faster than interest rates in general. Looking ahead, if volumes do not regain their previous levels, fee income from funds and from asset management and securities brokerage can be expected to be lower.

Expenditure growth remained under control

Notably higher staff expenses added to banking-sector costs.. Besides pay rises, there were increases in performance-based bonuses linked to banks' favourable developments. Another source of expenses arose from general business expansion, corporate restructuring in the banking sector and single large investments, such as Basel II. Recognised impairment losses were small and had scarcely any impact on bank profitability.

Overall, higher income sufficed to cover expenditure growth. The cost-to-income ratio did improve slightly from the previous year.

Slight increase in impairment losses and overdue assets

Despite strong lending stock growth over several years, the quality of banks' credit portfolios as a whole remained good. But banks' gross impairment losses started to increase, with a large part of banks recognising new impairment losses more than they received as recoveries and booked as reversals. Hence, the net effect was to weaken the entire banking sector's financial results.

Banks' non-performing assets increased in the course of the year, while still remaining small relative to the stock of lending. In contrast, overdue assets grew faster than in the previous year. Their share of the lending stock was on a slight increase, which may presage deterioration in the quality of banks' credit portfolios.

In the autumn, the FIN-FSA conducted a survey of risks incurred by major banks in connection with funding provided to the real estate sector and real estate investments. Although provision of funding to the real estate sector is significant, the risks involved do not appear to deviate from risks related to ordinary corporate lending. However, real estate and mortgages held by banks also increase their real estate risks.

Tighter market liquidity posed no problems to Finnish banks

Dependence on market-based funding has increased further, as housing loan growth continues to be considerably stronger than deposit growth. Market liquidity that tightened in the course of the autumn had an impact on certain European banks, and risks related to cost and availability of funding materialised notably in banks which had investments or liquidity commitments in respect of structured credit risk products or were highly dependent on short-term money market funding. Finnish banks' liquidity remained good in the autumn, too, and no risks were realised in connection with cost or availability of funding, despite a moderate increase in the cost of market-based funding. This highlighted the importance of adequacy of banks' liquid investments (liquidity buffers) and long-term financial and contingency planning.

Interest rate risks increased

Financial account income risk affecting Finnish banks' net interest income grew from the previous

year. The rise in the level of interest rates did not directly increase interest rate risk, but higher interest rates than in the previous year and keener competition in the deposit market curbed the growth rate of net interest income. Slower growth, in turn, boosted income risk relative to net interest income.

As well as influencing banks' financial results, interest rate changes also affect valuation of balance sheet items. From the beginning of 2008, the FIN-FSA starts applying a more accurate measure for assessment of such balance sheet effects. Introduction of the new method is part of international supervisory cooperation, and is intended to contribute to greater transparency in banks' interest rate risks and better comparability between banks.

Systemic risks remained moderate

Subprime problems in lending markets and the consequent loss of confidence between banks have underscored the importance of monitoring contagion of problems among banks. The FIN-FSA monitors and analyses both direct interbank channels of contagion and implications of risk propagation from external sources.

The situation with respect to systemic risk can still be regarded as being good in Finland. The underlying reasons are increasingly wide contacts between banks and resultant risk diversification. Even if sources of contagion have generally increased in the Finnish banking sector because of internationalisation of banking, direct channels of propagation between Finnish banks have diminished.

Banking sector's capital adequacy on a strong footing

The Finnish banking sector's capital adequacy has continued to remain high. The new capital adequacy framework Basel II that became effective at the beginning of the year under review has not yet caused major changes in the banking sector's capital adequacy ratio. The end-September ratio continued to be 15% ie at the same level as at the end of 2006. In comparing capital adequacy ratios, it should be remembered, however, that the 2006 figures were calculated using old methods and are therefore not fully comparable with new data.

Of large banks, both the OP-Pohjola Group and Sampo Bank continued to apply old capital adequacy rules (Basel I), preparing their Basel II-compliant capital adequacy calculations according to transitional provisions from the beginning of 2008. The impact of the reform on the sector as a whole will not be seen until all banks migrate to the new framework in the course of 2008.

Looking further ahead, the revised framework is expected to reduce banks' capital requirements. However, such implications will not materialise at a time, as transitional provisions of advanced capital calculation methods require a stepwise calculation of capital requirements over several years. An easing of capital requirements affects credit risk in particular. On the other hand, lending stock growth has continued at a brisk pace, which in turn increases capital requirements for credit risk. New operational risk capital charges also eliminate the effect of lower capital requirements for credit risk. The impact of the revised framework on the capital requirement for market risk is more limited.

Banks' capital adequacy would withstand even major losses

A stress test conducted jointly by the FIN-FSA, the Bank of Finland and the Insurance Supervisory Authority provided an estimate of banks' capital adequacy for 2007-2009 in the case of an adverse shock to the macroeconomic environment. The scenario was 'a Finland-specific global shock'. In the scenario, private consumption contracts and investment in Finland collapses. On top of this, GDP declines in three consecutive years. The situation elsewhere in the euro area, however, remains such as foreseen in the Bank of Finland's baseline scenario, and due to the European economic climate, the risk of inflation even increases, causing the three-month interest rate to rise higher than the level currently expected by the markets. Long-term interest rates also go up.

According to the results of the stress test, banks' capital adequacy is not endangered, but there are bank-specific differences as regards implications

for profitability and capital adequacy. Nevertheless, the majority of banks would withstand even considerable losses without jeopardising their capital adequacy in the short term. One important reason for coping with the shock are own funds in excess of the 8% minimum capital requirement that operate as loss buffers.

Investment firms maintained strong momentum

Investment firms continued to post strong performance, the main source of income remaining asset management. Favourable income developments clearly raised the sector's average profitability. Capital adequacy also remained at sound levels, on average. Dispersion in both profitability and capital adequacy was considerable among investment firms.

Investment firms were permitted to apply transitional provisions for capital calculation in the year under review. The majority of investment firms start applying Basel II capital adequacy regulations only from the beginning of 2008. Part of them already reported their capital adequacy figures according to the new regulations, which complicates comparability of data.

A decline in managed assets in the third quarter was mainly due to corporate restructuring. A corresponding increase was seen in assets of management companies providing asset management services. More than half of assets managed under asset management agreements are still mutual fund assets.

Management companies posted stable profitability

Management companies continued to deliver smooth financial performance throughout the year. Volume growth affected similarly both income and expenses. Profitability was stable, remaining at the previous year's level.

The level of management companies' own funds met capital adequacy requirements. Management companies providing asset management services are required to apply the Basel II capital adequacy framework from 1 January 2008. This hampers comparability of capital adequacy data both inside companies and in relation to other market participants.

In the summer, net assets of mutual funds exceeded EUR 70 billion for the first time. In early autumn, the market turbulence triggered about EUR 1 billion worth of net redemptions from mutual funds in two consecutive months. Market uncertainty was reflected in volatility in mutual funds' net assets in the latter part of the year. This was visible in both bond and equity funds. However, net assets of mutual funds were higher at the end of the year than a year earlier.

Supervised entities show robust risk-bearing capacity

Supervised entities' risk-bearing capacity is generally robust, and Finnish financial markets can be regarded as stable. Identified risks are under control, but particularly liquidity and credit risks need to be monitored closely. Global news last autumn served as a reminder of the possibility of prompt realisation of risks and rapid propagation of market disturbances the world over.

BASEL II SUPERVISION

New methods for prudential supervision

The revised capital adequacy framework Basel II became effective from the beginning of the year under review with most supervised entities introducing the new rules at that time. Some banks made use of the transitional provisions allowing an extension until the beginning of 2008, as laid down in the Capital Requirements Directive.

The majority of supervised entities currently apply the basic and standardised methods for calculating minimum capital requirements. The options available also include more risk-sensitive, advanced methods. These are the Internal Ratings Based Approach (IRBA), the Advanced Internal Ratings Based Approach (AIRBA) for credit risk and the Advanced Measurement Approach (AMA) for operational risk. Application of advanced methods

for capital calculation is subject to permission from the supervisory authority.

Assessment and approval of methods applied by multinational banks are coordinated by the home country supervisor, with supervisors of subsidiaries also taking part in the process. By Nordic supervisors' joint decision, the Nordea Group and the Danske Bank Group have been allowed to introduce Internal Ratings Based Approaches. The FIN-FSA participated in the approval inspection concerning the Nordea Group's method, coordinated by the Swedish Finansinspektionen, and in the approval inspection concerning the Danske Bank Group's method, coordinated by the Danish Finanstilsynet. Applications for IRBA approval have also been received from other banks, and relevant approval inspections are under way.

The requirements placed on the reliability of advanced methods are very challenging for supervised entities, necessitating the postponement of the introduction time frames, in some cases. Capital requirements of banks using these methods declined slightly, as envisaged, compared with earlier requirements under Basel I.

Supervised entities' capital adequacy and capital planning under scrutiny

Supervised entities' capital levels must be adequate to cover their material risks. Capital adequacy must also be ensured in an economic downturn and other exceptional circumstances, where supervised entities may incur unexpected but possible large losses. Under Basel II regulations, supervisors need to review and evaluate the internal capital adequacy and capital planning of each bank, other credit institution and investment firm, annually. The FIN-FSA conducts these reviews (Supervisory Review and Evaluation Process, SREP) using information received from regular reporting by supervised entities and from inspections. Such evaluations are based on supervised entities' own Internal Capital Adequacy Assessment Processes (ICAAPs) and on estimates produced by them for capital required to cover various risks.

The Nordea Group's capital adequacy review process was coordinated by the Swedish supervisor, while Finnish, Norwegian and Danish supervisors participated in the review process. Evaluation concerning the Danske Bank Group was coordinated by the Danish supervisor, with the FIN-FSA taking part in the review process. The FIN-FSA also prepared reviews of other major banks and investment firms.

According to observations made in the supervisory review process, supervised entities mainly fulfilled the requirements for introducing the Basel II framework, even if there were substantial differences between supervised entities in respect of their state of readiness to apply the Internal Capital Adequacy Assessment Processes. Therefore, certain ICAAP areas still need improvement in respect of risk and capital adequacy assessment methods. It was also observed that there is a need for the FIN-FSA to specify its guidelines for capital adequacy assessment and define more precise criteria for some areas, such as assessment of concentration risk, stress testing and use of risk diversification effects as factors reducing capital requirements. A joint preparation of measures for addressing specific areas was started among European banking supervisors within the Committee of European Banking Supervisors (CEBS).

Prudential reporting and disclosure of information underwent revision

Revision of prudential reporting reached completion and the Common Reporting Framework (COREP) was introduced in Finland in June. The reporting revision also involved the adoption of the XBRL reporting language (eXtensible Business Reporting Language). COREP was created as a joint supervisory project under the auspices of CEBS. The aim of COREP is to harmonise official reporting of capital adequacy within the EU and thereby reduce reporting costs of the financial sector. Uniform reporting is expected to improve comparability of capital adequacy data across countries.

The reform failed to achieve full reporting harmonisation in the EU, as member states may partly choose the data reported under the framework. In the autumn, the FIN-FSA and other Nordic supervisors started work aimed at wider harmonisation of reporting required from Nordic multinational banking groups.

Supervised entities complying with the Basel II framework started to disclosure capital adequacy data under the new regulations in their interim reports. The FIN-FSA analysed adequacy and comparability of published information and decided to specify requirements for disclosure of key capital adequacy figures in order to ensure consistency in supervised entities' disclosure procedures.

Supervisory Review and Evaluation Process under ongoing development

Supervised entities continued to develop their Internal Capital Adequacy Assessment Processes (ICAAPs) and prepared internal calculations of their capital needs. Another reason why reliability of supervised entities' own systems is of primary concern for capital adequacy assessment is that the FIN-FSA's annual supervisory reviews are partly undertaken on the basis of outcomes provided by the systems of its supervised entities. In the latter part of the year, the FIN-FSA started elaboration of more precise criteria for supervised entities' Internal Capital Adequacy Assessment Processes. At the same time, work was launched to specify the criteria that the FIN-FSA applies to capital adequacy assessment.

The Supervisory Review and Evaluation Process is particularly challenging, because annual assessments need to cover all banks, other credit institutions, investment firms and management companies providing asset management services. The process is broadly focused on the largest supervised entities and specifically selected supervised entities with highest risk sensitivity. Reviews of other supervised entities are undertaken on the basis of ICAAP surveys of supervised entities and risk reports submitted to the FIN-FSA. The Supervisory Review and Evaluation Process concerning savings banks and local cooperative banks was developed with the Savings Bank Inspectorate and the Local Cooperative Bank Association.

CONTINUOUS MONITORING AND REGULAR INSPECTIONS

Inspections were increased further, with particular emphasis laid on supervised entities' risk management systems. The FIN-FSA assessed supervised entities' Basel II-compliant capital management processes and clarified its expectations of the types of stress tests supervised entities should perform in respect of their operations. The new solvency reporting framework COREP was introduced.

Inspections addressed internal controls, risks and risk management

In its supervisory work, the FIN-FSA paid attention to banks' rapid lending growth and the effects tight competition has on the market. Supervision emphasised observance of sound lending criteria in an environment of keen competition. Meanwhile, attention was also given to the requirement that marketing of loans should not promote over-indebtedness of customers. Non-performing loans started to grow in the latter part of the year, which pointed to slight deterioration in banks' lending stock quality following a protracted period of favourable developments.

Discussion continued on contingency planning in the event of liquidity crises and on preparations for market disturbances. Banks' contingency arrangements had been upgraded further, and were put to the test in the autumn, when liquidity conditions deteriorated in the market.

Inspections concerning management of market risks were also conducted in cooperation with the Insurance Supervisory Authority (ISA) during the year. Supervised entities have relatively small market risks, and their management is mainly organised well. Inspection visits related to measurement of interest rate risk and measurement of economic capital calculated for interest rate risk in the banking book were conducted at banks whose methods for interest rate risk measurement deviate from FIN-FSA recommendations.

The FIN-FSA explored the chances of supervised entities' internal audit units to perform their tasks independently and objectively: to assess and ensure adequacy, functionality and efficiency of internal control. The FIN-FSA considers it advisable that internal audit organisations be segregated from business operations and operate under board guidance and oversight. In pursuing its

supervisory work, the FIN-FSA also paid attention to the operation of internal audit work planning processes at supervised entities and the organisation of reporting of audit results to board and senior management.

Standard on operational risk management complemented with guideline on making preparations for emergency situations

Inspections related to operational risk management focused on surveying the methods used by supervised entities for risk identification and assessment. The FIN-FSA has considered it important that systems for collecting loss data concerning operational risk also be developed by supervised entities whose capital calculation methods do not directly require maintenance of such systems. According to the understanding obtained by the FIN-FSA in its supervisory work, operational risk still plays a relatively minor role on average in supervised entities' Internal Capital Adequacy Assessment Processes.

The FIN-FSA updated its standard on management of operational risk by adding a guideline on making preparations for emergency situations for those supervised entities who are obliged to prepare for such situations under the Emergency Powers Act. The guideline includes information on the practical meaning of the obligation as imposed by the Act, describes the contents of plans for emergency situations and presents requirements for a centralised IT infrastructure. In the autumn, the FIN-FSA started inspection visits aimed at gaining an insight into banks' preparedness for emergency situations defined in the Emergency Powers Act.

Banks improved risk management and continuity planning for payment systems

The FIN-FSA scrutinised its largest supervised entities' systems for foreign payments processing. The inspections confirmed improvements made by banks in management of payment system risks, continuity planning and internal control, which the FIN-FSA had required on the basis of its earlier inspections. International integration of payment systems, related system reform projects and outsourcing of operations continue to require careful risk identification and prevention on the part of supervised entities.

The FIN-FSA oversees payment systems in close cooperation with the Bank of Finland. The forms of cooperation include joint oversight meetings in the area of payment systems, information exchange and a close liaison in inspectional work.

The FIN-FSA undertook inspections of continuity planning for securities trading and settlement and backup arrangements for information systems. According to the FIN-FSA's observations, guidance for and organisation of continuity planning at inspected supervised entities were at adequate levels. Supervised entities had also tested their contingency arrangements in practical exercises.

Migration to the Single Euro Payments Area advanced

The Single Euro Payments Area (SEPA) is a common initiative by European banks, the European Central Bank and the European Commission to create a single payment transmission area. SEPA services (credit transfer, cards and direct debit) will be rolled out from the beginning of 2008, with the transitional period extending until the end of 2010. The legal basis of the SEPA project originates in the Payment Services Directive (PSD), which member states are required to transpose into their respective national legislations by 1 November 2009.

The FIN-FSA has followed banks' SEPA preparations by means of a survey and in connection with inspections of the largest supervised entities' systems processing foreign payments. Such monitoring will continue throughout the transitional period, ie 2008–2010. One of the aims is to ensure banks' readiness to manage SEPA migration risks. The FIN-FSA seeks to contribute to continued safety and efficiency of payment systems and payment services in Finland, including easy accessibility. Performed inspections did not reveal any significant risks or defects in payment systems, continuity planning, risk management or internal control. Based on the survey and inspection results, banks' SEPA preparations move on as planned, even if the project timetable is very tight, with the commencement of the transitional period due in January 2008.

NATIONAL AND INTERNATIONAL SUPERVISORY CO-OPERATION

Close cooperation in monitoring risks of financial and insurance conglomerates

The framework for cooperation between the FIN-FSA and the Insurance Supervisory Authority (ISA) is agreed in a Memorandum of Understanding (MoU). In practice, supervisory cooperation comprises exchange of supervisory information on financial and insurance conglomerates, joint inspections, assessment of group-level risks and financial development, coordination of sector-specific guidance and exercise of influence on EU-level supervisory convergence in respect of financial and insurance conglomerates through committees of supervisors.

The FIN-FSA's prudential supervision organisation worked together with the ISA especially in the supervision of the OP-Pohjola Group. Supervisory cooperation commenced in the supervision of the Aktia-Veritas Group and the Tapiola Group. In addition, the FIN-FSA and the ISA exercised sector-specific supervision in these groups, the former focusing on banking and the latter on insurance.

The key objective of supervisory cooperation is to identify the groups' internal business operations and interdependencies between risks and assess their significance for the whole group's capital adequacy. The FIN-FSA and the ISA undertook a joint supervisory review of the OP-Pohjola Group, in which the group's risk profile, risk management and capital adequacy as a whole were under perusal. The group's condition was assessed as being stable.

Multinational banking groups supervised within the framework of Nordic cooperation

Supervision of the Nordea Group continued to be exercised jointly by Finnish, Swedish, Norwegian and Danish authorities. Supervisory coordination was ensured by the Swedish authority, Finansinspektionen. Agreement on cooperation exercised in the supervision of the Nordea Group is based on a group-specific Memorandum of Understanding (MoU), with practical supervisory measures taken by a supervision group in which the above supervisors participate. The supervision group is responsible for monitoring Nordea's situation, coordinating joint inspections, dealing with inspection results and pre-coordinating supervisory decisions on Nordea that may have implications in a number of countries. The supervision group also discusses the annual supervisory review on the Nordea Group prior to its presentation to the Nordea Group's management.

A Memorandum of Understanding was drawn up with the Danish Finanstilsynet on the supervision of the Danske Bank Group, with the inclusion of principles of supervisory cooperation to be applied at the time when Sampo Bank plc starts operating as a Danske Bank branch in Finland. Supervisory cooperation was enhanced with the Icelandic supervisor FME following the Icelandic Kaupthing Bank plc's start of operations in Finland in 2005 and granting of deposit bank authorisation in the year under review to Glitnir Bank Ltd (former FIM Securities Ltd), acquired by Icelanders. The Icelandic Straumur-Burdaras Investment Bank hf. acquired in May the majority of the share stock of the Finnish commercial bank eQ Bank plc. Nordic banks' risks and financial positions were discussed in joint Nordic supervision groups and at supervisors' management meetings. The risks of multinational Nordic banking groups did not threaten the stability of Finnish financial markets.

CEBS made progress in attainment of key objectives

One of the aims of the Committee of European Banking Supervisors (CEBS) is to promote supervisory convergence within the EU ie harmonisation of supervisory practices based on common regulation. The FIN-FSA's involvement in CEBS operations in the year under review was for resource reasons selective, with participation focusing on exercise of influence on matters that are key to Finnish financial markets. The FIN-FSA took part in CEBS high-level main committee meetings.

The FIN-FSA's Deputy Director General Jukka Vesala was a member of the CEBS Bureau and has chaired the key preparatory working group of CEBS, Groupe de Contact, since July. In addition, the FIN-FSA participated in the most important preparatory expert groups in order to influence the contents of CEBS opinions and guidelines and benefit from CEBS work in practical supervision. For more information on CEBS activities and objectives, see pages 39–40.

Cooperation with the Bank of Finland in monitoring overall financial market developments

Forecasts for the financial sector's outlook for profitability and capital adequacy were prepared in cooperation with the Bank of Finland. The Bank of Finland undertakes analyses of macroeconomic developments and their overall impact on economic variables of key importance to the financial sector. The FIN-FSA is responsible for examining the financial sector's risks and profitability on the basis of supervisory information at its disposal and the Bank of Finland's macroprudential analysis. Close dialogue and information exchange between the FIN-FSA and the Bank of Finland proved useful in the evaluation of bank liquidity problems that turned up in international markets.

Together with the Bank of Finland, FIN-FSA participates in the work of the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB). The Committee focuses on assessing the stability of the EU financial system and promoting joint projects of significance to stability. Crisis management capabilities of supervisors and central banks were improved through development of a common analytical framework for assessing systemic implications of crises. The BSC prepares annually a report on EU banking sector stability and contributes to the ESCB financial stability review with commentaries on the financial sector. The FIN-FSA and the Bank of Finland are responsible for provision of information on Finland for these reports.

SUPERVISORY INFORMATION SYSTEMS

FIN-FSA resources devoted to setting up information systems for EU directives implementation

FIN-FSA set up a reporting system based on an XBRL reporting format, as recommended by CEBS, in support of Basel II prudential reporting, The system is composed of a COREP taxonomy for definition of contents and technical representation of reported information, a reporting application used by supervised entities, a data storage and management programme, and an application for data monitoring and analysis. Finland was among the first EU countries to have a national COREP taxonomy in place. A common reporting format facilitates information exchange between supervisors, enabling financial institutions with cross-border operations to provide centralised solutions for official reporting.

An information system for reporting securities transactions under the Markets in Financial Instruments Directive (MiFID) was elaborated in cooperation between Nordic and Baltic supervisors. The system enables daily collection of information on securities transactions from securities intermediaries and stock exchanges, storage of the data in the FIN-FSA's database and exchange of information on executed deals with foreign supervisory authorities. For data collection, the FIN-FSA uses an operator (known as a TYVI operator), which transmits sufficiently authenticated information from companies and other organisations to the FIN-FSA. The system was launched on 1 November.

In connection with MiFID implementation, necessary changes were made to information systems and websites maintained by the FIN-FSA. The most important ones included a public register related to supervised entities' authorisations and a public notification register concerning cross-border service provision by both national and foreign service providers.

Market supervision

Market supervision promotes the reliability of market infrastructures, high levels of investor and customer protection and sound practices in the markets. Through its operations, Market supervision also supports the healthy growth of Finnish financial markets and a level playing field.

Main events in 2007

- *Transparency Directive entered into force*
- *MiFID Directive and related amendments to standards entered into force*
- *FATF country inspection completed*
- *10 trading guidelines for insiders published*
- *Trading supervision based on transaction reporting launched*
- *Transparency of cost structure of structured investment products improved*
- *Competition over OMX ownership*
- *Quality of financial reporting by listed companies and impairment testing of assets in IFRS financial statements surveyed*

To come in 2008

- *New standard 5.1 on regular reporting obligation under the Transparency Directive enters into force*
- *New operating license applications for provision of investment advice during the spring*
- *Supervision of MiFID functionalities concentrates on the autumn*
- *Impact of OMX's new ownership structure to be assessed*
- *IFRS enforcement to focus more on company-specific supervision*
- *New trading supervision system to be developed further*

Integration of EU financial markets proceeded

The main events in the review period still revolved around the implementation of the EU's financial markets action plan (FSAP). This included the entry into force of the Transparency and MiFID Directives and the requisite preparations. Changes to the Securities Markets Act due to the Transparency Directive entered into force in February. The entry into force of this Directive sparked preparations for a new standard (5.1.) on the regular disclosure obligations for listed companies. In addition, updating of standard 5.2b on the disclosure obligations of the issuer and shareholder was launched. The new standard 5.1 and update of standard 5.2b will enter into force in the first half of 2008. The MiFID Directive and related standards entered into force at the beginning of November.

Regulation and supervision of money laundering inspected

A country inspection on FATF regulation and supervision on money laundering was conducted in Finland in the review year. The report itself contained no surprises since a large part of the measures proposes by the FATF will be rectified when the third Money Laundering Directive is implemented by the new act on money laundering in 2008. More information on the outcome of the FATF inspection is presented on page 32.

Additional instructions on insider regulations

At the end of 2006 and the beginning of 2007 there was public debate on the content of insider

regulations including criticism on their complexity. FIN-FSA has sought to improve the comprehensibility of the regulations by compiling 10 guidelines for trading by insiders. These were published in June.

SUPERVISION OF PRACTICES

Availability of basic banking services continues to be good and price level reasonable

FIN-FSA reviewed the pricing and availability of basic banking services based on the situation at the beginning of March.

In comparison to the previous review, there had been some changes in prices, mainly small increases. Although individual service charges in some cases may be considered high, when assessing reasonability whether there are alternative and less expensive procedures available must be taken into account. There are still many alternatives available for paying bills, and every bank offers direct debiting facilities free of charge. In addition, many banks have service packages for special groups, such as the young and elderly.

There had also been some developments in the availability of services after the previous review. Some banks had streamlined their branch network and others had expanded. The number of banking terminals at customers' disposal had remained largely unchanged. The number of automated teller machines had decreased somewhat. The proportion of direct debiting as a method of paying bills had increased somewhat.

According to the view of the FIN-FSA, the availability of different forms of basic banking services is good and the price level of the services is reasonable. Nor have any individual instances of excessive pricing come to FIN-FSA's knowledge.

Contacts made to the Financial Supervision Authority remained at the same level

The number of written contacts made by private individuals and companies remained unchanged, with a total of 98 such contacts being made in 2007.

A majority of the contacts concerned the practices of banks, investment firms and management companies. The most frequent issues in contacts concerning banks were questions related to loans, collateral and collection, but questions relating to cards, different means of accessing one's account and bank secrecy also increased. Towards the end of the year, questions related to Finland's deposit guarantee surfaced, both as inquiries made over the Internet and by phone. The problems that emerged were mainly individual cases rather than problems related to general market practice. FIN-FSA has taken the appropriate measures when irregularities have been observed.

Disputes between service provider and individual customers were also handled at the Advisory Office for Bank Customers and the Securities Complaint Board. The Advisory Office received 1,477 (1,479 in 2006) contacts and the Securities Complaint Board 244 (274 in 2006). A majority of issues handled by the Advisory Office concerned banks' cards, account usage, payments and loans, but the deposit guarantee fund has also made the list of frequently asked questions. The Securities Complaint Board received questions that most often concerned securities broking, mutual fund operations and investment advice.

Pawnshops also offering short-term loans

The instant loan business has been reflected in pawnbroking to the effect that pawnshops have also begun offering shorter-term loans.

FIN-FSA revoked the authorisation of Satapantti Oy on 16 June 2006. The company has filed for a reversal of the revoking decision. The complaint made by the company was declined by the Helsinki Administrative Court by a decision given on 29 October. A complaint of the decision has been made to the Supreme Administrative Court, so the decision is not yet legally valid.

Custodians of mutual funds and marketing by foreign collective investment undertakings as inspection themes

From the point of view of supervision, the most important processes in mutual fund operations are the methods used in the calculation of net asset value, maintenance of the unitholder register and risk

management. Based on observations made in related inspections, FIN-FSA updated its instructions and interpretations as well as issued new ones.

The inspection themes in the review year included the marketing by foreign UCITSs in Finland as well as the organisation of the operation of the management company's custodian. The focus of inspection of custodians was the custody arrangements for foreign securities, use of sub-custodians and so-called Prime Broker operations. Contents of the Prime Broker service may be defined in various ways. In practice, it refers to a service covering the settlement and collateral arrangements related to securities lending and derivatives trading in particular.

In the context of regular supervision, attention was paid to the impact of the market turbulence relating to the so-called subprime crisis in the United States on Finnish mutual funds. Based on the observations, the crisis did not seem to have significant impact on Finnish mutual funds. Of course, the crisis was reflected in the development of mutual fund assets to the effect that the protracted growth of assets turned into a decline.

MiFID left its imprint on the supervision of investment firms

Preparation for the MiFID regulation which entered into force at the beginning of November was clearly seen in the supervision of investment firms. This regulation among other things subjected the provision of investment advice to an authorisation and enabled the provision of multilateral trading.

FIN-FSA mapped the capability of entities presently supervised by it to comply with the new regulation. At the same time, the organisation of supervision of investment services, procedures and systems was inspected. New procedures were created for the authorisation process for investment services in order to enable rapid handling of applications and issue instructions to new applicants for an authorisation among other things with a model application. Education events were arranged for both existing and new participants.

Due to recent structural arrangements in the industry, there were a number of applications for authorisation related to investment services. These were made amid changes in corporate structures related to eg improvement of operative efficiency or ensuring the commitment of key personnel. New authorisations were granted eg for asset management, broking and corporate finance activities.

The supervision of investment services focused on the functionality of the participants' internal monitoring, risk management and particularly of their compliance function. The supervision of asset management procedures concentrated on the development of private banking at both existing participants and new applicants.

FATF inspection on the prevention of money laundering

Earlier in 2007, an inspection on the approach to combating money laundering and terrorism was made in Finland. The country inspection was conducted by the international Financial Action Task Force on Money Laundering (FATF). The report by the task force states that Finnish legislation against money laundering is relatively good. Although the situation in Finland is fairly strong, the report lists a number of issues which are not yet fully compatible with FATF recommendations. Finland will have to provide a written follow-up report on recommendations with the rating "partially compliant" or lower.

The FIN-FSA received positive feedback in the report for well-organised operation, its standards and Internet site. Likewise, FIN-FSA's activities against money laundering were considered solid. However, some aspects of the operations also gave grounds for hopes of reform.

FIN-FSA's legally provided authority to supervise compliance with the act on money laundering by supervised entities was recommended to be specified. The number of FIN-FSA inspections on the prevention of money laundering is considered low. Its sanction powers are considered appropriate but the number and severity of sanctions issued low. The report also points out that the powers to issue norms and sanctions by different supervisory authorities in Finland are not consistent at the moment. The FATF suggests that the standards be developed in more detail with respect to money laundering and finance of terrorism.

The ratings received by Finland were in line with the ratings of other Nordic countries.

A large part of the deficiencies pointed out by the FATF will be rectified and its suggestions will materialise when the third Money Laundering Directive enters into force in Finland by virtue of a new act on money laundering, being drafted by a working group established by the Ministry of the Interior (more on the reforms on page xx). FIN-FSA standards will also be updated in accordance with the new act.

SUPERVISION OF THE DISCLOSURE OBLIGATION

Proactive and reactive supervision of the disclosure obligation

The main objective of supervision of the disclosure obligation is to ensure that investors always have access to essential and adequate information in order to allow a reasoned assessment of a security and its issuer. As part of this task, FIN-FSA monitors the continuous and regular disclosure obligation of listed companies. The supervision is both proactive and reactive by nature.

Increased interaction with listed companies and the markets

Interaction with representatives of listed companies and other market participants was quite active, particularly in the context of different regulation projects. In connection with drafting and amending standards and during the actual consultation rounds statements and opinions were requested and received from more parties than previously.

As a new operating procedure, meetings were held with companies planning an IPO. In these meetings, the procedures planned by the companies for continuous and regular disclosure obligation, as well as insider management, were discussed by company management and personnel handling disclosure obligation issues in practice. Feedback on this operating mode has been positive. Companies in the listing process are automatically subject to enhanced supervision during their first year on the stock market list.

Towards risk-based supervision

The focus in the supervision of the disclosure obligation was shifted more towards risk-based supervision. The criteria of risk-based supervision emphasise the listed company's previous supervision track record, industry, cyclical and structural change situation, concentration of ownership and size of company as well as its impact on the practices and knowledge on the disclosure obligation. In addition to risk-based supervision, the regular supervision of the disclosure obligation paid particular attention to companies which had issued profit warnings.

More transparency to fee structures

The popularity of structured investment products continued to increase, and FIN-FSA continued its efforts to increase the transparency of their terms and conditions as well as pricing. Significant progress was made in this respect when the Finnish Structured Products Association at the end of the year made a recommendation to its members to open the structuring costs. Issuers have largely begun to publish fee information in their marketing material.

Since a large proportion of the structured products offered come with the so-called Euro passport from outside Finland, FIN-FSA must continue to increase public awareness of the special characteristics of the products and related risks by customer enlightenment.

No significant deficiencies in marketing material related to securities offers

FIN-FSA discontinued advance commenting on marketing material related to securities offers and issues at the beginning of February. However, the discontinuation of advance commenting did not apply to marketing material related to IPOs and situations where the issuer offers securities for the first time. To evaluate marketing material published after the discontinuation of advance commenting and its appropriateness, FIN-FSA undertook a sample-based theme inspection in the summer. The inspection revealed no significant deficiencies in the marketing material related to securities offers.

FIN-FSA will continue to monitor actively the marketing of securities and make similar theme inspections.

Regulation initiatives on disclosure obligation

An amendment to the Securities Markets Act related to the implementation of the Transparency Directive and Ministry of Finance Regulation on the regular disclosure obligation of an issuer and a shareholder's obligation to disclose major holdings entered into force on 15 February. Due to the amendment of the act, supervisors of the disclosure obligation focused largely on regulation, drafting of the new standard (5.1) on the regular disclosure obligation and amendments to the currently valid standard (5.2b) on issuer's and shareholder's disclosure obligation.

ENFORCEMENT OF FINANCIAL REPORTING

Enforcement of financial reporting is directed at listed companies and also at non-listed banks and other entities supervised by the FIN-FSA

The objective of financial reporting enforcement by the FIN-FSA is to promote the provision of transparent, sufficient, understandable and timely financial information to the markets to support decision making by investors. In addition, it aims to support consistent application of the financial reporting standards.

Financial reporting enforcement concerns Finnish listed companies and companies that have applied for admission to trading of their securities on a regulated market. At the beginning of the review year, enforcement was extended to companies issuing only bonds. The scope of enforcement also encompasses the financial reporting by entities supervised by the FIN-FSA, such as banks and investment firms.

Company-specific financial reporting enforcement

In its financial information enforcement work, FIN-FSA applies the methods that have been defined in the standards issued by the CESR. According to these standards the enforcement of financial information is risk based supervision whereby the selection of companies for enforcement purposes is based on risks. The concept of risk relates on one hand to assessment of factors relating to the company and on the other hand to the impact a potential material error would have on market confidence in the company.

In 2006, financial statements of 20 companies were selected to FIN-FSA's company specific enforcement. Selection of companies was based on the companies' market value, industry, financial position as well as FIN-FSA's previous enforcement observations. The industries selected were forestry, information technology, food industry and communications. Around half of the reviews of the financial statements led to requests for supplementary information or recommendations to improve the quality of financial statement information.

Survey of the quality of financial statements: Listed companies' financial statements developed although there is still need for improvement

In addition, FIN-FSA conducted a survey of 80 companies' financial statement information for 2006. The survey was published in October. The aim of the survey was to assess whether the companies had developed their financial reporting in the areas highlighted by the FIN-FSA in its review of financial statements for 2005. These areas were the presentation of financial statements, business combinations, goodwill impairment testing, share-based payments and segment reporting. Another aim was to gain information and assess the application of the key requirements of IAS 36 regulating impairment testing.

The financial statements for 2006 were more extensive than the previous year's in terms of both accounting policies and other notes. Disclosure information on goodwill impairment testing and share-based payments had improved from the previous year. In contrast, the companies had not made significant changes in their segment reporting or improved the disclosure on business combinations. FIN-FSA is of the view that further

development is needed in these areas for achieving higher transparency.

Asset impairment tests are an important part of the process of preparing the financial statements of a listed company, and therefore FIN-FSA reviewed the application of the key requirements of IAS 36. Application of the standard is challenging and there was variation in the practises used by different companies. Based on the review, it seemed that the independence of cash inflows was not always carefully assessed in the determination of a cash generating unit. Furthermore, the companies need to improve their assessment of indications of impairment. The practises applied may have an impact on the results of the impairment tests and thus on the book values of the assets.

The FIN-FSA's objective is to enhance the quality of financial reporting in order to support investors' decision making. FIN-FSA also considers it important that companies take into account the observations of the survey when developing their financial reporting. FIN-FSA will continue to address these issues as part of its company-specific financial reporting enforcement.

Valuation of loans and receivables in banks - improvements still needed

FIN-FSA reviewed the accounting policies applied by the largest banks with respect to loans granted and noticed that they were partly based on the requirements of capital adequacy calculations. The recognised impairment losses in financial statements were not always in line with the requirements of IAS 39 due to differences between the requirements of IFRS and capital adequacy calculation. FIN-FSA has given bank-specific feedback and instructions for further development to the banks involved.

Inconsistent treatment of deferred tax liabilities on investment properties

FIN-FSA also carried out a survey on accounting treatment of deferred tax liability in investment property acquisitions. According to the survey the companies had applied IAS 12 Income Taxes inconsistently. Furthermore, it was observed that there were inconsistencies in the application of IFRS 3 *Business Combinations* regarding the categorisation of investment property acquisitions into business combinations or direct asset purchases. Inconsistent accounting treatment weakens significantly the comparability of financial information among companies in the same industry. The IASB is expected to both change and clarify regulation on income taxes.

Enforcer database enhances consistent application of IFRSs

Members of a CESR working group have in their use a supervision database to which relevant decisions on enforcement of financial information are submitted. Extracts of the enforcement decisions were published already in April and December, and publication will continue on a regular basis. The purpose of publication is to provide market participants information on the issues the enforcers have paid their attention to.

TRADING SUPERVISION

Surveys often concern cross-border trading and order execution chain

The internationalisation of trading almost without exception requires the clarification of the order execution chain in cross-border trading. FIN-FSA has intensified and participated in developing the co-operation between foreign supervisors. Co-operation between Nordic supervisors has been smooth.

Co-operation between the FIN-FSA's and Helsinki Stock Exchange's market supervision has continued to be good. The importance of cooperation is highlighted in investigation suspected price manipulation. As in the previous year, investigations have concerned cases where the principal has been a private investor and trading orders have been made through the broker's online trading services.

FIN-FSA received 5 (11) reports from securities brokers of suspicious securities trades or other transactions and 15 (15) reports from the Helsinki Stock Exchange relating to trading practices. FIN-FSA noted that the number of reports was low.

Dispersion of trading poses a challenge to the supervisors' systems

Enabled by the MiFID, dispersion of trading throughout Europe as well as outside regulated marketplaces, poses new types of challenges to trading supervision and supporting supervision systems. Even these new, so-called alternative marketplaces will be supervised as regards trading.

The whole EU area has shifted to trading supervision based on transaction reporting. Implementation of MiFID required that FIN-FSA build a new trading system. This was carried out as a joint project with the Nordic and Lithuanian supervisors.
The objective was to create transaction reporting requirements for securities brokers in the area that are as uniform as possible in terms of both report content and technical solution. The second aim was largely achieved, but the first proved more challenging than expected, and harmonisation of transaction reporting requirements did not fully materialise in the Nordic countries or rest of Europe. Furthermore, Nordic cooperation sought and achieved cost savings for both supervisors and reporters. The Nordic Baltic TRS (Transaction Reporting System) was led by the Swedish supervisor, Finansinspektionen.

The new transaction reporting system AKVA receives transaction data from all domestic securities brokers exercising trading orders and all branches of foreign securities brokers operating in Finland. In addition, AKVA exchanges transaction data on a daily basis through the TREM, the joint data exchange mechanism of European supervisors. For example, the FIN-FSA receives data on the transactions of remote brokers operating in our markets from the supervisors of their home country through exchange of information.

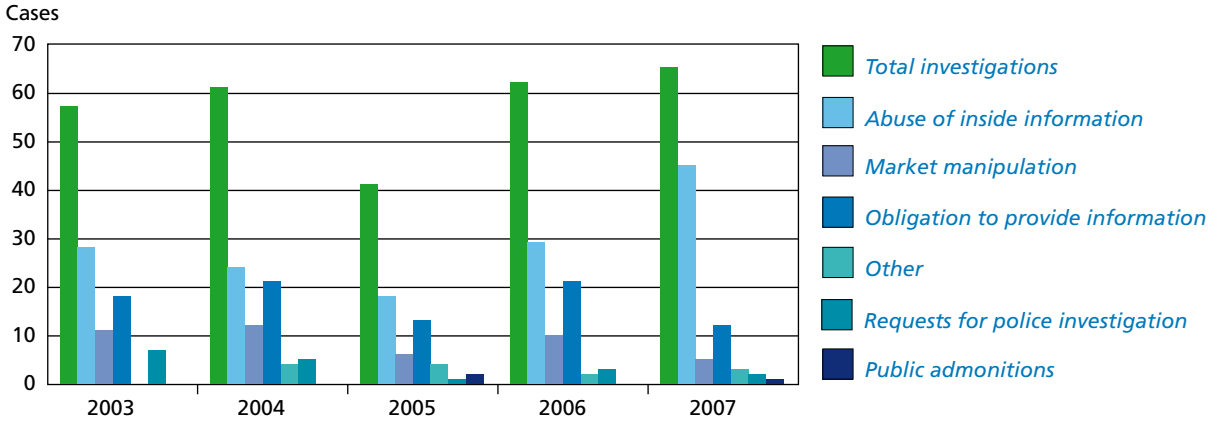
The transaction reporting requirements were issued on 26 October in the Transaction reporting standard RA5.1 and its appendix Instructions on electronic reporting.

Transaction reporting began in accordance with the original plan on 1 November. Reporting began on all cash instruments and some of the derivatives instruments, and will be complemented throughout Europe during 2008.

Insiders' trading guidelines published

FIN-FSA responded to the wish of the markets to have additional guidance on insider issues by compiling 10 trading guidelines for insiders. According to the feedback received, the guidelines have been considered highly welcome and it has been stated that they do a good job in summing up important issues insiders must pay attention to in their trading. The guidelines were published in June.

Securities market inspections conducted by FIN-FSA 2003 – 2007



Source: Financial Supervision Authority.

SUSPECTED ABUSE CASES INSPECTED AND ADMINISTRATIVE SANCTIONS IMPOSED

Suspicions of securities market abuse at previous year's level

FIN-FSA made two (3 in 2006) investigation requests to the police. These concerned suspected abuse of inside information. In addition, the FIN-FSA gave one public reprimand for neglect of disclosure obligation. Co-operation with the police and prosecutors has continued.

During the year, 65 supervision cases were investigated (62 cases in 2006). Out of this number, 45 (29) concerned suspected abuse of insider information, 5 (10) market manipulation and 12 (21) neglect of the disclosure obligation. There were 3 (2) other cases under investigation, concerning mostly market practices.

SUPERVISION OF FINANCIAL MARKETS INFRASTRUCTURE

OMX Group targeted in ownership arrangements

The securities market infrastructure in Finland is maintained by the OMX Nordic Exchange Helsinki Oy of the OMX Group and the Finnish Central Securities Depository APK of the NCSD Group. Since both groups operate in many countries, supervision is conducted in co-operation with Nordic supervisors.

The year was characterised by a bidding contest over OMX AB owned by OMX Nordic Exchanges Group and OMX Nordic Exchange Helsinki, both supervised by the FIN-FSA.

Nasdaq Stock Market, Inc, holding company of the US stock exchange Nasdaq made a public tender offer in December for the shares in OMX AB, the Swedish holding company of the OMX Group. In August, Borse Dubai Limited, the holding company of two Dubai-based stock exchanges made its tender offer for OMX shares. Subsequently, the two rival bidders settled on a co-operation agreement which would made Nasdaq the majority shareholder in OMX while Borse Dubai would receive a fifth of Nasdaq shares.

Since OMX Nordic Exchange Helsinki engages in securities exchange operations in Finland, the intended arrangement has required that FIN-FSA's approve both Nasdaq and Borse Dubai as indirect shareholders of the stock exchange. In the autumn, FIN-FSA announced that it does not oppose the acquisition of OMX shares by either party.

The ownership arrangements in the OMX Group that will likely be completed in early 2008 require that the present OMX supervision co-operation is extended beyond the Nordic countries. For this purpose, negotiations have been initiated between the OMX supervisors and the SEC. Going forward, supervision needs to focus on the potential impact of the corporate arrangements on organisation of the operation of the stock exchange.

No major changes in the operation of the Finnish Central Securities Depository

The Finnish Central Securities Depository Oy (APK) has been a fully-owned subsidiary of the Swedish CSD, VPC AB since the end of November 2004. The companies together form the NCSD Group (Nordic Central Securities Depository).

Supervision of the Finnish CSD is conducted in close co-operation with the Bank of Finland.

During the year in review, FIN-FSA continued to monitor the NCSD's internal Nordic Single project aimed at harmonising operative procedures. The project aims to harmonise operative procedures related to securities clearing and settlement in Finland and Sweden.

Markkinat publication caters to the information needs of listed companies

Market Supervision continued to publish a separate Markkinat (Markets) publication sent to subscribers. The bulletin addresses topical issues relating to regulation or market supervision from the viewpoint of the supervisor, listed companies and other market participants. Markkinat was released four times in 2007, two of these were theme issues with the February's bulletin discussing the entry into force of the Transparency Directive and the one in June addressing insider trading guidelines.

Regulation

The regulatory activities of the Financial Supervision Authority (FIN-FSA) comprise both issuance of its own regulations (standards within the Authority's set of regulations) and participation in legislative preparation in Finland and at EU level. At EU level, the FIN-FSA participates in the work of the level three committees of supervisors, while at the national level representatives of the FIN-FSA take part in the law drafting groups set up under the auspices of various ministries.

In this work, the objective of the FIN-FSA is to promote the convergence of regulatory and supervisory practices within the EU, ensure the clarity and key focus of the FIN-FSA's own regulatory issuance and support the development of accountable self-regulation.

Major events in 2007

- *Implementation of the European Union's Financial Services Policy, with the aim of achieving an effective and genuinely integrated single market in financial services*
- *Incorporation of the Markets in Financial Instruments Directive (MiFID) into FIN-FSA standards, supervisory practices and the authorisation processes*
- *Adoption of the Basel II Framework*
- *Strengthening of the cooperation model based on multilateral colleges of supervisors between EU regulators*
- *Introduction of new margin notes in the FIN-FSA's standards to differentiate between binding rules and recommendatory provisions in the FIN-FSA's regulatory issuance*

Forthcoming events in 2008

- *Translation of principles-based regulation into concrete practices*
- *Further progress in the convergence of regulatory and supervisory powers and practices within the EU*
- *Revision of the Capital Requirements Directive (CRD) for example in respect of the provisions on home and host country supervision, to ensure better correspondence with the current structures and supervisory requirements of international banking*
- *Further integration of CESR and CEBS level three guidelines with FIN-FSA standards*

Enhancement of supervision and implementation of the Financial Services Policy continued at EU level

An effective and genuinely integrated single market in financial services is the key aim of the Commission's Financial Services Policy. Within the EU, the focus has been on the implementation of the Financial Services Policy and the guidelines of the Francq report adopted by the Ecofin Council, as well as the improvement of the Lamfalussy model (introduced in the 2006 Annual Report). The committees of supervisors play a key role in this implementation, with the focus of their work shifting from regulatory activities to enhancement of supervisory cooperation and convergence of supervisory practices between home and host country supervisors.

The consistent application of regulations and convergence of supervisory practices is monitored by making comparisons between the practices of individual countries. For this monitoring work, the committees of supervisors, CEBS and CESR, have set up Peer Review Panels and introduced mediation mechanisms.

Revision of the FIN-FSA's set of regulations nearly completed

The FIN-FSA's own regulatory issuance was dominated by incorporation of the provisions of the Markets in Financial Instruments Directive (MiFID) into the standards. The renewal of the set of regulations, which started in 2002, is now nearly

completed. Now, save for a few, all the standards of the new set of regulations have been issued. In the future, regulatory focus will rest on regulatory update, as well as integration of the level three guidelines of CESR and CEBS with the FIN-FSA's standards. In the drafting process, the dialogue with various actors has been stepped up.

Efforts for the benefit of multilateral colleges of supervisors

As an active member of CEBS and CESR, FIN-FSA has taken part in the formulation of level three guidance and the development of mutually agreed approaches to intensifying supervision, also contributing to their implementation. In cross-border supervision, FIN-FSA favours the approach of multilateral cooperation entrusted to colleges of supervisors. CEBS has put forward a supervisory model based on the idea that all the relevant supervisors of the member companies of cross-border conglomerates participate in the overall supervision of the conglomerate. Application of the model to the supervision of banks organised as branches, as well as to financial groups with subsidiaries, has also been encouraged. This view was adopted in autumn as a guideline for enhancement of cooperation in the supervision of cross-border conglomerates. The changes in EU provisions on home and host country supervision, kept alive by the FIN-FSA, were taken up for review in connection with the revision of the Capital Requirements Directive towards the end of the year. The proposed amendments are designed to consolidate the status of multilateral colleges of supervisors and the role of host country supervisors in the supervision of cross-border conglomerates, including major branches.

It has yet to be resolved how the costs arising from supervisory cooperation, for example delegation of duties, will be covered. This may require amendment of national legislation. The supervisory powers of individual supervisors are not adequately convergent in all areas to allow for as efficient cooperation as possible. Now these problems have also been identified at the political level within the EU. In 2008, the Commission will, hence, undertake a survey of the differences between supervisory powers, with a view to defining a sufficient minimum level of supervisory powers to ensure efficiency of operations.

Towards principles-based regulation

Practical ways of improving the quality of regulation, cut down on regulatory detail and reduce national differences are sought. Principles-based regulation is gathering new wind. This means that regulatory activities focus on objectives and results rather than means. It also means that the application of regulations may vary, for example depending on company size and business area. Principles-based regulation contributes to market competitiveness and innovation.

Measures have been taken to identify concrete practices for principles-based regulation and the principles of better regulation. There is, for example, a growing need for interpretations and application guidelines. The new margin notes of the standards introduced in the year (binding and application guideline/example), on the one hand, indicate more clearly which sections of the standard represent provisions issued by the FIN-FSA under its regulatory powers and, on the other hand, allow for the issue of practical application guidelines for example for supervised entities of different size and type. Comments from the market, however, indicate that the new margin notes have not so far been fully adopted by users.

COMMITTEES OF SUPERVISORS

CEBS in the core of supervisory convergence

The responsibility of the Committee of European Banking Supervisors (CEBS) is to foster the convergence of banks' supervisory practices, issue advice to the Commission and promote cooperation and exchange of information between supervisors.

Other important aims of CEBS include promotion of the cost efficiency of the EU supervisory framework and improvement of cross-border supervision. The White Paper of the Commission on Financial Services Policy 2005–2010 highlights the importance of consistent application of capital adequacy regulations in day-to-day supervision. It also encourages cooperation between level three committees.

The FIN-FSA takes part in the CEBS main committee meetings and in the work of the CEBS

Bureau. The FIN-FSA is also involved in the work of Groupe de Contact, the Expert Group on Capital Requirements (EGCR) and the Expert Group on Financial Information (EGFI).

The FIN-FSA has given priority to the objectives promoting convergence of supervisory practices, improvement of cross-border supervision and enhancement of capabilities for crisis management. In addition, the FIN-FSA places emphasis on issues related to liquidity risk control and regulations of own funds in capital adequacy requirements.

Convergence of supervisory practices underway

CEBS promotes the harmonised application of the Capital Requirements Directive (CRD) and CEBS Guidelines by introducing a peer review mechanism, with the related Review Panel of supervisors, in the work of which the FIN-FSA also takes part. For the settlement of any disagreement between supervisors a mediation mechanism was created in the year under review.

CEBS' efforts towards convergence of supervisory practices continued especially in the Subgroup on Operational Networking subordinate to Groupe de Contact. The FIN-FSA was actively involved in this work. The group formulated the principles for supervision of cross-border conglomerates designed to steer the practical work of colleges of supervisors. A contract template for cooperation in the supervision of cross-border conglomerates was finalised.

Groupe de Contact aimed to develop principles and workable solutions for the delegation of duties between home and host country supervisors. Smooth delegation of duties and better availability of delegation opportunities is an integral element of the development of the work of colleges of supervisors. The FIN-FSA contributed to the settlement of delegation issues and to the drafting of proposals for delegation guidelines.

Common practices for the Supervisory Review and Evaluation Process (SREP)

In the year, strong emphasis has been placed on Pillar 2 supervisory issues under the Basel II Framework and harmonisation of supervisory practices. In the work of the subgroup of Groupe de Contact, common approaches to the conduct of the Supervisory Review and Evaluation Process (SREP) are sought to ensure as equal treatment of supervised entities as possible. The subgroup prepares proposals and more detailed interpretations related to Pillar 2 supervision, for example on the analysis of economic capital models, treatment of diversification benefits, stress testing and capital allocation. The FIN-FSA takes an active part in this work.

Greater emphasis on liquidity risk management

A subgroup of Groupe de Contact examined the current status of liquidity risk regulations and any further regulatory requirements in this area within the EU. The group prepared responses to the consultation of the EU Commission on the regulation of liquidity risks and aimed to formulate common EU principles for liquidity risk control. This work will continue in spring 2008.

CESR improves practical supervision

Enhancement of practical supervisory cooperation is also a key objective of the Committee of European Securities Regulators (CESR). The mediation mechanism for settlement of conflicts between members is already available. Similarly, peer review of members is undertaken by the Review Panel of CESR. In addition, greater convergence of supervisory practices is sought through common training and staff exchange programmes. CESR prepares a common training scheme with CEBS and CEIOPS.

Preparations for the implementation of MiFID, improvement of the supervision of mutual funds and enforcement of the Transparency Directive were the main projects undertaken in the year under review.

The work of the Review Panel was strengthened in the year, with the adoption of new procedural rules and rules on peer review of members.

An analysis of the exercise of the powers required under the Market Abuse and Prospectus Directives was published. The findings of the analysis indicate that

the supervisory and sanctionary powers of securities regulators differ between the EEA countries and that the powers have not been completely implemented in all member states. The Finnish supervisory authorities were found to lack, for example, the powers to obtain traffic data and to order the freezing of assets.

The permanent working groups CESR-Fin and CESR-Pol remained active. CESR-Fin, which concentrates on the enforcement of financial statements, focused on the discussion of national enforcement issues in the European Enforcers' Coordination Sessions (EECS) and the design of a database of supervisory decisions. Furthermore, CESR-Fin was engaged in the evaluation of the correspondence of third country financial reporting standards with IFRSs, as well as the implementation of the CESR-SEC cooperation programme. At the end of the year, CESR-Fin also published a report on the enforcers' experiences from the enforcement of the first financial statements prepared under IFRS. CESR-Pol has concentrated on the consistent application of the Market Abuse Directive. The group has also set up a subgroup for the exchange of information on suspicions of market abuse.

NATIONAL REGULATORY REFORMS

New regulations for credit institutions

The new Credit Institutions Act entered into force at the beginning of November, entailing changes in the contractual terms applied by banks, especially loan terms and collateral commitments.

In the third phase of the total reform of the Execution Act, provisions on the final statute of limitations were issued. The provisions entered into force on 1 January 2008. The new provisions on limitation of outstanding debt entered into force already on 1 January 2004 but the Act provides for a three-year transitional period, which means that the first limitations under this Act became effective at the beginning of 2007. These new provisions are expected to expedite the collection of outstanding debt and speed up supervised entities' collection processes.

The Act on Continuing Powers of Attorney also entered into force at the beginning of November. At the same time, amendments were made to the Guardianship Act. By issuing a continuing power of attorney, a person may in advance authorise a selected person to attend to his affairs where his own capacity is no longer sufficient. The more widespread use of such powers of attorney may facilitate and simplify the conduct of personal banking.

The deposit guarantee legislation was amended at the end of December. For closer details on the deposit guarantee scheme, see page 21.

Implementation of the Markets in Financial Instruments Directive (MiFID) through FIN-FSA standards

The Directive on Markets in Financial Instruments (MiFID), together with the Commission Directive implementing MiFID, were transposed into national law on 1 November 2007, partly through standards issued by the FIN-FSA.

Standard on the principles of corporate governance

The key aim of the standard on corporate governance and organisation is to define the principles to be applied by the supervised entity in order to ensure professional management in line with sound and prudent business principles. The key objective is to ensure the efficient and effective risk management and internal control of supervised entities.

The standard includes the organisational requirements set out in the MiFID Directive. There is a separate section in the standard that only applies to supervised entities providing investment services. This section on organisation includes provisions on the management of conflicts of interest, conduct of private business transactions, protection of customer assets, storage of data and processing of customer complaints.

As the standard applies to different kinds of supervised entities and various types of operations, supervised entities may consider the nature, scope and complexity of operations and any other relevant factors in deciding on the appropriate and efficient manner of compliance with the objectives of the standard.

Advance notification of outsourcing arrangements related to key business functions

The implementation of MiFID included the issue of a standard on outsourcing arrangements and a related standard on notifications for outsourcing arrangements for credit institutions, investment firms, fund management companies and the stock exchange.

The standards address the outsourcing arrangements related to key business functions, which are subject to regulation and supervision. Legislation on outsourcing arrangements introduces the new concept of tied agent. The provision of certain investment services may only be outsourced to tied agents. Operations subject to authorisation may, as a rule, only be outsourced to an institution with the appropriate authorisation. Outsourcing of key business functions is subject to advance notification.

Standards on code of conduct and marketing amended in line with MiFID

The FIN-FSA's standards on code of conduct and marketing were amended in line with the Commission Directive (2006/73/EC) implementing MiFID. The amendments are related to the code of conduct for the provision of investment services and the marketing of investment services and financial instruments. A new section on investment services was added to the standard on code of conduct, discussing for example the supervised entity's obligation to provide and acquire information and the best execution requirements regarding customer orders for securities and other financial instruments. The standards also take account of the CESR level three guidelines on inducements and best execution.

More explicit provisions on eligible assets for mutual funds

In March, the Commission issued a level two Directive (2007/16/EC), which seeks to clarify the provisions on eligible assets especially for mutual funds under the UCITS Directive. Until now, interpretations of the provisions on the eligibility of, for example, credit derivatives and closed funds have varied. The new Directive introduces more explicit criteria for financial instruments embedding a derivative element. It also clarifies the eligibility criteria for money market instruments not admitted to trading on a regulated market and specifies the characteristics of index-replicating UCITS. The Directive further provides stricter criteria for financial derivatives and derivatives on financial indices.

The Directive will be implemented in Finland through a government decree. National implementation must take place by 23 March 2008. The decree will enter into force in July 2008.

Real Estate Funds Act entered into force; no new real estate funds as yet

Amendments to the Real Estate Funds Act and the Mutual Funds Act entered into force on 1 May 2007. Despite advance market interest, no mutual funds were set up under the new rules in the year under review. Although the Real Estate Funds Act seeks to address the special requirements of funds specialising in real estate investment, fund liquidity issues, such as value calculation and publication, as well as subscriptions and redemptions, continue to present a challenge.

Revision of simplified fund prospectus underway

The Investment Management Expert Group (IMEG) has drafted a Key Investor Information (KII) document that will replace the simplified fund prospectus. The aim is to produce a consistent and brief, informative prospectus that better serves investors' information needs. At the same time, cross-border operations are promoted by reducing the scope for additional national requirements to the prospectus. The first round of consultations on the draft document is currently in progress.

The debate has particularly centred on the proposed synthetic risk indicator to be presented in the KII document. This indicator, which would be presented in addition to the verbal description of risk, is based on an agreed formula and allows for comparison by investors in the analysis of the risks involved in different funds. In other respects, the headings of the KII document would be largely identical with those of

the current simplified fund prospectus but the length of the document would be limited to two pages. In some member countries, the length of the prospectus has been manifold in comparison with this.

Revision of the UCITS Directive would change the notification process

Revision of the UCITS Directive (85/611/EEC) will start in 2008. The revision is mainly designed to speed up and simplify the notification process but also addresses issues such as the management company passport, ie the conditions for taking up business in other member states, cross-border mergers, asset pooling, revision of the simplified fund prospectus and cooperation between supervisory authorities.

Implementation of Third Money Laundering Directive specifies customer due diligence (CDD) requirements

Anti-money laundering regulations will be revised following implementation of the Third Money Laundering Directive in Finland. The forthcoming amendments will impose more detailed customer and owner due diligence requirements on supervised entities and other businesses covered by this legislation. The control of risks related to customer relations, products and services requires that a risk-based classification of customers be undertaken, while enhanced due diligence should be introduced for high-risk customer relations (eg cross-border correspondent relations and politically influential persons). In addition, continuous risk-based monitoring of customer relations and transactions should be put in place. Existing customer relations should also be analysed and customer information updated in line with the new requirements, where necessary.

Registration requirement for companies providing foreign exchange, payment transfer and corporate services

The regulation and monitoring of companies providing foreign exchange, payment transfer and corporate services will be stepped up. These companies shall register with the State Provincial Office of Southern Finland under the provisions of the new Anti-Money Laundering Act. The State Provincial Office shall also continually control that the owners and management of these companies meet the fit & proper criteria. It is further proposed that the registration authorities are afforded broader information access and supervisory powers. With the provision of payment services becoming subject to authorisation, the companies providing payment transfer services will fall under the supervision of the FIN-FSA by the end of 2009.

IFRS revision continued

The International Accounting Standards Board (IASB) has continued the revision of IFRS standards. In the year, major amendments were made to several standards, including those on Business combinations and Presentation of financial statements. EU adoption of the new standard on segment reporting (Operating Segments) was preceded by an impact analysis undertaken by the European Parliament. This was the first time an impact analysis of a standard was undertaken before its adoption as legislation applicable to European listed companies. This new standard and the amendments to the standards will enter into force in 2009.

The unofficial round table set up by the EU Commission in 2006 to promote the consistent application of IFRSs convened twice in the year.

Application of IFRS regulations in the United States

The cooperation between the IASB and the United States Financial Accounting Standards Board (FASB) for convergence of financial reporting regulations is aimed at a situation where the US Securities Exchange Commission (SEC) no longer requires foreign companies applying IFRSs to disclose reconciliation with US GAAP.

In November SEC decided that foreign companies may prepare financial statements according to the IFRSs issued by the IASB, without having to disclose reconciliations with US GAAP. In this context, preparations of a proposal allowing US companies to prepare financial statements in accordance with IFRSs, and not US GAAP, have been made.

Transparency Directive transposed into Finnish law in February

The Transparency Directive (2004/109/EC) governing the regular reporting requirements of securities issuers, shareholders' obligation to disclose holdings and the dissemination and storage of regulated information was transposed into national law on 15 February. In the implementation, consideration was also given to the Commission Directive Implementing the Transparency Directive issued in March.

In October, the Commission further issued a recommendation on the minimum requirements to be met by the officially appointed mechanisms for the central storage of regulated information (OAM) set up under the Transparency Directive and on the establishment of a network between national OAMs.

Several amendments to FIN-FSA standards applicable to listed companies

The completely redrafted standards 5.2a and 5.2c and the amended standard 5.2b entered into force on 1 February. The revision of standard 5.2a on securities offerings and listings was related to the amendment of the Securities Markets Act of 1 July 2005 following the implementation of the Prospectus Directive. The revision of standard 5.2c on takeover bids and mandatory bids and the amendment of standard 5.2b on disclosure obligation of the issuer and shareholder were, in turn, related to the amendment of the Securities Markets Act of 1 July 2006, implementing the Directive on Takeover Bids.

In the autumn, consultations were launched on the draft standard 5.1 on regular reporting requirements and on the amendment of standard 5.2b. The draft standards were related to the amendment of the Securities Markets Act implementing the Transparency Directive. The standards are scheduled to enter into force in the early part of 2008.

Payment services to become subject to authorisation in 2009

The Commission issued a proposal for the Payment Services Directive (PSD) in December 2005. On 26 April 2007, the European Parliament endorsed the proposal for submission to the EU Council, which will issue the Directive. Member states are to transpose the Directive into national law by 1 November 2009.

The Directive is designed to provide a common EU framework for the provision of payment services. With the implementation of the Directive, provision of payment services will become subject to authorisation. The Directive will also include provisions on the information requirements and codes of conduct applicable to payment service providers.

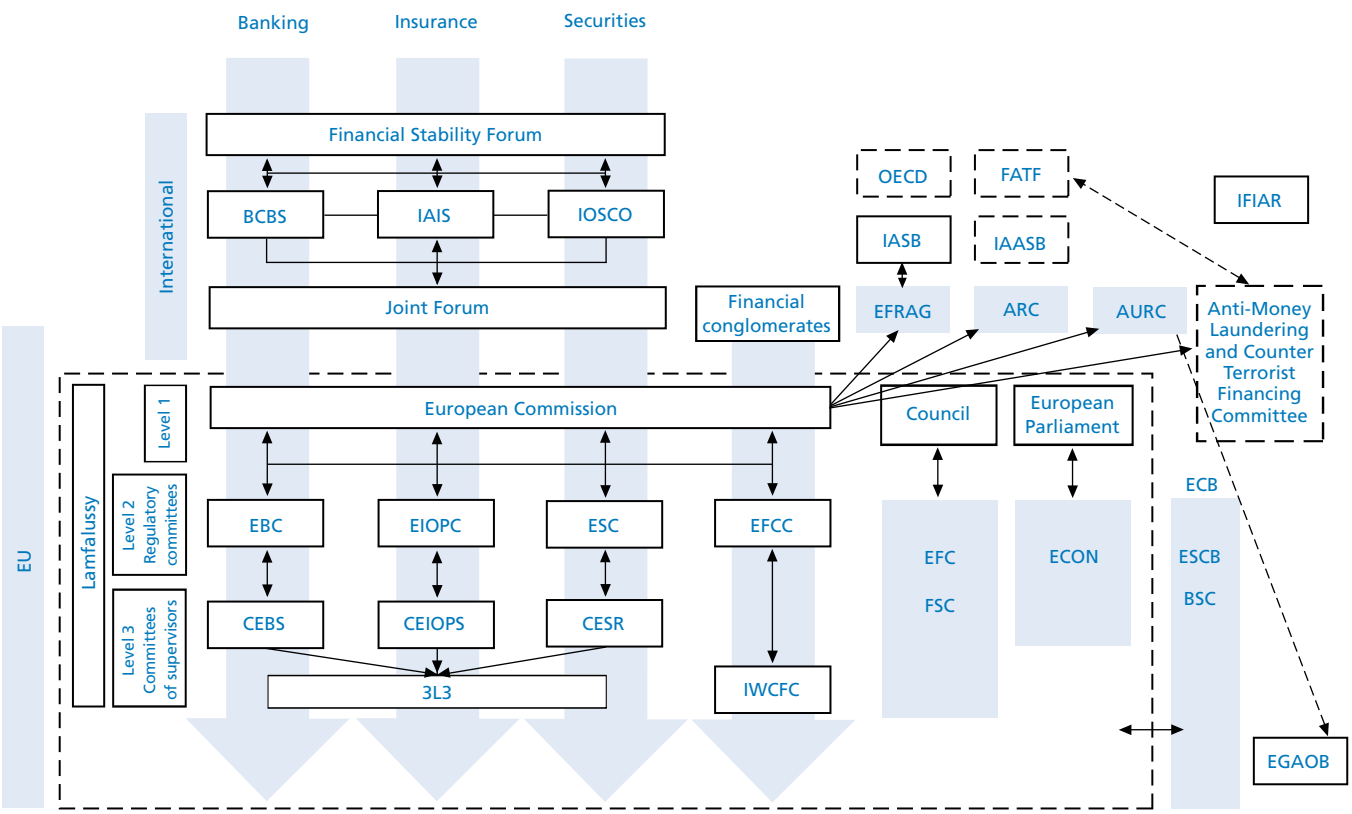
In Finland, responsibility for the national implementation of the Directive is shared by the Ministry of Justice and the Ministry of Finance. The Ministry of Justice working group is responsible for the national implementation of provisions on the conclusion and terms of payment services contracts as well as on the execution of payment transactions, while the Ministry of Finance working group attends to the national implementation of statutes related to licensing and supervision of payment services. The FIN-FSA is represented on both working groups, which will issue their proposals by 1 December 2008.

With the implementation of the Directive, supervision by the FIN-FSA will be extended to new businesses, including the payment transmitters currently registered with the State Provincial Office of Southern Finland and the providers of card services.

For current supervised entities, especially banks, implementation of the Directive will entail new reporting requirements related to the provision of payment services.

The Directive provides the legal basis for the realisation of the Single Euro Payments Area (SEPA), which is the common project of European banks, the European Central Bank and the European Commission.

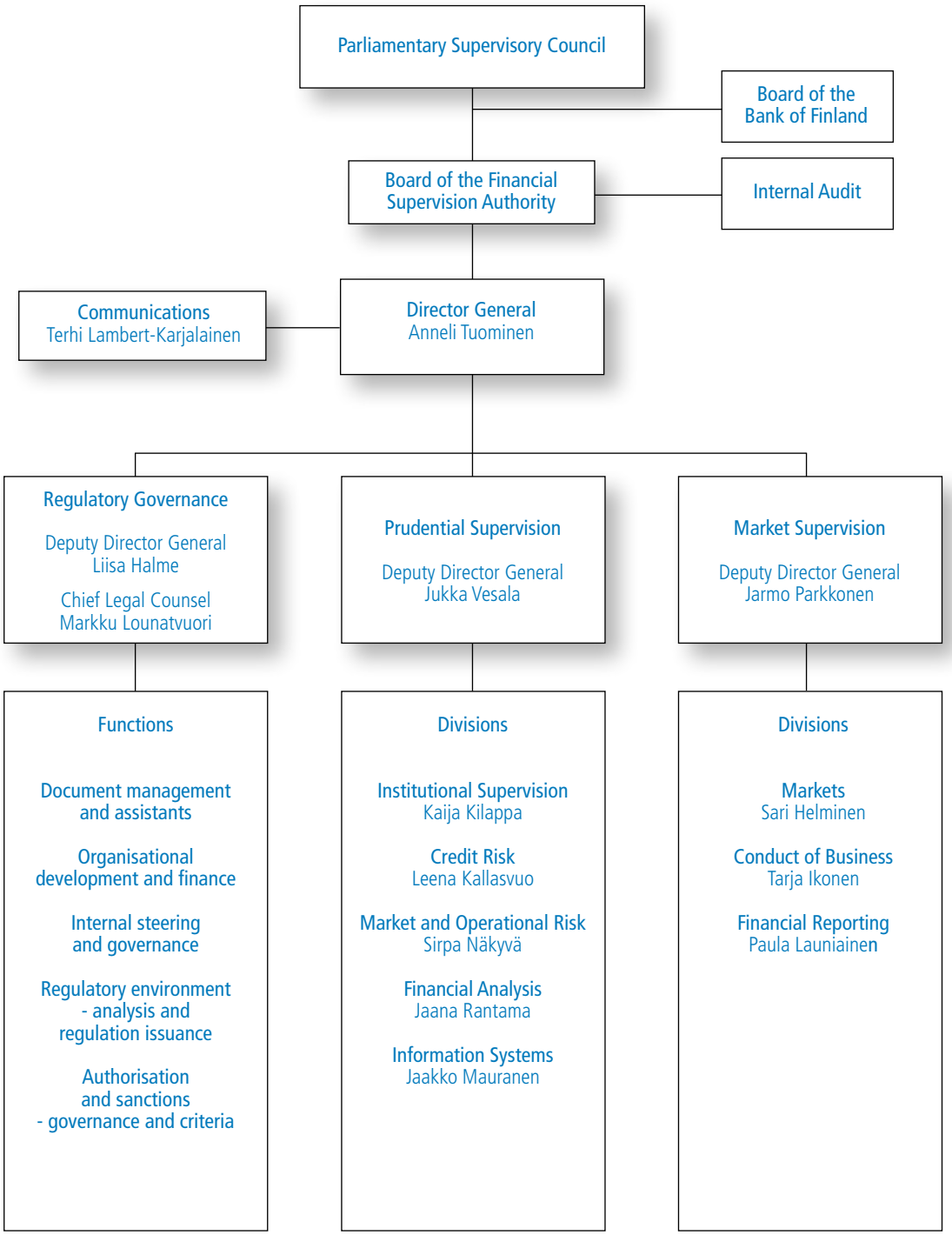
EU and international committees



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

Source: Financial Supervision Authority.

The Finnish Financial Supervision Authority 31 December 2007



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

The FIN-FSA staffing by task, 2007

	2007	
	Number of persons	Number relative to total staff, %
Licensing and authorisation function	6	4
Regulation issuance and process management	10,1	7
Sanctions and investigation	1	1
Internal control and governance	2	1
Monitoring and financial reporting	11,5	8
Financial reporting and analysis	14	10
Market supervision	13,5	10
• Public offer and listing prospectuses	5	4
• Reporting and disclosure obligations	3	2
• Stock exchange trading supervision and market abuse investigation	5	4
• Insider register	0,5	0
Inspection and supervision function	44,9	32
• Prudential supervision	27	19
• Monitoring codes of practice	11,4	8
• Financial market infrastructure (payment and IT systems, trading, clearing, payment and deposit systems, operators and counterparties)	6,5	5
International activities	4,3	3
Communications	2,7	2
Consumer information	0,5	0
Document management and assistants	6	4
Information systems	9	6
Organisational development and finance	3	2
Senior management, secretaries	12,5	9
Total	***141***	***100***

Source: Financial Supervision Authority.

The FIN-FSA staff, expenses and income 2003–2007

	2007	2006	2005	2004	2003
Number of personnel, at year end	141	137	138	138,5	138
Expenses and income, EUR million					
Operating expenses	16,2	17,2	15,8	15,6	15,0
Supervision fees	15,5	16,9	17,4	14,9	14,6
Processing fees	0,9	0,6	0,7	0,8	0,5

Source: Financial Supervision Authority.

Supervision and specific fees, 2003–2007

Table 1. Supervision fees, EUR thousands

Previous data is not comparable with figures for 2005–2007 because the Act on Supervision Fees that entered into force at the beginning of 2005 changed the criteria for supervision fees.

Fee-paying entities	2007	2006	2005	2004	2003
Credit institutions	9 991	11 016	11 482		
Investment firms	730	1 015	1 262		
Fund management companies	2 470	2 216	1 792		
Stock exchange	549	536	591		
Finnish Central Securities Depository (APK)	182	215	252		
Issuers	1 475	1 773	1 845		
Others	108	130	211		
TOTAL	*15 504*	*16 901*	*17 435*	*14 857*	*14 564*

Table 2. Specific fees, EUR thousands

Fee-paying entities	2007	2006	2005	2004	2003
Credit institutions	288	88	15	45	24
Issuers	187	207	374	422	285
Fund management companies	166	216	220	283	159
Investment firms	88	39	57	12	2
Others	182	42	3	1	2
TOTAL	*910*	*592*	*669*	*763*	*472*

Table 3. Total fees, EUR thousands

Fees	2007	2006	2005	2004	2003
Supervision fees	15 504	16 901	17 435	14 857	14 564
Specific fees	910	592	669	763	472
TOTAL	*16 414*	*17 493*	*18 104*	*15 620*	*15 036*

Source: Financial Supervision Authority.

The FIN-FSA budget 2008, expenses and income 2006–2007, EUR thousands

	Actual 2006	Actual 2007	Budjet 2008
Expenses			
Staff expenses			
Wages	8 500	8 521	8 832
Other staff expenses	2 456	2 444	2 596
Contribution to the Bank of Finland pension fund[1]	1 400		
Total staff expenses	*12 356*	*10 965*	*11 428*
Other expenses			
Training	183	177	240
Travel	385	418	471
IT expenses	1 002	1 333	1 172
Language services	282	274	250
Real estate rents and maintenance costs	1 262	1 286	1 322
Security	376	376	376
Other expenses	1 341	1 339	1 674
Total other expenses	*4 831*	*5 203*	*5 505*
Depreciation			
Equipment and furniture	24	27	57
Software	17	17	188
Total depreciation	*41*	*44*	*245*
TOTAL EXPENSES	**17 228**	**16 212**	**17 178**
Income			
Supervision fees	16 901	15 504	18 100
Processing fees	592	910	800
Other income	1	5	0
Surplus of the previous year[2]	*2 292*	*2 559*	
TOTAL INCOME	**19 787**	**18 988**	**18 900**

Lähde: Rahoitustarkastus.

[1] The Bank of Finland's pension fund was created with the purpose to prepare for covering pension liability and finance employees' pensions. The aim is to cover pension liabilities to a level of 110% by 2012 through regular accruals to the fund. To attain the targeted level the Bank of Finland has to pay a contribution to the pension fund for 2007. The amount and FIN-FSA's respective share will be confirmed later in spring.

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

Abbreviations and definitions index for 2007 Annual Report

AKVA, monitoring system for securities transactions
AIRBA, Advanced Internal Ratings Based Approach
AMA, Advanced Measurement Approach
APK, Finnish Central Securities Depository (Arvopaperikeskus Oy)
BSC, Banking Supervision Committee, a committee of the ESCB
CEBS, The Committee of European Banking Supervisors
CESR, The Committee of European Securities Regulators
CEIOPS, The Committee of European Insurance and Occupational Pensions Supervisors
CESR-Fin, Operational group on Financial Reporting
CESR-Pol, Operational group for enforcement of Market Abuse
COREP, Common Reporting Framework
EECS, European Enforcers Coordination Sessions
EGCR, Expert Group on Capital Requirements
EGFI, Expert Group on Financial Information
ECB, European Central Bank
ESCB European System of Central Banks
FASB, Financial Accounting Standards Board
FATF, Financial Action Task Force on Money Laundering
FK, Federation of Finnish Financial services
FSAP, Financial Services Action Plan
FSC, Financial Services Committee
IASB, International Accounting Standards Board
ICAAP, Internal Capital Adequacy Assessment Process
IFRS, International Financial Reporting Standards
IIMG, Inter-institutional Monitoring Group
IMEG, Investment Management Expert Group
IPO, Initial Public Offering
IRBA, Internal Ratings Based Approach
MiFID, Markets in Financial Instrument Directive
PSD, Payment Services Directive
SEC, Securities and Exchange Commission (USA supervisory authority)
SEPA, Single Euro Payments Area
SREP, Supervisory Review and Evaluation Process
TYVI, Data reporting system from companies to authorities
UCITS, undertaking for collective investments in transferable securities
XBRL, eXtensible Business Reporting Language

Nordic supervisory authorities
Finansinspektionen, Sweden
Kredittilsynet, Norway
Finanstilsynet, Denmark
Fjármálaeftirliti, Iceland

The Annual Report is based on data available from 15 January 2008.
The texts refer to the reporting year 2007, unless otherwise mentioned.

Editorial committee
Terhi Lambert-Karjalainen, Chairman
Liisa Koikkalainen
Juha Savela
Jari Virta
Minna Söderholm, secretary

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Financial Supervision Authority
P.O. Box 159
FI-00101 Helsinki
Telephone +358 10 831 51
Telefax +358 10 831 5328
www.fin-fsa.fi
rahoitustarkastus@rahoitustarkastus.fi