

**Finland: Financial System Stability Assessment, including Reports on the
Observance of Standards and Codes on the following topics:
Financial Policy Transparency, Banking Supervision,
Insurance Supervision, Securities Regulation, and Payment Systems**

The Financial System Stability Assessment on **Finland** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **September 25, 2001**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Finland or the Executive Board of the IMF.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623 7430 • Telefax: (202) 623 7201
E-mail: publications@imf.org • Internet: <http://www.imf.org>

Price: \$15.00 a copy

**International Monetary Fund
Washington, D.C.**

INTERNATIONAL MONETARY FUND

FINLAND

Financial System Stability Assessment

Prepared by the European I and Monetary and Exchange Affairs Departments

Approved by Michael Deppler and Stefan Ingves

September 25, 2001

- The Financial System Stability Assessment (FSSA) is based on the work of IMF missions that visited Finland as part of the Financial Sector Assessment Program (FSAP) February 26–March 2, 2001, and April 2–12, 2001. Follow-up discussions were held in Helsinki on June 13–14, 2001, in the context of the Article IV mission. The FSAP team was led by Mr. R. Barry Johnston, and included Mr. Paul Kupiec, Ms. Mary Zephirin, Mr. Haizhou Huang, Ms. Claudia Mariel (Senior Administrative Assistant), and Ms. Sonia Echeverri (Staff Assistant), all from the Monetary and Exchange Affairs Department; Ms. Christina Daseking (European I Department); Mr. Jack W. Heyes, Office of the Superintendent of Financial Institutions in Canada; and Mr. Stefan Niessner, Deutsche Bundesbank (both banking supervision experts); Mr. Bruce D. White, Reserve Bank of New Zealand (financial transparency expert); Mr. Dermot Maher, Central Bank of Ireland (payment systems expert); Mr. Jaap Turkesteen and Mr. Ruud Pijpers, Pensions and Insurance Supervisory Authority of the Netherlands (both pensions/insurance experts); and Ms. Andrea Corcoran, U.S. Commodities Futures Trading Commission (securities expert).
- Finland has a very sound financial system that reflects Finland's strong macroeconomic performance in recent years, and the restructuring, recovery, and generally conservative lending behavior of banks in the wake of the banking crisis in the early 1990s. Strong macroeconomic performance has strengthened balance sheets across sectors, and stress tests indicate that the financial system is fairly robust to sizable asset price fluctuations. The risks to the economy from adverse financial sector developments appear fairly low in current circumstances.
- Despite the overall profile of soundness in the financial system, there are some deficiencies as regards compliance with certain banking supervision and securities standards primarily related to the explicit powers of the regulator. Crisis management arrangements pose a challenge in view of the highly concentrated nature of the financial systems and the dominant role of complex financial conglomerates. Finland demonstrates a high degree of compliance with international standards and codes in the areas of payment systems, insurance, and transparency.
- The authors of this report are R. Barry Johnston, Paul Kupiec, Haizhou Huang, and Mary Zephirin.

Contents	Page
Overall Stability Assessment	5
Section I—Staff Report on Financial Sector Issues	10
I. Financial System Overview	10
A. Financial Institutions and Markets	10
B. Regulatory Framework for the Financial System	13
II. Macroeconomic Risks and Financial Sector Exposures	14
A. Macroeconomic Environment	14
B. The Financial Environment	18
C. Stress Testing Exercises	20
III. Regulatory, Supervisory and Transparency Arrangements and Financial Safety Nets	23
A. Banking System	23
B. Insurance and Pensions	24
C. Securities	25
D. Payment Systems	25
E. Transparency of Financial Regulations	26
F. Financial Safety Nets and Crisis Management	27
Deposit and other insurance arrangements	27
Emergency liquidity support	28
Crisis management	28
IV. Challenges Confronting the Finnish Financial System and Recommended Responses	29
A. Strengthening Supervisory Arrangements	29
Strengthening the FSA	29
Strengthening the ISA	30
B. Strengthening Crisis Prevention and Management	30
Section II—Observance of Financial System Standards and Codes: Summary Assessments	33
I. Basel Core Principles for Effective Banking Supervision	34
A. Institutional Setting	34
B. General Preconditions for Effective Banking Supervision	34
C. Main Findings	35
II. MFP Transparency Code—Banking Supervision	38
III. IAIS Insurance Supervisory Principles	40
A. General	40
B. Institutional Setting	40
C. Main Findings	41
IV. MFP Transparency Code—Insurance Regulation and Supervision	44

V. IOSCO Objectives and Principles of Securities Regulation.....	46
A. Supervisory Framework and Market Structure	46
B. General Preconditions for Effective Securities Regulation.....	47
C. Main Findings	48
VI. MFP Transparency Code—Securities Regulation and Supervision	50
VII. Assessment of Payment and Settlement Systems.....	50
A. Introduction	50
B. Assessment Against Core Principles.....	52
The BOF-RTGS System.....	52
The POPS System	52
The PMJ System	52
VIII. MFP Transparency Code—Payment Systems Oversight.....	53
IX. MFP Transparency Code—Deposit Insurance and Investment Guarantees	54
A. Institutional and Market Structure	54
B. Main Findings Summary	55
Text Tables	
1. Finland: Financial Sector Overview, December 1999	11
2. Finland: Ownership Structure of Financial Sector, December 2000	12
3. Finland: Main Economic Indicators, 1996-2000	15
4. Finland: Indicators of Financial Vulnerability in Major Sectors, 1996-2000	16
5. Finland: Composition of Aggregate Bank Lending by Sector, 1997-2000.....	19
6. Main Findings of the BCP Assessment and Recommendations.....	36
7. Main Findings of Assessment of MFP Transparency Code—Banking Supervision.....	39
8. Summary of Main Findings of Assessment of IAIS Supervisory Principles, Recommendations and Corrective Actions.....	43
9. Summary of Main Findings of MFP Transparency Practices—Insurance Regulation and Supervision.....	44
10. Summary of Main Findings of Assessment of IOSCO Objectives and Principles of Security Regulation.....	49
11. Summary of Main Findings of Assessment of MFP Transparency of Payment System Oversight	53
12. Summary Findings of the Assessment of the MFP Transparency Code for Deposit Insurance and Investment Guarantees.....	56
Boxes	
1. Central Government Debt Management.....	17
2. Stress Tests Results	21

Glossary

<i>Terms/ Acronyms</i>	<i>Definitions</i>
APK	Finnish Central Securities Depository
ATM	Automated teller machine
BCP	Basel Core Principles
BIS	Bank for International Settlements
BOF	Bank of Finland
BOF-RTGS	Bank of Finland real-time gross settlement system
CPSS	Committee on Payment and Settlement Systems
CSD	Central Security Depository
DGF	Deposit Guarantee Fund
ECB	European Central Bank
EEA	European Economic Area
EFTPOS	Electronic funds transfer point of sale
ELA	Emergency liquidity assistance
EMU	European Monetary Union
EPM	ECB Payment Mechanism
ESCB	European System of Central Banks
EU	European Union
FATF	Financial Action Task Force
FIM	Finnish markkaa
FSA	Financial Supervision Authority
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
HEX	Helsinki Stock Exchange
IAIS	International Association of Insurance Supervisors
ICT	Information and communication technology
IOSCO	International Organization of Securities Commissions
ISA	Insurance Supervisory Authority
MOF	Ministry of Finance
MOSAH	Ministry of Social Affairs and Health
MOU	Memorandum of understanding
NPLs	Nonperforming loans
OM	APK settlement system for equity rated securities
PMJ	PMJ system for retail payments
POPS	POPS interbank payment system for express transfers and checks
PSC	Parliamentary Supervisory Council
RM	APK settlement system for non-equity rated securities
SROs	Self Regulatory Organizations
TARGET	Trans-European Automated Real-Time Gross Settlement Express Transfer System
TBTF	Too-big-to-fail
UCITS	Undertakings on Collective Investments in Transferable Securities

OVERALL STABILITY ASSESSMENT

1. ***Finland has a very sound financial system*** that reflects Finland's strong macroeconomic performance in recent years, and the restructuring, recovery, and generally conservative lending behavior of banks in the wake of the banking crisis in the early 1990s. The financial system has been reorganizing through financial service mergers both across products (banking, insurance, and securities) and across borders. While this reorganization reflects the trends in financial services worldwide, the implication for Finland is that the financial system is now very concentrated and is dominated by three complex financial conglomerates. Some key points are:

- ***The banking system has a strong capital position, with capital adequacy ratios above Basel minimums, and very modest levels of nonperforming loans.*** Profitability of banks is good, reflecting: favorable net interest margins from relatively weak price competition; strong growth of net fee income as banks have developed their wealth and asset management activities; reduced costs including through a rationalization of bank branch networks and increased reliance on internet banking and ATMs; and very low loan losses in a benign economic environment in recent years. Growth in bank lending has been concentrated in lending to households.
- ***The insurance and pension industry is well capitalized and highly concentrated.*** Many insurance and pension-insurance companies are organized as mutual companies, but the industry is reorganizing, with the introduction of a bank-insurance-pension conglomerate and entry of foreign firms, resulting in a more competitive market environment.
- ***The Finnish securities industry is generally well regulated,*** consisting of the Helsinki Exchanges (HEX), 50 investment firms, and 25 fund management companies. Turnover on the HEX is dominated by trading in a single share (Nokia). The HEX index has followed closely the Nasdaq and has been subject to considerable volatility.
- ***The Finnish payment system is in good shape.*** The Bank of Finland's real-time gross settlement system (BOF-RTGS), linked to the TARGET systems, the POPs system for express transfers and checks, and the PMJ retail payments system has adequate procedures and controls.
- ***As a member of the euro area, Finland benefits from integration in the system of euro-wide bond and money markets and reduced currency risks.*** Agents have increasingly met their investment and liquidity management needs through euro-area instruments as the fiscal surplus is reducing the stock of outstanding Finnish government debt. The elimination of currency risk for transactions involving the euro has been associated with much larger cross-border investment flows.

- ***Strong macroeconomic performance and savings in recent years have strengthened balance sheets across sectors.*** Nonfinancial corporation gross debt (as a percent of GDP) and debt-to-equity ratios are modest, as corporations have funded themselves in buoyant equity markets and through retained earnings. Households' gross debt (as a percent of GDP) and debt to income ratios are well below the levels reached prior to the banking crisis in the early 1990s.
 - ***The stress test results for declines in exports, stock and real estate prices suggest that stresses due to recent asset price fluctuations are manageable.*** House prices have recovered strongly from the crisis of the 1990s, but they remain below pre-crisis levels in real terms and have recently shown some tendency to stabilize. Equity prices have been subject to large increases and more recently sharp declines, but exposures of households and banks to equity price movements appear to be limited. The solvency of insurance companies that have significant equity and real estate exposures would be strained by asset price corrections.
 - ***The risks to the economy from adverse financial sector developments appear fairly low in current circumstances.*** This reflects, inter alia, the significant reduction of exchange rate risk with the adoption of the euro, the solvency position of firms and households, and the access of corporations to international financial markets.
 - ***The Finnish authorities are drafting or considering new legislation to cover a range of financial sector issues and have strengthened supervisory coordination.*** As a member of the European Union (EU), Finland takes its cue for legislation from EU directives. However, financial sector developments in Finland require preparation of legislation in some areas in advance of the EU, such as proposed legislation on financial conglomerates. The Nordic area has also been at the forefront of promoting cross-border cooperation among supervisors, and recently a memorandum of understanding (MOU) has been signed concerning the supervision of the largest financial conglomerate in Finland.
 - ***Finland has in place the legislation, regulatory structure, and supervisory practices appropriate to money laundering prevention.*** As a member of the Financial Action Task Force (FATF), Finland has enacted a Money Laundering Act, which mandates know-your-customer rules, relevant staff training, reporting of suspicious transactions, and the imposition of penalties for nonobservance. Credit institutions must file regular reports and are subject to specialized inspection in this area. Finally, a specialized unit has been established by the police to investigate reports.
2. ***Finland is at the forefront of electronic banking and financial sector consolidation. Mitigating potential vulnerabilities in a more demanding financial market environment will require strengthening regulatory and supervisory arrangements.*** In particular, the Financial Supervision Authority's (FSA's) empowering legislation needs to be more precise and transparent regarding the powers the FSA can use to conduct a more proactive supervisory process. Specific areas where the supervisory arrangements could be

strengthened, and which would help address issues identified in the Basel Core Principle and International Organization of Securities Commissions (IOSCO) assessments (discussed below), include:

- ***Transferring the licensing authority for banks from the Ministry of Finance (MOF) to the FSA.*** The licensing authority provides the ultimate sanction for the “birth” and “death” of financial institutions. The present assignment of the licensing authority to the MOF limits the supervisory and regulatory independence of the FSA, restricting its accountability for the entire supervisory life of the institution. Reassignment of the licensing authority to the FSA would also address questions that may arise because of MOF’s present role as both a major shareholder in a financial institution and a regulator focusing on safety and soundness issues. The independence of the Insurance Supervisory Authority (ISA) would also be strengthened by transfer of the licensing powers to the ISA.
 - ***Clarifying the powers of the FSA in the law.*** The FSA’s discretionary powers should be clearly defined (purpose, criteria, limits). Examples of additional regulatory and supervisory discretionary powers include: prior approval for major investments and acquisitions; powers to approve or block appointments to the Board of Directors; ability to set requirements to prevent abuse arising from connected lending; and discretion to establish capital requirements that are reflective of the risk of the institution and to prescribe prudential loan loss provisioning.
 - ***Formalizing the laws, regulations and protocols necessary to effectively supervise mixed bank-insurance conglomerates.*** The necessary powers to handle such conglomerates should be legislated. Harmonization of the regulatory and supervisory frameworks that affect oversight of banking, insurance, and securities is important in order to mitigate the possibility of regulatory arbitrage.
3. ***Arrangements for crisis prevention and management need to balance the conflicting goals of minimizing moral hazard and providing adequate safety nets in the financial system.*** Discussions with the authorities and their handling of the financial crisis in the 1990s suggest that the balance is tilted toward safety net provision. Without adopting necessary safeguards, this policy stance could create the conditions for strong moral hazard. Measures that could help in controlling moral hazard could include the following:
- ***More pro-active supervisory measures*** to prevent financial difficulties in a large institution from becoming a major financial crisis, consistent with the proposed measures to strengthen the powers of the FSA.
 - ***Early warning systems*** to monitor the financial situations of large institutions, including ongoing comprehensive information on the structure and conduct of business. The establishment of an effective early warning system would require cross-discipline and cross-border cooperation to monitor the full range of activities of complex conglomerates.

- ***Development of a full range of crisis management strategies*** that can guide the authorities to take prompt and appropriate corrective measurements after identifying the problems. In this regard, the authorities are preparing new legislation on the winding up and reconfiguration of Finnish credit institutions.

In view of the complexity of the financial institutions in Finland, a key element in strengthening the above approaches would be to build on the extensive arrangements for supervisory cooperation that already exist among the agencies in Finland, the Nordic area, and in the EU more generally.

4. ***While Finland demonstrates a high degree of compliance with the international standards and codes in the areas of payment systems, insurance, and transparency, there are some deficiencies as regards compliance with certain of the banking supervision and securities standards.***

- The three ***payments systems*** in Finland that are designated systemically important—the BOF-RTGS, the POPS, and the PMJ—fully comply with the requirements of the Core Principles for Systemically Important Payment Systems. There are some issues with the OM system for securities settlement as compared with the recommendations made for such systems by the CPSS-IOSCO Recommendations for Securities Settlement Systems. These will be addressed with the OM system’s move to real-time gross settlement in 2002.
- The ***insurance and pensions*** industry is supervised by the ISA, while the Ministry of Social Affairs and Health (MOSAH) is the licensing authority. The regulatory and supervisory arrangements demonstrate a high degree of compliance with the International Association of Insurance Supervisors (IAIS) Insurance Supervisory Principles and supervisory capacities are generally adequate for the current market environment. More demanding market circumstances will require upgrading supervisory procedures and practices regarding investment analysis. It is recommended that licensing authority (granting and revocation) be transferred from MOSAH to the ISA and that a legal basis be given for early intervention for life company solvency.
- A high degree of ***transparency*** and openness characterizes Finland’s approach to financial regulation and supervision, which conforms in most respects to the Code of Good Practices on Transparency in Monetary and Financial Policies.¹ Operational transparency could, nevertheless, be strengthened by improving transparency of the deposit insurance schemes and organizing the considerable volume of information to make it more convenient to use.

¹ The transparency of monetary policy was not assessed by the team as the Bank of Finland is a member of the European System of Central Banks and no longer conducts independent monetary policy.

- While the essential conditions for effective *bank supervision* are generally in place and are being administered satisfactorily, certain essential criteria were assessed as being materially noncompliant with the Basel Core Principles (BCP). The weaknesses are primarily associated with the ability and power of the supervisor to take prompt remedial action to address compliance with laws as well as safety and soundness; to establish criteria for reviewing acquisitions and investments; to enforce adequate loan loss provisions and reserves; and to control connected lending.
- The assessment of the *securities regulations* against the IOSCO Objectives and Principles of Securities Regulation identified a number of issues in common with the review of the BCPs, including issues related to: the independence of the supervisor; and the adequacy of inspection, compliance, and enforcement powers. In addition, in view of the thin market for certain securities in Finland, a high level of surveillance may be required to detect and prevent price manipulation of the stock index.

5. ***In view of the advanced stage of development of Finland's financial system, supervisory arrangements will need to meet and even exceed international standards.*** Priority needs to be given to legislating the early intervention powers of the FSA and the ISA, and to strengthening their independence and accountability. The dynamic structure of the Finnish financial services industry will increasingly require harmonization of regulatory and supervisory arrangements across different regulatory jurisdictions, both within Finland and more broadly in the Nordic and euro area. This will call for the speedy enactment of new legislation on the FSA, the ISA, and financial conglomerates, as well as for enhancing the existing cross discipline and cross-border cooperation among supervisors. The risk-management systems of the major financial conglomerates will also need to keep pace with their expanding cross-product and cross-border activities.

SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. FINANCIAL SYSTEM OVERVIEW

A. Financial Institutions and Markets

6. *Finland has a well-managed financial sector in which credit institutions, particularly the deposit banks, and insurance and pension-insurance companies are the most important institutions* (Table 1). Credit institutions (the EU designation) include commercial banks, cooperative banks, and savings banks. With the exception of the amalgamated cooperative bank group,² the savings and cooperative banks represented less than 10 percent of the loan market in 1999. The most important segment of the insurance market is pension insurance, which plays a distinctive and important role through the management of the mandatory earnings-related pension system. The system is concentrated with three large groups maintaining important presence through ownership of institutions in all segments of the financial markets.

7. *Three groups, which have significant cross-segment ownerships and alliances, dominate the financial sector in Finland.* Their banks' market shares are illustrative. Merita Pankki, the Finnish Bank in the Nordea Banking Group, has about 41 percent of the deposit and domestic loan markets. Leonia Pankki, the bank in the Finnish Sampo-Leonia financial conglomerate, which has recently (April 1, 2001) been reorganized as the Sampo Group, a bank holding company structure, has about a 20 percent share of the domestic loan market. The Okobank Group, a group of 244 cooperative banks (and a commercial bank acting as the group's central bank) as of year-end 2000, has about a 26 percent share of the domestic loan market. The first two of these groups are pursuing a strategy of Nordic and, to a lesser extent, Baltic expansion. The cooperative bank group is retail-market oriented.

8. *Privately managed statutory occupational pension schemes are the distinctive feature of the Finnish insurance and pensions sectors.* The schemes, which are partially funded, cover all private sector workers and are integrated with public social security. The schemes are managed by pension insurance companies or special pension institutions and are the most important segment of the insurance business (see Table 1).

9. *State ownership of financial institutions remains important* (Table 2). The Finnish government owns 40 percent of the Sampo-Leonia Group, and retains shares in the HEX Group. The Swedish government owns 18 percent of the Nordea Group. There is fairly significant cross ownership of financial institutions by banks and insurance companies.

10. The *Finnish securities industry* consists of HEX Plc, a limited company holding the Helsinki Exchanges (which include a market operating under rules for trading securities, a market operating under rules for trading derivatives, and clearing operations for derivatives), a technology company eHEX, a central securities depository, clearing operations for securities, approximately 50 investment firms, certain remote exchange members and 25 fund management companies. Equity trading on the HEX is dominated by Nokia, which represented 70 percent of market capitalization at the end of 2000.

² Members of the group are mutually liable for each other's debts and commitments.

Table 1. Finland: Financial Sector Overview, December 1999

	Number of Institutions	Financial Sector Assets (Billion €)	Assets (Percent)	Banks' Loan Market Share (Percent)	Investment Management Companies' Market Share (Percent)	Financial Sector Assets (As percent of GDP)
Credit institutions		149.0				123
Deposit banks		120.0				99
Commercial banks	9	87.9	39.9	62.2		72
<i>Of which</i> Merita Bank				41.0		
Leonia Bank Group				19.5		
Savings banks	39	11.0	5.0	5.4		9
Cooperative banks 1/	287	21.1	9.6	28.0		17
<i>Of which</i> Okobank Group 2/		10.8	7.3	26.1		
Domestic nonbank credit institutions 3/	15	18.0	8.2			15
Foreign credit institutions' branches	18	11.0	5.0	4.4		9
Insurance corporations		60.8				50
Nonlife insurance	36	11.5	5.2			9
<i>Of which</i> Pohjola-yhtymä		2.9	1.3			2
Sampo		1.7	0.8			1
Vahinko-Pohjola		1.5	0.7			1
Life insurance	14	16.0	7.3			13
<i>Of which</i> Merita		3.6	1.6			3
Henki-Sampo		3.4	1.5			3
Henki-Pohjola		2.2	1.0			2
Pension insurance	6	33.3	15.1			27
<i>Of which</i> Varma-Sampo		14.1	6.4			12
Ilmarinen 4/		11.5	5.2			9
Eläke-Tapiola		3.8	1.7			3
Investment management companies 5/	25	10.3	4.7			8
<i>Of which</i> Merita FMLtd. 6/					29.9	
Leonia MM FMLtd. and Leonia FMLtd.					10.0	
OP-Rahastoyhtiö Oy 7/					13.9	
Other					46.2	
Total		220.1	100.0	100.0	100.0	181.3
<i>Memorandum items:</i>						
<i>Group shares in GDP, end 2000</i>						
Merita Bank Group 8/		61.1				46.4
Sampo-Leonia 9/		32.8				24.9
Okobank Group 10/		27.1				20.6

Sources: Insurance Supervisory Authority, *The Insurance Companies, 1999*; Financial Supervision Authority, *Annual Report, 1999 Sampo 2000 Annual Report*; *Okobank Group Annual Report, 2000*.

1/ Cooperative banks include the 244 banks of the amalgamated group cooperative and 43 local cooperative banks.

2/ The amalgamation of cooperative banks.

3/ Includes finance companies, mortgage banks, investment banks, and other special credit institutions.

4/ Ilmarinen has a 40 percent stake in Pohjola, which has a loose alliance with Okobank.

5/ Net asset value.

6/ FMLtd. = Fund Management Ltd.

7/ A subsidiary of Okobank Group Central Cooperative.

8/ Includes Merita Bank Group and Merita Real Estate.

9/ Consolidated banking, investment services, and insurance assets at end-2000.

10/ End-2000 assets for Okobank Group which comprises 244 member cooperative banks, their central institution, the Okobank Group Central Cooperative with its subsidiaries, the largest of which is Okobank, a commercial bank which is also the group's central bank. Okobank's subsidiaries include the Okobank Finance Company, OP-Financce Ltd. Loan share is of euro-denominated credit.

Table 2. Finland: Ownership Structure of Financial Sector, December 2000
(In percent)

Shareholders of the Three Largest Banks by Country and Type	Ownership Shares (Percent)	Shareholders of Insurance Companies 1/	Ownership Shares (Percent)	Securities Market	Ownership Shares (Percent)
Merita Bank/Nordea Group 2/	100.0	Sampo	100.0	HEX Group	77.7
Finnish	16.4	Government	41.0	OM Gruppen AB	15.6
Public	6.2	Deposit banks	0.0	Sampo Insurance Corporation	12.1
Institutions	10.2	Foreign	27.0	Merita plc and Merita Bank	11.3
Swedish	39.1	Varma-Sampo Mutual Pension Insurance Company	13.0	OKO Bank Group	8.9
Public	2.1	Kaleva Mutual Insurance Company	3.0	Bank of Finland	7.0
Institutions	18.8	Other	16.0	OKR Issuers	6.9
State	18.2			Evli Group	5.8
Danish	18.0	Pohjola	100.0	Government (State Treasury)	4.5
Public	4.0	Foreign	26.0	Pohjola Insurance Group	3.7
Institutions	14.0	Ilmarinen Mutual Pension Insurance Company	32.0	Pension Insurance Ilmarinen	1.9
International	26.5	Suomi Mutual Life Assurance Company	12.0		
		Amalgamation of the Cooperative Banks	9.0	Total numbers of owners	153
		Other	21.0		
Sampo-Leonia Group 3/					
Sampo-Leonia Plc.	100.0				
State	40.2				
Insurance companies	14.7				
Listed companies	6.1				
Others	38.8				
OKOBANK Group 4/	100.0				
OKOBANK	41.3				
Member cooperative banks	24.2				
External	34.5				

Sources: Bank of Finland and Financial Supervision Authority.

1/ Only the insurance companies where there are significant concentrations of ownership are shown. Sampo and Pohjola between them held 51 percent of industry assets.

2/ The Nordea group in Finland owns Merita Bank, Merita Life Insurance Company, Merita General Insurance, Merita Real Estate (recently merged with Merita Bank) and Partita, an investment firm.

3/ Sampo-Leonia plc, a holding company formed in April 2001, has as subsidiaries Sampo Bank plc, Sampo Life Insurance Company Ltd, Mandatum Bank plc, Sampo Fund Management Ltd, Mandatum Asset Management Ltd, Sampo Insurance Company Ltd, and Sampo Industrial Insurance Company Ltd. Sampo Life works in close cooperation with Varma-Sampo Mutual Pension Insurance Company, the largest pension insurance company, and Kaleva Mutual Insurance Company.

4/ Okobank Group contains, in addition to the 244 member cooperative banks and the commercial bank, Aurum Life Assurance Company, OP Fund Management Company, Okobank Group Mortgage Bank plc and Okobank Group Mutual Insurance Company.

B. Regulatory Framework for the Financial System

11. ***The general principles and characteristics governing legislation for the financial system are determined by the Finnish Constitution.*** In addition, the laws are governed by EU institutions and directives. Finland has a codified legal system. Constitutional law and its interpretation by the Constitutional Committee of Parliament have played an important role in the internal debate on defining supervisory authorities.³

12. ***The framework governing regulation of the financial system assigns authority for legislation and licensing to a government ministry, and prudential and conduct-of-business supervision to independent supervisory authorities.*** With the exception of the insurance and pensions sector, the formulation of legislation and licensing authority in the financial system rests with the MOF, and the supervisory authority is the FSA, an independent agency established under the administrative umbrella of the BOF in 1993. The insurance and pensions industry is regulated by the MOSAH and supervised by the ISA, which was established in 1999 as an independent agency under the auspices of the Ministry. The Act on the FSA was modified in 1999 when the ISA was created, to give the two authorities a near identical Board of Directors, in order to ensure cooperation between the two authorities.

13. ***The BOF has the status of a national central bank in the European System of Central Banks (ESCB).*** The Bank of Finland Act, 1998, gives the BOF responsibility for the oversight of payment systems in line with this status. The remit of the BOF also includes financial stability and liquidity management functions. The BOF is accountable to the Parliamentary Supervisory Council comprising members of different parties of Parliament.

14. ***The Helsinki Exchanges are self-regulatory organizations*** but rules of the exchange are approved by the MOF, and listing particulars and public offering prospectuses are approved by the FSA in accordance with rules specified by the MOF. The Ministry is also responsible for the authorization of exchanges, clearing organizations, investment firms, and fund management companies.

³ Article 2, paragraph 3 of the Finnish Constitution requires: "The exercise of public authority must be based on law," that is, the discretionary powers of public bodies must be defined in law. Article 80 of the Constitution permits delegation of "the right to lay down legal rules in defined matters, if it is justified by special reasons... and the scope of such delegation precisely delimited," that is, legislative (or rule-making) power must be carefully delegated and precisely delimited. In practice, these provisions have created some difficulties to the drafters of laws delegating discretionary powers for intervention to the supervisory authorities. Ways to handle such difficulties are under active consideration in view of the recognized need to allow for elements of discretion as part of effective supervisory arrangements.

II. MACROECONOMIC RISKS AND FINANCIAL SECTOR EXPOSURES

A. Macroeconomic Environment

15. *Following a severe recession and banking crisis in the early 1990s, Finland has seen several years of rapid economic growth since 1994* (Table 3). GDP grew by an average of 5 percent during 1996-2000, with inflation rates in the range of 1-3 percent. A large depreciation set the stage for an export-driven recovery that has transformed Finland into an increasingly open economy. This development was fostered by a dynamic information and communication technology (ICT) sector, which has contributed an average of 2 percentage points to annual GDP growth in the past three years. In 2000, the sector, dominated by Nokia, accounted for 9 percent of total value added, one-quarter of industrial production, and 30 percent of exports, having overtaken the traditional forest industry on all three measures.

16. *The recovery process was mirrored in an improvement in private sector balance sheets* (Tables 3 and 4). Growing current account surpluses led to a reduction in Finland's net external debt ratio from over 30 percent of GDP in 1996 to less than 15 percent in 2000. Household indebtedness, which had risen to more than 80 percent of disposable income at the outset of the crisis, fell to around 60 percent in the mid nineties, and has increased slowly since 1998, accompanied by steady growth in financial assets. Helped by strong competitiveness, Finnish firms generated steadily rising gross operating surpluses, and debt ratios, which had peaked in 1992, where almost halved by 1997. Since then, debt ratios in the nonfinancial corporate sector have remained broadly stable, with some increase since 1998. In recent years, surpluses in the corporate sector have been boosted by high productivity growth in the ICT industry, with Nokia, in particular, providing financing (both in the form of venture capital and vendor financing) rather than having to raise funds for its own operations.

17. *Economic growth in 2000 was boosted by an exceptionally favorable international environment and strong Finnish competitiveness, but slowed noticeably in 2001*. On the back of a weak euro, the foreign contribution to Finnish growth reached a record, accounting for half of overall GDP growth of 5¾ percent. As a result, the current account surplus reached 7½ percent of GDP. Both energy price developments and a depreciating euro also led to some acceleration in consumer price inflation to 3 percent (on a harmonized Eurostat basis)—some ¾ percentage points higher than the euro-area average. Since late 2000, exports and industrial production have slowed noticeably in a weaker international environment.

18. *Stock market prices as measured by the HEX index have followed world market trends, and have exhibited high volatility*. The index peaked in May 2000, at 18,304, and had declined to 8000 by March 2001. On the close of trading following the World Trade Center bombing on September 11, 2001 the index reached a low of 5584. Real estate price pressures, which had been significant throughout 2000, moderated early in 2001.

Table 3. Finland: Main Economic Indicators, 1996-2000

	1996	1997	1998	1999	2000
Real economy (change in percent)					
Real GDP	4.0	6.3	5.3	4.0	5.7
Domestic demand	2.9	6.0	5.8	2.0	4.0
Foreign contribution to growth	0.3	2.0	1.0	1.6	2.7
CPI harmonized (average)	1.1	1.2	1.3	1.3	3.0
Unemployment rate (in percent)	14.6	12.6	11.4	10.3	9.8
Gross national saving (percent of GDP)	20.7	24.1	25.0	25.2	27.5
Gross domestic investment (in percent of GDP)	16.6	18.5	19.3	19.2	20.1
Net external debt (in percent of GDP)	31.6	26.4	25.3	16.6	11.7
Public finance (percent of GDP)					
General government balance	-3.2	-1.5	1.3	1.9	6.9
Structural balance 1/	0.3	0.1	2.0	2.5	6.9
Structural primary balance 1/	1.8	2.1	3.8	4.1	6.2
Money and credit (end of year, percentage change)					
M3 (Finnish contribution to euro area)	-1.3	7.2	2.5	5.8	-3.8
Domestic credit	-0.7	1.0	11.9	10.6	5.9
Interest rates (percent)					
3-month money market rate (nominal average, in percent)	3.6	3.2	3.6	3.0	4.4
Deflated by core inflation index	3.5	2.0	2.2	1.8	2.3
10-year government bond yield (nominal average, in percent)	7.1	6.0	4.8	4.7	5.5
Deflated by core inflation index	6.9	4.7	3.4	3.6	3.4
Balance of payments (percent of GDP)					
Trade balance	8.9	9.5	9.7	9.5	11.3
Current account	4.0	5.6	5.6	6.0	7.4
Exchange rate					
Exchange rate regime			EMU Member		
Nominal effective rate (increase in percent)	-2.9	-2.5	0.0	-2.7	-5.2
Real effective rate (increase in percent) 2/	-7.5	-5.8	-1.4	-3.8	-4.7
Memorandum item:					
Core inflation (harmonized, excluding energy and seasonal food)	0.1	1.2	1.4	1.1	2.0

Sources: Bank of Finland, the Finnish Bankers' Association, Statistics Finland, and staff estimates.

1/ For 2000, excludes exceptional revenues from one-off dividend payments and taxes on extraordinary capital gains, which are treated as cyclical, and estimated at about 1.8 percent of GDP.

2/ Based on relative normalized unit labor costs.

Table 4. Finland: Indicators of Financial Vulnerability in Major Sectors, 1996-2000

Key Financial Indicators	1996	1997	1998	1999	2000
Households					
Total household debt (in percent of GDP)	32.8	30.7	30.5	31.5	31.2
Structure of households' financial assets (in percentage of total)					
Deposits	33.1	29.8	27.6	22.3	21.0
Bonds	2.8	2.2	1.9	0.7	0.4
Equities 1/	54.6	57.9	58.9	66.6	66.3
Of which quoted shares	5.9	7.4	8.3	14.4	14.1
Of which mutual funds	0.6	0.8	1.3	2.0	2.6
Insurance technical reserves 2/	8.6	9.5	10.6	9.6	11.5
Debt-to-income ratio	61.1	57.5	58.5	61.2	64.1
Nonfinancial corporations					
Gross debt (in percent of GDP)	53.7	48.7	46.2	48.2	53.2
Debt-to-equity ratio 3/	97.6	84.1	65.6	67.2	...
Debt-to-equity ratio 4/	73.1	60.9	57.9	60.2	74.6
Government					
General government debt (EMU definition, in percent of GDP)	57.1	54.1	48.8	46.9	44.0
Central government debt (in percent of GDP)	67.1	65.3	60.2	56.0	48.0
Banking sector					
Outstanding credit to nonfinancial sectors (percent change) 5/	-0.7	1.0	11.9	10.6	5.2
Of which housing loans (percent change) 5/	1.3	3.5	13.1	15.8	10.6
Housing loans in percent of total lending to nonfinancial sectors 5/	33.4	34.2	34.5	36.2	37.7
Asset quality					
Nonperforming loans/total loans (in percent) 6/ 7/	2.8	1.8	1.2	1.0	0.6
Capital adequacy					
BIS capital asset ratio 7/	11.4	11.9	11.5	11.9	11.6
Equity/total assets (percent) 7/	3.7	4.2	4.9	5.3	5.5
Profitability					
Interest rate margin 5/ 8/	4.1	4.3	4.0	3.5	4.3
Net interest income as a percentage of total income 7/	58.1	62.2	61.8	62.4	61.0
Return on equity (percent) 7/	11.8	17.7	25.8	19.4	22.4
Return on assets (percent) 7/	0.6	0.9	1.2	1.0	1.2
Liquid assets/total assets (percent) 7/	21.9	22.2	19.9	20.3	16.0
Off-balance-sheet liabilities/total assets (percent) 7/	15.1	15.5	16.4	16.5	18.4
Stock market					
Change in stock market index (in percent, e.o.p.)	37.7	35.1	58.8	162.0	-10.6
Change in housing price index (in percent, e.o.p.)	19.0	21.9	9.5	16.2	0.1

Sources: Bank of Finland, The Finnish Bankers' Association, Financial Supervision Authority, Statistics Finland, and staff estimates.

1/ Includes certain home ownership, evidenced by securities that reflect the ownership of individual units in multifamily owner-occupied housing. This helps explain the high proportion of equities in household portfolios.

2/ Funds related to individual voluntary pension schemes and life assurance. Funds related to the mandatory and collective pension insurance system are classified as general government (social security) savings.

3/ Data are provided by Statistics Finland and the estimates are based on book value of equity.

4/ Defined as total debt as a percentage of common equity. Data source is Worldscope database. Estimates are based on accounting or book value of equity.

5/ Data provided by Bank of Finland (BOF) and are based on the "Financial Market Statistical Review," BOF. Estimates are based on unconsolidated data, including foreign banks' branches in Finland, excluding foreign branches of Finnish banks.

6/ Based on net nonperforming loans (i.e., net of other specific loan loss provisions which are deducted from total assets and are recorded as an expense). Loans are defined as loans to the public and public sector entities plus loans to credit institutions.

7/ Estimates are based on prudential, consolidated, and group level data on domestic banks, collected by the FSA.

8/ Average lending rate minus average deposit rate.

19. *The macroeconomic policy mix in recent years was characterized by fiscal consolidation in an environment of accommodative monetary conditions.* Sound fiscal policy, anchored on expenditure restraint, moved the general government balance from a deficit of 7 percent of GDP in the midst of the recession to a surplus of the same size in 2000. As a result, gross (consolidated) public sector debt fell from a peak of nearly 60 percent of GDP to 44 percent of GDP in 2000. Central government debt of close to 50 percent of GDP remains high, however, from a historical perspective, and the government targets a further reduction with little anticipated effects for the financial sector (Box 1).

Box 1. Central Government Debt Management

Central government debt has fallen substantially in recent years, but remains high from a historical perspective at close to 50 percent of GDP. To lower the cost of debt service, while maintaining liquidity at all times, the government aims to reduce its indebtedness to around 20 percent of GDP over the medium term.

The overall debt strategy is prudent, limiting both interest rate risk (floating rate debt is 17–25 percent of total debt) and refinancing risk (short-term liabilities on a remaining maturity basis are not to exceed 25 percent of total debt). Exchange rate risk is also limited, as debt is issued predominantly in euros, and the share of outstanding foreign currency denominated claims is only 15 percent. Liquid assets are mainly invested in certificates of deposit (CDs), foreign government securities, and commercial paper, subject to limits according to the counterparty's rating. At the same time, short-term liquidity is managed by issuing treasury bills. Investment in CDs (currently equivalent to about EUR 2 billion) is expected to be gradually reduced. The counterparties to the transactions are domestic and increasingly foreign (mainly euro area) banks.

While the State Treasury is in charge of the government's liquidity management on an operational basis, the asset and debt management guidelines (e.g., the share of floating rate debt) are formulated in two separate departments within the MOF. The Treasury uses a cash management forecasting system, linked to individual budgetary units, that allows a fairly accurate prediction of liquidity needs over a three-week period. In this setting, and an environment of budget surpluses and easy access to liquidity in the wider Euro-area market, reserves (hovering at around EUR 5–10 billion, or 8–16 percent of outstanding debt) appear high. In particular, the need to issue treasury bills should now be much lower. A full integration of the state's asset and debt management—as currently discussed within the government—may yield efficiency gains in this regard.

The anticipated reduction in outstanding government bonds is not expected to have noticeable implications for the financial market. Spreads over German long-term bonds are already low compared with those in other small Euro-area countries, and the collateral function can be performed by bonds issued by any member country government. Similarly, a prospective reduction in liquid assets, and particularly CDs, is not expected to have a significant impact, as their share in banks' balance sheets is not large.

B. The Financial Environment

20. ***By virtually all measures, the Finnish banking system is at present well capitalized and profitable*** (Table 4). The aggregate equity-to-asset ratio for the banking system has posted steady improvement in recent years reaching about 6 percent at the end of 2000. This capitalization level exceeds banking system averages in the EU. Consistent with a strong Tier I capital position, the Finnish banking system's BIS capital adequacy ratio of 11.6 percent is among the highest in the euro area. The capital adequacy position of Finnish banks is reinforced by a favorable credit climate. Nonperforming loans (NPLs) have been declining since at least 1995. At year-end 2000, the NPLs of Finnish banks were reportedly only 0.6 percent of aggregate loan values.⁴

21. ***The three systemically important banking institutions are also adequately capitalized and profitable.*** Their Moody's ratings range from Aa3 to A2. Although there is some variation in the sectoral distribution of their loan portfolios, they have been expanding both functionally and cross-border, mainly through mergers in the Nordic region. Their risk management systems will need to keep pace with this expanding range of activities.

22. ***After suffering heavy losses in the early 1990s, Finnish banks regained profitability in 1996.*** According to Finnish Bankers' Association statistics, banks posted a 19.4 percent return on equity in 1999, and a 22.4 percent return in 2000. Profits in 2000 were buoyed by a number of factors including widening interest rate margins, and a favorable credit environment with negligible loan losses. Assisted by growth in euro-denominated lending, and sharp increases in non-interest related bank income, bank income grew strongly in 2000, after being flat for most of the last five years.

23. ***Bank restructurings in the 1990s and the widespread adoption of new banking technologies have made Finnish banks among the most cost efficient in the EU.*** Ranked by return on assets, return on equity, or by operating cost to operating income ratio, the Finnish banking system compares favorably to many European banking systems. As of end 2000, banks' after-tax return on equity was over 22 percent; it exceeded 20 percent for all major categories of Finnish deposit-taking institutions.

24. ***The liquidity position of the Finnish banking system is relatively strong.*** Banks retain a significant portion of their balance sheets in very liquid assets or marketable debt instruments. On the funding side of the balance sheet, Finnish banks fund almost half of their assets with core deposits and 20 percent with marketable debt securities. On a maturity gap

⁴ Finnish regulations require credit institutions and financial holding companies to classify assets as non-performing if the interest payable, or repayment of the principal, or any part thereof (whether interest has been paid or not), has been in arrears for three months. Assets may be also recorded as non-performing before the three-month period has elapsed. Among other provisions, the regulation also requires that zero-interest assets (resulting from debt restructuring) be included in the non-performing asset report.

basis, in maturities under one year, the banking system is short-funded; beyond the one-year maturity band, the banking system has substantially more maturing assets than liabilities. Virtually all Finnish bank deposits and lending are conducted using floating rate instruments so mark-to-market interest rate risk exposures are minimal.

25. *With the start of monetary union in 1999, liquidity management benefits from the money market of the euro area.* Its major segments include unsecured deposits, secured repos, derivatives, and short-term securities. The Eurosystem of the European Central Bank (ECB) provides liquidity on the basis of the Euro-area's global refinancing needs, and the relatively small size of Finnish institutions means that they are generally price takers in Euro-area markets. The euro area cash and derivatives markets have achieved a high level of unification and standardization. Liquidity has also improved in the repo segment of the money market, relative to the situation in the smaller domestic markets, thus improving the scope for liquidity management for a country such as Finland.

26. *Household lending is by far the most important use of bank credit in Finland* (Table 5). Residential mortgages account for 71 percent of bank household lending and 28 percent of their assets. Residential mortgages are predominantly floating rate and historically losses on these mortgages have been very low. About 15 percent of bank credit is used by domestic nonfinancial corporations, of which roughly 10 percent fund ICT-related businesses, and about 2 percent fund commercial mortgage firms and construction activities. Subsequent to the introduction of the euro, Finnish banks carry relatively little foreign exchange lending or foreign exchange exposure.

Table 5. Finland: Composition of Aggregate Bank Lending by Sector, 1997-2000

	1997	1998	1999	2000
Total household lending (€ billions)	27.1	29.4	32.8	35.4
Residential mortgages (€ billions)	17.4	19.6	22.7	25.1
Percentage of bank household lending	64.2	66.7	69.2	70.9
Percentage of bank total assets	23.7	26.3	27.0	27.6
Loans to domestic government and government-owned enterprises (€ billions)	1.6	2.1	1.2	1.8
Percentage of bank assets	1.4	1.9	1.0	1.4
Loans to domestic nonbank financial institutions (€ billions)	4.2	4.9	5.8	5.7
Loans to domestic nonfinancial corporations (€ billions)	15.5	18.2	19.2	19.1
Expressed as percent of bank assets	13.6	15.9	16.8	14.9
of which ICT-related lending	1.7	2.4	2.1	...
Commercial mortgage and construction	0.9	0.9	0.8	1.0
Forest products related lending	1.0	1.1	0.9	1.0
Foreign currency lending (€ billions)	2.7	3.0	1.4	1.2
Percentage of bank assets	2.4	2.6	1.2	0.9

Sources: Bank of Finland, FSA, and staff estimates.

27. ***The solvency positions of the large pension institutions and insurance companies are strong.*** Smaller nonlife companies are less strongly capitalized but still have satisfactory solvency ratios. In 2000, solvency margins⁵ were 23 and 70 percent, respectively, of total liabilities of life and nonlife insurance companies. Pension insurance companies' solvency margin was 23 percent of total liabilities and their greatest investment exposure is to government debt securities. The asset portfolios of the average life insurance company is about 8 percent real estate, 35 percent equities, and 55 percent debt, a large part of which are government bonds. The average nonlife insurance company has a portfolio that is about 9 percent real estate, 66 percent equities, and 22 percent debt, again primarily government bonds.

28. ***Independent nonbank, non-insurance credit institutions (finance companies, credit card companies, and investment banks) are small and pose no systemic risk to the financial system in Finland.*** Any disruptions to Finland's domestic securities markets would be problematic but would not prevent systemically important institutions from hedging on other markets.

C. Stress-Testing Exercises

29. ***A series of stress-testing exercises performed by the BOF, in cooperation with the FSA and the ISA, quantify the potential exposures of the financial sector to macroeconomic risk factors.*** The stress tests focused on the three largest financial groups and included exposure estimates associated with export sector, equity and real estate shocks (scenarios 1-3) and a combined test scenario that assumed three years of zero growth (scenario 4). Stress test details are discussed in Box 2. In view of the predominant use of floating interest rate instruments in Finland and very low exchange rate exposures of Finnish financial institutions, stress tests of interest rates and exchange rates are not very relevant in assessing the exposures of Finnish financial institutions to macroeconomic risk factors.

30. ***The stress test results suggest that the financial sector in Finland is currently fairly robust.*** The individual stress scenario (scenarios 1-3) estimates suggest only modest losses that would have little effect on the major institutions' solvencies or their ability to regain profitability after the shock.

- ***The relatively small effect of the drop in ICT exports reflects the Finnish banking system's focus on household lending.*** Direct ICT exposures in banks and insurance companies are reportedly small, as much of the credit to this sector has reportedly been in the form of trade credits or direct investments by Nokia. Indirect effects on banks' portfolios have been recognized in the stress test as the loss estimates exceed those that could be generated by these banks' ICT exposure alone, but the banking groups' assets lose less than 0.6 percent of their value. The aggregate data suggest similarly insignificant exposures in the insurance subsidiaries.

⁵ The solvency margin is the additional capital that insurance companies are required to hold as cover against adverse events whose effects exceed their usual estimates.

Box 2. Stress Tests Results

The BOF, FSA, and ISA together performed a series of stress tests to analyze the macroeconomic and financial sector implications of potential shocks to the Finnish economy. The macroeconomic simulations were carried out on the basis of the BOF's BOFMINI model, a condensed version of the BOF's comprehensive macroeconomic forecasting model. The nature of the shocks reflects the current shared assessment of the main macroeconomic risks. Their magnitudes, while necessarily arbitrary, were chosen in the context of past observations, striking a balance between shocks that are both severe and still within plausible ranges. The financial sector implications were assessed using a BOF model of aggregate bank loan losses and balance sheet information of the three main financial conglomerates.

Four stress scenarios were analyzed: (1) a drop in exports of the ICT sector to end-1998 levels, implying a 33 percent decline, and a 10 percent fall in total exports, relative to 2000; (2) a stock price adjustment to end-1998 levels corresponding to a fall by 20 percent relative to end-2000; (3) a decline in real estate values to end-1998 levels, implying a fall in residential and commercial real estate values by 10 and 15 percent respectively; and (4) a combination of the above shocks with a larger fall in stock prices (by 40 percent) and a further decline in total exports, by 5 percent in 2002 and 2003, to generate zero GDP growth in the current and following two years. All shocks were assumed to be permanent, with the respective variables adjusting immediately, and remaining at the depressed level throughout the simulation period. The stress test estimates were mark-to-market losses, and financial institution solvency was assessed on a hold-to-maturity accounting basis.

Bank and insurance capital calculations differ in some important respects. On the individual level, insurance capital includes hidden reserves, which are a form of capital that is not recognized in the insurance companies' equity account. Hidden reserves can be substantial for some Finnish insurers. In addition, insurance companies can include long-term subordinated debt in their capital base. This source of capital is removed in consolidation at the financial group level if a related bank provides the subordinated debt funding.

In the simulations, the export shock, though dampened by a parallel decline in imports, lowered investment via an increase in real interest rates (due to lower inflation), and implied a strong immediate growth response of -3.2 percentage points. The stock and real estate price shocks decreased GDP by an annual average of 0.3 and 0.6 percent, respectively, between 2001 and 2003 via wealth effects on consumption and lower investment due to a higher cost of capital and a decline in residential investment, respectively. The macroeconomic impact, however, was relatively small on the basis of estimated elasticities, and making some allowance for the high concentration of stock market wealth. In contrast, the combined shock scenario was calibrated to result in zero GDP growth over three consecutive years. While unlikely, such a shock is not entirely implausible in the event of a substantial and prolonged weakening of international demand or Finnish competitiveness.

The resulting estimates for the individual stress scenarios (1 to 3) suggested only small losses to the financial sector, with little effect on solvencies. The insurance sector was more strongly affected by the assumed decline in stock prices, whereas the impact on the banking sector was larger under the export shock. Under the combined three-year shock scenario, with a larger stock price decline (scenario 4), financial institutions were severely strained, the decline in asset value representing 42 percent of equity in the aggregate. Even in these quite extreme circumstances, however, estimates suggested that they would likely remain solvent, especially if allowances are made for behavioral adjustments (which are not assumed in the simulations), and income from continuing operations.

While economic developments subsequent to the Finland FSAP mission have been more negative than was anticipated in March 2001, they remain within the stress parameters. The HEX index has recorded lows very close to the simulated stock price stress (a 70 percent decline from the peak index value); the other components of the simulated stress scenarios remain pessimistic relative to current economic projections.

- ***The impact of the equity shock (a 20 percent decline from March 2001 price levels and a cumulative drop of almost 70 percent from peak index levels) on banks is also modest, though the impact on insurance companies is significant reflecting more substantial equity exposures in insurance.*** The equity shock reduces the value of banks' assets by only 0.2 percent given the low bank exposures to equity and real estate share participation. However, the results identify the importance of equity exposures in the conglomerates' insurance subsidiary portfolios, the market value of their assets falling by 5.8 percent.
- ***The mild losses associated with the real estate sector shock are explained by the importance of residential mortgages in lending portfolios.*** Losses associated with direct and subsidiary bank exposures to real estate are capable of explaining most of the estimated losses. Estimates of indirect loan losses on residential real estate are minimal in the stress test, as the historical residential loan loss rates have been small in Finland. Larger losses associated with commercial or residual real estate lending would likely remain controlled. Total losses do not exceed 0.4 percent (banking conglomerate) and one percent (insurance).

31. ***The combined stress test, sufficient to generate zero growth in the current and two following years, would test the solvency of the major financial institutions.*** The banks would be strained in this scenario, but their losses would be less than 40 percent of equity. It is of course possible that loan loss experiences would be more severe than those projected in these estimates. The stress test assumes a precipitous decline in economic conditions, and applies a mark-to-market methodology that takes account of future losses. In practice the investment environment would be expected to deteriorate progressively and the accounting impact on balance sheets would be less than the mark-to-market valuations, allowing banks and insurance companies more time to adjust to the shocks. For example, the BOF estimates that bank profits from continuing operations would in large part offset the loan losses in a dynamic simulation context.

32. ***The combined stress test would represent significant challenges for the insurance subsidiaries of the financial conglomerates.*** These insurance companies have significant exposures to equities and real estate. While the hidden reserves of these companies would be exhausted in all but one group, and asset values would record substantial declines, solvency analysis by the ISA indicates that all of the firms would satisfy minimum solvency criterion under this scenario. One of the insurance firms would be in severe distress, yet its solvency position reportedly would not mandate its liquidation.

33. ***The stress test results suggest that the conglomeration of insurance and banking may increase the risks to a bank in a conglomerate group relative to the risk of a stand-alone bank***—at least with regard to the specific economic shocks that are analyzed in this exercise. Banks in this example have little direct exposures to commercial real estate and equities whereas insurance companies have significant exposures to both asset groups. There is always a potential that the severe losses on the insurance side could raise reputational risks for the banking member of the conglomerate.

34. ***The risks to the economy from adverse financial sector developments also appear fairly low in the current environment.*** First, with the adoption of the euro, foreign exchange exposures have been greatly reduced, limiting both the risks and implications of a large exchange rate depreciation that contributed to the severity of the crisis in the early 1990s. Second, Finnish firms and households have significantly improved their solvency positions, providing some cushion in the event of potential income losses. Third, with increased access to international financial markets and equity financing, Finnish firms have greatly reduced their reliance on domestic bank financing. Indeed, the direct impact of financial sector problems would mostly be felt by small- and medium-sized enterprises and households, suffering from a reduced availability of funds.

III. REGULATORY, SUPERVISORY, AND TRANSPARENCY ARRANGEMENTS AND FINANCIAL SAFETY NETS

35. The adequacy of Finland's regulatory, supervisory, and transparency arrangements in the financial system have been assessed against the main international codes and standards: the Basel Core Principles for Effective Banking Supervision; the IOSCO Objectives and Principles of Securities Regulation; the IAIS Insurance Supervisory Principles; the Core Principles for Systemically Important Payment Systems; and the Code of Good Practices on Transparency in Monetary and Financial Policies. Section II provides the summary assessments of observance of financial system standards and codes. The following provides a summary of key findings and the potential vulnerabilities identified by the assessments.

36. The general prerequisites for adequate supervision are largely in place. Finland possesses a well-developed and stable overall institutional and legal infrastructure, with modern actuarial, legal and accounting professions. Finland as yet has no specific legislation or regulation on mixed insurance-bank conglomerates; nevertheless, a cooperation agreement has been entered into on supervision between the ISA and FSA, and there are protocols with pan-Nordic supervisors. Finnish legislation on financial conglomerates is presently under preparation, and is expected to be in place in advance of directives from the EU.

A. Banking System

37. ***Within the current regulatory and supervisory framework, the FSA has limited independence as the responsibility for licensing and revocation of a credit institution's license remains within MOF.*** In addition, there is no authority explicitly charged with supervising the FSA with regard to the effectiveness and appropriateness of its official functions. The FSA has recommended that the focus of the oversight function of the Parliamentary Supervisory Council be redirected from administration to responsibility for evaluating the effectiveness of the FSA.

38. ***Certain essential criteria associated with the Basel Core Principles were found to have weaknesses.*** In particular, weaknesses were found in compliance with the Core Principles dealing with objectives, autonomy, powers, and resources; investment criteria;

loan evaluation and loan loss provisioning; connected lending; and remedial actions (see Section II, Chapter I).

39. ***Each of the weaknesses identified inhibit the power of the supervisor to take (or require a bank to take) prompt remedial action.*** The use of moral suasion has been the primary supervisory technique used by the FSA to have banks respond to regulatory and safety and soundness shortcomings in a timely manner. While moral suasion is an important and effective tool for the supervisor, the supervisor should also have available legislative discretion and empowerment to take discretionary action when required.

40. ***The FSA recognizes the need to take a more proactive approach to banking supervision.*** During the past year, the FSA has provided the MOF with a “wish list” of additional supervisory powers that it believes will assist it with achieving its objective. The type of early intervention powers will allow for supervisory action to be taken when moral suasion does not achieve the desired results and well before solvency is in question. Proactive supervision may require a stronger on-site supervision program.

B. Insurance and Pensions

41. ***The ISA has a range of legal instruments available for appropriate and proportional supervision of insurance and pensions, including early solvency intervention.*** Legal provisions and practices for the regulation are predominantly based on EU directives and requirements.⁶ The ISA is generally well and reasonably pro-actively managed, with clarity of objectives, priorities and strategy, and an open and supportive internal culture. The overall resources and supervisory “power” and credibility are commensurate with the current state of the pensions and insurance market in Finland, which displays high solvency and a still substantial degree of informal self-regulation. The supervisory capacities are generally adequate for that market; and these capacities would be strengthened through the application of a sophisticated risk analysis model.

42. ***The regulatory and supervisory arrangements for insurance and pensions are either fully or largely in compliance with IAIS Insurance Supervisory Principles.*** However, there are areas where supervisory and regulatory independence and accountability could be clarified by transferring the licensing authority to the ISA, and by providing a legal basis for the early intervention mechanism for life insurance solvency (see Section II, Chapter III). As the insurance market is getting more competitive, the supervisory resources and expertise are being strengthened through use of consultants and hiring of specialized staff.

⁶ The entry of Finland to the EU implied a degree of liberalization of the insurance market. In particular, ex ante approval of premiums was abolished, market entry of foreign providers became easier, and unit-linked insurance products were introduced.

C. Securities

43. ***The framework for the securities markets is well developed with satisfactory supervision and oversight of the markets, intermediaries and transactions by the FSA.*** The MOF exercises licensing authority and certain regulatory functions including approval of the rules of non-UCITS mutual funds and exchanges. Both the stock and derivatives exchanges have self-regulatory responsibilities and practical arrangements have been put in place to facilitate oversight. The IOSCO principles have been broadly implemented, with some weaknesses relating primarily to three areas: regulatory independence; sufficiency of regulatory powers; potential systemic financial risks related to short selling or the structure of market arrangements for equity settlements and trading allotments (see Section II, Chapter V).

44. ***The securities supervisory and regulatory arrangements would benefit from strengthening by enhancing the independence and enforcement powers of the FSA.*** The issues here include the transfer of the MOF's role as a regulatory and ultimate licensing authority to the FSA; providing the powers to the FSA so it does not need to approach the police to bring cases for manipulation, misleading disclosure, and fraud; the need for graduated remedies since the principal sanction of withdrawal of a license or trading termination may be too severe to serve as a practicable deterrent; and strengthening the FSA's legal basis to assist foreign regulators on enforcement issues. The rules for protecting clients in the event of insolvency of a market intermediary meet EU standards, but practical procedures have not been developed and, as elsewhere, improved bankruptcy legislation is desirable. Conditions in place with regard to disclosure, the treatment of investors, and accounting standards also could be enhanced.

D. Payment Systems

45. ***The payment systems comply with the Core Principles for Systemically Important Payment Systems.*** In Finland there are three payment systems which are designated as Systemically Important Payment Systems: the BOF's real-time gross settlement system (BOF-RTGS), the POPS system for express transfers and checks, and the PMJ system, which is used for retail payments. Of these, BOF-RTGS accounts for overwhelmingly the largest value of transactions, followed by the POPs and PMJ.

- The BOF-RTGS provides the functionality required of a real-time system, with immediate payment finality in central bank money. The BOF-RTGS is subject to on-going ESCB monitoring as to its effectiveness, reliability and risks, and high-level contingency requirements are placed on the system as a member of the TARGET system.
- The POPS system provides a real-time settlement facility for participants' customers. Agreed bilateral limits provide an effective control mechanism for credit risk.

- The PMJ system is used for retail payments between banks. The system operates on a bilateral netting basis between participants with settlement in central bank money.

46. *The securities settlement systems largely meet the requirements of the CPSS-IOSCO Recommendations for Securities Settlement Systems.* There are two securities settlement systems: OM in the case of equity-rated securities and RM in the case of nonequity rated securities. The RM system operates on a real-time gross settlement basis. In contrast, the OM system operates on the basis of a single daily batch securities settlement, while the underlying cash settlement is effected on a net basis. As a result, settlement for each participant relies on completion of the previous settlements. However, the system has arrangements in place to control the risk, including removing the trades of a failing party. The introduction of the planned real-time gross settlement system for OM transactions in 2002 would remove the residual risks in the system.

47. *Concerning the implications of future payment system developments for Finland:*

- Use of the Euro Banking Association's Euro I or STEP I end-of-day net settlement is unlikely to confer any particular advantage over the existing PMJ and POPS systems, and thus the Finnish payments system should not be much affected by these systems.
- The introduction of Continuous Linked Settlement facilities for settlement of the euro-leg of foreign exchange transactions would reduce TARGET (and BOF-RTGS) transaction volumes. The reduction in volumes could impact on RTGS pricing policy, and consequently on the competitive position of TARGET and local RTGS systems. Replacement of the existing decentralized TARGET system in the longer term with a centralized system would be expected to improve this cost position.
- A merger of the Finnish Central Security Depository with another securities depository could potentially impact on the BOF-RTGS by reducing the number of necessary RTGS payments per day per participant to those needed to fund the CSD cash account, compared to the present arrangements in the RM system, that require one RTGS payment per transaction.

E. Transparency of Financial Regulations

48. *Overall, Finland maintains an open and transparent approach to financial regulation and supervision that complies with the IMF's Code of Good Practices on Monetary and Financial Policies.* This philosophy of openness can be traced to at least three major factors:

- There is a tradition of consultation, both amongst regulatory and supervisory agencies, and with directly affected parties;
- Regulatory and supervisory requirements are generally codified by way of laws, regulations and guidelines that are placed on the public record;

- There is a freedom of information law. Under this law, which applies to all ministries and official agencies, information must be made available to the public unless specified criteria provided for in the law for withholding the information are satisfied.

49. *As a result of this environment of official openness, a large amount of information on financial regulation and supervision is available to the public.* The information is available through a range of channels, including official registers (of laws and regulations), official agencies' websites, official publications, and explanatory publications.

50. *Transparency in Finland could, nevertheless, be strengthened by better organizing the considerable volume of information available from the various Finnish financial agencies to make it more convenient to use.* For example, it would be helpful to be able to obtain the complete set of the laws, regulations, and guidelines for banking in Finland, organized in a way that reflects the structure of the overall regulatory framework, accompanied by explanatory material. As regards the frameworks and practices by which the relevant agencies give account, and are held to account, for the conduct of their responsibilities, the BOF, the FSA, and the ISA all publish informative annual reports, by which they give account for their activities and for developments during the year under review. However, the FSA is not subject to examination by the Parliamentary Supervisory Council, with regard to the conduct and effectiveness of its supervisory responsibilities.

F. Financial Safety Nets and Crisis Management

Deposit and other insurance arrangements

51. *Financial safety nets in Finland have been shaped by the recent financial crisis in the 1990s and by EU directives.* Deposit insurance is covered by the Deposit Guarantee Fund, security insurance by the Investor Compensation Fund, securities depository and clearing by the Central Securities Depository Fund, insurance compensation by the joint guarantee system of insurers, respectively. The voluntary Guarantee Fund of local cooperative banks and the Guarantee Fund of savings banks provide initial cover for small local cooperative and savings banks.

52. *Finland has a long history of adopting deposit insurance schemes,* with a voluntary scheme during the 1920s that became compulsory in the 1960s. In 1992, with the Finnish banking system in crisis, the Law on the Government Guarantee Fund was passed to enable the government to borrow to supplement the banks' own insurance scheme in the event of a crisis. In 1993, the Parliament adopted a resolution by which the Finnish state guaranteed the commitments of Finnish banks to depositors and other creditors under all circumstances. In 1995, the EU directive on deposit-guarantee scheme (94/19/EC) was transposed through a legislative amendment. The Finnish deposit guarantee scheme was revised at the beginning of 1998 with entry into force of amendments to the Act on Credit Institutions (1229/97) which limited the maximum amount of compensation per depositor per bank to FIM 150,000. The guarantee does not cover deposits held by the State or other banks.

Emergency liquidity support

53. *The BOF, as a member of the ESCB, follows ECB principles on the provision of emergency liquidity assistance (ELA) by means other than the normal monetary policy operations of the Eurosystem for solvent but illiquid banks at the domestic level at the BOF's own cost and risk. The Bank of Finland Act requires that all lending by BOF is adequately collateralized. To date, no public discussion of the prospective procedures for the ELA has taken place and no institution in the euro area has received emergency assistance, and thus the mechanisms have not been tested. In addition, the procedures for the provision of ELA to a complex cross-border financial conglomerates, which operate in the euro area and non-euro areas, is an area of uncertainty. In view of the potential systemic importance of the large financial conglomerates in the Finnish financial system, the BOF could be exposed to liquidity problems that affected any part of the Group.*

Crisis management

54. *In the first half of the 1990s, Finland, along with other Nordic countries, experienced a severe banking crisis. The banking crisis followed the collapse of asset prices and a severe recession after a period of significant domestic overheating. During 1992–94, deposit banks' three-year average loan loss ratio (relative to total lending) amounted to 5.2 percent. However, no major banks failed. Most problem banks were either merged with other healthier banks, or were able to continue after receiving financial support from government, insurance (and security) funds or private owners. The five largest banks all received public support from the Government Guarantee Fund. By the end of 1996, the total amount of public support disbursed was FIM 56.6 billion (approximately 10 percent of GDP). The final net loss to the public sector stemming from the banking crisis is estimated at about 7 percent of 1997's GDP.*

55. *The Finnish financial crisis in the 1990s demonstrated the importance of cooperation and coordination among all the relevant authorities at the earliest possible stage of this crisis. It also showed that at different stages different authorities need to take leading roles in crisis management. For example, at the beginning of the Finnish financial crisis in the 1990s, the BOF took the leading role, e.g., by taking over the most troubled bank (Skopbank). Then, cooperative ad hoc groups were established, and later the MOF became more extensively involved and put in place bank supporting mechanisms. And finally, the Government and the Parliament adopted necessary resolutions to provide guarantees for the commitments of Finnish banks to depositors and other creditors under all circumstances. Moreover, the crisis demonstrated the importance of institutional infrastructure, in particular the insolvency regime, creditor rights, and the laws on collateral in crises resolution management.*

IV. CHALLENGES CONFRONTING THE FINNISH FINANCIAL SYSTEM AND RECOMMENDED RESPONSES

56. The analysis of the adequacy of the regulatory and supervisory arrangements and financial safety nets raises questions on how to strengthen the current arrangements and make them more effective in what is likely to be a more competitive financial market environment. This section discusses how the supervisory and crisis prevention and management arrangements might be strengthened.

57. In Finland, as in some other countries, an ongoing discussion on the structure of financial regulation and supervision is taking place. Countries employ various models and supervisory frameworks, which meet the requirement of adequate supervision, be it on stand-alone entities, sectoral groups, or mixed financial conglomerates. Such discussions, or any steps taken, should not detract from the quality of supervision.

58. Another issue concerns the supervisory and regulatory implications of MOF's role both as a shareholder in financial institutions and a regulator focused on safety and soundness issues. The authorities are of the view that no conflict of interest arises since MOF separates its responsibilities for exercising shareholder rights in financial institutions from its responsibility for licensing financial institutions. A combination of large government ownership and assignment of the licensing authority to the MOF is, nevertheless, unusual among EU and other advanced countries. The licensing responsibilities should preferably be fully independent from the shareholder.

A. Strengthening Supervisory Arrangements

Strengthening the FSA

59. As noted above, the FSA has limited independence and discretionary powers. In addition, there is no authority explicitly charged with supervising the FSA with regards to the effectiveness and appropriateness of its official functions. There are a number of key elements that could help address these issues:

- ***First, the powers of the FSA should be clearly set out in the law.*** The FSA's discretionary powers should be clearly defined (purpose, criteria, limits). Examples of additional regulatory and supervisory discretionary powers that would result in closer compliance with the essential criteria identified in the Core Principles include: (1) prior approval for a major investment; (2) criteria for reviewing and approving applications for different types of acquisitions; (3) approval to block appointments to the Board of Directors or management; (4) ability to set requirements to prevent abuse arising from connected lending; (5) discretion to establish capital requirements that are reflective of the perceived risk of the institution; and (6) the ability to prescribe prudential loan loss provisioning. Enhanced legislative powers would normally need to be accompanied by an additional level of internal controls relating to on- and off-site inspections in order to obtain more proactive supervision.

- ***Second, the responsibility of the Board of the FSA should be expanded.*** The Board should be responsible for the licensing process and the revocation of a license, the budget of the FSA, and any decision that might have an impact on the safety and soundness of the financial system.

60. ***Regulatory and supervisory powers affecting the oversight of banking, insurance, and securities must be designed to mitigate the possibility of regulatory arbitrage.***

Regulatory and supervisory activities should be applied in a manner that is fair, equitable, and consistent. Consideration should be given to developing supervisory and licensing protocols that achieve these goals.

Strengthening the ISA

61. ***Entry into the insurance market of more assertive and aggressive players has the potential to threaten overall market profitability, and the solvency of all market participants, and to lessen the degree of self-regulation.*** The ISA response is to broaden and strengthen the organization, enabling it also to operate quickly and decisively under more difficult circumstances. A speedier and more ambitious schedule for implementation may nevertheless be appropriate. A legal basis for early intervention to address life insurance solvency should be provided.

62. ***More demanding market circumstances also require an improved quality of the "audit trail" of supervision and more sophisticated risk models.*** Experiences from other countries indicate that substantial efforts often need to be made to change the supervisory "mind set" into a much more precise and documented style of supervision. The ISA has recently implemented an electronic audit trail, but it has not yet implemented an advanced risk analysis model. The implementation of a specific insurance-based model would help the ISA to carry out a consistent risk analysis and a more targeted allocation of supervisory resources.

63. ***As in the banking area, stronger accountability and the granting of wider powers to the insurance supervisory agency is desirable.*** The lines of accountability and responsibility would be clarified by transferring the licensing authority to the supervisory agency, and implementing a Board consisting of independent experts.

B. Strengthening Crisis Prevention and Management

64. ***In view of the soundness of the financial system, crisis prevention and management are not immediate concerns.*** However, an approach to crisis prevention and management that reduces moral hazard and strengthens market discipline can help reduce the risks of future crises. Advance preparation of a crisis management strategy that retains the necessary flexibility in implementation, can also help to reduce the costs of crises should they develop. To this end, the Finnish authorities are planning legislation to permit the MOF to temporarily close a bank and freeze its liabilities, allowing for restructuring oversight, when continuing

the business of the deposit bank would jeopardize the stability of the financial markets or payment systems.

65. ***When dealing with large institutions, the Finnish authorities face a critical problem originating from the too-big-too-fail (TBTF) consideration.*** As large institutions account for substantial shares of the financial services market in Finland, a disorderly failure by a single institution could have substantial spillover effects to the Finnish financial market, damaging the economy. Because the Finnish authorities could not afford to leave such systemic risks uncontained, a large institution might exploit the situation even before a crisis. The control of this moral hazard effect on the one hand, while containing systemic risks on the other, is one of the biggest challenges facing regulators of large institutions.

66. ***A general principle for regulators to follow would be to strike a balance between controlling moral hazard (in taking excessive risks) and providing adequate safety nets in the financial system.*** Discussions with the authorities, and their handling of the financial crisis in the 1990s suggest that the balance that the authorities are striking leans towards providing safety nets. Without adopting necessary safeguards, this policy stance could create the conditions for strong moral hazard.

67. ***Measures that could help in controlling moral hazard could include the following:***

- ***More pro-active supervisory measures*** to prevent financial difficulties in a large institution from becoming a major financial crisis, consistent with the proposed measures to strengthen the powers of the FSA. This would require that the authorities focus on identifying any financial problems in large institutions quickly and promptly, and take preventive measures to correct the problems.
- ***Early warning systems*** to monitor the financial situations of large institutions, including comprehensive information on the structure and conduct of business, on an ongoing basis. The establishment of an effective early warning system would require cross-discipline and cross-border cooperation to monitor the full range of activities of complex conglomerates. The need to develop the early warning system may require further enhancing the existing cross-discipline and cross-border cooperation.
- ***Development of a full range of crisis management strategies*** that can guide the authorities to take prompt and appropriate corrective measurements after identifying the problems. Notwithstanding the unpredictable and ad hoc nature of crises, which requires that the authorities have a certain level of discretion for alternative solutions, well-planned strategies for crisis management beforehand would give confidence to the market and help to control and contain a crisis. A comprehensive strategy for crisis management should guide the authorities to take prompt and appropriate corrective measurements to deal with problems at each stage of the crisis.
- ***Greater transparency to the existing deposit insurance and investor protection schemes.*** While there was considerable public discussion on the roll-back of the

blanket guarantee to depositors, it would be appropriate for the authorities to consider how best to ensure that the limited protection of the schemes is not lost from the public's consciousness.

68. *In view of the complexity of the institutions, a key element would be to build on the extensive arrangements for supervisory cooperation that already exist.* Cooperative ad hoc groups were established during the financial crisis in the 1990s, and these groups, consisting of representatives from the FSA, MOF, BOF, ISA and MOSAH, now operate on a regular basis. There also exist mechanisms of supervisory cooperation and coordination at regional and international levels. The Nordic countries have established special groups to supervise international conglomerates operating in the region, and in April 2000 the supervisory authorities signed an MOU covering supervision of the Nordea Group. There are also many forms of cooperation and coordination among EU countries. These mechanisms generally focus on information sharing and there is no clear delineation of responsibilities for critical crisis-prevention mechanisms, such as an early warning system.

SECTION II—OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains information on adherence to and consistency with the major international standards and codes relevant for the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory frameworks have been adequate to address the potential risks in the financial system. It has also provided a source of priority areas for ongoing legislative revision, and recommendations for improved financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a collegial peer review process under the supervision of Mr. R. Barry Johnston (Mission Chief), as part of the Financial Sector Assessment Program (FSAP), by Messrs. Jack Heyes (Office of the Superintendent of Financial Institutions in Canada, retired), and Stefan Niessner (Deutsche Bundesbank) for the *Basel Core Principles for Effective Banking Supervision*; Messrs Ruud Pijpers and Jaap Turksteun (Pensions and Supervisory Authority of the Netherlands) for *IAIS Insurance Core Principles*; Ms. Andrea Corcoran (U.S. Commodities Futures Trading Commission) for the *IOSCO Objectives and Principles of Securities Regulation*; Mr. Dermot Maher (Central Bank of Ireland) for the *Core Principles for Systemically Important Payment Systems*; and Mr. Bruce White (Reserve Bank of New Zealand) for the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies*. The latter assessment did not include an assessment of the transparency of monetary policy as the Bank of Finland is a member of the European System of Central Banks and no longer conducts independent monetary policy. The assessors prepared detailed assessments by drawing on information provided by the Finnish authorities, including self-assessments, and fieldwork during the February and April 2001 missions. This section contains summaries of the detailed assessments contained in the FSAP report.

The Finnish legislative and regulatory framework is based on EU directives and institutions, and reflects Finnish constitutional law. The systems of supervision and regulation are generally compliant with international standards and codes, and highly compliant in the areas of payment systems, insurance and financial policy transparency. However, the assessments identified some weaknesses related to the powers and independence of the regulators. The assessments of banking supervision, securities regulation, and insurance and pensions supervision all identified lack of clarity in accountability and the separation of supervisory and licensing (issue and revocation) authority as lacunae which could become sources of vulnerability in a stressful market environment. In particular, the early intervention powers of the FSA and its discretionary powers to implement a "proactive supervisory process" require strengthening. Legislation on the supervision of bank-insurance conglomerates is pending.

The Finnish authorities were largely aware of these weaknesses and work is ongoing to correct them. The FSAP mission's findings identified the issues of the powers and accountability of the FSA on which the authorities should focus in their legislative review, and the mission's recommendations will help inform the plans of the supervisory authorities. Work has begun to draft the required laws on conglomerate supervision.

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. Institutional Setting

The Finnish system of financial regulation assigns authority for legislation, rule formulation, and licensing to the MOF and prudential supervision to the FSA, an independent supervisory authority established under the administrative umbrella of the BOF in 1993. The FSA's board includes its Director General, the Director General of the Insurance Supervisory Authority (ISA), representatives of the BOF, the MOF, and the Ministry of Social Affairs and Health. It is overseen by the Parliamentary Supervisory Council (PSC). The duties of the FSA are to ensure that the supervised entities operate in accordance with legislative Acts, in particular with the Act on Credit institutions, and with associated decrees, regulations, and guidelines issued by authorities including the FSA under its own Articles of Association. The FSA supervises credit institutions include commercial banks, cooperative banks, and savings banks.

69. The Finnish banking system is concentrated. Three large financial groups (Merita Pankki, Sampo Group, and Okobank Group) control the majority (over 85 percent) of banking system assets and deposits and include nonbank subsidiaries that have significant market share in all segments of the Finnish financial markets. Savings and cooperative banks unaffiliated with the Okobank group represented less than 10 percent of the loan market in 1999. Merita Pankki is part of the Nordea Group, a cross-border financial conglomerate domiciled in Sweden with banking operations in all Nordic countries. Sampo Group is primarily a domestic financial conglomerate but has recently expanded operations outside of Finland into the Baltic region. The Okobank Group is a cooperative group that is dominated by retail-market-oriented individual cooperative banks. The Okobank Group is a financial conglomerate that includes insurance and securities market group members or affiliates.

B. General Preconditions for Effective Banking Supervision

70. Finland possesses a well-developed and stable overall institutional and legal infrastructure. Actuarial, legal and accounting standards are well developed and in general are compatible with international standards. The credit culture fosters the honoring and enforcement of financial contracts. Transparency requirements allow investors and supervisors to evaluate the financial condition of the credit institutions, and the credit institutions can monitor the health of the entities to which they lend. The FSA has a range of procedures to achieve the resolution of problems in banks, but for the most part the procedures are not anticipatory in nature. The safety net consists of the Deposit Guarantee Fund and of the emergency liquidity assistance (ELA) of the BOF.

71. The dominance and systemic importance of the three banking groups gives rise to moral hazard concerns, which are heightened by the Finnish experience during the 1992 banking crisis when blanket government guarantees were extended to all depositors and creditors. The size, history, and systemic importance of these financial institutions will lead

many to assume that the government would not allow their failure. In such a setting, the effective mitigation of potential moral hazard problems requires early warning monitoring systems and proactive intervention by supervisors to address problems in a prompt and effective manner.

72. While the FSA has not prescribed “corporate governance” best practice for regulated institutions in Finland, corporate governance has not been undermined by government efforts to influence commercial decisions, particularly lending operations. As financial institutions become more complex, corporate governance prescriptions are a useful supplement to supervision.

C. Main Findings

73. The assessment of compliance with the *Basel Core Principles for Effective Banking Supervision* found that the essential conditions for effective bank supervision have in general been put in place, and for the most part are being administered satisfactorily. Nevertheless, certain essential criteria have been assessed as being materially noncompliant with the Basel Core Principles. The weaknesses are primarily associated with the lack of FSA powers to take prompt remedial action including: powers to require compliance with safety and soundness measures recommended by the supervisor; powers to establish criteria for reviewing acquisitions and investments; powers to assess the adequacy of loan loss provisions and reserves; powers to control connected lending; and powers to bring about timely remedial action. While legislative factors restrict its proactive powers, it is also possible that the FSA could be more proactive within the context of existing legislation.

74. Table 6 discusses the main findings and recommendations following from the Basel Core Principles Assessment. In particular, existing regulatory and supervisory discretionary powers need to be enhanced in a number of areas. At present, the FSA has limited independence and accountability. Independence is limited as the responsibility for the licensing and revocation of a bank remains with the MOF. Accountability is limited as no authority is explicitly charged with supervising the FSA with regards to the effectiveness and appropriateness of its functions. A more proactive supervisory process will bring additional responsibilities to the FSA and the possibility for greater confrontation with the industry, where the FSA’s historical reliance on moral suasion may be challenged. These issues highlight the need for the development of a more clearly articulated proactive supervisory framework with appropriate accountability.

75. The authorities were largely aware of the weaknesses, and in the last year the FSA has provided MOF with a list of additional supervisory powers that it believes will assist it with achieving its objectives.

Table 6. Main Findings of the BCP Assessment and Recommendations

Objectives, Autonomy, Powers, and Resources (CP 1)
<p>Findings: Although the FSA participates in the resolution process for problem banks, powers that allow it to take early intervention actions to minimize the potential losses to depositors or to the deposit-guarantee fund are inadequately expressed in the law. Its powers are restricted to recommendation of license withdrawal. Without the power and willingness to impose an early intervention regime, the FSA cannot take prompt remedial action to address safety and soundness concerns.</p> <p>Recommendations: The FSA needs to reassess its current powers to ensure that they are reflective of industry practices and will allow for early intervention actions. Once assessed, any resulting enhancements should be clearly articulated in enabling legislation to minimize the potential losses to depositors or to the deposit-guarantee fund.</p>
Licensing and Structure (CPs 2-5)
<p>Findings:</p> <ul style="list-style-type: none"> • In the case of foreign banks establishing a branch or a subsidiary (with the exception of credit institutions from another EEA country which have complete freedom of entry), neither prior consent nor a statement of “no objection” from the home country supervisor is required by law before granting a banking license. The MOF has to come to the opinion that foreign institutions are subject to sufficient public supervision in their home country. • Although the FSA has issued a guideline on the contents of fit and proper assessments, there are no binding regulations on the fitness and propriety of directors and the senior management . • Neither the Act on Credit Institutions nor any regulations define what types and amounts (absolute and/or in relation to a bank’s capital) of acquisitions and investments in other credit or financial institutions or insurance companies need supervisory approval. <p>Recommendations: The FSA should:</p> <ul style="list-style-type: none"> • have included in the law a requirement to seek consent or a statement of “no objection” from the home country supervisor before granting a banking license to a foreign bank that is not an EEA branch; • issue binding regulations on the fitness and propriety of directors and the senior management; • establish regulations that define the types and amounts (absolute and/or in relation to a bank’s capital) of acquisitions and investments in financial institutions, which need supervisory approval.
Prudential Regulations and Requirements (CPs 6-15)
<p>Findings:</p> <ul style="list-style-type: none"> • The Act on Credit Institutions allows credit institutions to use capital loans as tier one capital (original own funds). These capital loans have neither a minimum term nor a period of notice. • The FSA cannot require a higher minimum capital ratio if it deems that the risk profile of an individual credit institution warrants a capital ratio in excess of 8 percent • Although the FSA completes onsite credit reviews and assesses the appropriateness of the loan loss provisioning, it does not have the statutory authority to require a credit institution to strengthen its lending practices, credit-granting standards, and level of provisions and reserves if it deems the level of problem assets to be of concern. • The Act on Credit institutions should be amended to provide that exposures to connected or related parties may not be extended on more favorable terms (i.e., for credit assessment, tenor, interest rates, amortization schedules, requirement for collateral) than corresponding loans to nonrelated counterparties. The FSA lacks the power, which may be prescribed in law, to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralization of such loans. There are no regulatory reporting requirements on aggregate lending to connected and related parties. • There is no supervisory oversight of the setting of appropriate provisions against country risk and transfer risk, since the FSA cannot require a credit institution to increase its provisions related to country and transfer risk. • The statutory power of the FSA appears inadequate for requiring the strengthening of a credit institution’s risk management system.

- Neither the FSA nor the MOF have the legal authority to require changes in the composition of the board and management in order to satisfy themselves that the composition of the board of directors and senior management reflects the size and nature of the activities of the credit institution

Recommendations: The FSA should

- be able to require a higher minimum capital ratio if it deems that the risk profile of an individual credit institution warrants a capital ratio in excess of 8 percent;
- have the statutory authority to require a credit institution to strengthen its lending practices, credit-granting standards, and level of provisions and reserves if it deems the level of problem assets to be of concern;
- establish regulatory reporting requirements on aggregate lending to connected and related parties;
- have the relevant regulation or laws amended to provide that exposures to connected or related parties not be extended on more favorable terms than corresponding loans to unrelated counterparties;
- have the power to review and prescribe appropriate provisions against country risk and transfer risk;
- have the ability to require the strengthening of a credit institution's risk management system;
- have the legal authority to require changes in the composition of the board and management of credit institutions, which reflect the size, and nature of the activities of the credit institution.

Methods of Ongoing Supervision (CPS16-20)

Findings:

- There is no explicit legal requirement for a supervised institution to seek prior approval or advise the supervisor of material changes in their activities with the exception of where the supervised institution breaches the minimum capital ratio of 8 percent.
- The FSA does not have the explicit legal authority to limit or circumscribe the range of activities the consolidated banking group may conduct or to limit the overseas locations in which activities can be conducted.
- The supervisory methodology in place is in transition and, while the assessment of a risk profile uses sound quantitative analytical methodology, there is a need to reinforce the importance of an effective balance of on and offsite assessment techniques and practices.
- The FSA has not established criteria to assess the work of internal audit and therefore it is difficult for the FSA to come to an opinion on whether a reliance process is reasonable.
- The FSA, while having the statutory power to review external audit working papers has not enforced this power. Enforcement may result in a productive "reliance process" to be established with the external auditors.

Recommendations: The FSA should:

- require a supervised institution to seek prior approval or advise the FSA of material changes in their activities.
- have the explicit legal authority to limit or circumscribe the range of activities the consolidated banking group may conduct or limit the overseas locations in which activities can be conducted.
- establish criteria to assess the work of internal audit and thereby establish whether reliance on this process is reasonable.

Information Requirements (CP 21)

Findings:

- The FSA does not have adequate powers to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis. Nor does the FSA have adequate powers to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion. The only supervisory response available to the FSA is the imposition of a conditional fee on the credit institution.
- The FSA does not have the right to revoke the appointment of an auditor of a credit institution.

Recommendations: The FSA should:

- have enhanced powers to hold management responsible for financial records and data, timely and accurate supervisor-required reports, and externally-audited annual management reports and financial statements;

<ul style="list-style-type: none">• have the right to revoke the appointment of an auditor of a credit institution.
Formal Powers of Supervisors (CP 22)
<p>Findings: The FSA's supervisory powers are broad, but for the most part are focused on ex post reaction. The actions allowed are primarily limited to noncompliance with capital adequacy requirements or other material issues, which may require the liquidation of a credit institution. The supervisory powers do not cover various possible ladders of intervention or provisions for approval of new acquisitions, restrictions on asset transfer and purchase of credit institution's own shares.</p> <p>Recommendations: The FSA's supervisory powers should include early intervention, provisions for approval of new acquisitions, and the ability to restrict asset transfer and purchase of credit institution's own shares.</p>
Cross-Border Banking (CPs 23-25)
<p>Findings:</p> <ul style="list-style-type: none">• The FSA cannot require the closing of overseas subsidiaries, or impose limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the subsidiary presents or if it determines that legislation or regulations hinder effective supervision on a consolidated basis.• The FSA as the host supervisor, before recommending the issuance of a license, does not seek the approval or statement of "no objection" from the home supervisor, with the exception of subsidiaries of credit institutions from another EEA country. The MOF has to come to the opinion that such an institution is subject to sufficient public supervision in their home country. <p>Recommendations:</p> <ul style="list-style-type: none">• The FSA should be able to require the closing of overseas subsidiaries, or impose limitations on their activities, if it determines that the supervision is not adequate or if it determines that legislation or regulations hinder effective supervision on a consolidated basis.• Include a requirement in the law that the FSA as the host supervisor, before recommending the issuance of a license, should when appropriate, seek the approval or statement of "no objection" from the home supervisor.

II. MFP TRANSPARENCY CODE—BANKING SUPERVISION

76. Banking supervision in Finland is conducted by the Financial Supervision Authority (FSA) within a framework of transparent law and regulation. Indicative of the high level of transparency is the recent initiative of the FSA to commence publishing most supervisory actions in respect of individual institutions (save for a small range of actions which could be destabilizing). Table 7 provides a summary of findings on observance of the *IMF Code of Good Practices in Transparency in Monetary and Financial Policies* for bank supervision.

77. There is a large amount of information available on the banking supervision law and subsidiary by-laws and decrees. However, there is a question whether the available information is in a form that conveys the principles, structure and objectives of supervision as clearly as possible. The information may not be as "accessible" to the non-expert as it could be. The FSA is already considering this issue, including how the body of law, regulation and guidelines can be presented within a framework that would better reflect the underlying principles and objectives, and also clarify the respective responsibilities of the supervisor and of the supervised institutions.

78. A further issue concerns the transparency and focus of the accountability arrangements for banking supervision. The primary body to which the FSA is accountable is the Parliamentary Supervisory Council, although only in respect of the efficiency, not the

effectiveness of its operations. The FSA has indicated that it is considering strengthening the focus in its annual reporting on the effectiveness of its supervision.

Table 7. Main Findings of Assessment of MFP Transparency Code–Banking Supervision

<i>V. Clarity of roles, responsibilities and objectives of banking supervision regulatory and supervisory agencies</i>
<p>Findings: The duties and responsibilities of the FSA are clearly prescribed in legislation. The assessment noted the following issues:</p> <ul style="list-style-type: none"> • The broad objectives of the FSA are disclosed and explained in its Annual Report, but consistent clear alignment with other explanatory material is lacking. • The assignment of banking supervision roles and responsibilities as between the FSA and the MOF is somewhat complex. This arises from the split between the authorization and supervision functions, and the apparent reliance of the FSA on the MOF in relation to matters of enforcement. (the scope and extent of the FSA’s power of enforcement are not fully transparent). • The FSA is subject to the oversight of the PSC only in respect of administrative matters, not in respect of the effectiveness of its supervision. • The procedures for the appointment, the terms of office, and the criteria for removal of members of the Board of the FSA are somewhat scattered. It could be beneficial if these key elements of the governance structure for the FSA were incorporated into the Act on the FSA. <p>Recommendations:</p> <ul style="list-style-type: none"> • Develop a structure (possibly a manual/compendium) for the body of law and regulation for banking supervision that reflects the structure of the supervisory framework, and the objectives and principles that underpin it. • The modalities for oversight of the effectiveness of the FSA’s supervision should be strengthened and disclosed. Possibilities might include extending the role of the PSC or (as is being considered) establishing a panel of experts.
<i>VI. Open process for formulating and reporting of banking supervision regulatory and supervisory policies</i>
<p>Findings: The process for formulating and reporting regulatory and supervisory policies is an open one. The body of policy and regulation is codified and available on the public record, and it is normal practice to consult with affected parties during the policy/law making stage.</p>
<i>VII. Public availability of information on banking supervision regulatory and supervisory policies</i>
<p>Findings: The FSA maintains an active publications program that explains its role and activities. This program includes a comprehensive Annual Report, and quarterly newsletter. This publications program is in addition to the public availability of the body of law and regulation administered by the FSA. Summary statistical information on the prudential condition of the Finnish banking system is also published, principally in the FSA Annual Report. However, it is generally highly aggregated and not accessible for analysis.</p> <p>Recommendation: Consider publication of disaggregated prudential data. Such a publication could parallel the annual statistical publication of the ISA.</p>
<i>VIII. Accountability and assurance of integrity by insurance regulatory and supervisory agencies</i>
<p>Findings:</p> <ul style="list-style-type: none"> • The FSA is subject to the oversight of a Board of Directors and, through it, the Parliamentary Supervisory Committee. However, the scope of the Committee’s oversight is constrained to administrative matters, and does not extend to supervisory effectiveness. It would be desirable for the Committee’s oversight role to be widened, and also elevated so as to bring more prominence to the processes by which the FSA gives, and is held to, account for the performance of its functions. • The procedural rules that govern the FSA are partly publicly disclosed, but partly limited to internal dissemination. Also, the internal audit arrangements are not publicly disclosed. • Officers of the FSA are covered by the same legal protections as apply to members of the civil service. These appear broadly adequate, although it might be useful to include in the Act on the FSA express

reference to these protections, and to consider whether they are adequate for the particular liabilities that might arise in connection with the conduct of a banking supervision function.

Recommendations:

- Extend and elevate the oversight role of the Parliamentary Supervisory Committee in respect of the FSA
- Consideration should be given to extending disclosure of the internal procedures that govern the FSA, at least so that they would be available to members of the public on request. Also, greater disclosure might appropriately be made of the internal audit function.

III. IAIS INSURANCE SUPERVISORY PRINCIPLES

A. General

79. This section contains a joint assessment of the observance of sound supervisory principles for pension and insurance. The Insurance Supervisory Authority (ISA) has supervisory responsibility not only for insurance companies and private sector pension institutions, but also partly for government pension institutions, for insurance brokers and, recently, unemployment funds. This assessment focuses on the supervision of insurance companies and private sector pension institutions.

B. Institutional Setting

80. Pension provision in Finland is largely a reflection of the continued wish for and policy on social protection, and is dominated by a residence based pay-as-you-go national pension scheme and a partly funded statutory earnings-related scheme, covering almost all paid employment. Nonlife insurance, also strongly influenced by the wish for social protection, features statutory insurance for workers' compensation and motor liability. The principle of social protection is further underlined by the existence of mandatory guarantee schemes for the three main statutory products: statutory pensions, workers' compensation, and motor liability. There is also a mandatory insurance scheme for professional liability for the medical profession.

81. Finland has a very concentrated pensions and insurance market, dominated by four large pension-insurance groups. Two of the four main groups are of a mutual nature, and two of them are quoted. At the beginning of 2001, one of the quoted groups changed into a mixed pension-insurance-bank conglomerate, the first in Finland. Finnish insurers themselves are mainly active on their home market. Business expansion abroad is centered on the Baltic countries and Poland. Competition is increasing in Finland from pan-Scandinavian companies.

82. The regulatory authority for both pensions and insurance is the Ministry of Social Affairs and Health (MOSAH). The pension and insurance sectors are supervised by the Insurance Supervisory Authority (ISA), which was established in 1999 under the auspices, but independent, of MOSAH with a certain supervisory role for the MOSAH. The ISA has a supervisory board with representatives of the main financial regulatory and supervisory bodies: the MOSAH, the MOF, the BOF, and the director-generals of both ISA and FSA.

83. The principal objective of supervision by the ISA is to protect the direct financial interests of the policyholders and pension entitlements. The emphasis of supervision is thus on the financial supervision, particularly on the adequacy of the technical provisions, solvency margin, and investment policy and procedures. Fit and proper testing is carried out in conjunction with the MOSAH, and, as appropriate, the FSA. A further supervisory responsibility, and aim, is the safeguarding of a sound and competitive insurance market.

84. The ISA has a range of legal instruments available for appropriate and proportional supervision. These include early solvency intervention powers, which are set by decree for the pension insurance companies and non-life companies, and which currently operate on a voluntary basis for the life companies. Legal provisions and practices are predominantly based on EU directives and requirements. For insurance the three generations of life and non-life directives and the directive on supplementary supervision of insurance undertakings in an insurance group have been transposed into Finnish legislation. The main components of Finnish pension provision—the residence based national scheme and the statutory earnings-related scheme—are classified as Pillar I by the EU. Specific legal provisions regarding mixed financial (bank-insurance) conglomerates are under preparation in Finland, and expected to be in force by the end of the year.

85. A number of legal firewalls exist to reduce and manage the contagion risk within groups. EU-based legislation limits the activities of an insurance company to the business of insurance. Assets covering the technical provisions must be unencumbered. Further legal separation exists between life and non-life insurance companies. Pension insurance companies, which are the main providers in the private sector of the statutory earnings-related pension, are not allowed to enter into any other business activities. The investment departments of such companies must be separate, and may not be engaged in investment management for other entities or purposes. In addition, legal restriction regarding the governance of pension insurance companies are in force. Privacy law, in particular the Personal Data Act, restricts the use of client information between the various legal entities in a group.

C. Main Findings

86. Finland's pension and insurance sector meets the general preconditions for effective supervision. Finland possesses a well-developed and stable overall institutional and legal infrastructure, with well-developed actuarial, legal and accounting professions. There are no macro-economic instabilities of substantial concern. The general prerequisites for adequate supervision are largely in place.

87. Table 8 summarizes the assessment of observance of compliance with the *IAIS Insurance Supervisory Principles* and recommended actions. Finland generally complies well with the IAIS Supervisory Principles. The ISA has a range of legal instruments available for appropriate and proportional supervision, including early solvency intervention powers, which are set by decree for the pensions insurance companies and non-life companies, and which currently operate on a voluntary basis for the life companies. A legal basis should be

given to the early intervention mechanism for life insurance solvency. The ISA is generally well and reasonably pro-actively managed, with clarity of objectives, priorities and strategy, and an open and supportive internal culture. The overall resources and supervisory “power” and credibility are a reflection of, and largely proportional to, the current state of the pensions and insurance market in Finland, which displays high solvency and a still substantial degree of informal self-regulation. The supervisory capacities are generally adequate for the present market.

88. Finland as yet has no specific legislation or regulations on mixed insurance-bank conglomerates, although it is expected that such legislation will be put in place in 2001. A cooperation agreement was entered into with the FSA immediately after the emergence of Sampo as the first Finnish mixed conglomerate. In addition, there are protocols on pan-Scandinavian groups. Finnish legislation is expected to be in place by the end of this year. Consideration should also be given to providing a legal basis for the early intervention mechanism for life companies.

89. The ISA is aware of the potential consequences of the market changes. More assertive and aggressive players, either national or from abroad, may threaten overall market profitability, and thus the solvency of all market participants, and lessen the degree of self-regulation. The ISA strategy to broaden and strengthen the organisation, enabling it also to operate quickly and decisively under more difficult circumstances is appropriate, although a speedier and more ambitious schedule may be desirable. More demanding market circumstances also impact on the required quality of the “audit trail” of supervision. Experiences from other countries indicate that substantial efforts often need to be made to change the supervisory “mind-set” into a much more precise and documented style of supervision. The ISA is aware of this issue, and recently implemented an electronic documentation and audit trail system. This use of this support tool should be extended further.

90. The ISA does not yet apply a sophisticated risk analysis model, although one is being developed. The implementation of a specific insurance-based model, which would enable the ISA to carry out a consistent risk analysis and a more targeted allocation of supervisory resources, is desirable.

91. The respective roles, responsibilities and accountability of the main parties involved in financial regulation and supervision emphasize cooperation and social protection. This results in opaque lines of responsibility and accountability, which might induce sub-optimal supervision in stressed market circumstances. A stricter separation between regulation and supervision is therefore recommended. This implies, inter alia, that the responsibility for granting and revoking licenses would be shifted from the MOF to the supervisory authority. A supervisory board consisting of independent experts is also recommended.

Table 8. Summary of Main Findings of Assessment of IAIS Supervisory Principles, Recommendations and Corrective Actions

<i>Organization of an Insurance Supervisor (CP 1)</i>
Findings: The responsibility and accountability of the ISA are formally defined. The composition of the board structure at the ISA and FSA, and the frequency of meetings, could lead to a lack of clarity when a supervisory emergency occurs, or other major decisions need to be taken. Recommendation: A board consisting of independent experts is therefore recommended.
<i>Licensing and Changes in Control (CPs 2-3)</i>
Findings: The criteria with regard to licensing are observed, but the current segregation of responsibilities does not appear optimal. Recommendations: It is recommended that the authority to grant and revoke licenses be transferred to the ISA. This would enhance the overall credibility of the ISA, allow the ISA to act more swiftly and decisively in emergency situations, and it would allow the ISA to play a more substantial role in assessing the original quality of any submission for a license, including fit and proper testing and the business plan. It would also lead to a better trail of accountability and transparency.
<i>Corporate Governance (CP 4)</i>
No issues were identified.
<i>Internal Controls (CP 5)</i>
No issues were identified.
<i>Prudential Rules (CPs 6-10)</i>
Findings and corrective actions: <ul style="list-style-type: none"> • The ISA is fully aware of the importance of strict and well-qualified supervision on the asset side. The actual supervision of the investment strategy, policies and procedures, however, was sub-optimal due to the relative scarcity of investment expertise at the ISA, as a result of the ISA's competitive disadvantage in the market for investment specialists. The ISA is addressing the lack of investment specialists through training, and recruiting investment expertise. • The actual supervision of financial derivatives is sub-optimal due to the restricted availability of specific expertise at the ISA. A consulting firm is helping the ISA to develop new regulations and supervisory guidelines for derivatives.
<i>Market Conduct (CPs 11)</i>
No issues were identified.
<i>Monitoring, Inspection and Sanctions (CPs 12-14)</i>
Findings and corrective actions: The sanctions available to the ISA in respect of insurance and pension companies and insurance brokers are basically the same: a warning, a prohibition to carry on an irregular action, a request to remedy an irregularity within a set period of time, a conditional fine. Both in granting and revoking the license of an insurance company, the MOSAH requires a statement from the ISA. Legislation for conglomerate supervision is being developed for implementation in 2001. Recommendations: It is recommended that the ISA should receive the right to restrict or revoke the license of an insurance company; that a legal basis be given to the early intervention mechanism for life company solvency; and that supervisory instruments regarding financial conglomerates and the constituent legal entities need to be developed and given a sound legal basis.
<i>Cross-border Business Operations (CP 15)</i>
No issues were identified.
<i>Supervisory Coordination and Cooperation, and Confidentiality (CPs 16-17)</i>
No issues were identified.

IV. MFP TRANSPARENCY CODE—INSURANCE REGULATION AND SUPERVISION

92. Regulation and supervision of the insurance sector in Finland is generally transparent, and either fully or broadly complies with most of the *IMF Code of Good Practices on Transparency in Monetary Policy and Financial Policies* (Table 9). This high level of transparency reflects: a philosophy of openness that characterizes financial sector regulation and supervision in Finland; the fact that the law and supervision requirements are mostly codified (in legislation, regulations and decrees) and thus are on the public record; and the fact that Finland has a freedom of information law that requires all official information to be publicly available unless specific grounds to withhold are satisfied. However, being a relatively new organization, the ISA does not yet have a fully developed information service and publications program.

93. In common with observations made in respect of the conduct of banking and securities market regulation and supervision, two principal means by which the transparency of insurance regulation and supervision in Finland could be enhanced:

- The development and publication of a framework, which provides more structure to the body of specific legislation, regulation and decrees. Such a document, or manual, could make the body of law and policy more accessible to the non-expert in insurance regulation and supervision. It could also help to provide a stronger “connect” between the detailed body of law and regulation and the objectives and principles that underpin the law, and provide users with a cohesive organized body of law and regulation.
- Improve the transparency of the processes by which the ISA gives account for, and is held publicly accountable for, the conduct, and effectiveness of its supervision. This could include making the ISA subject to the oversight of a body like the Parliamentary Supervisory Council.

Table 9. Summary of Main Findings of MFP Transparency Practices—Insurance Regulation and Supervision

<i>V. Clarity of roles, responsibilities and objectives of insurance regulatory and supervisory agencies</i>
<p>In establishing the ISA, attention has been given (including in the law) to the potential for supervisory roles and responsibilities to overlap, for example, in the case of banking /insurance conglomerates, there is the potential for overlap with the banking supervisory agency. The result is a generally clear allocation of roles and responsibilities amongst the relevant regulatory and supervisory agencies</p> <ul style="list-style-type: none">• The objectives of insurance supervision are less clearly defined in legislation, which takes the purpose (protection of the interests of the insured) as being largely implicit, and goes straight to the duties to be performed. An explanatory pamphlet published by the ISA does provide an explicit statement of the objective, as being to “ensure that the Finnish insurance market is stable and produces secure, competitive insurance services.” How tightly aligned this objective is with the specific provisions of the legislation is more difficult to gauge.• As indicated by the ISA, the broad objective could be elaborated to give it more practical content. Working objectives could be published. <p>A framework for formal accountability to the MOSAH, and to Parliament, is in place. However, in practice, the accountability of the ISA to Parliament, because it works through the Ministry—which is responsible for a wide range of social policy and health policy matters—is not particularly focused. The PSC, which oversees</p>

the BOF and the FSA, does not have jurisdiction over the ISA. The objectives of the ISA should be made more explicit in legislation.

VI. Open process for formulating and reporting of insurance regulatory and supervisory policies

The ISA, like the FSA, maintains an open process for formulating and reporting of insurance and regulatory and supervisory policies. This takes the form of active consultation with the insurance industry on legislative, regulatory and supervisory policy proposals, codification of policies and requirements into documents that are on the public record, and reporting to the MOSAH, and through it to Parliament and the public, on the conduct of its supervision and on relevant developments in the insurance industry.

VII. Public availability of information on insurance regulatory and supervisory policies

Findings: The primary means by which information is made available to the public is by way of the public availability of the legislation, regulations and decrees that govern insurance supervision. As a new agency, the ISA has not yet developed a comprehensive publications program that explains for non-expert audiences the nature and scope of its supervisory role; but information is disseminated on the web. Noteworthy, moreover, is the comprehensive and detailed statistical information on insurance firms in Finland that is published by the ISA.

- The ISA does publish a comprehensive annual report, and also an annual publication containing comprehensive financial data on the insurance industry. There is also an excellent publication, which provides an overview of the insurance industry, and of the framework of law and supervision, published by the Federation of Finnish Insurance companies.
- The senior officials of the ISA have made themselves available to the public, for the purpose of explaining the ISA's objectives and performance. This has been done mostly by being available to the news media, and by occasional speeches. There is not a practice of appearing before the relevant committee of the Parliament.
- The ISA might consider whether the relevant law is available to users in as "user friendly" a manner as might be possible. The ISA should continue to develop, for publication, material that explains, for the insurance industry, and for the public, its objectives and roles.
- The protection provided to policyholders is established by way of legislation, which is on the public record. However, the scope, terms and limits of that protection seem not to be at all prominent in the public domain, such that the policyholders will probably have no more than a vague consciousness of them.
- Information is publicly available on consumer protection services, although not with a high level of prominence.

Recommendations: Consideration should be given to how the law and regulation on insurance supervision can be organized and/or supported with explanatory material that connects the separate pieces of legislation to the objectives and principles that underpin it.

VIII. Accountability and assurance of integrity by insurance regulatory and supervisory agencies

Findings: Key elements of the governance and accountability structure within which the ISA operates comprise (a) oversight by a Board of Directors (comprising principally members from "sister" regulatory agencies and competent ministries, and (b) accountability to the MOSAH (through Board representation and annual planning and reporting procedures). The ISA is accountable ultimately to Parliament, although Parliamentary scrutiny, in practice tends to be limited. At an operational level, the ISA can be required to account for its decisions by virtue of those being appealable to the Supreme Administrative Court. The integrity of the Authority's internal operations is promoted by way of rules of procedure promulgated under the Act on the Insurance Supervision Authority, and by way of codified procedures that govern staff conduct and authorities (which is being extended to address conflicts of interest).

- Since MOSAH is the primary policy agency with respect to insurance (and the drafting of insurance sector laws), it is officials from the Ministry, rather than the ISA, who mostly appear before the Parliamentary Committee on insurance matters.

Recommendation: Elevate the role of the ISA's annual reporting, and the processes by which it gives, and is held to, account, including at the political level (the PSC and/or the relevant committee of the Parliament). A code of conduct on conflicts of interest has been adopted by the ISA Board.

V. IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

A. Supervisory Framework and Market Structure

94. The primary regulator of the securities markets is the FSA, in particular, its Capital Markets Department which is organized into three divisions: on regulation, supervision, and market supervision. The authorities and duties of the FSA are spelled out in the Act on the Financial Supervision Authority and in the other substantive legislation affecting the Finnish capital markets. In general, Finland has a comprehensive, well-articulated, and transparent framework for the supervision of securities markets, issuers, intermediaries, and collective investment vehicles.

95. Many responsibilities relative to implementing capital markets legislation are directly conferred on the MOF. The MOF, for example, authorizes and revokes licenses of supervised entities. The MOF also has the authority to take decisions with respect to the content of listing particulars for the official list, prospectuses and other matters. The FSA has some delegated specific administrative powers.

96. In addition to the regulatory supervisory functions of the FSA's Capital Markets Department, Finnish law also recognizes that authorized exchanges may exercise self-regulatory powers, including disciplinary authority, and the law commits certain specific matters to their execution, subject to the oversight of the FSA and the MOF. There are also professional bodies whose members agree upon best practices or standards relevant to securities markets, such as the Securities Intermediaries Association, the Bankers Association and the Accounting Board. Accounting principles are under the supervision of the Ministry of Trade and Industry.

97. The FSA supervises the HEX Group, which includes the Helsinki derivatives and securities market, the central securities depository (the APK) and equities and derivatives clearing arrangements. Securities trade execution and clearing services—as well as registration and custody services—in Finland are provided primarily by the HEX Group.

98. The Helsinki Exchanges are all electronic. In addition to official list securities, the exchange also lists for the I-market, the New Market, and the Pre-list, subscription allocation market. Stock, subscription right, warrant and bond trading occur on the Exchanges HETI trading system. Almost all trading in equity products is conducted on the market because of the 1.6 percent stamp tax that applies to over-the-counter transactions. Product listing criteria are specified in the rules of the exchanges approved by the MOF upon recommendation by the FSA. Product listings are reviewed by the FSA only when the exchange applies for an exemption from the official listing requirements.

99. The Helsinki Exchanges are the central counterparty for derivatives contracts traded on the exchanges. In 1999, the most active derivatives products were moved to the Eurex where Helsinki Exchange members are granted common membership.

100. The APK maintains the system of book entry registers. True title and other rights of holders of shares are based on these. Shares are registered in the beneficial owner's name except for shares owned by foreigners, which may be registered in the name of a nominee (custodian). Nominees cannot exercise voting rights. All publicly traded securities (i.e., official list, I-, NM- and Prelist securities) must be dematerialized in the APK.

101. Trades executed in the Helsinki Exchanges' HETI trading system are automatically transferred for clearing to APK's KATI clearing system (OM system). The OM system clears on a batch basis. The cash side of the securities transactions is settled net in Central Bank funds, and the securities deliveries side is settled on a gross basis. As a practical matter, then, delivery versus payment is qualified for the gross transactions. The Exchanges maintain several lending facilities, including a pool of securities to facilitate the settlement of transactions, but there are no rules requiring the collateralization of short sales. The APK also maintains the RM (a real-time gross settlement system—RTGS system for settlement of transactions in nonequity rated securities).

102. The Act on Common Funds (amended in 1999) governs two types of collective investment scheme: UCITS funds and non-UCITS Special Funds. The Act implements the 1985 European Directive on Undertakings on Collective Investments in Transferable Securities (UCITS). Fund management activities are at an early stage of development in Finland. Currently, 250 domestic funds are licensed under the Act on Common Funds; 200 of these satisfy the stringent portfolio requirements for UCITS.

103. Ten securities account for 92.6 percent of the turnover and 85.2 percent of the market value on the Helsinki exchanges. Foreign holdings measured by market capitalization are 66 percent, and by number of shares are 38 percent. Over 50 percent of trading originates from foreign orders.

B. General Preconditions for Effective Securities Regulation

104. The preconditions listed by IOSCO as essential for effective securities regulation appear to be broadly satisfied. Finland has transposed into its national legislature all EU Directives related directly to the oversight of securities markets. There are, however, some areas where additional improvements could be made, including the ability of exchanges to adopt binding collateral rules, and the adequacy of insolvency laws.

105. The staff of the FSA is dedicated, willing and expert. FSA has sought to increase its market expertise by recruiting specialists, and to improve its ability to provide adequate coverage of the markets, intermediaries and offerings that it regulates, by making effective use of electronic technology to receive and review reports and by entering into appropriate arrangements and understandings with self-regulators and other domestic and international regulatory authorities. The international nature of the Finnish securities markets requires that the competent authorities have pragmatic arrangements to address the supervision of cross border activity.

C. Main Findings

106. Findings on the implementation of the *IOSCO Objectives and Principles of Securities Regulation* are summarized in Table 10. Three areas were identified where the objectives are only partially met: regulatory independence; sufficiency of regulatory powers; and potential systemic financial risks related to short selling or the structure of market arrangements for equity settlements and trading allotments. Key issues are the following:

- To the extent that the ultimate licensing and revocation authority lies with the Ministry of Finance, the ability of the FSA to exercise effectively the powers that it has may potentially be impaired, or have the appearance of lacking independence;
- Additional administrative powers would enhance the FSA's ability to enforce the rules and regulations that apply to the securities markets, and to cooperate with other regulators. The FSA has itself identified areas where new powers and authorities are needed to ensure that its enforcement capabilities are an effective deterrent to misconduct, to reduce any appearance of lack of independence, and to enhance its capacity to cooperate with foreign regulators.
- Due consideration should be given to ensure that the FSA has sufficient resources and expert capacity appropriately to oversee the securities markets. Further resources would enable the FSA to provide more effective checks of required disclosures.
- The securities settlement system may permit potential exposures that could cause disruption of the market (or a loss of confidence) from the failure of individual transactions in the event of severe volatility during the period between contracting for a trade and final settlement. The FSA and the market are aware of the risk and are taking steps to ensure that risks are kept to acceptable levels.⁷
- The FSA is in the process of conforming its program to make the best and most effective use of its existing authority. The FSA should prioritize areas (such as risk based inspections and oversight, enforcement of accounting standards), which may require more attention.

⁷ The source of concern relates to the "chaining" of transactions in the OM system for equity-rate and securities. The OM system has several risk-control and other arrangements that help to ensure timely settlement. These include the possibility to take out the trades of a failing party and settle the rest on time, and settlement funds raised by the participant. In addition, securities loans are available and their use is highly encouraged by the exchange and the authorities. These measures in practice cover most of the problem situations, with only intra-day delays. Real-time gross settlement for the OM system is scheduled for introduction in 2002.

- From a structural perspectives: the dominance of the market by a single issue, Nokia, and the lack of depth of certain securities traded should be taken into account in the exchange's and the FSA's oversight program for markets and in designing index products that are not susceptible to manipulation. The remedy of suspending trading for up to a week, as permitted in the relevant legislation, is unlikely to be an attractive solution to market problems. When such suspensions of trading have occurred as in several "emerging" markets, they have resulted in long-term harm to confidence in the marketplace.

Table 10. Summary of Main Findings of Assessment of IOSCO Objectives and Principles of Security Regulation

<p><i>Principles relating to the regulator, (CPs 1-5)</i></p> <p>Some issues arise with respect to the sufficiency of powers of the FSA and the appearance of independence.</p> <ul style="list-style-type: none"> • The regulatory structure while doubtless intended to provide for checks and balances by committing ultimate licensing authority to the MOF may raise questions as to regulatory independence. Consideration also should be given to clarifying the permissible bases for removal of top personnel of FSA and otherwise reviewing how to improve the perception of operational independence and accountability. • The FSA should explore further uses of its existing powers and due consideration should be given to its request for additional authorities—especially enforcement authorities. • While the processes of the regulator appear to be consistent and transparent, and significant guidance is available, more user -friendly technology would assist users in interpreting existing procedures. Ideally, the web site would indicate applicable confidentiality requirements
<p><i>Principles of self-regulation (CPs 6-7)</i></p> <ul style="list-style-type: none"> • The FSA makes effective use of the powers of its current self-regulatory authorities, the exchanges, and the MOF expects to expand certain self-regulatory requirements to certain non-exchange trading systems and also to add authority to amend rules of the stock exchange as well as those of derivatives exchanges and other trading systems. • The FSA and MOF have, or are putting in place, measures to oversee effectively the existing SROs. Ultimately such effectiveness depends on the resources and actual independence of the regulator.
<p><i>Principles for the enforcement of securities regulation (CPs 8-10)</i></p> <ul style="list-style-type: none"> • The FSA has substantial investigative and surveillance powers with respect to supervised entities and is seeking additional powers with respect to other users of the markets. The FSA could also explore further uses of its existing authorities. • The FSA is hindered by the lack of administrative authorities. The effectiveness of FSA's regulatory program to deter abuses would be enhanced by providing FSA with authority to bring cases seeking intermediate sanctions. • In addition to the above, attention should be paid to keeping investigative resources sufficient. FSA also should review for improper financial disclosure and other failures to meet relevant requirements.
<p><i>Principles for cooperation in regulation (CPs 11-13)</i></p> <ul style="list-style-type: none"> • While the FSA can assist other domestic and foreign counterparts, participates in practical arrangements with other EEA and Nordic countries to provide efficient exchange of supervisory information, and cooperates regularly with the US authorities, it currently cannot itself exercise compulsory powers on behalf of a foreign regulator. The FSA is seeking additional powers.
<p><i>Principles for issuers (CPs 14-16)</i></p> <ul style="list-style-type: none"> • Disclosure of results is required, and information is published on the Internet. The FSA should keep under review the adequacy of investor access to information. • Improvements in the ability to enforce accounting standards and in the standards themselves are ongoing. Some jurisdictions require specific reporting and disclosure of the removal or dismissing of

auditors.
<i>Principles for collective investment schemes (CPs 17–20)</i>
The legal requirements for oversight of collective investment schemes appear to be sufficient and oversight is consistent with available resources. Inspections should test for compliance with segregation requirements from time-to-time. There is some scope to improve access of investors to required reports.
<i>Principles for market intermediaries (CPs 21–24)</i>
<ul style="list-style-type: none">• Reform of bankruptcy law is desirable. Also, there should be a better understanding of how a firm failure would be handled at the regulatory level.
<i>Principles for the secondary market (CPs 25–30)</i>
<ul style="list-style-type: none">• Because of the structure of the Finnish market and certain of the index products, special attention should be paid to surveillance for manipulation. FSA and the exchange should continue to coordinate their surveillance efforts.• Adequate procedures for managing default risk and market disruption seem to be in place in the derivatives markets but could be more clearly specified for securities. Additionally, contingency planning should address how existing authorities would be used.• The procedures for settling equity transactions and permitting short selling should be reviewed to determine how, pending contemplated changes in the settlement system, default risks can be mitigated. The Helsinki Exchanges and the FSA are aware of the risks and are in the process of completing improvements begun in October 2000.

VI. MFP TRANSPARENCY CODE—SECURITIES REGULATION AND SUPERVISION

107. Securities supervision in Finland is conducted by the Financial Supervision Authority (FSA) within a framework of transparent law and regulation. Indicative of the high level of transparency is the recent initiative of the FSA to commence publishing most supervisory actions in respect of individual institutions (save for a small range of actions which could be destabilizing). The assessment of compliance with the *IMF's Code of Good Practices in Transparency in Monetary and Financial Policies* for securities regulation and supervision mirrors that of the assessment for bank supervision (see Section II, Chapter II) and is not repeated. The main differences refer to the role of self-regulatory bodies where no issues arise.

VII. ASSESSMENT OF PAYMENT AND SETTLEMENT SYSTEMS

A. Introduction

108. There are three payment systems operating in Finland: the BOF's real-time gross settlement system (BOF-RTGS), the POPS system for express transfers and checks, and the PMJ system, which is used for retail payments.

- The *BOF-RTGS* provides the functionality required of a real-time system, with immediate payment finality in central bank money. The BOF-RTGS is subject to ongoing ESCB monitoring as to its effectiveness, reliability and risks. The BOF-RTGS has been part of the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system since the introduction of the euro in January 1999. The TARGET system, which is a decentralized system consisting of 15 national RTGS systems, the ECB Payment Mechanism (EPM) and the Inter-

linking system (a telecommunication network linking the national systems and the EPM), is the real-time gross settlement system for the euro.

- The *POPS system* provides a real-time settlement facility for participants' customers and a net settlement facility for participants. Agreed bilateral limits provide an effective control mechanism for credit risk.
- The *PMJ system* is used for interbank claims arising from retail payments. The system operates on a bilateral netting basis between participants with settlement in central bank money.

109. The BOF-RTGS turnover in 1999 amounted to EUR 4,369 billion with 449,000 transactions of which 193,000 were cross-border transactions. In addition to the BOF-RTGS system, both the POPS and the PMJ systems have been designated by the Finnish authorities as systemically important payment systems (SIPS). The POPS system was used for 930,000 transactions in 1999, with a total value of EUR 318.7 billion and is considered a potential source of systemic risk because it handles large value transfers and checks. The PMJ system, which processed 307 million transactions amounting to EUR 117 billion in 1999, handles payments in batch mode and is considered systemically important as it includes high-value commercial payments and can have high inter-bank positions during the day. As there is no limit on the size of transactions in the system, large-value transactions can be channeled through the system. Payment instruments used in Finland include notes and coin, credit transfer (gyro), checks (to a limited degree and for large average size), direct debit, debit cards, credit card and prepaid cards. ATM and EFTPOS usage is sizeable while internet and mobile phone banking is growing. The end-1999 circulation of notes and coin was 2.29 percent of Finnish GDP, the lowest in the EU, while the use of debit/credit/ATM cards is extremely high by average EU standards. The use of such instruments falls outside the scope of this Assessment.

110. APK, which acts as the Finnish Central Securities Depository and provides two settlement systems (the OM system for equity-rated securities and the RM system for non-equity-rated securities). APK is wholly owned by the HEX Plc., which is also the holding company of the Helsinki Exchanges. The RM system operates on a real-time gross settlement basis. In contrast, the OM system operates on the basis of securities being settled on a gross basis, while the underlying cash settlement is effected on a net basis.

111. The BOF is responsible for oversight of payment systems in Finland. This derives from its membership of the ESCB. The Treaty, which established the European Community, and the Statute of the European System of Central Banks and the ECB recognize oversight as one of the basic tasks of the Euro system and define its broad objectives. Article 105(2) of the Treaty and Article 3 of the statute state "the basic tasks to be carried out through the ESCB shall be ... to promote the smooth operation of payment systems." The Bank's role is further specified in the 1998 Act on the BOF where it is stated "The BOF shall ... participate in maintaining the reliability and efficiency of the payment system and overall financial system and participate in their development." The Financial Supervision Authority (FSA) is

responsible for supervision of financial markets and individual supervised institutions and, in that role, inspects the risks, risk management and security procedures relevant to the payment systems within the financial institutions.

B. Assessment Against Core Principles

112. The following sections provide the assessments of the payment system against the *CPSS Core Principles for Systemically Important Payment Systems* for the BOF-RTGS system, the POPS system and the PMJ system. The Core Principles, in summary, require a sound legal basis covering the payment systems, clarity and appropriate procedures for managing related risk, secure final settlement with no (or little) liquidity or credit risk, operational reliability, fair and open access, effective governance and clarity of the central bank's role and objectives in this area.

The BOF-RTGS System

113. The Bank of Finland's real-time gross settlement system, which is a part of the TARGET system, observes all of the *CPSS Core Principles for Systemically Important Payment Systems*. It provides real-time settlement with finality in central bank money. It facilitates cash settlement in respect of the other Finnish payment systems (POPS and PMJ) and also in relation to the Finnish Central Securities Depository. The rules and hours of operation are very clear and readily available to interested parties. The system is secure and reliable, with a "hot back-up site" providing high-level contingency cover.

The POPS System

114. The POPS payment system, which is used for express transfers and checks, complies with all of the *Core Principles for Systemically Important Payment Systems*. The system provides an efficient mix of a real-time payment facility between customers of participants and a net settlement facility for participants (although some payments may be settled gross through the BOF's real-time gross settlement system). Settlement between participants takes place with finality in central bank money. Security and operational reliability are high, with access criteria for the banks clear and requiring operational capability.

The PMJ System

115. The PMJ payment system, which is used for retail payments, complies with all of the *Core Principles for Systemically Important Payment Systems*. It provides an effective and practical method of settlement of inter-bank claims arising from retail payment obligations and an efficient payment mechanism for customers. The rules of operation are clear and readily available. Participation in the system is subject to the relevant banks being members of the POPS payment system to indicate operational capability. Settlement is effected with finality across accounts in the Bank of Finland via the Bank of Finland's real-time gross settlement system.

VIII. MFP TRANSPARENCY CODE–PAYMENT SYSTEMS OVERSIGHT

116. The Bank of Finland maintains a transparent approach in discharging its payment oversight roles, and as a central bank institution either fully or broadly observes most of the *IMF's Code of Good Practices in Transparency in Monetary and Financial Policies* (Table 11). To the extent that the payment system in Finland is governed by law and regulation, that body of law is publicly available, and the Bank of Finland similarly makes publicly available the terms and conditions it applies to participants in its system. Moreover, the Bank of Finland has published a number of informative background articles on the Finnish payments system, on how the Bank of Finland discharges its oversight responsibility in relation to it, and on how that oversight role contributes to the Bank of Finland's overall responsibility for promoting the stability and efficiency of the overall financial system in Finland, that is for promoting "macro-prudential" stability. Finland's "Blue Book" description of payment systems in Finland is currently outdated, but an updated edition is due to be published.

Table 11. Summary of Main Findings of Assessment of MFP Transparency of Payment System Oversight

<p><i>V. Clarity of roles, responsibilities and objectives of payment system regulatory and supervisory agencies</i></p> <p>The broad responsibilities of the BOF in relation to the payment system are prescribed in legislation, both the Act on the BOF, and the applicable ECB law. While detailed roles and responsibilities of the BOF in its payment system oversight capacity are not prescribed, the BOF has published a range of material that explains the objectives of its oversight and the developments that have been taking place under that oversight.</p> <p>Overall, there is a good level of transparency in the roles, responsibilities and objectives of the BOF with respect to the payment system.</p> <ul style="list-style-type: none">• Generally account is given by the BOF on the discharge of its responsibilities in relation to payments systems in its annual reporting. The practice has been for the Board's report to the public to include a chapter on the subject. Annual reporting by the PSC to Parliament on payment systems has varied according to events and developments. Consideration could be given to the PSC reporting on a regular (annual) basis on developments in the performance of, and the BOF's oversight of, payment systems.• There are various strands to the way in which the BOF's role as overseer of payments systems is publicly disclosed. This reflects that the BOF conducts its oversight role acting as both a system operator (notably of BOF-RTGS) and in its more general central banking oversight capacity. However, the BOF has usefully drawn these strands together in published articles and publications. No further actions are recommended.• The nature of the oversight role by the BOF in respect of the payment systems is not based entirely on the law, although certain rules are approved by the Ministry of Finance. Those rules are available to those subject to them and to the public on request. However, the oversight role is mainly conducted within a framework of collaboration and consultation, which is less transparent.• The rules, procedures and by-laws for the retail payment systems (POPs and PMJ) are not publicly disclosed. They are legally speaking agreements amongst the banks. The agreements include stipulations that disclose security features of the systems. Thus they are open to authorities such as the BOF and Ministry of Finance. They would also be open to new members of the system.
<p><i>VI. Open process for formulating and reporting of payment system regulatory and supervisory policies</i></p> <p>The BOF has adopted a consultative and participatory approach to its oversight role. With respect to the</p>

<p>RTGS-RTGS high value payment system, of which the BOF is owner and operator, its relationship with participants is mainly contractual in nature. However, the terms and conditions of participation are publicly disclosed.</p> <ul style="list-style-type: none">• While all the rules, regulations, and operating procedures are not published, all are publicly available.• There are no regulations that govern reporting by payment system participants to the BOF. There is an obligation in the agreement that participants in BOF-RTGS enter into with the BOF to “immediately notify the BOF of any faults in detects in BOF-RTGS” (Rule 12), and an obligation to provide the BOF with all the information it requires.• There are no formal MOUs amongst the BOF, MOF and FSA with respect to payment system oversight, although operational collaboration and cooperation appears to be good. The procedures are therefore not as transparent as they would be if relationships were formally documented.
<p><i>VII. Public availability of information on payment system regulatory and supervisory policies</i></p> <p>The BOF maintains an open, and comprehensive approach to reporting on developments in the payment system, both through its publications program, and through its Annual Report.</p>
<p><i>VIII. Accountability and assurance of integrity by payment system regulatory and supervisory agencies</i></p> <p>The BOF is subject to the oversight of, and is accountable to, the Parliamentary Supervisory Committee. Additionally there is an internal audit function and staff are subject to a code of conduct. These arrangements are generally transparent.</p> <ul style="list-style-type: none">• Consideration should be given to publishing the staff code of conduct, information on the internal audit function and other information on the corporate governance arrangements at the BOF in its annual report, and to reporting annually (say in the BOF’s Annual Report) on how the internal audit strategy was implemented during the year under review (i.e., disclosure of a backward looking review, rather than a forward looking plan).• Consideration could be given to publishing the code of conduct, say in the Annual Report (along the lines of the code published by the FSA in its Annual Report).• The legal protections for staff are those established in the law on civil servants. There is no direct and transparent application to BOF staff.

IX. MFP TRANSPARENCY CODE—DEPOSIT INSURANCE AND INVESTMENT GUARANTEES

A. Institutional and Market Structure

117. Finland maintains broadly parallel deposit insurance and investor compensation schemes. Both provide protection to “small,” nonprofessional depositors/investors only, and in the case of investor protection, only in respect of unpaid obligations in the event of the bankruptcy of the investment firm. Protection is not provided in respect of losses arising from movements of the market prices of investment assets.

118. The key features of the Deposit Guarantee Fund (DGF) are that:

- It is compulsory for Finnish deposit banks to join. Branches of foreign banks may join to supplement protection provided under home country deposit insurance arrangements.
- The maximum guarantee is 150,000 Finnish marks per depositor per deposit bank, and then only for nonprofessional depositors.

- The scheme is funded by deposit banks at a prescribed rate, which varies, to some degree, according to the capital adequacy ratio of the deposit bank.
- The Fund has power to require deposit banks to lend to it should the resources of the Fund be insufficient to meet claims.
- The Fund is administered by a delegation elected by the member banks, which elects a Board of Directors. Day-to-day administration is managed by an Executive Secretary, using the resources of the Bankers' Association (for a fee paid to the Association). The Fund has no personnel of its own. It does not have a supervisory or regulatory role.
- The Fund is supervised by the FSA.

The key features of the Investors' Protection Fund (IPF) are that:

- It is compulsory for Finnish investment firms and credit institutions that provide investment services to join. Branches of foreign firms may join to supplement cover available under home state protection arrangements.
- The compensation available is 90 percent of a valid claim, up to a maximum of 20,000 euro per claim, and then only for nonprofessional investors. However, compensation is payable only in respect of unpaid obligations of the investment firm to investors in the event of the firm's bankruptcy; not in respect of investment risk arising from changing market prices for investment assets.
- The Fund is funded by annual contributions from members, but additionally may take insurance cover (not to exceed half the capital of the Fund), and may borrow to cover a shortfall in its resources relative to claims due to investors. The members of the Fund are jointly liable for its obligations.
- The Fund is administered under arrangements that parallel those for the DGF, i.e., by a delegation elected by members, which appoints a Board of Directors. Day-to-day administration is as for the DGF. It does not have a regulatory or supervisory role.
- The Fund is supervised by the FSA.

B. Main Findings Summary

119. An assessment of the observance of the transparency of the deposit insurance and investment protection fund against *IMF's Code of Good Practices in Transparency in Monetary and Financial Policies* is provided in Table 12. When the DGF and IPF were introduced in 1998, as part of the rolling back of the comprehensive government support that had been provided to the banking system during the crisis in the early 1990s, and in response to EU Directives, there was considerable public discussion. It appears that now, however, they have a lower profile, and it is possible that the terms, in particular, the limits to

protection they provide, may be less well understood. Accordingly, it may be appropriate for the authorities to consider how best to ensure that the key features of the schemes are not lost from the public's consciousness. One way of achieving this may be to enhance the Annual Reporting of the Funds. The authorities agreed that it would be desirable to ensure that the features of the schemes are well understood by the public.

Table 12. Summary Findings of the Assessment of the MFP Transparency Code for Deposit Insurance and Investment Guarantees

<p><i>V. Clarity of roles, responsibilities and objectives of deposit insurance and investor protection regulatory and supervisory agencies.</i></p>
<p>The roles, responsibilities and objectives of the DGF and IPF in Finland are generally clear and transparent. Both schemes are established by legislation (the Act on Credit Institutions and the Act on Investment Firms respectively), and are governed by the provisions of that legislation and by by-laws made under it. The objectives as contained in the governing legislation are expressed in quite broad terms ("to safeguard the claims of depositors" and "to safeguard the cash and instruments (claims) of investors," although the specific terms of the protection afforded make it clear that the objective is narrower, and limited to (a) protecting "small," nonprofessional, depositors and investors and (b) in the case of investors who use the services of investment firms, only losses arising from the insolvency of the investment firm, not losses arising from, for example, poor investment advice.</p> <p>The DGF and IPF regulatory and supervisory roles are limited to the administration of their respective schemes. Those of the DGF are clearly established by legislation and by byc-laws made pursuant to that legislation.</p> <ul style="list-style-type: none"> • DGF's and IPF's objectives are only broadly expressed in law; it would be advantageous if they were more closely aligned with the particulars of the protection provided. • The objectives of the DGF and the IPF are more broadly stated than is consistent with the terms of protection actually provided. More prominence could be given to the publicly available information. • Accountability is exercised through submission of annual reports with limited circulation; best practice would be for the Boards of the Funds to give an account to their members and to the wider public of decisions taken and performance achieved. • Prescription of appointment criteria to the Funds' Boards is limited. The authorities could consider whether the governance and accountability arrangements are fully transparent to the public.
<p><i>VI. Open process for formulating and reporting of deposit insurance investor protection regulatory and supervisory policies.</i></p>
<p>At the time the current deposit guarantee and investor compensation arrangements were introduced in 1998, in response to EU Directives, and in the context of a roll-back of the comprehensive Government guarantees that had been put in place in response to the serious banking system crisis in the early 1990s, they were actively and openly debated, and there was an active process of consultation with the credit institutions and investment firms affected. Given the open processes generally in Finland for law-making, any material modifications to the two sets of arrangements would involve a similarly open process.</p> <ul style="list-style-type: none"> • Greater prominence could be given to the objectives and operations of the DGF and IPF, and best practice would suggest wider dissemination of more detailed annual reports. • The DGF and IPF mostly act on instructions received. The law would appear to provide for a free flow of information from the DGF and IPF to the FSA on all relevant matters. • Annual reports are prepared but not disseminated. The authorities could consider requiring the DGF and the IPF to more actively disseminate their annual reports.
<p><i>VII. Public availability of information on deposit insurance and investor protection regulatory and supervisory policies.</i></p>
<p>Information on the DGF and on the IPF is publicly available by way of (a) the relevant law and regulations/by-laws and (b) from the Bankers' Association (although not in a manner that results in the information receiving any prominence. Additionally, credit institutions and investment firms are required by law to inform their customers of the scope of the protection afforded, but it is not clear how actively</p>

this is done in practice.

- Neither Fund publishes aggregate data. A best practice annual report might include the data used for calculating contributions to the Funds, while maintaining commercial confidentiality (i.e., for example, not disclosing commercially sensitive details on the break-down of individual bank's insured (small) and uninsured (large) deposits.) Disclosure of individual bank premiums, which, inter alia, are risk based, would be consistent with harnessing market disciplines to promote safety and soundness in the banking system.
- Balance sheets and market transactions are not distributed on a regular basis. Best practice would be to disseminate annual reports, which include financial statements, information on contributions collected, the investment performance of the Funds, and any claims made on the Funds.
- There is not a legal requirement for distributions to be published; in practice they would be public events. The publication of annual reports would be an additional vehicle for observing this standard.
- Apart from information required by law, information to the public is insufficiently prominent to provide a clear understanding of the protections available and their limits.
- Neither the DGF nor the IPF have a publications program.
- Explanations about the DGF and IPF would be provided as required. The authorities might consider instituting a steady information flow.
- The DGF's and IPF's principal directives concern contribution rates; these are on public record but not actively disseminated.

VIII. Accountability and assurance of integrity by deposit insurance and investor protection regulatory and supervisory agencies.

The DGF and IPF are each administered by a Supervisory Board elected by the member institutions and by a Board of Directors elected by the Supervisory Board, and governed by rules drawn up under the relevant legislation, and confirmed by the Ministry of Finance. Amongst the matters to be covered by the rules is the audit of the Funds.

Annual financial statements are prepared and available, but not disseminated. There may be scope to strengthen the annual reporting, both to increase the prominence of the Funds (and in particular the boundaries to their role) and as a demonstration of best practice governance.

- Officials can be called to appear before a designated public authority, but requests are rare.
- Neither Fund publishes audited financial statements on a pre-announced schedule though audited financial statements are provided to any interested party on request.
- The governance arrangements for the DGF and IPF are prescribed in the Act on Credit Institutions and in the Act on Investment Firms, and the rules and by-laws made under those acts, and as such are on the public record. Additionally, however, there would be merit in publicly disclosing the terms of the arrangement by which the Bankers' Association administers the Funds, including so that the administrative arrangements are seen to be arms length in nature (or that any subsidy is made transparent).
- Since the Funds are administered by the Bankers' Association, they have no operating budget of their own; rather, they pay a fee to the Bankers' Association annually, based on covering the costs incurred by the Association. Nonetheless there may be an advantage in the interests of the administrative arrangement being seen to be conducted on an arms-length basis, for the details on which the fee is based to be published.