

**FOR  
AGENDA**

SM/01/291  
Correction 1

CONTAINS CONFIDENTIAL  
INFORMATION

November 5, 2001

To: Members of the Executive Board

From: The Secretary

Subject: **Finland—Financial System Stability Assessment**

The attached corrections to SM/01/291 (9/25/01) have been provided by the staff:

**Page 34, para. 69, line 6:** for “cross broader” read “cross-border”  
**lines 9 and 10:** for “Finland into the Baltic region, and is planning to merge with Storebrand, a major financial group in Norway.”  
read “Finland into the Baltic region.”

**Page 48, footnote 7, lines 4 and 5:** for “settlement funds raised by the participant, and emergency funds raised by the exchange.”  
read “and settlement funds raised by the participant.”

**Page 52, para. 113, line 2:** for “CPSS/IOSCO Principles” read “CPSS Core Principles”

Questions may be referred to Mr. Johnston (ext. 38980), Mr. Kupiec (ext. 39733), and Ms. Zephirin (ext. 38680).

Att: (3)

Other Distribution:  
Department Heads



## 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 Turkesteen (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

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.<sup>7</sup>
- 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.

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<sup>7</sup> 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.

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.