SUOMEN PANKKI • BANK OF FINLAND

Financial Markets Department

Financial Markets Report

2004 - No. 1

- Sound results from Finnish banks last year
- Housing loan growth continues to rise briskly
- Record dividends from listed Finnish companies
- Risk premiums at exceptionally low levels on non-financial corporation loans
- Banks seek significant savings through more efficient processing on payments

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Project team

Pertti Pylkkönen, chairman
Timo Iivarinen
Karlo Kauko
Heli Paunonen
Hanna Putkuri
Katja Taipalus
Mervi Toivanen
Jukka Vauhkonen

Nina Björklund
Kati Salminen
Petri Uusitalo
Janne Villanen

Taina Seitovirta
Korhonen Ilkka
Lehto Ulla
Park-Ahonen Louise
Puttonen Eija
Tervonen Eija

Coordination

Financial Markets
Management Group

POSTIOSOITE PL 160, 00101 HELSINKI
KÄYNTIOSOITE Snellmaninaukio
PUHELIN (09) 1831
FAKSI (Rahoitusmarkkinaosasto) (09) 624 842
SÄHKÖPOSTI: etunimi.sukunimi@bof.fi

POSTADRESS PB 160, 00101 HELSINGFORS
BESÖKSADRESS Snellmansplatsen
TELEFON (09) 1831
FAX (Finansmarknadsavdelningen) (09) 624 842
E-POST förnamn.efternamn@bof.fi

POSTAL ADDRESS P.O. Box 160, FIN-00101 HELSINKI, FINLAND
STREET ADDRESS Snellmaninaukio, Helsinki
PHONE International + 358 9 1831
FAX (Financial Markets Department) + 358 9 624 842
EMAIL first name.surname@bof.fi http://www.bof.fi

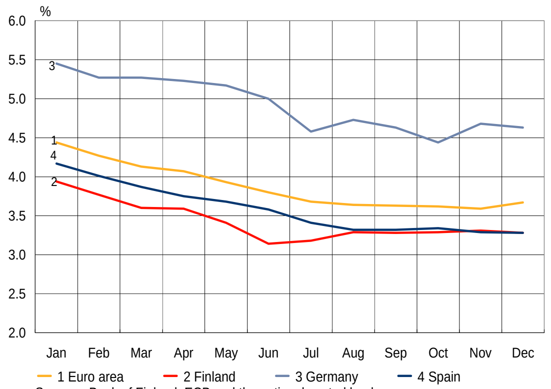
1 Financial intermediation

1.1 Housing loans growing fast in some euro area countries

Pertti Pylkkönen

Interest rates on new housing loans in the euro area continued to decline in 2003. Low interest rates have accelerated the growth of the housing loan stock in Finland as well as in eg Ireland and Spain. In Finland, the stock of housing loans is presently growing at an annual rate above 15%. In Spain and Ireland, the growth rate has already climbed to about 25%.

Chart 1. Interest rates (%) on new housing loans given by financial corporations, loans with up to one-year initial rate fixation, year 2003



Sources: Bank of Finland, ECB and the national central banks.

Average interest rates on new housing loans in the euro area declined in 2003. The sharpest drop was for housing loans tied to one-year and shorter reference rates. Interest rates on such new housing loans declined on average by 0.8 percentage points in the euro area. Also longer-term interest rates on new housing loans in the euro area decreased, albeit to a lesser degree than the shorter-term rates. In Finland, interest rates on new housing loans with up to one-year fixed rate declined last year by 0.65 percentage points, to 3.29% in December.

Average interest rates on all new housing loans in Finland have long been the lowest in the euro area. However, the differential against a number of countries has declined, and in Spain in December 2003, the interest rates on new housing loans with up to one-year fixed rate were on the same level as in Finland (3.29%). For example, in January 2003, the interest rate differential between Finland and Spain was still almost 0.3 percentage points. In a number of other euro area countries, interest rates declined during 2003 more than in Finland.

For a long time, Finnish banks have been among the most efficient in the euro area. Besides a tight competitive situation, this has been reflected in narrow interest rate margins on housing loans. At present, the situation in the Spanish housing loan market is similar to that in Finland. Banks' efficiency has improved notably in recent years, which is reflected in a narrowing of interest rate margins on new housing loans. Another factor in common for these countries is a clearly faster growth of housing loan stock than the euro area average. In December 2003, the growth rate of the housing loan stock was more than 15% year-on-year in Finland and a good 20% in Spain, while in Ireland housing loans actually grew slightly faster. As regards the largest euro area countries, the growth of the housing loan stock has also been relatively rapid in France (about 10%). In Germany, the growth of housing loan stock has been slow for some time; at present, growth is slightly positive.

Interest rates for up to one year continue to be the most frequently used reference rates in housing finance in Finland. Interest rates on 90% of new housing loans drawn in 2003 were tied to reference rates for up to one year. In most euro area countries, housing loans are tied to longer-term interest rates than in Finland.

In September–December 2003, over 93% of housing loans were granted by banks. Other financial corporations (eg mortgage banks) and the public sector each accounted for 3%.

1.2 Record dividends from listed Finnish companies

Hanna Putkuri

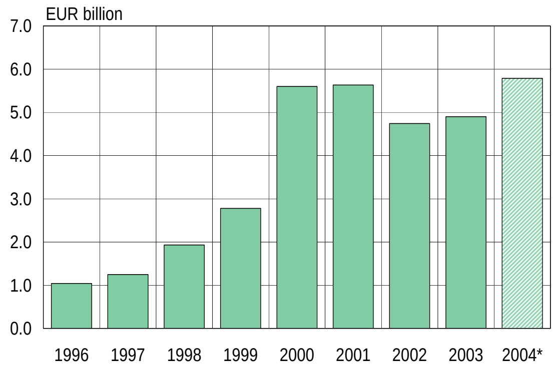
Based on proposals published earlier this year, listed Finnish companies will pay record dividends this spring. Part of the increase is explained by the anticipated tightening of dividend taxation from the beginning of next year. Dividends paid by the entire corporate sector (incl. unlisted companies) have increased steadily since the mid-1990s. At the same time, households' annual dividend income has increased manifold from ten years ago.

In November 2003, the Government announced its statement on the reform of corporate and capital income taxation. The statement entails a proposal to tighten the taxation of dividend income by shifting from the *avoir fiscal* system to a system of partial double taxation of dividends[1]. According to rough preliminary estimates by the Government, the dividend taxation reform would increase the Government's tax revenue by EUR 130–180 million, in which EUR 100–150 million would be accounted for by listed companies and the remaining EUR 30 million by other companies. The Government intends to present a bill to Parliament on the legislative proposal in spring 2004.

If the reform is implemented, it will be first applied to the taxation of dividends received in 2005. Due to the tightening of taxation, particularly family-owned companies with strong balance sheets, as well as other companies mainly owned by domestic private investors, are expected to run down excess capital by distributing exceptionally large dividends. Finnish tax provisions do not generally apply to foreign equity investors.

Based on the proposals released by the boards of listed companies earlier this year, the aggregate dividends from listed companies will increase by more than 18% from last year (see Chart 2).

Chart 2. Dividends paid by listed Finnish companies, 1996–2004*



* Preliminary information as of 5 March 2004, calculated on the basis of proposed dividends and the number of shares listed.

Source: HEX Integrated Markets.

According to the proposals published up to early March, the increase in dividend distributions is relatively modest compared to the situation at end of the 1990s, when both the number and market value of listed companies were growing rapidly. In 2000, when growth was at its highest so far, the aggregate amount of dividends paid by listed companies doubled from the previous year. Since the recession, there have been changes in Finnish companies' dividend policies; in line with international practice, a larger share of profits than before has been distributed to shareholders.

This year over 40% of listed companies have announced increased dividends from last year while a little less than a third will keep dividends unchanged. By sector, dividend payout increases were most frequent

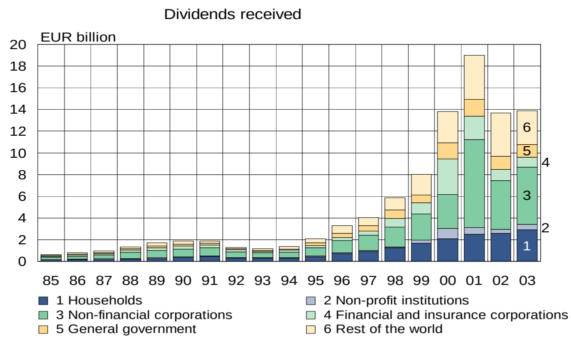
[1] Under the *avoir fiscal* tax credit system, which has been in place since 1990, the receiving of dividend incurs no tax-related costs for the recipient, because the recipient's taxes are credited with taxes paid by the dividend-paying company. After the reform, 70% of dividends paid by listed companies would constitute taxable capital income, on which the tax rate would be lowered from 29% to 28%. Dividends from unlisted companies would remain partially tax exempt; for more details see memorandum of the Ministry of Finance on the reform of corporate and capital income taxation (13 November 2003).

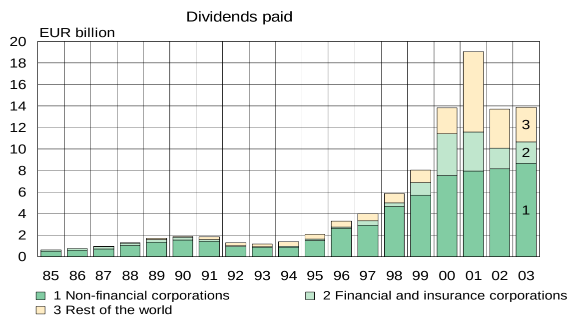
within trade, media and publishing. In contrast, there will be no increases by forestry companies, which suffered from weak results.

In terms of percentages, the largest dividend increases will come from Alma Media, PKC Group and Sampo, all of which are more than tripling their dividend per share. Other companies increasing their dividends by at least one euro are the Ilkka-Yhtymä Group, Ponsse, Kesko and Finnlines. Tulikivi, Tamfelt and Lemminkäinen, which paid exceptionally large dividends last year, are leading the pack in dividend reductions this year.

As regards the aggregate amount of dividends, by far the biggest dividend payers are the largest enterprises: Nokia, Sampo, TeliaSonera, UPM-Kymmene, Stora Enso and Fortum. The Government's dividend income will increase from last year because of larger dividend distributions in particular by Sampo, but also by TeliaSonera, Fortum and Kemira.

Chart 3. Dividends paid and received by sector in 1985–2003





Source: Statistics Finland, Annual accounts.

According to annual accounts of Statistics Finland, the amount of dividends paid by domestic non-financial and financial and insurance corporations (incl. unlisted companies), and dividends paid from the rest of the world to Finland have increased very sharply between the mid-1990s and 2001 (see Chart 3). The amount of dividend distributions by foreign companies increased sharply in 2001 when they more than tripled from the previous year. Also dividends paid by financial and insurance corporations increased sharply at the end of the 1990s. In 2002, the aggregate dividends paid by these sectors dropped from the highs of 2001 back to the level of year 1999.

The growth of dividends paid by the corporate sector has been continuous but decelerating ever since 1995. In 2003, corporate dividends were almost ten times higher than ten years earlier. The growth of corporate dividends has increased households' dividend income sharply during the last ten years.

The distribution of dividends by sector has varied rather little from year to year. However, the proportion of dividends paid to the rest of the world, and particularly dividends received from the rest of the world, has increased significantly from ten years ago (see Chart 3).

2 Banks and insurance companies

2.1 Banks did well in 2003

Mervi Toivanen

Net operating profit of banks (excl. Nordea) improved in 2003. Although banks' net interest income declined in response to lower market rates and narrower interest rate margins, an improvement in other income bolstered the results. The trend in expenses varied across banking groups but, in the aggregate, expenses remained almost unchanged from 2002. Capital adequacy continues to be sound.

Financial results in 2003

The combined net operating profit for the banking sector (excl. Nordea) increased 3.7% from the year before. Including Nordea's retail banking operations in Finland, the combined net operating profit, however, declined. The comparison is impaired by non-recurring items included in the figures for comparison years.

Table 1. Banks' financial results, 2003

	Net income		Other income		Total expenses		Operating profit	
	EUR m	Change %	EUR m	Change %	EUR m	Change %	EUR m	Change %
Nordea Group	3 366	-2.5 %	2 273	2.4 %	3 955	1.0 %	1 812	17.1 %
*Nordea Group, banking	3 658	-2.6 %	2 165	5.5 %	3 930	1.4 %	1 587	-7.8 %
*Nordea retail banking in Finland	782	-11.5 %	378	14.9 %	615	2.5 %	575	-5.9 %
Sampo Group								
*Sampo Group banking and investment services	404	-9.8 %	239	1.7 %	414	-5.3 %	233	-7.5 %
OP Bank Group	798	-6.9 %	458	11.2 %	766	1.1 %	515	12.2 %
*OKO Bank Consolidated	161	0.0 %	162	-	139	6.9 %	174	81.3 %
Savings banks (excl. Aktia) Total	114	-10.8 %	36	13.8 %	109	8.4 %	41	-30.0 %
Aktia Savings Bank plc Group	74	-1.7 %	41	9.1 %	83	-8.0 %	30	53.3 %
Local cooperative banks	76	-8.2 %	23	38.1 %	68	2.1 %	30	-8.0 %
Bank of Åland plc (Group)	30	-6.0 %	19	21.7 %	33	3.4 %	15	7.0 %
eQ online Group	2	51.4 %	14	22.0 %	16	7.8 %	0	-
Total	5 156	-4.1 %	2 986	6.2 %	5 419	0.8 %	2 452	-4.1 %
Other than Nordea, total	1 498	-7.8 %	830	9.4 %	1 489	-0.7 %	865	3.7 %

Other income includes net fee income but excludes the income statement item 'profit/loss of companies consolidated by the equity method'.
Expenses include depreciations as well as unrealised losses on tangible and intangible assets.
Nordea's expenses include goodwill depreciation and write-downs.
The items of the table do not add up to the operating profit, as not all the banks' income statement items are included.
The change % was calculated on the corresponding figures for 2002.

Source: Banks' financial press releases.

Net interest income declined in response to a lower level of interest rates and narrower customer margins. The decline was, however, slightly offset by using derivatives to hedge against interest rate risk. The growth of the lending stock also had an alleviating effect on the decline.

The decline in net interest income was partly offset by an increase in other income. Overall, banks recorded an increase in income from asset management, securities trading and brokerage, other income on business operations (one-off capital gains) and fee income.

Banks' aggregate expenses remained almost unchanged from the previous year, although there was some variation across individual banks. Expenses were boosted by the establishment of new branches but constrained by rationalisation, staff reduction and elimination of one-off items. The loan losses of banks (excl. Nordea) declined further and stood at EUR 13 million (EUR 15 million in 2002). By contrast, the loan losses of Nordea increased by 39% from the year before, to EUR 363 million.

Profitability and capital adequacy

Profitability and cost-efficiency within the banking sector has developed along two different lines. Whereas some banks have been successful in improving return on equity (ROE%) and cutting costs (expenses, % of income), for others return on equity has fallen and expenses have increased. Banks' capital adequacy continues to be sound overall.

2.2 Performance of major European and American banks improved in 2003

Jukka Vauhkonen

The performance of European banks improved especially in response to cost cutting measures and lower loan loss provisions. American banks recorded their best result ever.

The major European banks improved their results in 2003 despite the subdued economic development. In recent years, banks have responded to a more problematic operating environment with pronounced cost cutting, which is reflected in their results for 2003. Banks' loan loss provisions also declined partly in response to the low interest rate level, thus facilitating the servicing of loans.

European banks' lending to households increased, whereas lending to companies declined. In several countries, low interest rates boosted demand for housing loans, in particular. Corporate lending declined as companies restrained investments and strengthened their balance sheets. Other income turned up partly due to the recovery of the stock market.

The profitability and efficiency of European banks vary considerably across countries. Among the large EU countries, the profitability of German banks has been the weakest in recent years. Banks have responded to the sluggish economic development and banking sector overcapacity witnessed in Germany in recent years by mergers and acquisitions and heavy cost cutting measures. Of the major German banks, Deutsche Bank and Hypo-Vereinsbank improved their performance in 2003, whereas Commerzbank recorded a loss of about EUR 2.3 billion.

Over the past few years, the major UK banks have been the most profitable in Europe, with the largest banks recording excellent results in 2003. HSBC and Royal Bank of Scotland, in particular, improved their performance considerably. In their home market, UK banks have benefited from the strong demand for housing loans. It should, nevertheless, be noted that a considerable part of the income of the largest banks originates in foreign operations.

In recent years, the major banks of other large EU countries have showed higher profitability, on average, than German banks but lower profitability than UK banks. The performance of central and southern European banks was fairly good on average in 2003. For instance, the Dutch bank ABN Amro recorded its best performance ever.

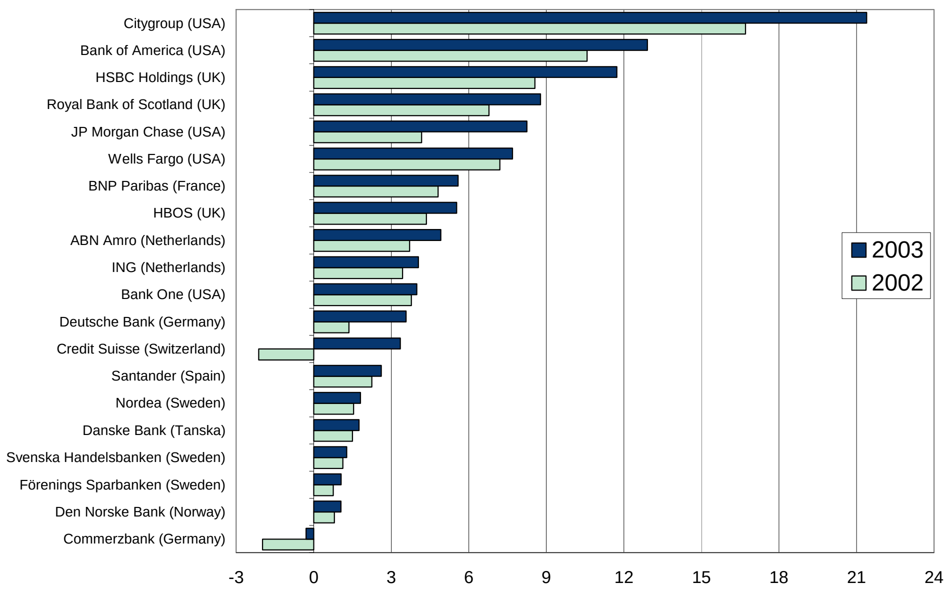
Other banks that have notably improved their performance include the Swiss banks UBS and Credit Suisse and the French bank BNP Paribas.

The large Nordic banks also improved their results, mainly as a result of expense reductions and increases in other income. Despite the fairly rapid growth of the lending stock, net interest income either improved only slightly or decreased, as interest rate margins were squeezed by a fall in market rates.

In 2003, American banks achieved their best performance ever. The combined result for the banks covered by the US deposit insurance scheme increased by 14% from 2002, and stood at USD 121 billion. Similarly, with 1.38 (1.30 in 2002), return on assets (ROA) reached a new record. Of the major banking groups, Citigroup and JP Morgan Chase showed the biggest improvement in performance.

The decline in loan loss provisions, in particular, improved the results for the American banks. The drop in loan loss provisions accounts for two-thirds of the improvement in the combined results for banks. The quality of banks' corporate claims has improved significantly since the economic recession of 2001, and this is reflected in lower loan losses. The strong growth of lending to households also boosted profitability. The volume of housing loans, as well as credit card and other consumer loans, increased rapidly, whereas corporate lending fell for the third year running.

Chart 4. Operating profits of international banks, 2002–2003, EUR billion



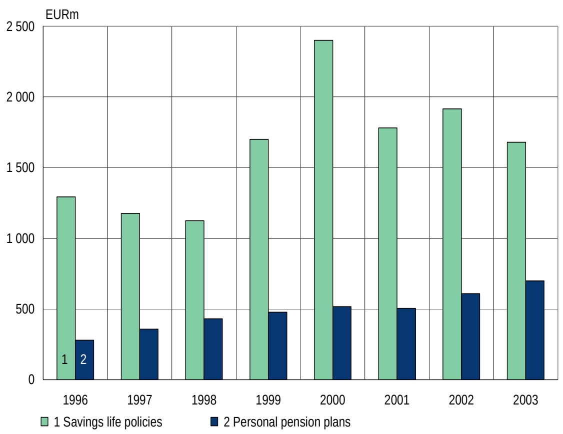
Sources: Banks' financial statements and Bloomberg.

2.3 Broad restructuring in insurance sector

Pertti Pylkkönen

The investment income of insurance companies turned up last year. This was reflected in a clear improvement in profitability. Premiums written by insurance companies showed a less favourable trend than in the year before, with the exception of premiums written for personal pension plans, which continued to increase relatively strongly.

Chart 5. Premiums written by life insurers



Source: Federation of Finnish Insurance Companies.

According to preliminary data, the rate of growth of premiums written in the insurance sector slowed in 2003 from the year before. Premiums written by employee pension insurers rose by only 3%. Total premiums written by life insurers fell by more than 10% as premiums written on savings life insurance declined. Premiums written on capital redemption contracts declined substantially as some companies withdrew from the market. By contrast, personal pension plans sold by life insurers continued to gain popularity in 2003. Premiums written grew by around 15%, with unit-linked pension insurance increasing most in popularity and accounting for as much as slightly over 40% of premiums written on pension insurance.

The proportion accounted for by private insurance savings in households' financial wealth has been steadily increasing and stood at 15% in September 2003. This was clearly higher than the proportion accounted for by mutual funds (10%).

The lively debate on the revised tax treatment of personal pension plans in the latter part of the year seems to have boosted investment in personal pension plans. Especially in December, accrued premiums written on pension insurance grew at an exceptionally fast pace.

The more subdued increase in premiums written, compared to 2002, was offset by a clear improvement in investment income. The higher investment income was due in large part to the steep ascent in share prices in the spring of 2003. Following the increase in investment income, insurance companies' results improved considerably last year. This is seen most clearly in the overall results for pension insurance companies. The combined performance of the five Finnish pension insurance companies amounted to about EUR 2.2 billion[1] in 2003, against a loss of almost a billion in the previous year. Operating profits of life insurance companies owned by banking groups (Nordea, OP Bank Group and Sampo) grew last year from EUR 61 million to slightly over EUR 370 million.

Following the rise in share prices, the focus of the investments of pension and life insurers shifted towards equities. At the end of 2003, equities accounted for nearly a fourth of the total investment portfolio of pension insurance companies. For other pension insurers, the weight of equities was slightly higher yet. In the investment portfolio of life insurers, equities accounted for slightly over a fifth. For non-life insurance companies, by contrast, the weight of equities in the investment portfolio declined in the course of 2003 and amounted to a little over 15% of the portfolio at year-end.

The regional allocation of insurance companies' investments outside of Finland is smoothing out. At the end of 2003, some 40% of assets were invested in Finnish investment vehicles, while the proportion of

[1] Includes following companies: Eläke-Fennia, Eläke-Tapiola, Etera, Ilmarinen and Varma.

investments in other euro area countries was somewhat higher. The remaining around 15% of investments was almost exclusively in OECD countries outside of the euro area. New fixed income investments, in particular, are directed to the euro area countries, as bond issues have been rare in Finland recently.

The reorganisation of the insurance sector was stepped up again at the start of 2003 when Sampo acquired a majority stake (about 90%) in IF, the largest Nordic non-life insurance company, from the Swedish insurance company Skandia, its subsidiary Skandia Liv and the Norwegian company Storebrand. A little later Sampo sold its holding in Skandia, amounting to 7.4% of the share capital. Skandia Liv sold its holding in Storebrand in March. The insurance companies Pohjola, Suomi and Ilmarinen signed a preliminary agreement on the reorganisation of their life insurance operations. Under this agreement, Pohjola will purchase an insurance portfolio of about EUR 1 million from the Insurance Company Suomi at the beginning of 2004 and will return to the life insurance business. Suomi Insurance Company will no longer sell new policies. Under the agreement, ownership in Pohjola will be reorganised so that the holding of Suomi Insurance Company in Pohjola increases to 49.9% and that of Ilmarinen decreases to 9.3%. The Tapiola Group opened up its newly established bank to the public in February.

3 Securities markets

3.1 Continued growth on the share markets

Hanna Putkuri

In January-February, share prices continued the rising trend that began in spring 2003, in both Finland and the international markets, but growth came to a halt in early March. In the euro area in particular, share market liquidity has improved markedly since the start of the year.

The rise in international share prices, observed since spring 2003, continued until the beginning of March. By the end of February, the broad share price indices in the USA, Japan and euro area had increased, over the previous twelve months, by 36%, 32% and 35%, respectively. In the USA and euro area, banking share prices rose roughly in line with the overall trend in share prices, while in Japan they climbed considerably faster.

Until early March, Finnish share prices followed the upward trend after hitting a four-year low in March 2003. By the end of February 2004, the HEX All-Share Index and HEX Portfolio Index had risen, year on year, by 40% and 38%, respectively.

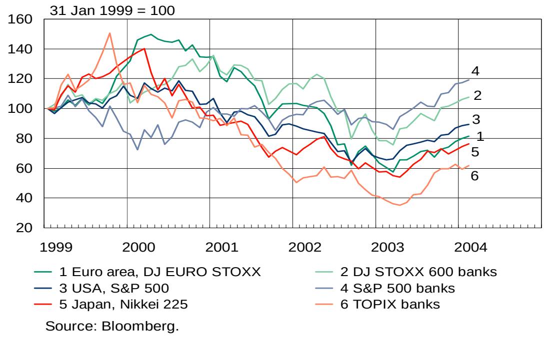
Looking at sectoral share price performance in Finland, developments have been somewhat uneven. While the share price indices for the banking and finance sector, metal and engineering, and telecommunications and electronics have outperformed the HEX All-Share Index, forest industry shares, amid poor financial results, have risen at a clearly slower pace.

Share market liquidity has improved significantly since the start of the year. In January 2004, the total value of share turnover at euro area stock exchanges was the highest in 18 months, helped by a 27% increase since January 2003. Trading in the USA and Japan also picked up markedly compared to January 2003, but to a lesser extent than in October.

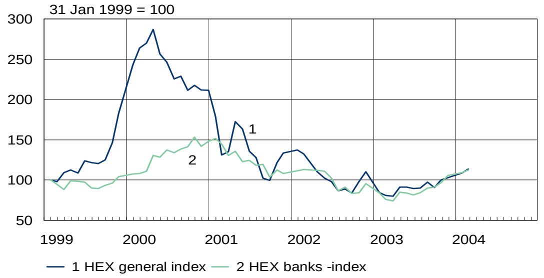
In January-February, cumulative share turnover on the Helsinki Exchanges grew by 35%, year on year, in terms of both volume and value, with particularly rapid growth for the I list and NM list. Total early-year trading on the HEX, in terms of market capitalisation, was nevertheless close to the previous year's level, owing to the rise in share prices.

The number of domestic listed companies has fallen steadily since the record reached in 2000. Four companies were removed in 2003 and two more in the first few months of 2004. At the same time, the number of brokers has increased. At the end of February, HEX had 44 securities brokers, of which 28 were remote brokers. The share of remote brokers in total HEX trading has increased in recent years, to nearly 54% in January-February.

Chart 6. Stock indices, euro area, USA, Japan and Finland



Source: Bloomberg.



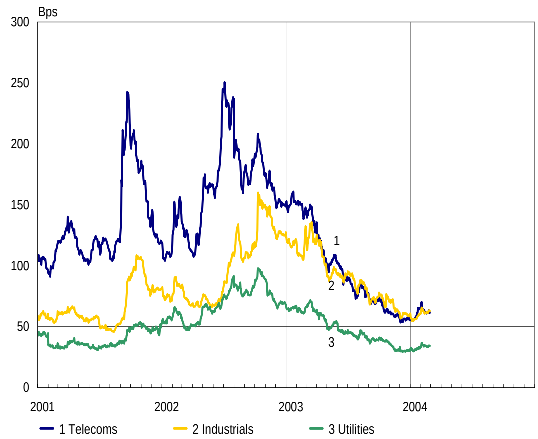
Source: HEX.

3.2 Risk premiums at exceptionally low levels on non-financial corporation loans

Katja Taipalus

The pace of future economic growth and changes in exchange rates will have a major impact on developments in the fixed-income markets.

Chart 7. Spreads



Source: Sampo Bank plc.

The financial debacle of the Italian food group Parmalat was headline news at the end of 2003, and the case is still pending. Investigations concerning Parmalat bonds are still under way, the focus being on the banks which continued to arrange Parmalat's bond issues in June and September 2003. Securitised assets are once again linked to a financial scandal: according to some allegations, Parmalat subsidiaries are suspected of having sold inflated trade receivables to an ABCP conduit of a major international bank, which then securitised the receivables. The subsidiaries could have used this funding to create paper profits for Parmalat's balance sheet.

Overall, the corporate bond market remained more or less unchanged in that interest rate spreads remained very narrow. However, since the start of 2004, spreads have widened slightly. Although very modest for bonds with better credit ratings, the widening amounted to several tens of basis points for higher-risk bonds.

In addition to the improved economic prospects, the narrowing of spreads can be attributed to a strong demand for corporate bonds. Keeping spreads tight will probably require a prolongation of the positive outlook and keen interest in corporate bonds.

Conflicting signals have come in this year as to the demand for corporate bonds. There are signs that insurance companies in particular have shifted investment money from shares into corporate bonds. Yet fund managers seem to be indicating that bonds are currently over-priced. Furthermore, continued low volatility could result in demand shifting from traditional bonds to structured debt instruments in order to boost yields. This could soften the demand for corporate bonds. With spreads this narrow, the demand for corporate bonds is also sensitive to negative news on overall economic growth.

It does not seem that the supply of bonds will alleviate the possibly permanent demand pressure, as the value of euro bond issuance by the start of February was only EUR 22.1 billion. Although there is still time until the end of the first quarter, it is beginning to be evident that bond issues will not reach the record figure of EUR 70.8 billion reached in the first quarter of 2003. All in all, euro bond issues totalled EUR 260 billion in 2003.

Credit rating agencies have expressed their concern over the quality of the bonds issued. With the tightening of spreads, the issuance of poor quality bonds has increased, particularly in the USA. At worst, this could lead to an increase in default ratios within a few years.

As far as corporate ratings are concerned, the situation seems to have improved, as in Europe, for example, the downgrades-to-upgrades ratio seems to have declined. Looking ahead to companies' prospects, sectoral differences can be found. For one thing, the notable appreciation of the euro will affect the profits of export-driven companies such as European car manufacturers and forest companies. Another concern going forward is the increased, and bond-financed, M&A activity. This could have an impact on the indebtedness of companies seeking finance.

The Finnish bond market has been relatively quiet. In November, the State Treasury held an auction for the benchmark bond maturing in 2006. Bids amounting to EUR 600 million were accepted, which raised the outstanding stock of the benchmark bond to EUR 7,100 million. In December, Rautaruukki, a Finnish construction and mechanical engineering company, issued EUR 130 million in bonds and in February, Sampo Bank Ltd issued both Tier 1 (EUR 125 million) and subordinated securities (EUR 150 million) as well as bonds totalling EUR 500 million. OKOBank also issued EUR 600 million in bonds and in March, the State Treasury issued bonds totalling USD 1500 million. Other events in the domestic market were mainly concerned with the lowering of corporate credit ratings. Moody's reduced Metso's (paper technology, rock and minerals processing) rating to Ba1, while S&P reduced Sanitec's (bath and shower elements) rating to B+. S&P also downgraded M-Real's (paper and packaging) rating (BB+) to conform with Moody's prior downgrade to Ba1. Moody's upgraded Fortum's long-term rating to Baa1.

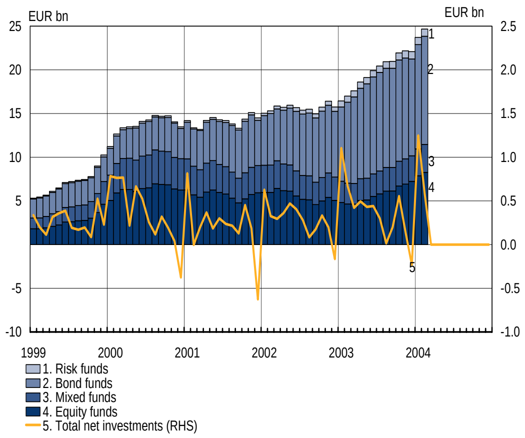
3.3 Mutual fund markets showing strong growth

Pertti Pylkkönen

In 2003, Finnish mutual funds achieved record growth in new investments. This notwithstanding, mutual fund investment per capita is still among the lowest in Europe. The value of Finnish mutual funds is now about EUR 4,000 per inhabitant.

The flow of new capital into mutual funds registered in Finland was unprecedented in 2003. The net inflow amounted to EUR 4.5 billion, up a third on 2002.

Chart 8. Mutual fund issues in Finland by type



Sources: HEX and Finnish Association of Mutual Funds.

The last year of record performance was 2000, when new investment amounted to EUR 4.3 billion. Growth was fastest in money market funds, but following the pick-up in share prices in spring 2003, investors were attracted to stock funds. As a result, the flow of new capital into equity funds increased markedly in the second half of the year. The behaviour of Finnish mutual fund investors during the three years of falling share prices in 2000–2003 differed from that of international investors in that Finnish investors did not withdraw their money from equity funds when the prices fell.

At the end of 2003, the total amount of investments in Finnish mutual funds was nearly EUR 23 billion, of which equity funds and money market funds accounted for some EUR 7.5 billion. The total investment assets of bond funds and mixed funds were approximately EUR 3.5 billion. Turning to special purpose funds, the amount of investment assets in hedge funds doubled in 2003. The main reason for this is that some of the existing funds were converted into hedge funds, thereby increasing the amount of capital. New investment in hedge funds remained low despite the emergence of several new funds.

At the end of 2003, about a third (EUR 7 billion) of the investment assets of Finnish mutual funds were in domestic instruments. Of international investment, nearly a half

(EUR 6.7 billion) was in the euro area and the remaining EUR 8.5 billion outside the euro area. The proportion of assets invested outside Finland increased slightly compared to the previous year.

Ownership structures of mutual funds did not change during 2003. With a 28% share of all mutual fund capital at the end of the year, households were still the biggest investor group in 2003. Collectively insurance companies and employee pension insurers accounted for a quarter of the value of mutual fund units. Non-financial corporations are also increasingly investing liquid funds in mutual funds, with their share of total investments amounting to 16%. The share of foreign investment has been increasing slowly year by year, totalling 12% at the end of 2003.

From an international perspective, the total amount of investment assets in mutual funds is still modest in Finland. At the end of 2003, investment in mutual fund units totalled only slightly over EUR 4,000 per capita, which is the lowest in the EU after Greece and Portugal. Of the Nordic countries, mutual fund investments per capita in Sweden and Denmark clearly exceed EUR 8,000. The smallest mutual fund market in the Western Europe is Norway, where mutual fund investments per capita are less than EUR 1,900.

4 Infrastructure

4.1 EU: Swift introduction of comprehensive legislative framework for retail payments

Timo Iivarinen

The European Union's legislative framework concerning retail payments is to undergo revision in the near future. The objective of the revision is to harmonise the laws governing the various EU member states' payment systems and payment instruments. The European Commission will also consider using regulation.

The Commission's key objective is to establish a uniform legislative basis for retail payment services. In order to achieve this objective, in December of last year, the European Commission published a consultative document on the new legal framework for payments in the internal market (COM (2003) 718)[1]. The document aimed at consulting with the various parties over their general objectives and principles which should be applied to any modernisation or simplification of the legal framework concerning retail payment services in the internal market.

A significant part of present regulations on payments are based on national legislation and regulations. There are significant differences between the various legislative instruments on this issue from one EU member state to another, which can hamper the participants' ability to take full advantage of the EU-wide payment system infrastructure. It is hoped that by removing any juridical obstacles it will guarantee the provision of safe and efficient payment services and a level playing field for all participants in the services. Through this, the Commission also aims at implementing effective tools for the prevention of money laundering.

It is also intended that the new legal framework should apply to all payments with a value not exceeding EUR 50,000. As an exception, the framework would not apply to cheques, as they tend to be used principally at national level and their use is being increasingly discouraged, due the costly nature of processing them. Bills of exchange, money market instruments and commercial papers are also excluded from the coverage of the new legal framework as they are not generally used as a means of payment.

According to the European Commission, the basic principles of the new legal framework are the efficiency and security of the payment systems and instruments. The providers of the payment systems should also guarantee equal competitive conditions and sufficiently high levels of consumer protection for the service users. In addition to which, the new legal framework will be neutral in that no one payment service will be favoured at the expense of another. It is essential that the modernisation of the legislative framework creates added value in that it promotes financial sector stability and, for example, the efficiency of the EU's payment systems.

The consultative document has 21 annexes that go into more detail on various judicial and technical questions related to payments-area. These questions relate, for example, to the right to provide payment services to the public, information requirements regarding the details that are provided to customers about the payment services, the definition of the value date of transactions made, the increase in customer mobility to other financial institutions as well as the revocability of payment orders, execution times for credit transfers, direct debiting, data protection issues, the security of payment networks and the threat of network breakdowns.

[1] The Consultative Document can be found on the Commission of the European Communities' Internet page: http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0718en01.pdf.

Comments on the consultative document were requested by the middle of February. An additional month's response time was allowed, on top of the original schedule, enabling many more of the participants to put their views forward to the Commission on its consultative document. At least the various EU financial sector authorities, such as the central banks, legislative bodies and consumer protection organisations have forwarded their comments to the Commission.

However, it still remains unclear which judicial instrument will be used for this new legal framework. In principle the formats of regulation, directive and recommendation can all be used, separately or jointly. The Commission's objective is, however, to create a clear and uniform high level legal framework which will probably mean that, when making the choice of judicial instrument, a combination of various levels of regulatory solutions will be avoided. The Commission's consultative document makes extensive reference to the possibilities for establishing the proposed framework through a directly binding Council Regulation.

It is the Commission's intention that the proposed legislation should be presented this spring, after which it will be handled through the normal law drafting procedure. It is possible that new legislation may therefore be expected already as early as next year.

4.2 Banks seek significant savings through more efficient processing of payments

Heli Paunonen

The banks in Finland have set their sights at achieving improved efficiency in the processing of payments. There are also pressures to improve the operations of the securities clearing and settlement systems.

Banks seek improved efficiency in payment systems and there have been several examples recently of how the banks have tried reach this goal. Increased efficiency of cross-border transfers has been the objective behind the development of STEP2. This payment system, designed to handle small-value payments, which commenced operations in summer 2003, grew by 11 new member banks in March of this year. Of the Finnish banks, Nordea was already a member of STEP2 and OKOBank was one of those joining in March 2003.

Another example of increased efficiency is the move made by Nordea in October 2003, when it made public its joint venture agreement on an IT infrastructure with IBM. The bank's IT functions will be concentrated in Sweden. The Bank of Åland and Aktia Savings Bank have also been planning the establishment of a joint IT venture. Aktia's objective was to buy the licence for Bank of Åland's core banking system. However, after some investigation, Aktia decided to abandon the cooperation plan and to continue as a client of the IT company Samlink. Similarly, Aktia continues to serve as the central financial institution for the savings banks and local cooperative banks.

The Bank of Åland has supplied a core banking system to Tapiola Bank that started to provide its primary service from the beginning of February, after a period of using the pilot version.

National e-money systems appear to be under threat, at least in the Nordic countries: According to reports in the press, in autumn 2004, the decision was taken in Sweden to terminate its 'Cash' e-money system. There have also been speculations in the Finnish press about the future of Finland's Avant e-money system.

Questions concerning payment systems have otherwise occupied the press recently. The Finnish media has covered discussions on how reasonably-priced various banking services are, as 122 Members of Parliament have signed a petition to have banking charges limited, by law. The Parliamentary

Commerce Committee is looking into the matter.

Other structural change

The Bank of Lithuania took a new payment system, LITAS, into use from January 2004. LITAS replaces the TARPBANK system, in use since 1993, and handles both inter-bank and customer payments, regardless of value. The LITAS system combines the features of a Real-Time Gross Settlement system (RTGS) and a Deferred Net Settlement (DNS) system. Settlement takes place in the Lithuanian currency, the Lithuanian litas.

At the same time, the Lithuanian government initiated the privatisation process of the National Stock Exchange of Lithuania (NSEL), situated in Vilna, and Lithuania's Central Securities Depository (CSD). The CSD put a new clearing and settlement system into use in January. From the beginning of February, OMHEX which maintains Finland's securities market infrastructure also participated in this privatisation process. The Warsaw Stock Exchange, together with Euronext, was also involved in the process. In addition to which, on 3 March, OMHEX reported that it has agreed with some of the leading Lithuanian market participants and investors that it would buy out their stakes in the NSEL.

In December, OMHEX announced that the Helsinki, Tallinn and Riga stock exchanges have revealed that they would be joining the NOREX alliance. The key objective is to promote integration of the Nordic and Baltic securities markets. On top of this, OMHEX has entered a long-term cooperative agreement which includes, for example, technical infrastructure development with the key CSD in China.

In January, the European Central Bank published a report on its assessment of how accession countries' securities settlement systems meet with the standards for the use of the EU securities settlement systems in Eurosystem credit operations. The assessment revealed that the accession countries' securities settlement infrastructures, in general, meet the recommended criteria.

The European Commission is currently preparing a proposal for a legal framework concerning the EU area's clearing and settlement infrastructure. In December, the European Commission's issued a consultative document on the new legal framework for payments in the internal market. Section 4.1 of this report, (above), deals with the new legal framework in greater detail.

5 Major development projects in regulation and supervision

5.1 The Committee of European Banking Supervisors commenced operations

Karlo Kauko

A new Committee of European Banking Supervisors has been set up, and has already convened for its first meeting. The Committee members include representatives from all EU countries, the European Commission and the European Central Bank. The Committee provides assistance to the Commission in respect of issues concerning banking regulation and supervision. The purpose is also to promote consistent application of directives, convergence of regulatory practices and exchange of information. Hence, the Committee is entrusted with a wide range of challenging tasks.

In July 2000, The EU Council meeting in the composition of the ministers of finance and economy (ECOFIN Council) established a working group to consider the development of EU securities market legislation. This working group is known as the Committee of Wise Men, and was chaired by Alexandre Lamfalussy. Within the European Union, efforts have been made to develop financial market regulation on the basis of the Committee's recommendations of 2001, ie in accordance with the 'Lamfalussy process'. The aim of this process is to speed up and improve preparation and application of EU regulation.

The Lamfalussy process provides a four-level approach to regulatory development. At the first level, the focus is on primary legislation, such as EU directives and regulations. The second level is concerned with more detailed implementation measures in the regulatory committees. At the third level, the emphasis is on consistent national implementation of legislative rules. The fourth level addresses the monitoring of compliance with, and enforcement of, legislation.

The European Parliament approved the Lamfalussy process in November 2002 and also proposed the extension of its application to banking and insurance. In November 2003, on request of the European Parliament and EU Council, the European Commission decided to establish two third-level committees envisaged in the Lamfalussy process, ie the Committee of European Banking Supervisors (CEBS)[1] and the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS). The Committee of European Securities Regulators (CESR) had already been set up earlier. At the same time, it was decided to reorganise the regulatory committees of the banking and insurance sectors, though these decisions have not yet been implemented.

The Commission Decision establishing the Committee of European Banking Supervisors (2004/5/EC) was published in January in the Official Journal of the European Communities, and the Committee has begun its work. It is an independent advisory body, with membership consisting of national authorities having supervisory responsibility for credit institutions and (non-voting) representatives of central banks. According to the Decision establishing the Committee, even central banks with no tasks in the area of banking supervision may have representatives on the Committee.

All 15 EU Member States are represented, and the ten accession countries send observers to the Committee meetings prior to their full membership of the EU on 1 May 2004. The European Central Bank and the European Commission also participate in the activities of the Committee as observers. Permanent observers are Norway and the other EEA countries that are not members of the EU. The Committee may, if required,

[1] See www.c-ebs.org.

invite outside experts and observers to attend its meetings. Working groups may also be established as necessary.

The establishment of this new Committee does not directly affect banking supervision, related legislation or the operations of the relevant authorities in the member countries or at EU level. The duty of the Committee is to give advice to the European Commission on measures concerning the banking sector. Such advice may be given upon Commission request, but the Committee may also raise questions on its own initiative. In addition, the Committee promotes consistent implementation of directives and convergence of regulatory practices. The Committee is also required to contribute to cooperation between supervisors, for instance, as regards information exchange. Even matters concerning an individual credit institution may be brought up, but in such case the discussion can be carried out in a small circle consisting only of those national authorities who are directly responsible for the supervision of the particular credit institution. The Committee must submit an annual report to the European Commission.

According to the Decision establishing the Committee of European Banking Supervisors, it must cooperate with market participants and consumers.

The chairman of the Committee of European Banking Supervisors is José María Roldán of the Spanish central bank and the vice-chairman is Danièle Nouy of the French banking supervision authority. Finland is represented on the Committee by the Director General of the Financial Supervision Authority, Kaarlo Jännäri, and the Head of the Bank of Finland's Financial Markets Department, Heikki Koskenkylä.

The Committee's first meeting was held in Barcelona on 29 January 2004. The Committee will have a permanent secretariat based in London.

5.2 Regulatory initiatives for securitisation in Europe

Katja Taipalus

In Europe too, growing volumes of securitised assets have turned the focus of attention to regulation of securitisation and related regulatory reform.

The volumes of securitised assets have continued to reflect strong growth in Europe. In the first three quarters of last year, the number of new issues increased by as much as 45.9% compared to the corresponding period of the previous year, thereby even approaching the level of new Pfandbrief issuance. In this light, it is not surprising that, at the same time, many countries have paid increasingly closer attention to the regulation of securitisation.

As regards international and Europe-related initiatives, the New Basel Capital Accord (Basel II), for instance, contains regulations specifically applicable to securitisation, the contents of which have already been vigorously criticised. Because of this criticism, the Basel Committee on Banking Supervision published in January 2004 a memorandum on amendments to regulations concerning securitisation. One of the issues dealt with in the memorandum was the mapping of internal risk assessments to external credit ratings and its simplification. The memorandum also provides a brief analysis of the consistency of computation methods (‘Supervisory Formula’) within the securitisation framework, as well as an overview of the consistency between the treatment of originating and investing banks.

The European Securitisation Forum has issued new market principles, ‘Securitisation Market Practice Guidelines’, aimed at enhancing transparency in the securitisation markets. These guidelines, published at the end of 2003, are to serve as recommendations for a set of best practices to be observed in the securitisation markets. Other ongoing projects concerning securitised assets markets include the reform of accounting rules (IFRS/IAS, International Accounting Standards) and the already finalised

'Prospectus Directive' on prospectuses to be published when securities are offered to the public or admitted to trading (2001/34/EC). Accounting rules have left scope for a wide spectrum of interpretations as to how the new rules will finally affect the markets for securitised instruments. According to some estimates, the effects eg on instrument features may be quite considerable.

Some European banks have also fostered the idea of setting up a Europe-wide mortgage bank.

Country-specific developments

National regulation has been reformed in several countries. The Norwegian Parliament passed new legislation on securitisation already in December 2002. The new legislation is intended to facilitate securitisation of financial institutions' loan portfolios, in particular.

In Ireland, the Government has made amendments to existing legislation in order to facilitate securitisation of different types of financial market instruments. The amendments to the existing regulatory framework were included in the 2003 Finance Act.

In France, existing securitisation legislation has been reformed with a view to enhancing the capability of the Fonds Commun de Créances (FCC) to issue debt instruments and to granting it permission to participate in synthetic securitisation transactions. The FCC is used in the French securitisation process, rather than a special purpose vehicle. A full implementation of these measures is expected to generate strong growth in the French securitisation markets.

In Germany, measures that may be seen as the most important securitisation initiatives are the new tax regulations announced in spring 2003 and a notification by the Federal Authority for Financial Services Supervision (Bundesanstalt für Finanzdienstleistungsaufsicht, BAF) regulating the ability of German insurance companies to invest in asset-backed securities (ABS) and credit-linked notes (CLN). The new tax regulations seek to ensure that special purpose vehicles used in connection with securitisation benefit from tax treatment equal to that of other German financial institutions.

Existing legislation has also been relaxed in Portugal, where legislative amendments have changed the company form of securitisation firms to correspond very closely to that of a special purpose vehicle. Until now, companies engaging in securitisation had to have finance company status.

Regulatory reforms and increased regulation can be considered as a pan-European response in the terms of securitisation regulation to the growing volumes of securitised assets in Europe.

6 Key corporate arrangements and events in the financial sector

Date	Event and description
Jan 2003	Nordea acquired the remaining 60% of Nordisk Renting, which is engaged in buying, owning and development of real estate properties for long-term renting purposes.
	Forex announced it will apply for a banking licence in Finland.
	OKOBANK closed down its branch office in Stockholm and agreed on cooperation with FöreningsSparbanken.
Feb 2003	Dun & Bradstreet discontinued provision of credit risk ratings for the Bank of Finland's collateral.
	OKOBANK made an offer to its member banks on the acquisition of their shareholdings in the life assurance company Aurum.
Mar 2003	Norway's two largest banks, Den Norske Bank ASA and Gjensidige NOR Sparebank, announced merger plans.
	Japanese banks Asahi Bank and Daiwa Bank merged to form Resona Bank.
	Ilmarinen insurance company and 33 savings banks agreed on cooperation.
Apr 2003	In Iceland, Kaupthing Bank and Bunadarbanki Islands announced merger plans.
	Pohjola insurance company sold Conventum Corporate Finance to its executive management.
	Evening trading period on the Helsinki Stock Exchange was reduced by a half an hour, to end at 7.30 pm, with effect from the beginning of April.
	SEB acquired the entire share capital of Enskilda Securitis. SEB also acquired a 22.5% stake in the Norwegian company Orkla at a price of NOK 807 million.
May 2003	Barclays acquired the Spanish company Banco Zaragozano at a price of EUR 1.14 billion.

Date	Event and description
	HBOS Plc made an offer for the remaining 43% stake in Bank of Western Australia Ltd.
	Nooa Säästöpankki savings bank opened its first 6 branch offices in the Helsinki region.
	Nordea sold the entire share capital of its real estate investment subsidiary, Nordisk Renting AB, to Royal Bank of Scotland.
	Resona bank, formed by a merger of Japanese banks Asahi and Daiwa, was granted capital support amounting to approximately USD 17 billion in order for it to fulfil capital adequacy requirements.
	EFG Private Bank and Banque Edouard Constant announced merger plans.
	Societe Generale announced its intention of acquiring a 67% stake in Compagnie Bancaire Geneve.
	Sampo Card Ltd to merge with Sampo Bank at the beginning of 2004.
	The Boards of Directors of HEX and OM announced merger plans.
Jun 2003	Clearnet and London Clearing House announced merger plans.
	The Board of Directors of Nordea decided to instigate proceedings concerning a change in the group’s legal structure. The aim is to establish a single banking company to conduct business, as a ‘Societas Europeae’, based on a European Company Statute that will enter into force next year.
	Nordea Bank Polska and LG Petro Bank were merged.
Jul 2003	Moody’s raised OKOBank’s ratings: long-term Aa3 to Aa2 and financial strength B to B+. Short-term remains P-1. Stable rating prospects.
	Moody’s raised Sampo Bank’s ratings: long-term A2 to A1 and financial strength C+ to B-. Short-term remains P-1. Stable rating prospects.
Sep 2003	Kaupthing Bunadarbanki from Iceland declared its intention to acquire a majority holding in the Finnish investment company Norvestia from the Swedish investment company Havsfrun.

Date	**Event and description**
	Eurex and US-based The Clearing Corporation signed a cooperation agreement.
	Nordea sold the Norwegian debt collection company Inkassosentralen to Aktiv Kapital ASA.
	The merger of HEX and OM to form OMHEX was approved. Bank of Finland sold its HEX holdings.
Oct 2003	Bank of Finland sold its 40% stake in Setec Oy to mutual funds managed by Capman.
	Royal Bank of Scotland declared its intention to acquire Switzerland-based Bank von Ernst & Cie AG from HVB Group.
	Bank of America to acquire FleetBoston. Following the transaction, BofA will be the second largest bank in the USA.
	HSBC Holdings Plc acquires Bank of Bermuda.
	Suomi Mutual Life Assurance Company and its subsidiary Suomi Insurance Company Ltd (Henki-Suomi) to merge.
	Euroclear carries out a reorganisation by which Euroclear Bank becomes a subsidiary
	Nokia submitted a delisting application to the London Stock Exchange. London has recently accounted for less than 1% of total trading in Nokia shares.
Nov 2003	Authorities issued permission for the merger of DnB ASA and Gjensidige NOR ASA. The name of the new company will be DnB NOR ASA. The two Norwegian banks belonging to the group, Den Norske Bank and Union Bank of Norway were also given permission to merge.
Dec 2003	HEX Integrated Markets announced it will join NOREX Alliance.
Jan 2004	A banking licence was granted to Nordea AB, which changed its name to Nordea Bank AB. The process of simplifying the Nordea Group's structure will be continued by the merger of Nordea Bank Sweden and Nordea Bank AB in March.

Date	Event and description
	JP Morgan Chase acquired Bank One. The acquisition is carried out as a stock swap valued at USD 55 billion. This is the second-largest bank merger in the United States.
	OMHEX sold the share capital of Natural Gas Exchange Canada Inc. to a subsidiary owned by TSX Group (Toronto Stock Exchange) at a price of CAD 38 million.
	The Helsinki branch of EFG Fondkommission AB applied for a banking licence in Finland.
	The EC Merger Regulation (No 139/2004) was adopted.
	The merger between Den norske Bank and Gjensidige NOR Sparebank ASA entered into force.
Feb 2004	Sampo Plc acquired the shareholdings of Skandia, Skandia Liv and Storebrand in If Holding AB. Following the acquisition, Sampo holds almost 90% of the share capital of If. The remaining 10.06% is held by Varma pension insurance company. The purchase price totalled EUR 1.35 billion.
	Eurex commenced trading in the United States.
	OMHEX and China Securities Depository and Clearing Corporation Ltd agreed initially on cooperation by signing a MoU. The MoU serves as the basis for future cooperation between OMHEX and SD&C.
	A draft proposal to amend the Act on the Bank of Finland was withdrawn from the Finnish Parliament.
	Estonia, Latvia and Lithuania signed an agreement with the Nordic countries that will affect the membership of the Baltic countries in the Nordic Investment Bank as from the beginning of 2005.
	Moody’s placed Metso Corporation’s long-term loans under observation and later downgraded them from Baa3 to Ba1 (non-investment grade).
	S&P placed Metso Corporation’s short-term loans (A-3) and long-term loans (BBB) on credit watch for possible downgrade.

Date	Event and description
	Moody's raised the rating of Fortum's long-term loans from Baa2 to Baa1.
	OMHEX submitted an offer for the shares of the National Stock Exchange of Lithuania and the Central Securities Depository of Lithuania. The shares are for sale in connection with the privatisation programme. Euronext also submitted an offer jointly with the Warsaw Stock Exchange.
	Citigroup announced it will acquire South Korea's sixth largest bank, Koram Bank, at a price of USD 2.7 billion. So far, the acquisition is the biggest individual foreign investment in South Korea.
	Commerzbank acquired the branch network of SchmidtBank AG.
	Sampo announced plans to merge Sampo Finance with Sampo Bank in September. At the same time, Sampo Credit plc will be merged with the parent company, Sampo plc.
	Pohjola insurance company, Suomi Mutual Life Assurance Company and Ilmarinen pension insurance company signed a preliminary agreement on reorganisation of life insurance business. Pohjola will re-establish Pohjola Life. Part of the insurance portfolio will be managed by Suomi Mutual and part will be transferred to Pohjola Life.
	OMHEX and Euronext submitted competitive bids for the majority stake (54.4%) in Lithuania Stock Exchange. OMHEX had earlier acquired a 34% stake.